

ONTARIO'S 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 Ontario's 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:
 - 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 only impacts on the 2016-17 consolidated financial statements from Ontario's Fair Hydro Plan is related to the fund set up to assist consumers in making their homes more energy efficient, which was expensed in the year and increased the annual deficit. In addition, the 8 per cent rebate on electricity bills, introduced as of January 1, 2017, while not part of the March 2017 announcement, also impacted the 2016-17 consolidated financial statements as an expense that increased the annual deficit.
- The implementation of OFHP is ongoing, with significant decisions with accounting and financial implications still being finalized. The government will present the Province's finances in the 2017-18 Public

Accounts fairly and accurately and in accordance with Public Sector Accounting Standards (PSAS).

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 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 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, as enabled by the Ontario Fair Hydro Plan Act, 2017 ("OFHPA"), a Financing Entity established by Ontario Power Generation will borrow 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 acknowledges that the current generation of electricity consumers has paid more than its fair share for these costs, and spreads these costs incurred out over more years so they are shared proportionally by future electricity consumers.
- 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.
- 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 recap, 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 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 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

- There was 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 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.
- 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 the Auditor General's opinion on the 2016-17 consolidated financial statements, the AG has 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 has not qualified the 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 (OFHPA) and its related regulations,

as it is not in accordance with Canadian public sector accounting standards.”

- Neither the IESO nor Office of the Provincial Controller Division (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 legislation and 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.
- It is expected that 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 Ontario’s Fair Hydro Plan (OFHP) on the Province’s books, OPCD 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 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 OFHP are finalized, the external auditors of IESO and OPG are expected to provide independent accounting opinions on the accounting treatment on IESO and OPG’s financial statements.

- OPCD will rely on those independent accounting opinions, 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.

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 Ontario's Fair Hydro Plan.
- In particular, the Auditor General has referred to legislated accounting prescribed by the OFHPA 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 (PSAS) 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 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.
- As far as the Province's financial reporting practices go, whether the deferred amounts reported in 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.

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 Auditor General said that the accounting for the Fair Hydro Plan is not permitted under PSAS because it is silent on rate-regulated accounting, despite the fact that standard accounting practice, including under PSAS, dictates that an entity should consult other accounting standards for transactions not specifically covered by primary standards.
- The Auditor General asserts in her report that the OFHPA creates an asset through legislation. This is a fundamental disagreement the government has with the Auditor General's report. The Province will prepare its consolidated financial statements in accordance with Public Sector Accounting Standards (PSAS).

Key Messages on AG's Special Report on the Fair Hydro Plan

- The government respects independent officers of the legislature, and values the important perspective they bring, but does not agree with the assertions and conclusions expressed in the Auditor General's Fair Hydro Plan report.
- The government has a strong track record of producing high-quality financial reports on a timely basis and continues to present the province's finances fairly and accurately and in accordance with Canadian Public Sector Accounting Standards.

- In developing the Fair Hydro Plan, the government considered a range of implementation options and consulted with legal, accounting, financial and energy sector third-party experts to provide advice and ensure due diligence was completed.
- The Fair Hydro Plan operates under a financial and accounting framework that is appropriate for the intended purpose. It is in accordance with Public Sector Accounting Standards and ensures the goals underlying the program are achieved in a cost-effective manner.
- PSAS are principle based -- they are not a set of specific prescriptive rules. Applying them requires the application of professional judgment. While we expect professional accountants to agree on the vast majority of issues, we acknowledge that they may not agree on everything. When that occurs, and the difference is material to the financial statements, the Office of the Auditor General can choose to issue a qualified audit opinion.
- The implementation of Ontario's Fair Hydro Plan is ongoing, with significant decisions with accounting and financial implications still being finalized. The financing plan and its impact will continue to be transparent and fully available to credit rating agencies, securities regulators, and the public.
- The Ministry of Energy, the Ministry of Finance, and the Treasury Board Secretariat remain committed to assisting the Office of the Auditor General in providing its independent views to the Legislative Assembly.

