Office of the Provincial Controller Division

Options for consolidation of Hydro One and Ontario Power Generation on the Province's Financial Reports

January XX, 2017

Draft – for discussion purposes

Overview

IFRS vs. US GAAP Differences for OPG and H1

Risk:	High
Impact in 2016-17 :	$ 1.0 B ((initial ARO estimation approach) $ 75 M (OPG's preferred estimation approach) (H1 differences immaterial)
Multi-year impact:	Yes (see slide # 9 – OPG ARO impact)
Impact included in FES:	No
Description of issue:	PSAB requires consolidation of OPG and H1 on an IFRS basis, whereas results for OPG and H1 are consolidated on a US GAAP basis in the Public Accounts (which is consistent with OPG and H1 reports to securities regulators and the OEB)
Current status:	Estimated difference between IFRS and USGAAP for 16/17 is $1B based on initial approach used by OPG to estimate asset retirement obligation on nuclear facilities; however, during 2016 OPG identified and communicated an alternative (preferred) estimation methodology which would result in a $75M comparative impact on the 2016-I17 annual results. The Auditor General has stated that she would use the original methodology to assess the impact for audit purposes.
Options under consideration:	(a) Continue to report OPG and H1 on a US GAAP basis in the CFS • Option to re-approach PSAB (standard setter) for re-consideration our position (b) Report OPG and H1 on an IFRS basis in the CFS (c) Report OPG on IFRS and H1 on a US GAAP basis (d) Legislated Accounting Under option a) or d) , also consider changes to the AG Act to require AG to issue audit opinion based on Province's accounting policies based on PSAB & legislation.
Timing of expected resolution:	2017 Budget -Legislative changes could be considered as part of Spring Bill -Consider changes to basis of reporting for OPG/H1 to be reflected in Budget
Province's ability to influence:	Province has limited ability to influence PSAB or the AG.
Role of other ministries:	Ministry of Energy is aware of ongoing considerations and stakeholdering with OPG and H1; OEFC involvement as necessary where potential impacts on f/s or audit opinion.
{ DATETIME:1 }	

Auditor General's position

- The AG does not agree that the use of US GAAP based financial statements for purposes of preparing the consolidated financial statements of the Province is in accordance with Public Sector Accounting Standards (PSAS).
- PSAS directs Government Business Enterprises (GBEs) to use IFRS, and PSAB did not agree to a recent request by TBS which would have supported consolidation on a US GAAP basis. The AG views this decision as definitive.
- The AG may consider not qualifying if the reference to legislation is removed from the basis of accounting note and the statements not refer to US GAAP as the basis of reporting OPG and Hydro One for consolidation.
- AG discussed in Chapter 2 of the AG's 2016 Annual Report, the AG will continue to track the differences in subsequent audits until the government adopts IFRS for the purposes of consolidating the results of OPG and Hydro One. Given the differences in how certain balances are treated under U.S. GAAP versus IFRS, we anticipate that these differences could <u>become material in future fiscal years, potentially as soon as the 2016-17 fiscal year</u>
- OPG and H1 auditors had audited USGAAP financial statements and issued clean audit opinion for 2016 results

Alternatives Considered

A. Status Quo - Accept qualified opinion from AG
   - Re-approach PSAB for re-consideration of TBS' earlier position (Feb 2016)

B. Adopt IFRS for purposes of consolidating Hydro One and OPG – Clean audit opinion

C. Hybrid – Consolidate H1 on USGAAP and OPG using IFRS – potentially clean opinion, but potential impact to the Province bottom line

D. Legislated Accounting - Potential qualified opinion

A. Status Quo - Accept qualified audit opinion

- Considerations
  - Public perception of qualified opinion
  - Impact on borrowing costs, if any
  - Qualified opinion would be expected in subsequent years
    - Does not eliminate requirement and cost for OPG and Hydro One to track, quantify and audit US GAAP vs. IFRS differences as AG will need to evaluate impact for SUDs

- Re-approach PSAB for re-consideration of TBS' earlier position
  - In February 2016, the TBS wrote CPA Canada's Accounting Oversight Committee and PSAB requesting that the PSAB standards recognize U.S. GAAP as a basis of reporting by publicly accountable enterprises because the current standards only refer to IFRS.
  - PSAB responded in July 2016 that the PSAB standards would not be changed and all GBEs should prepare their financial statements in accordance with IFRS and not U.S. GAAP

B. Adopt IFRS for purposes of consolidating Hydro One and OPG

Considerations

- Clean audit opinion, resolution of issue
- Consistent accounting for consolidation of all GBEs (LCBO, OLG, OPG and Hydro One)
- Consistent accounting for consolidation of GBEs with other provinces, but on different basis that OPG and H1 report to securities regulators and the OEB
- Hydro One and OPG will need to continue to prepare reconciliations to IFRS and the AG will require audit (although this requirement and cost will continue under the other alternatives as well)
- Lack of consistency for basis of reporting for consolidation and standalone financial statements for OPG and H1
- Calculation of difference between IFRS and US GAAP depends on which rate is selected to quantify the asset retirement obligation.

