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Office of the Provincial Controller Division

Ontario Fair Hydro Plan – Accounting for Market Accounts and Rate-regulated balances under Public Sector Accounting Standards

November 21, 2017

Agenda

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- Ontario's Electricity Market – Background and Context
- Ontario's Fair Hydro Plan
- IESO – Accounting policy changes
  - Accounting for the Market Accounts of IESO
  - Use of Rate Regulated Accounting under PSAS
- Impact to Province's financial statements

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ONTARIO'S ELECTRICITY MARKET – BACKGROUND AND CONTEXT

Ontario's Electricity Market

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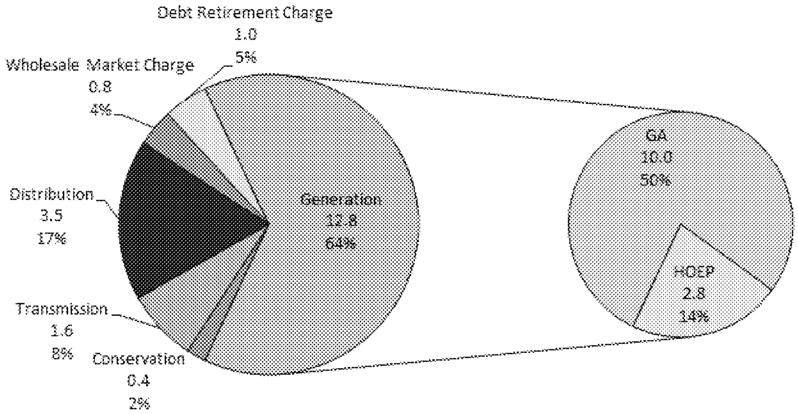
- In 2015, generation accounted for 64% of total electricity system costs. Total system costs in 2015 were $20 billion.

2015 Electricity System Cost
$ billion



Source: IESO

Significant Change in Supply Mix

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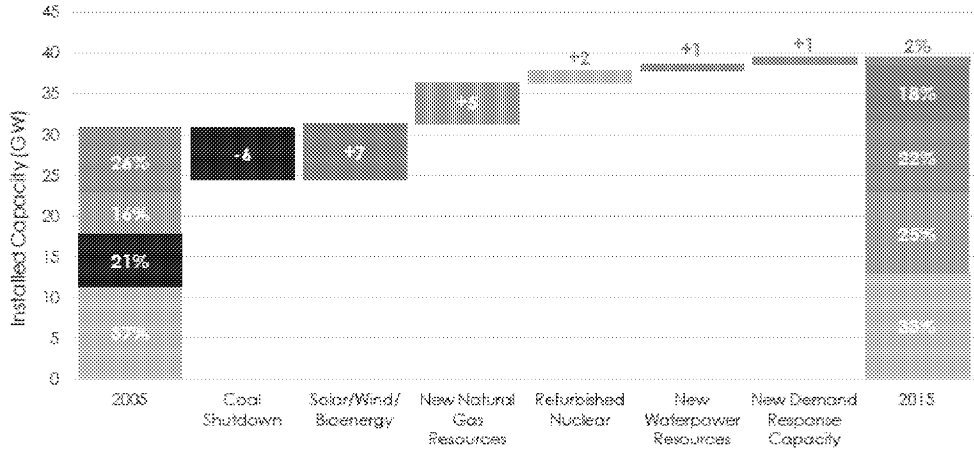
- Between 2005 and 2015, government invested more than $50 billion in the electricity system, including $35 billion in electricity generation to restore reliability, replace coal and meet environmental objectives.
  - Electricity costs are increasing as necessary investments are made to decarbonize and modernize the province's electricity infrastructure.

