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GLOBAL ADJUSTMENT REFINANCING (ACCOUNTING RELATED TO *ONTARIO'S FAIR HYDRO PLAN ACT, 2017*)

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 *Ontario's Fair Hydro Plan Act, 2017,* and comprises 16% of the 25% reduction in hydro rates for residential consumers.
- The other parts of the Plan making up the other 9% for residential consumers include:
  - Expansion of the Ontario Electricity Support Program;
  - Reductions in distribution rates for consumers in rural and remote areas;
  - Reductions for First Nations residential consumers living on-reserve; and,
  - A fund set up to assist consumers in making their homes more energy efficient.
- The Global Adjustment Refinancing will be recovered from future ratepayers through a charge on future electricity bills, while the other components noted are to be covered by general revenues from taxpayers, and therefore will be expensed as incurred.
- The impact of the Global Adjustment Refinancing is disclosed in the December 31, 2017 financial statements of the Independent Electricity System Operator (IESO) and Ontario Power Generation (OPG), which have been released with unqualified (or clean) audit opinions from their external auditors.
- The impact will also be reflected in the consolidated financial statements of the province for 2017-18 in accordance with Canadian Public Sector Accounting Standards.

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KEY MESSAGES:

GA Refinancing 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 have been finalized in the 2017-18 fiscal year and the final accounting for the GA Refinancing has been confirmed. The GA Refinancing did not commence until July 2017, therefore, there was 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 *Ontario's Fair Hydro Plan* on the Province's consolidated financial statements in 2017-18 and going 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/advice and financial statement audit opinions of their external auditors.
- Under GA Refinancing, as enabled by the *Ontario Fair Hydro Plan Act, 2017* ("OFHPA"), a Financing Entity established by OPG borrows amounts to fund the payment of 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.
- The Independent Electricity System Operator (IESO), an independent, not-for-profit agency of the Province, is responsible for the management and operation of

the wholesale electricity market. IESO makes payments to the electricity generators with cash received from the local distribution companies (and ultimately the consumers/ratepayers).

- Over the last 10+ years, investments have been made to phase-out coal and modernize Ontario's electricity system (i.e., build and maintain a reliable electricity system). This involves a move away from coal to cleaner, but more expensive methods of electricity generation, including wind, solar and natural gas. The cost of these investments were passed on to consumers/ratepayers as incurred or based on contractual payment terms, but not based on the period of benefit (i.e., the life of many generators is expected to exceed the length of the contracts).
- The GA refinancing spreads these costs incurred out over the period of benefit so they are shared proportionally by future electricity consumers.
- 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.
- OFHPA permits the IESO to 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 reiterate, the IESO will continue to pay the electricity generators at their current contract rates. But, it will do this with cash collected from the local distribution companies for electricity consumed (at a rate set by the OEB which reflects a significant portion of the 25 per cent reduction in the initial years) and cash received from the financing entity for the sale of the regulatory asset.
- The financing entity (Fair Hydro Trust) is controlled and consolidated by OPG, a government business

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enterprise, which in turn is wholly owned by the Province. The operations of OPG 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, the Fair Hydro Trust will purchase the shortfall amounts (or regulatory asset) from the IESO 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, 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

- In 2017, the shortfall that IESO incurred as a result of collecting less from the local distribution companies than it pays to the electricity generators has been accounted for as a rate-regulated asset. Most of this rate-regulated asset was then sold to Fair Hydro Trust for cash used to pay the electricity generators (the sale to the Trust is made on a delayed basis).
- The accumulated GA refinancing for 2017 was $1.4 billion, of which $1.2 billion was sold and transferred to the Fair Hydro Trust, leaving $200 million of rate-regulates assets on the 2017 IESO financial statements at year-end.
- Public Sector Accounting Standards (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.
- IESO is not the first entity that has prepared its financial statements using PSAS and rate-regulated accounting. Ontario Power Authority (which was amalgamated with IESO on January 1, 2015) prepared its financial statements with PSAS and used rate-regulated accounting. In addition the Province's consolidated financial statements are impacted by the use of rate-regulated accounting followed by both Ontario Power Generation and Hydro One.
- In the Auditor General's opinion on the 2016-17 consolidated financial statements of the Province, the AG included an "Other Matter" paragraph, drawing attention to the adoption of rate-regulated accounting by IESO. The AG's view is expressed as stating PSAS does not permit rate-regulated accounting, but that the AG did not qualify the opinion on this matter because the impact was not material to the 2016-17 consolidated financial statements.
- The AG further noted, "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 (OFHPA) and its related regulations, as it is not in accordance with Canadian public sector accounting standards."
- Neither the IESO nor the Office of the Provincial Controller Division (OPCD) agree with the statements that (a) the Fair Hydro Plan and its related legislation and regulations legislate the accounting for GA Refinancing, or (b) PSAS does not permit rate-regulated accounting (as previously noted, PSAS is silent with respect to rate-regulated accounting).

OPG Accounting

- The Auditor General has not raised any concerns to date with the intended accounting for the Fair Hydro Trust on the Province’s books.
- The Fair Hydro Trust is controlled and consolidated by OPG.
- Purchases in 2017 by Fair Hydro Trust of the $1.2 billion in rate-regulated assets from the IESO are reflected on OPG’s books as intangible assets which are 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 Ontario’s Fair Hydro Plan (OFHP) on the Province’s financial statements, the Office of the Provincial Controller worked closely with key ministries, the Ontario Energy Board (OEB), IESO, OPG and their respective external advisors.
- The final accounting treatment for OFHP-related activities has been confirmed based on all elements of the final GA Refinancing framework, including provincial guarantees and financing arrangements.
- The external auditors of IESO and OPG have provided independent accounting opinions/advice on the accounting treatment on IESO and OPG’s financial statements and have each issued unqualified (clean) opinion on the 2017 financial statements of the entities.
- OPCD will rely on those independent accounting opinions/advice, the audited financial statements of 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 of the Province.

Auditor General’s Special Report on the Fair Hydro Plan

- The Office of the Auditor General released **The Fair Hydro Plan: Concerns about Fiscal Transparency, Accountability and Value for Money** on October 17,

2017. The report focused on the financial and accounting framework of the OFHPA**.**

- The report included two recommendations:
    1. record the true financial impact of the Fair Hydro Plan's electricity rate reduction on the province's budgets and consolidated financial statements; and
    2. **use a financing structure to fund the rate reduction that is least costly for Ontarians**
- The government respects independent officers of the legislature, and values the important perspective they bring.
- The Province's financial statements are based on Public Sector Accounting Standards (PSAS) as issued by the Public Sector Accounting Board of CPA Canada.
- The *Ontario Fair Hydro Plan Act, 2017* and its related regulations do not create accounting rules or legislate the accounting.
- While the OFHPA does, under Section 24, require that 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.
- The deferred amounts reported in IESO's variance account classified as assets for financial reporting purposes will be consolidated as determined by the interpretation and application of Public Sector Accounting Standards, not by the legislation or regulations.
- The province will prepare its consolidated financial statements in accordance with PSAS, including the transactions resulting from *Ontario's Fair Hydro Plan*.

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