Risks

- IFRS may not support rate regulated accounting in the long-term
  - Total regulatory assets recognized as of March 31, 2016 is approximately $8 Billion
    - Under IFRS, if rate regulated accounting eliminated, write off of regulatory assets would increase net debt and increase volatility to annual surplus/deficit
  - See discussion on status of IFRS 14 in Appendix C
- Accounting for AROs under IFRS results in more volatility to annual surplus/deficit

C. Hybrid – Consolidate H1 on US GAAP, OPG on IFRS

- Considerations
  - Immaterial difference for H1 (based on current IFRS14)
  - Different results than reported by OPG with direct (significant) impact on both statement of operations and balance sheet
  - Exposure to changes in future IFRS standards (rate regulated accounting) for OPG's books
  - On-going requirement for both OPG and H1 to quantify impact and provide audit assurance (cost, time and effort)
  - Clean audit opinion
  - Potential bottom-line impact of OPG ARO
- Risks
  - IFRS may not support rate regulated accounting in the long-term
    - Total regulatory assets recognized as of March 31, 2016 is approximately $8 Billion
      - Eliminating regulatory assets would increase net debt and increase volatility to annual surplus/deficit
    - See discussion on status of IFRS 14 in Appendix C
  - Accounting for AROs under IFRS results in more volatility to annual surplus/deficit

C. Hybrid – Consolidate H1 on US GAAP, OPG on IFRS (Potential Question)

Question?	Comments
Users and other stakeholders may question why the Province consolidates OPG on IFRS and H1 on US GAAP basis	• H1 borrows funds from US market and can continue to report on a US GAAP basis as an SEC registrant • OPG does not currently borrow funds from the US market but reports under US GAAP based on an OSC-granted exemption effective until January 2019. • Uncertainty continues whether IFRS will continue to include rate regulated accounting in the future. • In 2011, OPG determined that balances in its variance and deferral accounts established by the OEB, including those authorized pursuant to Ontario Regulation 53/05, under the Ontario Energy Board Act, 1998, meet the definition of financial assets and financial liabilities, as defined in International Accounting Standard 32, Financial Instruments: Presentation. In view of this impact of IASB uncertainty would be mitigated to some extent. • Province expects to sell 60% H1 ownership in fiscal 18-19 and impact of IFRS would be lower than current 70% of ownership. This would also mitigate volatility on Province CFS due to change in % of ownership between now and 2018-19.

D. Legislated Accounting – Potential qualified opinion

- AG does not support legislation accounting, especially where not in compliance with PSAB
- Under the AG Act, the AG has given her opinion based on PSAB which she considers to be the “appropriate” accounting framework
- In her 2016 Annual Report, the AG raised the issue of Ontario having introduced legislation on a number of occasions to establish specific accounting practices that are not, in some cases, consistent with PSAB. She also noted that this has not had any material impact on the Province’s 2015-16 consolidated financial statements (see Appendix B for additional details).
- In fiscal 2015-16, the Province used legislated accounting for pension assets of its jointly sponsored plans, and AG viewed it as departure from PSAB as comparative numbers were not restated and issued a qualified opinion.
- If Province opts to use legislated accounting for H1 and OPG consolidation for 2016-17, and the difference between USGAAP and IFRS is material, there is high risk for a qualified opinion.
- Potential language changes to notes to the CFS – evaluated as low risk

OPG’s Estimated ARO Differences

Debit (Credit) $ Millions	31-Mar-17 **Income (projected)**	31-Mar-18 **Income (projected)**	31-Mar-19 **Income** (projected)	31-Mar-20 **Income** (projected)		Total impact 2015-2020
Alternative 2 (OPG’s Preferred ARO Estimation Approach **15 year historical rate – 4.95% at transition, update rate each year**						
Changes in Cost Estimates	(250)	-	-	-		
Discount Rate	225	225	225	225		
Other	100	200	300	450		
Total	**75**	**425**	**525**	**675**		**2,494**
Discount rate	*4.50%*	*4.30%*	*4.10%*	*3.9%*		
Alternative 1 (OPG’s Initial Estimation Approach) **15 year historical + 5 forward - 5.0% at transition; update at ONFA; every 5 years)**						
Changes in Cost Estimates	(250)			-		
Discount Rate	1,150	-		-		
Other	100	375	400	400		
Total	**1,000**	**375**	**400**	**400**		**2,590**
Discount rate	*4.00%*	*4.00%*	*4.00%*	*4.00%*		

OPG/H1 Reporting – Comparative Fiscal Impact

Summary of relative fiscal impacts under US GAAP vs. IFRS:

