Office of the Provincial Controller Division
Financial Reporting and Fiscal Support Branch

Adopting the Accounting Recommendations of the Auditor General – Market Accounts / Fair Hydro Plan

Issue:

Describe the options for adopting accounting treatment for the Fair Hydro Plan as recommended by the Auditor General.

Overview:

In the 2016-17 opinion on the consolidated financial statements of the province, the Auditor General raised two issues that relate to the Independent Electricity System Operator - (IESO) – 1) the recording of market accounts and 2) the use of rate regulated accounting, disagreeing with both.

Subsequently in October 2017, the Auditor General released a Special Report on the Fair Hydro Plan. In that report she commented on the accounting for the Global Adjustment Refinancing of the Fair Hydro Plan and noted four additional issues in Section 4.4:

> As stated in Section 4.1, the government of Ontario has historically chosen to use Canadian PSAS as the basis of accounting for its preparation of the Province's consolidated financial statements. So by legislating an accounting design contrary to Canadian PSAS, the government is also going against its own accounting policies. As described in Section 1.3.1, recording the Fair Hydro Act's rate reduction in accordance with Canadian PSAS entails the following:
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> - All related debt, including that of OPG and OPG Trust, would become debt on the Province's financial statements.
> - All interest expense would become an expense of the Province.
> - The annual shortfall between the amount paid to generators and the amount collected from local distribution companies would be recorded as an expense of the Province.
> - The amount collected in the future through the clean energy adjustment to pay down the accumulated principal and interest and other expenses of $39.4 billion would be recorded in the future as revenue of the Province.

While the 2017 financial statements of the IESO and OPG have been released, reflecting the impact of the Fair Hydro Plan on their organizations for 2017, the Province has not released its consolidated financial statements.

The Province has released its 2018 Budget and 2018 Pre-Election Report, both of which focus primarily on the projected surplus/(deficit) of the province in future years. The difference between the Province's accounting for the Global Adjustment Refinancing and that of the Auditor General is based on differing opinions on the application of rate-regulated accounting under Public Sector Accounting Standards (PSAS) and recognition timing of the associated impacts.

In summary the differences in accounting, noted in both the audit opinion for 2016-17 and the Special Report on the Fair Hydro Plan are:

	Issue	Province's Accounting Determination	Auditor General Accounting Determination
1	Recording of market accounts on the statement of financial position	Record the market accounts	Do not record the market accounts
2	Using rate-regulated accounting for entities applying PSAS, reporting the current shortfall and future recovery in the annual results (3 items)	Use of rate-regulated accounting is acceptable; reporting the shortfall and future repayment and associated impacts on net debt does not properly reflect the obligation of ratepayers vs. taxpayers	Use of rate-regulated accounting is not acceptable; shortfall should be expensed as incurred and future repayment recorded as revenue as earned
3	Recording of debt used to finance the Global Adjustment Refinancing	Debt issued by the province is recorded in Debt on the province's statement of financial position; Debt issued by OPG or its subsidiaries is recorded by OPG and recorded in the Investment in Government Business Enterprises on the statement of financial position	All debt should be recorded as if it was issued directly by the Province and should be recorded in Debt on the province's statement of financial position.
4	Recording of interest incurred on debt used to finance the Global Adjustment Refinancing	Interest on debt issued directly by the province is expensed as incurred. Interest recoverable from future ratepayers and that meets the criteria for recording rate-regulated asset is recorded as such.	All interest is expensed as incurred.

Market Accounts - Independent Electricity System Operator - (IESO)

The AG's position that these do not meet the accounting definition of assets or liabilities as there are no benefits or obligations related to these agreements and they should not be included in the government's financial statements. As a counterparty to the contracts between power generators and local power distributors, the IESO changed their accounting in 2017 to record these balances (which net to NIL on the balance sheet) in their financial statements.

Fair Hydro Plan / Global Adjustment

The Fair Hydro Plan was passed in May 2017. The Fair Hydro Plan's policy objectives were to reduce consumer hydro bills by 25%. Approximately one-third (9%) of the reduction was realized through a rebate equal to the provincial share of the HST and the transfer of some social rate-reduction programs to the tax base. There are no accounting issues associated with these changes.

For the remaining two-thirds (16%) of this reduction, the reduction was achieved through extending the timing of recovery from ratepayers for the investments in green energy to align with the generating service life while continuing to settle the contracts with power generator currently in effect. This timing difference creates a shortfall which must be made up through borrowing (to fulfill the contractual obligations to power generators). The future recovery from ratepayers to cover the borrowing (plus interest) will occur through the introduction of a dedicated charge (the Clean Energy Adjustment (CEA)) to consumers' electricity bills starting in 2022.

