Confidential **Drafted: August 21, 2017**

FAIR HYDRO PLAN ACCOUNTING (GLOBAL ADJUSTMENT REFINANCING)

ISSUE: What is the basis for the proposed accounting for the Global Adjustment Refinancing on the Province's books?

CONTEXT: The Global Adjustment Refinancing is one component of the Fair Hydro Plan announced in March 2017, and is the most significant contributor to the reduction in hydro rates for residential consumers. The other parts of the Plan for residential consumers include: (a) expansion of the Ontario Electricity Support Program, (b) reductions in distribution rates for consumers in rural and remote areas, (c) reductions for First Nations residential consumers living on-reserve, (d) a fund set up to assist consumers in making their homes more energy efficient.

The only impacts on the 2016-17 consolidated financial statements from the Fair Hydro Plan is (d) the fund set up to assist consumers in making their homes more energy efficient, which was expensed in the year and increases the annual deficit. In addition, the 8% rebate on electricity bills, introduced as of January 1, 2017, while not part of the March 2017 announcement, also impacts the 2016-17 as an expense that increases the annual deficit.

KEY MESSAGES:

GA Financing Status and Structure

- In order to meet the needs of users, including the legislature and the public, for accountability in government reporting and decision making, it is essential that public sector financial statements reflect the economic substance of the government's activities.

- All of the agreements necessary for the Global Adjustment (GA) Refinancing are not yet complete. The final accounting for the GA Refinancing will be completed once all of the elements are complete. The balance of the note is based on the expected outcome. As previously noted, there is no impact on the 2016-17 consolidated financial statements from the GA Refinancing.

- In analyzing the appropriate accounting treatment for the GA refinancing component of the Fair Hydro Plan on the Province's consolidated financial statements in 2017-18 and forward, the Province considered authoritative guidance issued by the Public Sector Accounting Board, as well as the accounting assessments of the Independent Electricity System Operator (IESO) and Ontario Power Generation (OPG) management, including the accounting opinions of their external auditors.

- The complexity and unique structure of the GA Refinancing structure requires the use of professional judgment to ensure that key financial reporting objectives of transparency and accountability are best served.

- Under GA Refinancing, the Province will borrow funds to pay a portion of electricity costs charged by the electricity generators, thereby temporarily reducing the amount paid by eligible consumers (or ratepayers). The deferred amounts, including interest and other costs, will be recoverable from consumers/ratepayers in the future.

- Specifically, the Independent Electricity System Operator (IESO), a not-for-profit organization controlled by the Province, operates the IESO-administered markets, meaning that it makes payments to the electricity generators with cash received from the local distribution companies (and ultimately the consumers/ratepayers).

- Over the last 10+ years, payments have been made for major refurbishments to the electricity grid as well as the cost to move away from coal and to cleaner, but more expensive methods of electricity generation, including wind and solar. These payments were passed on to consumers/ratepayers as incurred or based on contractual payment terms, but not based on period of benefit. The GA refinancing acknowledges that the current generation has paid more than its share for these costs, and spreads these costs incurred out over more years.

- In simple terms, the IESO will continue to make payments to the electricity generators based on their contractual terms, but will collect less from the local distribution companies, as the consumers or ratepayers will pay a reduced amount. The amount not collected from the consumers now, or the shortfall, will be collected from consumers/ratepayers in the future.

- The FHP Act permits the IESO sell that shortfall, also referred to in the Act as a regulatory asset, which represents the right to collect payments from consumers/ratepayers in the future, to a financing entity. To recap, the IESO will pay the electricity generators with cash collected from the local distribution companies for electricity consumed, but at a reduced rate, and cash received from the financing entity for the sale of the regulatory asset.

- The financing entity will be part of Ontario Power Generation (OPG Trust), a government business enterprise, wholly owned by the Province. The operations of Ontario Power Generation have been and will continue to be included in the consolidated financial statements of the Province using the modified equity method, the method Public Sector Accounting Standards (PSAS) require for government business enterprises.

- At its discretion, OPG Trust would purchase the shortfall amounts (or regulatory asset) through a combination of provincial borrowing (flowed through OPG as an equity investment), amounts advanced from OPG and direct borrowing from capital markets.

- In the future, when the consumers/ratepayers pay for the deferred amount or shortfall to the local distribution companies, those amounts will be used to repay the accumulated debt, whether that be direct borrowing from the capital markets, amounts advanced from OPG or provincial borrowing.