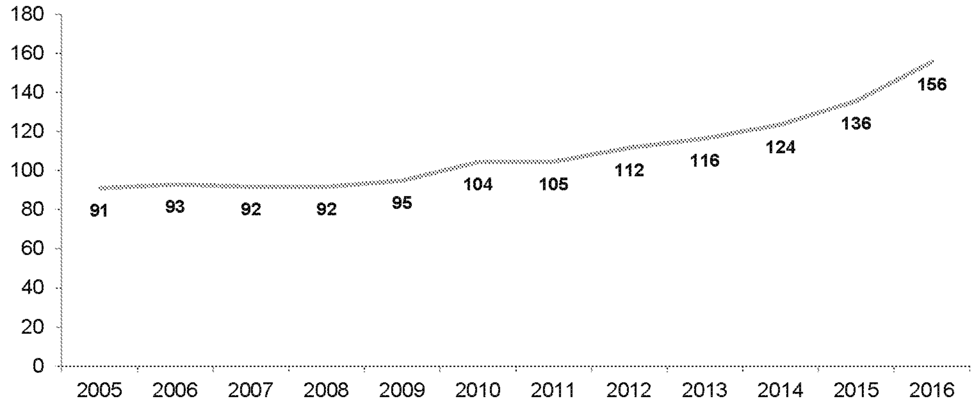


Source: *IESO*

Electricity Prices Have Increased

- Since 2010, electricity prices have increased at a rate higher than the Consumer Price Index (CPI).

Typical Residential Electricity Bills
in $ per month, 750 kWh consumption



Source: *Ministry of Energy*

Actions To Mitigate Electricity Rates

- Following the 2016 Throne Speech, several actions were announced to further reduce electricity costs.
  - As of January 1, 2017, Ontario is rebating an amount equal to the provincial portion of the HST to reduce eligible residential, small business and farm electricity bills by 8%.
  - Expanded support available to eligible rural ratepayers by updating Rural or Remote Rate Protection (RRRP) with additional relief, decreasing total electricity bills by an average of $45 each month when combined with the 8% rebate.
  - Expanding the Industrial Conservation Initiative (ICI) – up to one-third savings for participants.
  - Suspending the LRP II and the Energy from Waste Standard Offer Program (EFWSOP) – up to $3.8 billion in cost savings.
  - Limiting the Feed-In Tariff (FIT) 5 procurement target to 150 MW and suspending future FIT procurements – up to $129 million in cost savings.

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ONTARIO'S FAIR HYDRO PLAN

Ontario's Fair Hydro Plan – Announced March 2, 2017

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- The Ontario Fair Hydro Plan Act ("OFHPA") provides Ontario ratepayers with an average 25% reduction in their electricity bills effective July 1, 2017 by way of:
    1. Spreading the cost of Ontario's clean energy investments over the expected lifecycle of the generation infrastructure assets (i.e. global adjustment); this is expected to account for 18-19% of the overall reduction,
    2. Shifting the cost of the Ontario Electricity Support Program (OESP) and most of the Rural or Remote Rate Protection (RRRP) social program costs from ratepayers to taxpayer-funded programs,
    3. An 8% rebate equal to the provincial portion of the HST, which took effect on January 1, 2017.
- The OFHPA requires the IESO to create and maintain a variance account for the global adjustment (referred to in the OFHPA as a 'regulatory asset') to be recovered from the ratepayers, but the OFHPA does <u>not</u> establish any accounting definitions for this variance for financial reporting purposes
- By way of this government's policy decision, the 8% rebate and the social programs will be funded from the tax-base (not the rate-base); costs incurred, starting in 2016-17, have been accounted for as an expense in the Province's consolidated financial statements.

Ontario's Fair Hydro Plan

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

* Announced prior to the Fair Hydro Plan
** See additional detail on social programs in Appendix