	2016/17	2017/18	2018/19	2019/20
Hydro One	NA (likely immaterial)	NA (likely immaterial)	NA (likely immaterial)	NA (likely immaterial)
OPG:				
• Status Quo* (US GAAP)	-	-	-	-
• OPG ARO valuation (preferred)	$75M	$425M	$525M	$675M
• OPG ARO valuation (Initial Approach	$1000M	$375M	$400M	$400M
* Assumes legislated accounting to retain US GAAP				

Note:

- ➢ The recent FES reflected results for OPG and H1 on a US GAAP basis
- ➢ Assume that the H1 indirect overhead cost would be recoverable from rate payers

Appendix A

AG Mandate Summary

ON	(3) In the annual report in respect of each fiscal year, the Auditor General shall express his or her opinion as to whether the consolidated financial statements of Ontario, as reported in the Public Accounts, present fairly information in accordance with appropriate generally accepted accounting principles and the Auditor General shall set out any reservations he or she may have. 2004, c. 17, s. 14 (8).
BC	11 (1) The Auditor General must report each year, in accordance with generally accepted auditing and assurance standards, to the Legislative Assembly on the financial statements of the government reporting entity. (2) The report under subsection (1) must state whether these financial statements are presented fairly in accordance with generally accepted accounting principles. (3) The auditor in accordance with section 10 (3) must report each year on the financial statements of the government organizations and of the trust funds, in accordance with generally accepted auditing and assurance standards, to (a) the boards of management of the government organizations and the trustees of the trust funds to which the appointment is made, and (b) the minister responsible.
AB	(2) A report of the Auditor General under subsection (1) shall (a) include a statement as to whether, in the Auditor General's opinion, the financial statements present fairly the financial position, results of operations and changes in financial position of the Crown in accordance with the disclosed accounting principles,
SK	11. (3) For the purposes of this section, where an auditor, including an appointed auditor, is required to examine accounts and render an opinion on those accounts, he shall do so in accordance with generally accepted auditing standards as prescribed from time to time by the Canadian Institute of Chartered Accountants.
MB	9(4) The Auditor General must express an opinion as to whether the financial statements included in the Public Accounts fairly present information in accordance with the accounting policies of the government stated in the Public Accounts and on a basis consistent with that of the preceding year, and must set out any reservations the Auditor General might have.
NB	[.10]The Auditor General shall examine the several financial statements required by section 48 of the Financial Administration Act to be included in the Public Accounts and shall express his opinion as to whether they fairly present information in accordance with stated accounting policies of the Province and on a basis consistent with that of the preceding year, together with any reservations he may have.

Appendix A

AG Mandate Summary

NS	Auditor General Act	19 (1) The Auditor General shall audit the annual consolidated financial statements of the Government that are included in the public accounts required under the Finance Act. (2) The Auditor General shall submit a report to the House of Assembly, which must be included in the public accounts and which must provide an opinion, prepared in accordance with generally accepted auditing standards, as to the fair presentation of the consolidated financial statements . 2010, c. 33, s. 19.
NL	Auditor General Act	[.11] The auditor general shall examine the several financial statements required by the Financial Administration Act to be included in the public accounts of the province, and any other statement that is required to be audited by the auditor general under that Act or another statement that the Minister of Finance may present for audit and shall express his or her opinion as to whether the financial statements present fairly the financial position, results of operations and changes in the financial position of the province in accordance with the disclosed accounting policies of the provincial government and on a basis consistent with that of the preceding year, together with reservations the auditor general may have.
GOC	Auditor General Act	6. The Auditor General shall examine the several financial statements required by section 64 of the Financial Administration Act to be included in the Public Accounts, and any other statement that the President of the Treasury Board or the Minister of Finance may present for audit and shall express his opinion as to whether they present fairly information in accordance with stated accounting policies of the federal government and on a basis consistent with that of the preceding year together with any reservations he may have.
QC	Auditor General Act	38. In his report on the annual financial statements of the Government, the Auditor General (1) shall indicate whether, in his opinion, these statements present fairly the financial position of the Government, the results of its operations and the changes in its financial position in accordance with the accounting principles or policies stated in the financial statements and whether these principles or policies have been applied on a basis consistent with that of the preceding fiscal year;