RECENT MEDIA COVERAGE:

- October 23, 2017 – Global News reporter Alan Carter wrote an analysis on “truth” and Fair Hydro. He wrote, “The war between Lysyk and the Liberals is whether the Fair Hydro Plan and its use of Ontario Power Generation as a debt vehicle is a sign of devious politicking or just the way things get done.”
- October 23, 2017 – The Peterborough Examiner carried an opinion piece written by Minister of Energy, Glenn Thibeault. ‘I’m not surprised to see the Conservatives try to get in the middle of an accounting dispute between the government and the Auditor General for personal political gain. It’s how they deflect without putting forward any policy ideas of their own.’
- October 22, 2017 – The Toronto Sun’s Antonella Artuso wrote that the way the Liberals “hid” the cost of its Fair hydro Plan from taxpayers could raise concerns that other governments across the country could follow suit and bury deficits.
- October 22, 2017 – The Toronto Sun’s opinion piece says the Fair Hydro Plan is simply ‘long-term pain for short-term gain’.
- October 19, 2017 – CBC’s Mike Crawley writes about the Auditor General’s accusations that the government was trying to hide documents from her investigation. Crawley writes that the Progressive Conservatives have made a request to the province’s “top public servant to ensure that all relevant documents and emails are saved.”
- October 18, 2017 – CTV News (6pm) includes the Progressive Conservative’s reaction to the Fair Hydro report: “opposition calls for resignations of ministers of finance and energy after AG report.”
- October 18, 2017 – QP Briefing’s Jessica Smith Cross highlighted that the \$4 billion figure cited by the Auditor General and the Financial Accountability Office that would be wasted due to the government’s “needlessly complex” financing structure for Ontario’s Fair Hydro Plan was said 21 times by opposition parties during Question Period that morning.
- October 18, 2017 – The Globe and Mail’s Justin Giovannetti (A9) highlights the Auditor General’s Fair Hydro report. The article includes a quote from Minister Sandals: “‘Perhaps the essential accounting dispute that we have with the auditor is a dispute over what happens when the Canadian Public Sector Accounting Standards are silent, when they don’t give direction,’ Ms. Sandals said. ‘We keep running into this problem because, quite frankly, Ontario is the biggest province, and we often have bigger projects and do things a bit differently from all the smaller provinces.’”
- October 17, 2017 – The CBC’s Mike Crawley covers the Auditor General’s report, writing “The auditor says the plan could also result in Ontarians paying “up to \$4 billion more than necessary” in interest. That’s because OPG will be required to pay higher interest rates than the province would if the government took on the debt directly.”
- October 17, 2017 – The Toronto Star’s Robert Benzie also focused on the Auditor General’s so-called scathing report on Ontario’s Fair Hydro Plan, while acknowledging the historical dispute between the Auditor’s Office and the government.
- October 17, 2017 – The Ottawa Citizen’s David Reevely continues with key themes in the coverage, also writing: “The Liberals really, really, really wanted to keep that debt off their books, so they could also go into the next election saying the provincial budget is balanced. Borrowing billions in an election year would get in the way. So they did some advanced financial engineering to put the debt on Ontario Power Generation instead.”
- October 17, 2017 – The Canadian Press’ Allison Jones cites the Auditor General’s statements, and includes Minister Sandals’ rebuttal on the point of

asset accounting: “Treasury Board President Liz Sandals said credit rating agencies are ranking the hydro debt in preparation for selling it. ‘That’s the difference,’ she said. ‘Somebody actually wants to buy it, ergo it is an asset.’”

- October 17, 2017 – QP Briefing provided a primer on the report, and pointed to the Auditor General’s criticism of the government on the alleged willingness to accept a qualified audit opinion for the province’s Public Accounts.
- October 17, 2017 – The Auditor General’s report and remarks during the media conference were extensively covered across the media. Coverage consistently cited the key themes in the Auditor General’s report, highlighting the “needlessly complex” accounting structure, “improper accounting,” and the “anticipated \$4 billion more in interest payments than if the province had borrowed the funds directly.”
- October 17, 2017 – The Toronto Sun’s Antonella Artuso featured an overview of the Fraser Institute’s report released in the morning, arguing that “Soaring electricity prices resulted in 75,000 fewer manufacturing jobs for Ontarians since the recession”.
- October 17, 2017 – The Office of the Auditor General held a media conference for the release of The Fair Hydro Plan: Concerns about Fiscal Transparency, Accountability and Value for Money.
- October 17, 2017 – CBC News reports that today Auditor General Bonnie Lysyk will reveal the results of her investigation into the government’s Fair Hydro Plan. The report will look at how the rate cuts are financed and whether the plan is fair for taxpayers and hydro customers. Auditor Lysyk has already told a legislative committee in May that to borrow the money on OPG’s books rather than the province’s is “contrary to public sector accounting standards.”

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Appendix

Proposed Legislated Transaction Structure

Prepared by the Office of the Auditor General of Ontario