2017 Long-term Energy Plan

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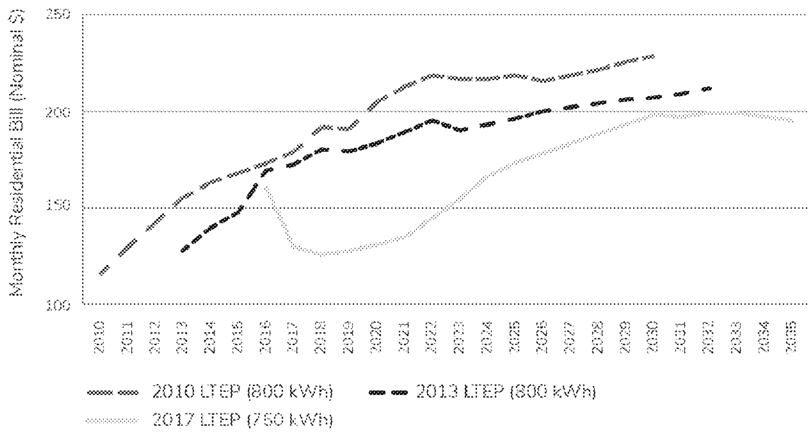
Electricity Price Outlook – Residential Consumers



Source: IESO, Ministry of Energy

Note: Forecasts used in *Delivering Fairness and Choice* reflect prevailing patterns of consumption. Between late-2009 and mid-2016, the OEB defined the typical residential customer as a household that consumed 800 kWh of electricity per month. As of May 2016, the OEB changed their typical residential consumption to 750 kWh per month, due to declining household consumption.

Global Adjustment (GA) Refinancing

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- Under the OFHPA, while the majority of generators are under 20-year contracts, the amounts paid by the IESO to the generators will be recovered from specified ratepayers over a longer period to reflect the expected period of benefits derived from these generating assets (as confirmed by analysis by external parties)
  - Electricity consumers will benefit from the ongoing useful life of these generating assets, and will be responsible for the costs of these assets over the same timeframe

- Refinancing the GA, which pays for the bulk of the recent investments in the electricity system, provides significant and immediate rate relief by matching the cost of electricity investments with the expected useful life of the generation that has been built.

- Rate increases are capped at inflation until 2021, after which rates will be recovered by including a component charge to cover the refinancing of the GA (principal and interest) over the following 25 years.

- The GA refinancing program ensures that costs are borne by the rate-base, as the beneficiaries of the electricity system, and not the tax-base.

Global Adjustment (GA) Refinancing (during initial years)

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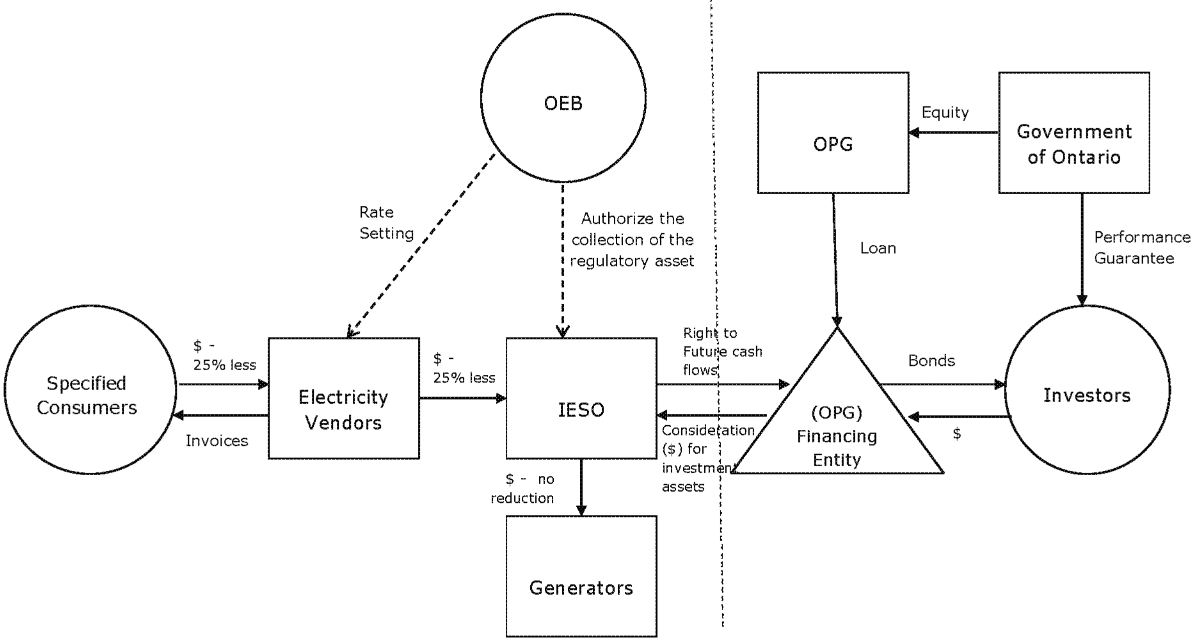

