Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

Legislated Accounting Included in Bill 132, Including the Proposed *Ontario Fair Hydro Plan Act, 2017*

Submission to Standing Committee on Justice Policy

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Introduction[1]

It is not the role of the Auditor General to comment on government policy. The government's intent to borrow money to lower hydro bills by 25% is a policy decision, and therefore we have no comment on this. The purpose of this submission is to highlight our concerns about the accounting implications of the proposed Act. Through Bill 132 and its proposed *Ontario Fair Hydro Plan Act, 2017* (the proposed Act), the government is planning to provide a 25% price reduction to certain electricity consumers (ratepayers), while at the same time showing no, or minimal, effect on the annual operating results and financial position of the Province.

Legislated accounting prescribed by the proposed Act is designed to produce the following impacts on the Province's consolidated financial statements:

(1) an increase in provincial borrowings for a portion of the debt needed to fund the 25% electricity price reduction;
(2) an increase in the Province's investment in Ontario Power Generation (OPG), funded by provincial borrowings;
(3) no increase in provincial net debt as a result of the offset between (1) and (2) above;
(4) no expense impact on the Province's annual deficit; and
(5) an increase in revenues in the Province's consolidated financial statements from OPG for interest and fees that it received through OPG Trust.

The proposed Act legislates the creation of a deferred asset account in the Independent Electricity System Operator's (IESO) books. This deferral account would track the cost paid to contracted power

[1] This analysis uses information from Bill 132, the Financial Accountability Office of Ontario's Spring 2017 report titled *An Assessment of the Fiscal Impact of the Province's Fair Hydro Plan*, and applicable Canadian Public Sector Accounting Standards as at the date of this submission.

generators in excess of the amount recovered from electricity consumers (ratepayers) for electricity used. Payments to generators are currently being fully recovered from ratepayers on an ongoing basis.

The reduction of ratepayer bills by 25% results in a cash shortfall that will need to be covered by IESO. As a result of the 25% reduction in ratepayer bills, IESO will need a source of cash to pay the contracted power generators in accordance with the terms of their contracts. Potential sources of cash to finance this shortfall could be the sale of an asset, and debt. IESO has no assets to sell with respect to these contracts, as the generating equipment belongs to the third-party power generators, thereby removing the sale of assets as a source for cash. The proposed Act puts in place a debt-financing structure in order to flow cash to IESO, but the financing structure would show no increase in the Province's net debt.

In order to avoid recording an increase in net debt on the Province's consolidated financial statements, the proposed Act will create a legislated asset, representing IESO's cash shortfall. This legislated asset does not meet the definition of an asset under Canadian Public Sector Accounting Standards (PSAS). IESO does not control the future power generation of the third-party generators or the future benefit of the generating equipment past the term of the contracts. Moreover, IESO is not engaging in rate-regulated activities, and the contracts under its administration were never subject to rate regulation.

The proposed Act outlines that the legislated asset will be sold by IESO on a monthly basis to a "financing entity" (which it proposes will be OPG Trust, to be set up in accordance with subsection 22 (2) of the proposed Act) to be created by the "Financial Services Manager" (OPG, as appointed by section 18 of the proposed Act). The asset to be sold is the loss or the cash shortage that IESO will experience as a result of collecting less money from ratepayers through the local distribution companies, while still paying 100% of the amounts owed to the third-party power generators under contract. OPG Trust will purchase the legislated asset on a monthly basis, using cash sourced from a mix of provincial borrowing flowed through OPG, amounts advanced from OPG's debt, and direct borrowing from capital markets.

Proposed Legislated Transaction Structure
Prepared by the Office of the Auditor General of Ontario