Companies in regulated sectors in Canada are permitted under a transitional provision in private-sector accounting standards (International Financial Reporting Standards or US GAAP) to defer recognition of expenses where future recovery is expected from customers. This is referred to as "rate-regulated accounting". In Ontario, both Ontario Power Generation and Hydro One use the approach. Public Sector Accounting Standards are silent on the use of rate-regulated accounting. In such cases, professional judgment is applied to assess the nature of the transaction and the most appropriate representation of the circumstances using sources of accounting guidance issued by other accounting bodies. In evaluating other sources, the principles adopted must be consistent with the concepts of Public Sector Accounting Standards (e.g. definition of an asset). In this case, the application of rate-regulated accounting by the Independent Electricity System Operator was determined appropriate as this entity is industry regulated (by the Ontario Energy Board). The application of rate-regulated accounting was determined consistent with the core concepts of Public Sector Accounting Standards.

Considerations:

For the market accounts, the IESO is currently classified as an Other Government Organization under PSAS. The government could adjust the balances consolidated for the IESO to remove the market accounts as an Other Government Organization, or review this classification and/or make legislative changes which would alter its classification to that of a Government Business Entity or a Trust Under Administration and report under IFRS. This latter change would result in the IESO being reported on a one-line basis (like Hydro One and Ontario Power Generation) as a GBE on the Province's consolidated financial statements, or not being consolidated, but solely disclose in the notes to the financial statements as a Trust Under Administration.

However, none of these approaches would not require the removal of the market accounts from the IESO financial statements, which is an issue raised by the AG. As a matter of practice, we rely on the opinion of the external auditors of the consolidated entities to confirm the balances being consolidating.

Pros	Cons
• The market accounts would not be recorded on the statement of financial position of the province (also remove any rate-regulated asset from the provinces CFS)	• Supporting rationale for the change would be subject to scrutiny; criticism that IESO continues to report market accounts
• PSAS requires adjustments for differences in accounting policies for consolidated entities; currently done in other circumstances (e.g. hospital capital projects under AFP model) to ensure consistency	• Management and external auditors of IESO may not agree with any change to its classification.
	• Creates discrepancies between the audited financial statement

presented in Volume 2 and the consolidated financial statements

For the Global Adjustment accounting of the Fair Hydro Plan, the accounting under the current structure of the Fair Hydro Plan is in compliance with Public Sector Accounting Standards. Changes to the FHP would be required that would no longer permit the recognition of a rate-regulated asset. The criteria for recognition are: 1) IESO is a regulated entity, 2) rates are related to the recovery of costs, and 3) a reasonable expectation that recovery is likely based on demand and rate levels.

The structure of the Fair Hydro Plan is most closely linked to the second criteria. The government can amend the *Ontario Fair Hydro Plan Act* to remove the recovery from ratepayers through the Clean Energy Adjustment; this would 1) remove the necessary circumstances related to future recovery from ratepayers needed to recognize a rate-regulated asset under US GAAP and the shortfall would be expensed by the IESO, 2) invoke the FHT guarantee and record the exist debt issue, and 3) require the province to provide all future borrowing to cover the shortfall with no future recovery under legislation.

Using a ratepayer recovery approach similar to the former Debt Recovery Charge for the former Ontario Hydro stranded debt would result in a financial statement presentation consistent with the AG's view.

Pros	Cons
• Clearly establishes the tax base as the source for repayment; no longer a rate-regulated asset under accounting guidance	• Deviates from established practice for energy investments being recovered from the ratepayer
• Provides option for government to borrow directly for the full financing and lower interest cost	• Changing policy direction to achieve a change in accounting treatment

The government may choose to amend the terms of the trust agreements with the Financial Services Manager of the Fair Hydro Plan Trust (currently OPG) to bring the Fair Hydro Plan Trust under the direct control of the Province requiring it to be consolidated as a government organization. While this would result in removing the debt issued from OPG to the Province's debt, the rate-regulated assets would continue to be reported without additional changes to the Fair Hydro Plan.

As shown in the chart, not one consideration will address all issues raised by the AG:

Considerations	**1**	**2**	**3**	**4**
Reclassify IESO as GBE (one-line) or Trust under Administration (not consolidated)	✓	✓		
Amend *OFHPA* to eliminate the future recovery through Clean Energy Adjustment		✓	✓	✓
Amend OPG agreements to establish control of the FHP Trust with the Province			✓	

Delivery/Timelines:

Legislative and/or policy changes invoked prior to the release of the 2018 Public Accounts and specifically applicable would be reflected in the consolidated financial statements. The Public Accounts is required to be released within 180 days after the fiscal year end (March 31).

Other Jurisdictions:

For both of these issues, factual circumstances are unique to Ontario and jurisdictional comparison may not be fully reflective of options available to the government.

Other Considerations:

The government may wish to create an Audit Committee composed of senior officials and the Auditor General to discuss emerging accounting issues and their impact on the Public Accounts. The purpose of this non-binding committee would be to bring forward items identified through the Public Accounts (and throughout the year) for a broader discussion of objectives and clarification in the government's reporting.