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GA Refinancing Concepts & Impacts

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- 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"
  - 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 – expects to have a small regulatory asset at each year-end
  - Has an increase in Provincial debt for equity injection to OPG offset by increase in investment in OPG

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IESO – ACCOUNTING POLICY CHANGES

Role of the Independent Electricity System Operator

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- The IESO is a corporation established pursuant to Part II of the Electricity Act, 1998, and administers $17 billion of the $20 billion annual electricity system, settling transactions between generators and consumers of electricity.
- One of IESO's roles is to settle the market accounts, which are the amounts due to the entities who provide electricity to the market (e.g. power generators) and due from those who consume electricity (e.g. local distribution companies on behalf of their consumers).
- The IESO is rate-regulated under the Electricity Act (1998) and the Ontario Energy Board Act (1998) by virtue of its right to recover the following costs from future ratepayers as determined by the Ontario Energy Board:
  - Revenue, expenditure requirement and fees
  - Smart meter expenses
  - PSAB transition items
  - Market settlements (Rate Protection Price (RPP), Ontario Electricity Support Program (OESP), Rural or Remote Rate Protection (RRRP))

IESO Changes in Accounting Policy

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- In 2016, IESO made two changes in its accounting policies:
  - reflected the "market accounts" in its statement of financial position
  - adopted rate-regulated accounting
- KPMG LLP audits IESO's financial statements and issued an unqualified opinion on the December 31, 2016 financial statements.
- The Ontario Power Authority, which merged with the IESO on January 1, 2015, presented in its unqualified, audited financial statements under PSAS, a segment of the market accounts for settlement with generators under contracts and referred to the use of rate regulated accounting

Accounting for IESO Market Accounts

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- The IESO is a party to agreements with each market participant, and each market participant either owes an amount to the IESO or is owed an amount from the IESO. 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
- 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 PSAB standards
- In connection with this change, the accounting for eight other independent system operators in North America were reviewed, and all but one recognize market accounts in the financial statements
- IESO management, their Audit Committee, their Board of Directors, their external auditor and the Office of the Provincial Controller support the change in accounting as being more transparent.
- A qualified opinion was issued by the Office of the Auditor General on the 2016-17 consolidated financial statements regarding the change in Independent Electricity System Operator's accounting for the "market accounts".

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As noted, IESO is a party to every agreement with a market participant, and every market participant either owes an amount to the IESO or is owed an amount from the IESO.

For example, Ontario Power Generator – who generates power that is sold to the market, has a receivable from IESO recorded on its financial statements related to the power sold – historically IESO did not have a payable recorded to Ontario Power Generation – now it does. The same point could be made for other independent power generators such as Bruce Power or Brookfield Renewable Power.

On the other side, Hydro One -- who purchases power from the market for its consumers, has a payable to IESO on its financial statements related to power purchased – historically IESO did not have a receivable recorded from Hydro One – now it does. The same point could be made for other independent local distribution companies such as Toronto Hydro or Ottawa Hydro.

These amounts due to and due from meet the definition of assets and liabilities under Public Sector Accounting Standards, and the accounting is consistent with the survey completed of 8 other independent system operators in North America. All but one recognize market accounts in their financial statements.

IESO's management, their Audit Committee, their Board of Directors, their external auditor and the Office of the Provincial Controller support the change in accounting as being more transparent.

The Office of the Auditor General issued a qualified opinion on the 2016-17 financial statements regarding this change in accounting.