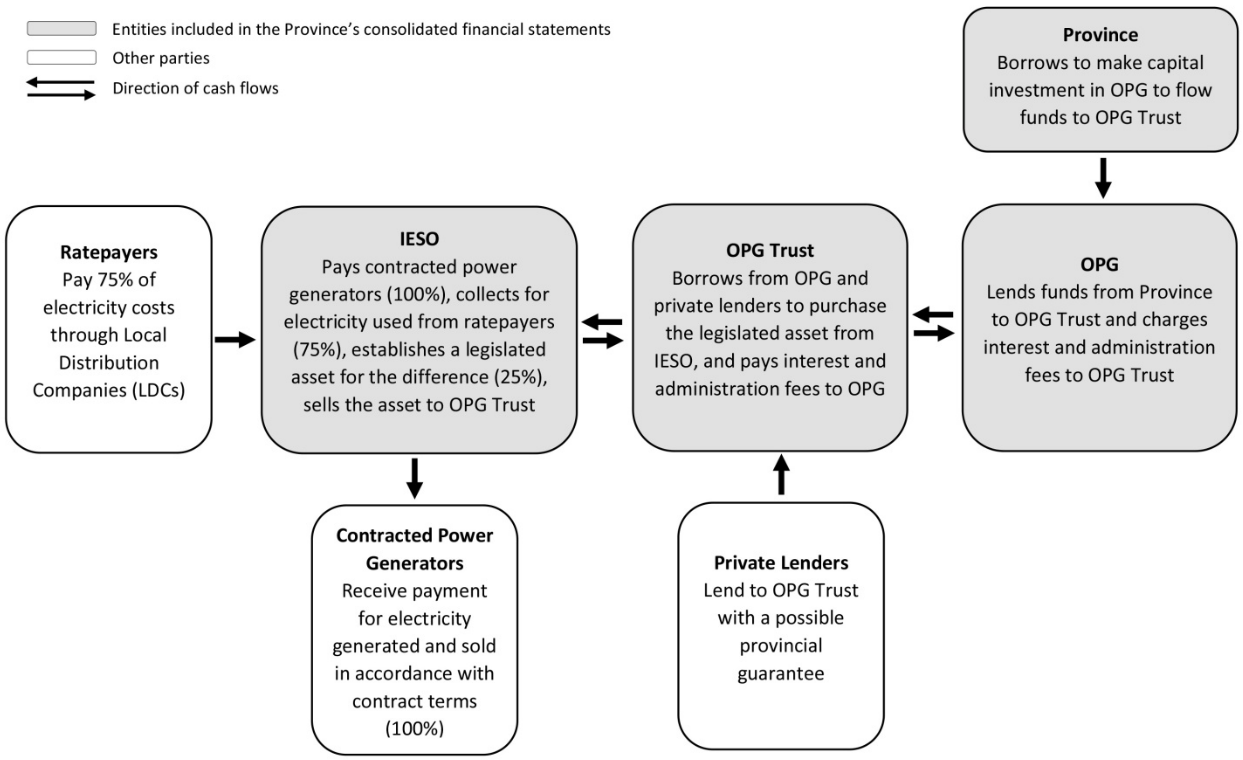

Illustration of Legislated Accounting Prescribed in the Proposed Act

The following illustrates how the proposed legislated accounting would impact the various entities that are included in the Province's consolidated financial statements.

For simplicity, we assume the following:[2]

- Ratepayer bill is \$400, and the related 25% reduction is \$100.
- The Province directly borrows 44%, or \$44, to make an equity contribution to OPG, which OPG then loans to OPG Trust.
- OPG directly borrows 5%, or \$5, and loans it to OPG Trust.
- OPG Trust directly borrows 51%, or \$51, from capital markets.
- OPG controls OPG Trust for accounting purposes.

[2] These assumptions were chosen to make it easier to follow the transaction flow. Actual rates and percentages are yet to be determined.

IESO

IESO pays the contracted power generator $400 for electricity used by the ratepayer, collects $300 from the ratepayer through their local distribution company (LDC), and sets up a legislated asset of $100 for the recovery shortfall. IESO sells the legislated asset to OPG Trust for $100 to obtain cash to make up the shortfall. These amounts net to zero and therefore show no accounting impact for the recovery shortfall on IESO's bottom line once all of the transactions have been settled in cash.

OPG Trust

OPG Trust records $49 ($44 + $5) borrowed from OPG as a "Due to OPG" (loan payable) and $51 borrowed from private lenders as long-term debt. OPG Trust purchases the legislated asset from IESO for $100 and records it as an Intangible Asset. OPG Trust incurs administration fees paid to OPG and interest expense. These costs are added to the Intangible Asset balance.

OPG

OPG records $44 from the Province as an increase in equity and cash. OPG borrows $5 from its credit facilities. OPG lends $49 to OPG Trust and records a loan receivable from OPG Trust. OPG also records administration fee revenue per its agreement with OPG Trust. OPG earns administration fees and interest revenue from OPG Trust and incurs an interest expense.

OPG's Consolidated Results, Including OPG Trust

OPG's consolidated balances reflect an Intangible Asset of $100, a Loans Due to OPG/Loans Due from OPG Trust of $0 (due to intercompany elimination upon consolidation), an Equity increase of $44 from the Province, a Long Term Debt increase of $56, plus income relating to administration fees and net interest earned.