IESO Accounting

- There is no impact on the 2016-17 consolidated financial statements from the GA Refinancing. The GA refinancing is expected to impact the 2017-18 consolidated financial statements.

- In 2017-18, the shortfall or regulatory asset that the IESO incurs as a result of collecting less from the local distribution companies than it pays to the electricity generators would be accounted for as a rate-regulated asset. The rate-regulated asset would then be sold to OPG Trust for cash used to pay the electricity generators.

- For 2016, IESO adopted the use of rate-regulated accounting for costs incurred unrelated to the GA Refinancing; however, the impact to the financial statements of the Province was immaterial (impact on annual deficit of $24 million).

- PSAS is silent on the use of rate regulated accounting, however, like all major accounting frameworks, PSAS encourages both preparers and auditors to consider guidance in other accounting frameworks when accounting for transactions not specifically addressed by the specific standards.

- IESO management, their audit committee, their board of directors and their external auditors, agree with the adoption of rate-regulated accounting by IESO. The Office of the Provincial Controller also supports the adoption of rate-regulated accounting by IESO.

- In her opinion on the 2016-17 consolidated financial statements, the Auditor General (AG) has included an “Other Matter” paragraph, drawing attention to the adoption of rate-regulated accounting by IESO. Her view is expressed as stating PSAS does not permit rate regulated accounting, but that she has not qualified her opinion on this matter because the impact is not material to the 2016-17 consolidated financial statements.

- The AG further notes, “However, the consolidated financial statements may become materially misstated in future periods, as a result of the legislated accounting prescribed under the *Ontario Fair Hydro Plan Act, 2017* (Fair Hydro Plan) and its related regulations, as it is not in accordance with Canadian public sector accounting standards.”

- Neither the IESO nor OPCD agree with the statements that (a) PSAS does not permit rate-regulated accounting (as previously noted, PSAS is silent with respect to rate-regulated accounting) or (b) Fair Hydro Plan and its related regulations legislate the accounting for GA Refinancing.

OPG Accounting

- The Auditor General has not raised any concerns to date with the intended accounting for the OPG Trust on the Province's books.
- OPG Trust will be controlled and consolidated by OPG.
- Purchases by OPG Trust of the rate regulated assets from the IESO will be reflected on OPG's books as intangible assets which will be included in the Province's financial statements as part of its investments in government business enterprises.

The Province's Accounting

- In assessing the appropriate accounting for the Fair Hydro Plan on the Province's books, OPCD worked closely with key ministries, the OEB, the IESO, OPG and their respective external advisors.
- The final accounting treatment for FHP related activities will be confirmed once all elements of the GA Refinancing framework are finalized, including provincial guarantees and financing arrangements.
- Once the details and commercial agreements of the FHP are finalized, the external auditors of the IESO and OPG are expected to provide independent accounting opinions on the accounting treatment on IESO and OPG's financial statements.
- The Office of the Provincial Controller will rely on those independent accounting opinions, the audited financial statements of the IESO and OPG as of December 31, 2017 and its own research and analysis in determining the impact of the GA Refinancing on the 2017-18 consolidated financial statements.

IF PRESSED: AG ACCUSATION OF LEGISLATED ACCOUNTING

- The Auditor General has made several incorrect references to legislated accounting which should be addressed to ensure clarity and transparency in terms of the government's accounting treatment for the Fair Hydro Plan.
- In particular, that Auditor General has referred to legislated accounting prescribed by the FHP Act that is designed to in some way manipulate the Province's financial reporting in its consolidated financial statements.
- The Province's financial statements are based on Public Sector Accounting Standards as issued by the Public Sector Accounting Board of CPA Canada. There is no legislated accounting that applies to the Province's consolidated financial statements.
- While the FHP Act does, under Section 24, require that the IESO set up a variance account to track the cash shortfall amount resulting from the deferred recovery amount, it is just another type of regulatory account, similar to those that OPG reports and for which the OEB is responsible for approving rates.
- As far as the Province's financial reporting practices go, whether the deferred amounts reported in the IESO's variance account are assessed as assets for financial reporting purposes will be determined by the interpretation and application of Public Sector Accounting Standards, not by the legislation or regulations.

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Approved by:	**Name:**	**Date Approved:**
ADM, Office of the Provincial Controller	Cindy Veinot	August 21, 2017
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Appendix

Proposed Legislated Transaction Structure

Prepared by the Office of the Auditor General of Ontario