Accounting Overview

Briefing for the Independent Financial Commission of Inquiry

July 27, 2018

CONFIDENTIAL

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Rate Regulated Accounting

- PSAS is silent on the topic of rate-regulated accounting.
- PSAB recognizes that their standards cannot address every potential situation, and that it may be necessary to refer to other sources of guidance.
  - *No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters, or when additional guidance is needed to apply a primary source to specific circumstances. (Section PS 1150.07 from the PSA Handbook)*
- The financial statements of the Province are impacted by rate-regulated accounting followed by Ontario Power Generation, Hydro One and the Independent Electricity System Operator.

PART 3:
ACCOUNTING FOR INDEPENDENT ELECTRICITY SYSTEM OPERATOR MARKET ACCOUNTS

Independent Electricity System Operator (IESO)

- Independent Electricity System Operator (IESO) is a corporation established pursuant to Part II of the *Electricity Act, 1998*, and prepares its financial statements in accordance with PSAS.
- IESO is controlled and consolidated into the consolidated financial statements of the province on a line-by-line basis.
  - IESO is classified as an Other Government Organization under PSAS.
    - It is controlled by the Province.
    - It is a separate entity with the power to contract in its own name and that can sue and be sued.
    - It is neither a government business enterprise nor a government not-for-profit organization.
- KPMG LLP audited IESO's financial statements and issued an unqualified opinion on the December 31, 2016 and December 31, 2017 financial statements.

IESO – Market Accounts

- As part of its role, IESO administers a $17 billion annual electricity market reflecting the amounts *due to* entities that provide electricity to the market (e.g. power generators) and *due from* entities who consume electricity (e.g. local distribution companies on behalf of their consumers).
  - These are referred to as market accounts.
- IESO is a party to each of these agreements with market participants
- In 2016, IESO changed the accounting for the market accounts, recognizing these amounts due from and due to the market participants as assets and liabilities respectively.
- For example:
  - Ontario Power Generation has a receivable from IESO recorded on its financial statements related to power generated, and historically, IESO did not have a payable recorded to Ontario Power Generation – now it does.
  - Hydro One has a payable to IESO recorded on its financial statements related to power purchases, and historically, IESO did not have a receivable recorded from Hydro One – now it does.
- This change had no impact to the province’s annual deficit, net debt or accumulated deficit.

Market Accounts – Recognition and Presentation under PSAS

- The amounts due from market participants meet the definition of an asset and the amounts due to market participants meet the definition of a liability under PSAS
  - The amounts due to and from the market participants result from contracts that meet the definition of a financial instrument under PS 3450
- In connection with this change, the accounting for eight other independent system operators in North America were reviewed, and all but one recognize the balances of market accounts in the financial statements.
- The accounting also aligns with:
  - Accounting treatment of the tax collected by the Government of Canada ("GoC") on behalf of the provinces and territories. The accounting policy for the Tax Revenue of the Government of Canada for the financial year ended March 31, 2017 states, in part:
    - *"Tax collected on behalf of the provincial/territorial governments is not included in tax revenues. It is recorded as payable to the provincial/territorial governments included within Other Accounts Payable and Accrued Liabilities and distributed by the Department of Finance in accordance with associated agreements."*
  - Accounting followed for stock exchanges that settle transactions in a financial market – e.g. TMX Group

PART 4:
RATE-REGULATED ACCOUNTING

Province's use of Rate-Regulated Accounting

- Rate regulated accounting is reflected in the Province's results through both entities that it consolidates using the modified equity method and entities it consolidates on a line-by-line basis (full consolidation).
- Ontario Power Generation, and Hydro One:
  - Reflected in the province's consolidated financial statements using the modified equity basis as prescribed by PSAS (equity method, but accounting standards are not adjusted to conform with those of the government)
  - Both apply rate-regulated accounting in preparing their financial statements.
  - Change in rate-regulated balances impacts the Province's deficit based on ownership level in entity
  - On a combined basis, entities had almost $10 billion in net rate-regulated assets at December 31, 2017
- Independent Electricity System Operator:
  - Reflected in the province's consolidated financial statements using full consolidation
  - Adopted rate-regulated accounting in its 2016 year
  - Entity had approximately $200 million in net rate-regulated assets at December 31, 2017
  - Prior to its amalgamation with IESO in 2015, the Ontario Power Authority (OPA) also referenced the use of rate-regulated accounting in its financial statements. OPA was fully consolidated with the Province.

Rate-Regulated Accounting Example

- If the rates an entity is able to charge to its customers are set by another party (i.e., a regulator), provided specified criteria are met, rate-regulated accounting permits the entity to defer costs that would otherwise be expensed to the period that the related revenue is charged to customers.
- Example:
  - A storm causes unexpected maintenance expenses of $100 million.
  - The regulator permits the utility to recover these costs from consumers through increased rates over five years as opposed to the year the costs are incurred by the utility.
  - The utility has a rate-regulated asset of $100 million when the costs are incurred and expenses these amounts over five years.
  - In the absence of rate-regulated accounting, the full $100 million would be recorded as an expense in the year incurred.