Comparison of Basis of Accounting Notes Appendix B

Province	Public Accounts	Extract of 'Basis of Accounting' in Note 1: Significant Accounting Policies
SK	2015-2016	These Summary financial statements are prepared in accordance with Canadian public sector accounting standards issued by the Public Sector Accounting Board.
BC	2015-2016	The government’s Summary Financial Statements are prepared in accordance with the Budget Transparency and Accountability Act (BTAA), which requires generally accepted accounting principles (GAAP) for senior governments in Canada, supported by regulations of Treasury Board under the BTAA.
NS	2015-2016	The Province’s financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP) for the public sector, which are represented by the Public Sector Accounting Standards (PSAS) of the Public Sector Accounting Board (PSAB) of the Chartered Professional Accountants of Canada (CPA Canada), supplemented where appropriate by other accounting standards of CPA Canada and the International Federation of Accountants.
MB	2014-2015	The summary financial statements have been prepared in accordance with Canadian public sector accounting standards. Effective January 1, 2011 all GBEs, except the Manitoba Hydro-Electric Board (Manitoba Hydro) adopted International Financial Reporting Standards (IFRS), as issued by the International Accounting Standards Board (IASB)
Fed	2014-2015	These consolidated financial statements are prepared using the Government's accounting policies stated below, which are based on Canadian public sector accounting standards. The presentation and results using the stated accounting policies do not result in any significant differences from Canadian public sector accounting standards.

Summary of legislated accounting Appendix C:

(excerpted from 2015 OAG Report – Ch 2) (to update for 2016 report)

- The *Investing in Ontario Act, 2008* (Act) and related regulations allows for the government to provide additional transfers to eligible recipients from unplanned surpluses reported in its consolidated financial statements. Any transfers made under the Act would be recorded as an expense of the government for that fiscal year, regardless of PSAB accounting standards.
- In the 2009/10 fiscal year, the *Education Act* and the *Financial Administration Act* were amended. The *Education Act* amendments specified that the government could prescribe accounting standards for Ontario School Boards to use in preparing financial statements. The *Financial Administration Act* amendments allow the government to prescribe accounting standards for any public or non-public entity whose financial statements are included in the province's consolidated financial statements.
- In 2011, a regulation under the *Financial Administration Act* directed Hydro One, a fully owned Ontario government business enterprise, to prepare its financial statements in accordance with U.S. generally accepted accounting principles, effective January 1, 2012. The government has since told another fully owned government business enterprise, Ontario Power Generation Inc. (OPG), to do the same. American accounting rules allow rate-regulated entities to defer current expenses for recognition in future years; the government's direction to adopt these U.S. rules came in anticipation of the planned Canadian adoption of International Financial Reporting Standards (IFRSs), which at that time did not allow for such deferrals.
  - OPCD – This legislation does not specify that the use of US GAAP is required for purposes of preparing the financial statements of the Province. It relates to the standalone financial statements of the entities.
- Ontario government regulations now require transfers for capital acquisitions and transfers of tangible capital assets to be accounted for by transfer recipients as deferred contributions. The deferred amounts are to be brought into revenue by transfer recipients at the same rate as they recognize amortization expense on the related assets. We have historically supported this accounting because we believe that it best reflects the economic reality of the underlying transactions and complies with generally accepted accounting principles. However, PSAB standards in this area are being interpreted differently by many stakeholders.
  - OPCD -- Since the issuance of this report, PSAB has completed a Post-Implementation Review of the government transfers standard which acknowledges the diversity in practice. PSAB has also determined that at this time, it will not issue any additional guidance. Based on discussions with the AG in August 2016, she does not intend to raise any concerns with the Province's current interpretation of this standard.
- The 2012 Budget further amended the *Financial Administration Act* to provide the government with full authority to make regulations regarding the accounting policies and practices used to prepare its consolidated financial statements.

IFRS 14 – history and status Appendix D

- In January 2014, the IASB issued *IFRS 14, Regulatory Deferral Accounts*
- The standard permits entities that previously applied rate-regulated accounting under another accounting framework to continue to account for regulatory deferral account balances using previous GAAP (e.g. US GAAP) when IFRS is first adopted
- IFRS 14 is intended to be a *temporary* standard
- A comprehensive project is currently underway by the IASB on the topic
  - The IASB is expecting to release the next discussion paper in 2017
  - In April 2016, the Canadian Accounting Standards Board announced that it is increasing its level of activity in the project
  - There is risk that the project will not result in a standard that continues to permit the recognition of regulatory deferral accounts
  - There is no timeline set for the resolution of this issue; however, it would be expected to take a number of years
- <u>Current status</u>:
  - In November 2016, the IASB staff met with the Accounting Standards Advisory Forum (ASAF) to discuss their preliminary proposals for an accounting model for rate-regulated entities. Support from ASAF is crucial for the project on rate-regulation as the ASAF members are key stakeholders (ASAF is an advisory group to the IASB consisting of 12 national accounting standard-setters, including FASB and AcSB
  - No major push-back on any of the key proposals discussed in the draft preliminary proposals (see my email of November 17).
- <u>Next Step</u>:
  - IASB meeting on December 13, 2016
  - Staff will present an overview of their preliminary proposals for the model
  - Staff will highlight the input received from ASAF members and other stakeholders and how that input has contributed to the development of the proposals