Rate Regulated Accounting under PSAS

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- Public Sector Accounting Standards are silent on the use of rate-regulated accounting; the standards neither explicitly permit nor prohibit its recognition, measurement, presentation or disclosures

- PS1150.19 provides examples (not an exhaustive list) of other sources of GAAP, while PS1150.20 emphasizes that "it applies professional judgment and evaluates the source in the context of the relative manner in which the standard setter requires its pronouncements to be applied".

- In applying professional judgment, a review of the PSAB concepts described in paragraph PS 1150.05(b) has been completed to ensure proper application of the GAAP hierarchy

- In looking to other standards, the recognition of the economic effects of rate regulation are required under FASB, and permitted under IASB (through IFRS 14), ASPE and GASB when an entity meets defined criteria
  - FASB has the only developed standard on rate-regulated accounting
  - IASB's project on rate-regulated activities is still in progress and it would be premature to assume any final conclusions by the IASB on regulatory deferral account balances

Rate-regulated Accounting

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- Recognizing the regulatory variance account, which is tracked as a result of the OFHPA and its regulations, as an asset in the Statement of Financial Position is appropriate in both the financial statements of the IESO and Province 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

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- 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.

- The IESO is 1) regulated by the OEB as a governing board which provides for it to 2) recover its costs based on 3) rates pursuant to the on-going demand for electricity in the marketplace

Role of the Ontario Energy Board

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- The OEB has been established by the Province to be Ontario's independent energy regulator; its mandate and authority come from the Ontario Energy Board Act, 1998, the Electricity Act, 1998, and a number of other provincial statutes.

- As noted previously, the rates charged by the IESO to electricity consumers are determined by the OEB, and therefore, it is considered the governing board of the IESO.

- While both the IESO and the OEB are controlled by the Province, this does not negate the role the OEB plays with respect the electricity market nor the determination of the IESO as a rate-regulated entity
  - Under US GAAP, the requirement is an independent, third-party regulator <u>or its own governing board empowered by statute</u> or contract.

Criteria for Capitalization

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- 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

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- 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.

- By establishing that ASC 980 is consistent with the concepts under PSAS, it provides guidance as to how to apply the primary source of PSAS in the regulatory environment.

(a) Future economic benefit – Future recovery from ratepayers

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- The regulatory asset, by statute, has the capacity to provide future cash inflows.
  Sec 25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.

- 2017 Long-term Energy Plan predicts that the demand for energy will be fairly steady over the planning period (to 2035), supporting that sufficient demand is expected to exist in the future to recover the regulatory asset at a reasonable unit price

- IESO has the right to sell the asset

(b) Controlling the Resource

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- As noted in Sec 25 of the OFHPA, the IESO holds the sole right to collect the variance account from ratepayers under statute

- As well, the OFHPA also provides for the IESO to realize it's collection through the transfer and sale of the variance account:

  26 (1) The IESO may from time to time, in accordance with this Act and the regulations, transfer a specified portion of the regulatory asset to a financing entity in accordance with this section.

  (2) An agreement between the IESO and a financing entity in relation to the transfer of a specified portion of the regulatory asset shall provide for consideration of a payment by the financing entity to the IESO in an amount equal to the amount of the specified portion.

- Access to future economic benefits is by way of collection from ratepayers or sale and transfer to a financing entity, and all associated risks are extinguished or transferred at that time.

(c) Occurrence of a Past Event

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- Upon the transfer of electricity into the grid by the generators, a recoverable amount is due from ratepayers related to their portion of consumption that must be settled by way of the IESO.

- PS3210 supports that the point of exchange at which risk transfers gives rise to an asset under PSAS:

  .26 The past transaction or event that gives rise to control of an economic resource resulting from exchange agreements or contracts usually occurs at the point of exchange. This arises when substantially all the benefits and risks of ownership have been transferred to the public sector entity and normally coincides with the disbursement of funds, exchange of other assets or assumption of liabilities.