Province's Consolidated Financial Statements

There is no effect on the Province's net debt, as the Province's $44 of debt is offset by the Province's $44 increased investment in OPG. There is no annual expense effect on the Province's surplus or deficit from the consolidation of IESO due to the creation of the legislated asset. This is because the legislated asset closes the gap between the amount IESO pays to third-party power generators and the amount it collects from ratepayers. However, the Province's annual deficit is lowered by the amount of administration fees and net interest revenue earned by OPG.

Illustration Using Canadian Public Sector Accounting Standards

The following illustrates how the application of the Canadian Public Sector Accounting Standards would impact the various entities that are included in the Province's consolidated financial statements.

For simplicity, we make the same assumptions as in the previous section, that is:[3]

- Ratepayer bill is $400, and the related 25% reduction is $100.
- The Province directly borrows 44% to make an equity contribution to OPG, which OPG then loans to OPG Trust
- OPG directly borrows 5% and loans it to OPG Trust.
- OPG Trust directly borrows 51% from capital markets.
- OPG controls OPG Trust for accounting purposes.

IESO

IESO pays the contracted power generator $400 for electricity used by the ratepayer, collects $300 from the ratepayers through their local distribution company (LDC), and records $100 in expenses for the

[3] These assumptions were chosen to make it easier to follow the transaction flow. Actual rates and percentages are yet to be determined.

recovery shortfall. OPG Trust loans IESO $100 to make up the shortfall. IESO records $100 as Due to OPG Trust (loan payable) and shows an annual deficit of $100 resulting from the recovery shortfall.

OPG Trust

OPG Trust records $49 ($44 + $5) borrowed from OPG as a "Due to OPG" (loan payable) and $51 borrowed from private lenders as long-term debt. OPG Trust lends $100 to IESO and records this as a Due from IESO (loan receivable). OPG Trust incurs administration fees paid to OPG and pays an interest expense to OPG and private lenders. These amounts are expensed in OPG Trust's financial statements.

OPG

OPG records $44 from the Province as an increase in equity and cash. OPG borrows $5 from its credit facilities. OPG lends $49 to OPG Trust and records a loan receivable from OPG Trust. OPG also records administration fee revenue per its agreement with OPG Trust. OPG earns administration fees and interest revenue from OPG Trust and incurs an interest expense.

OPG's Consolidated Results, Including OPG Trust

OPG's consolidated balances reflect a "Due from IESO" of $100, a Loans Due to OPG/Loans Due from OPG Trust of $0 (due to intercompany elimination upon consolidation), an Equity increase of $44 from the Province, a Long Term Debt increase of $56, plus income related to administration fees and net interest earned.

Province's Consolidated Financial Statements

The Province's net debt and annual deficit increase by $100 as a result of the consolidation of IESO. This reflects the expenses that IESO incurs from the shortfall between what it collects from the ratepayer through their local distribution company and what it pays to the contracted power generator. It also reflects IESO's loan payable balance for the cash borrowed by IESO from OPG Trust to fund the cash shortfall.

There is no effect on the Province's net debt from the consolidation of OPG. The $44 borrowed directly by the Province to provide equity funding to OPG is offset by a $44 increase to the Province's investment in OPG.

However, flowing provincial cash through a Government Business Enterprise (such as OPG) to lend to an Other Government Organization (such as IESO) is unusual. Under Canadian Public Sector Accounting Standards (PSAS), this flow would result in net debt being $100 higher (comprised of $144 in total debt offset by the Province's $44 investment in OPG) and total debt being $144 higher (comprised of the $100 IESO loan payable to OPG Trust, along with the $44 in provincial debt raised to fund the investment in OPG). Under PSAS, intercompany transactions between the Province and Government Business Enterprises are not eliminated upon consolidation. Therefore, the Province's $44 investment in OPG is not eliminated against the increased $44 equity balance reported in OPG's financial statements. This $44 anomaly will need to be addressed further. In addition, by flowing cash through OPG, the Province's annual deficit is lowered by the amount of administration fees and net interest revenue earned by OPG.

If the Province were to borrow directly, as is generally done, the total debt and net debt increase would be $100. As well, the Province's annual deficit would not be lowered by the amount of administration fees and net interest revenue earned by OPG.

Conclusion

Legislating the accounting treatment of a government policy does not necessarily mean that the impact of the policy decision will be fairly reflected in the Province's consolidated financial statements.

Accordingly, the Office of the Auditor General of Ontario will always provide an audit opinion to the Legislature and the citizens of Ontario based on whether the Province's consolidated financial statements fairly present Ontario's annual results and financial position in accordance with Canadian Public Sector Accounting Standards.