Components of plan to reduce electricity rates

Tax Base

- 8% rebate (effective 1/1/17)
- Ontario Energy Support Program
- Rural or Remote Rate Protection
- New First Nations On-Reserve Credit
- Affordability Fund

Rate Base

- Global Adjustment Refinancing

Currently the Global Adjustment (GA) variance is collected from consumers within 12 months. The revised structure requires the GA to be collected from consumers over the term of the GA refinancing structure.

Global Adjustment (GA) Refinancing Concepts & Impacts

- IESO
  - Collects less from the specified consumers through the LDCs, than it otherwise would have absent the OFHPA.
  - Pays the same amount to the generators, thereby creating a “shortfall” – referred to in the legislation as a regulatory variance account.
  - Has the right to collect the “shortfall” from the specified ratepayers in the future.
  - Has the right to sell the “shortfall” to another party.

- OPG Trust (consolidated by OPG)
  - Purchases the right to collect cash from the specified ratepayers in the future (the “shortfall”) from IESO.
  - Finances the purchase of the “shortfall” from a combination of the debt and an equity injection from the Province.
  - Recognizes an intangible asset (purchase of shortfall), as well as an increase in debt and equity.

- Province
  - Consolidates IESO on a line-by-line basis, and OPG on a modified equity basis

Rate-Regulated Accounting under Public Sector Accounting Standards

- Public Sector Accounting Standards (PSAS) are silent on the use of rate-regulated accounting.
- PSAS acknowledges that it does not provide guidance on all possible transitions and notes that it is necessary to refer to other sources of guidance:
  - *No rule of general application can be phrased to suit all circumstances or combinations of circumstances that may arise. As a result, matters may arise that are not specifically addressed in the primary sources of GAAP. It is necessary to refer to other sources when the primary sources do not deal with the accounting and reporting in financial statements of transactions or events that a public sector reporting entity encounters, or when additional guidance is needed to apply a primary source to specific circumstances.*
- The following accounting frameworks provide for the use of rate-regulated accounting:
  - International Financial Reporting Standards (if rate-regulated accounting used prior to adoption of IFRS through IFRIC 14);
  - Financial Accounting Standards Board;
  - Government Accounting Standards Board;
  - Accounting Standards for Private Enterprises.
- All of the standards lead back to the standards developed by the Financial Accounting Standards Board (ASC 980).

Rate-Regulated Accounting

- Recognizing the regulatory variance account, which is tracked as a result of the Ontario Fair Hydro Plan Act (OFHPA) and its regulations, as an asset in the Statement of Financial Position is appropriate if all of the following criteria are met:
  - the regulated operations of the IESO (or the relevant portion thereof) are within the scope of ASC 980 based on the criteria in ASC 980-10-15-2,
  - the variance account (under the Fair Hydro Plan) meets the criteria in ASC 980-340-25-1 for capitalization as a regulatory asset, and
  - ASC 980 is an appropriate source of GAAP under PSAS.

Scope of ASC 980 – US GAAP

- ASC 980-10-15-2 states the following:

  The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that meet all of the following criteria:

  - The entity's **rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute** or contract to establish rates that bind customers.
  - The regulated rates are designed to **recover the specific entity's costs of providing the regulated services or products**. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.
  - In view of the demand for the regulated services or products and the level of competition, direct and indirect, **it is reasonable to assume that rates set at levels that will recover the entity's costs** can be charged to and collected from customers.

Criteria for Capitalization under ASC 980

- ASC 980-340-25-1 states the following:

  Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

  a) It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

  b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

- The OFHPA and its regulations (the "Act") entitle the IESO to recover the amounts that have been deferred, including interest and carrying costs.
- The rate per unit of electricity that is collected from the specified ratepayers will be determined based on the amount of electricity consumed in the future, not whether electricity is consumed in the future – the 2017 Long-term Energy Plan predicts that the demand for energy will be fairly steady over the planning period (to 2035).
- The IESO is able to sell the regulatory asset.

Appropriate GAAP under PSAS

- The application of ASC 980 under US GAAP was assessed to ensure it's consistency with the concept of assets as described in PS3210 and PS1000.36:

    a) they embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows

    b) the public sector entity can control the economic resource and access to the future economic benefits; and

    c) the transaction or event giving rise to the public sector entity's control has already occurred.

Impact to the Province

- IESO's audited financial statements have been prepared using rate-regulated accounting
- OPG's financial statements reflect the purchase of the regulatory asset from IESO -- there is no gain or loss on the transaction
- The Province consolidates both IESO and OPG
  - The consolidation process does not result in the elimination of any of the transactions

Impact to the Province

- The transaction was evaluated with respect to whether the substance of the transaction is reflected in the accounting.
- Use of rate regulated accounting:
  - Reflects policy decision to isolate the cost to the rate-base
  - Cost is not expected to be borne by the tax base
- Recording of debt issued
  - Recording debt issued by OPG for GA refinancing as OPG debt is consistent with the existing $16 billion in debt recorded by the government business enterprises (GBE)
  - PSAS specifically notes that use of the equity method for GBEs avoids commingling its debt with that of the province as the debt of the GBE is expected to be repaid with its own revenues/cash flows
  - Net debt provides a measure of the future revenues required to pay for past transactions and events. As the policy decision was to isolate the cost to the rate-base, and the legislation requires the cost to be recovered from the rate-payers, future tax base revenue will not be needed to pay for the costs of the GA Refinancing.