- The incurrence of the cost that is to be settled with power generators is the event for which there is a right to recovery from ratepayers under statute, not the statute itself:

  .32 The past transaction or event giving rise to control of an economic resource must have occurred by the financial statement date. Legislation having retroactive application cannot create a past transaction or event. Any economic resources related to that legislation would be accounted for in the current and relevant future periods, not in the period of the effective date of the legislation.

Additional Evidence from GAAP

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- Additional evidence supporting the classification of rate-regulated assets as assets in other frameworks is contained within the Basis for Conclusions for FAS 71:

> *58. The economic effect cited by most respondents is the ability of a regulatory action to create a future economic benefit—the essence of an asset. For example, consider a regulated enterprise that incurs costs to repair damage caused by a major storm. If the regulator approves recovery of the costs through rates over some future period or is expected to do so, the rate action of the regulator creates a new asset that offsets the reduction in the damaged asset. The enterprise has probable future economic benefits—the additional revenue that will result from including the cost in allowable costs for rate-making purposes. The future benefits are obtained or controlled by the enterprise as a result of a past event—incurring the cost that results in the rate order. Thus, the criteria of Concepts Statement 3 for an asset are met.*

IMPACT TO THE PROVINCE

Impact on Net Debt

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- The GA refinancing is a transaction that will be recovered through a charge to ratepayers through their electricity bills over the service life of the power generating assets; it is not a transaction that has recourse to the tax-base.
- Under the PSAB Handbook, net debt is a measure of “the government's future revenue requirements and on its ability to finance its activities and meet its liabilities and contractual obligations”.
- Absent the recognition of the variance account under the OFHPA as an asset, the Province’s net debt would increase significantly, suggesting that the Province has a much higher future revenue requirement, while the recovery of the variance account is from the ratepayers
- Since the OFHPA regulatory asset is going to be recovered under statute from electricity consumers, not taxpayers, such an increase in net debt would be misleading and inaccurate to financial statement users based on the substance of the transaction.

Addressing Transparency

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- The GA refinancing will be carried out by Ontario Power Generation Trust (OPG Trust) which will issue debt on the open market for approximately ½ of the projected variance, and in exchange will receive the right to future revenues from consumers due to IESO under the OFHPA
- As a government business enterprise, OPG is reflected in the Province's consolidated financial statements on a modified-equity basis, such that it's assets and liabilities are not comingled with those of the Province
- The financial statements of OPG are publicly available and will contain all required presentation and disclosure of all material transactions undertaken during the fiscal year.
- The IESO financial statements are also available publicly.
- Given the materiality, additional voluntary disclosures are also under consideration in the Province's consolidated financial statements.

Conclusion

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- IESO's management, their Audit Committee, their Board of Directors, their external auditor and the Office of the Provincial Controller support the changes in accounting policy adopted by the IESO in 2016 as a more transparent reflection of their operation.
- The OFHPA is a legislative vehicle to invoke the mechanics of a policy decision to provide electricity consumers with a rate reduction by extending the period of recovery of clean energy investments to align with the productive life of those assets, as opposed to the contract duration, and does not provide any guidance on the accounting for the variance account
- In evaluating the proper accounting for balances under the OFHPA, in the absence of guidance under PSAS, the application of US GAAP for rate-regulated activities is the most appropriate guidance, and is consistent with the primary sources of GAAP.
- The financial statement presentation of the Province best reflects the economic substance of the financial components of this government policy by reflecting assets, liabilities and net debt in accordance with the principles under PSAS.

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APPENDIX – ONTARIO FAIR HYDRO PLAN – SOCIAL PROGRAMS

Helping Vulnerable Electricity Consumers

- Fair Hydro Plan initiatives to help vulnerable consumers include:
  - Enhancing the Ontario Electricity Support Program (OESP) and working to ensure the program uptake is as close as possible to 100%.
  - Broadening Rural or Remote Rate Protection (RRRP) program to provide distribution charge relief for the customers of the costliest local distribution companies (LDCs).
  - Establishing a new First Nations On-Reserve Delivery Credit.
  - Establishing a new Affordability Fund which would support Ontarians who have difficulty paying their electricity bills to be able to access energy efficiency improvements.

Enhancing the Ontario Electricity Support Program (OESP)

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- The OESP has been enhanced by increasing its monthly credits by 50%, expanded to cover more low-income Ontarians, and increasing uptake to as close to 100% as possible.
  - Sliding Scale #1 outlines basic program benefits, and Sliding Scale #2 outlines enhanced benefits for Indigenous households, electrically heated households, and households with certain medically intensive medical equipment.
- The government passed legislation to enhance the OESP and to have OESP costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

Existing OESP Credit Scales

Sliding Scale #1	Household Size						
	1	2	3	4	5	6	7+
< $28,000	$30	$30	$34	$38	$42	$50	$50
Income Bracket $28,001 - $39,000			$30	$34	$38	$42	$50
$39,001 - $48,000					$30	$34	$38
$48,001 - $52,000							$30

Sliding Scale #2	Household Size						
	1	2	3	4	5	6	7+
< $28,000	$45	$45	$50	$55	$60	$75	$75
Income Bracket $28,001 - $39,000			$45	$50	$55	$60	$75
$39,001 - $48,000					$45	$50	$55
$48,001 - $52,000							$45

Proposed +50% OESP Credit Increase*

Sliding Scale #1	Household Size						
	1	2	3	4	5	6	7+
< $28,000	$45	$45	$51	$57	$63	$75	$75
Income Bracket $28,001 - $39,000		$40	$45	$51	$57	$63	$75
$39,001 - $48,000			$35	$40	$45	$51	$57
$48,001 - $52,000					$35	$40	$45

Sliding Scale #2	Household Size						
	1	2	3	4	5	6	7+
< $28,000	$68	$68	$75	$83	$90	$113	$113
Income Bracket $28,001 - $39,000		$60	$68	$75	$83	$90	$113
$39,001 - $48,000			$52	$60	$68	$75	$83
$48,001 - $52,000					$52	$60	$68

Broadening Rural or Remote Electricity Rate Protection (RRRP)

- Rural or Remote Rate Protection (RRRP) provides a rate subsidy to rural or remote residential customers who are faced with higher distribution costs compared to urban areas.
  - The RRRP is currently provided to approximately 350,000 Hydro One R2 residential customers in Ontario.
- The Province expanded the RRRP to provide distribution charge relief to additional hydro customers served by local distribution companies (LDCs) with the highest distribution rates, including: Hydro One R1, Northern Ontario Wires Inc., Lakeland Parry Sound, Chapleau PUC, Sioux Lookout Hydro, InnPower, Atikokan Hydro and Algoma Power. This extends RRRP availability to about 800,000 customers.
- The government passed legislation to broaden the RRRP and to have RRRP costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

First Nations On-Reserve Delivery Credit

- In 2016, the Minister of Energy asked the Ontario Energy Board (OEB) to develop options for a First Nation delivery credit for households.

- The OEB, engaging with First Nations, including remote communities, the distributors serving them, and consumer groups, developed the following recommendations:
  - Eliminating the delivery charge for all on-reserve First Nations households and removing the monthly service charge for customers of licensed distributors which charge a bundled rate. The OEB estimates this would provide residential customers an average monthly benefit of $85.
  - Automatically qualify on-reserve First Nations households (~21,500 customers).

- The government passed legislation to create the First Nations On-Reserve Delivery Credit have its costs be funded by provincial revenues, reducing regulatory charges for all Ontario ratepayers.

Establishing a New Affordability Fund

- The Affordability Fund will assist electricity customers who cannot qualify for low-income conservation programs and need financial assistance to undertake energy efficiency improvements.

- The Affordability Fund provides LDCs with an additional tool to help customers in need. LDCs would use the Fund to provide support to customers for energy efficiency improvements to help reduce their future electricity bills.

- The Province will pay for the Fund through provincial revenues.