Legislative Assembly of Ontario

Assemblée législative de l'Ontario

AUDI·ALTERAM·PARTEM

STANDING COMMITTEE ON PUBLIC ACCOUNTS

THE FAIR HYDRO PLAN: CONCERNS ABOUT FISCAL TRANSPARENCY, ACCOUNTABILITY AND VALUE FOR MONEY

(2017 SPECIAL REPORT OF THE OFFICE OF THE AUDITOR GENERAL OF ONTARIO)

1st Session, 42nd Parliament
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The Honourable Ted Arnott, MPP
Speaker of the Legislative Assembly

Sir,

Your Standing Committee on Public Accounts has the honour to present its Report and commends it to the House.

Catherine Fife, MPP
Chair of the Committee

Queen's Park
June 2020

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INTRODUCTION

On April 17, 2019, the Standing Committee on Public Accounts held public hearings on the special report (The Fair Hydro Plan: Concerns About Fiscal Transparency, Accountability and Value for Money) on the Fair Hydro Plan led by the Ministry of Energy.

The Committee endorses the Auditor's findings and recommendations, and presents its own findings, views, and recommendations in this report. The Committee requests that the Ministry provide the Clerk of the Committee with written responses to the recommendations within 120 calendar days of the tabling of this report with the Speaker of the Legislative Assembly, unless otherwise specified.

ACKNOWLEDGEMENTS

The Committee extends its appreciation to officials from the Treasury Board Secretariat, Ministry of Finance, Ministry of Energy, Ontario Financing Authority and the Independent Electricity System Operator. The Committee also acknowledges the assistance provided during the hearings and report-writing deliberations by the Office of the Auditor General, the Clerk of the Committee, and staff in the Legislative Research Service.

BACKGROUND

The *Ontario Fair Hydro Plan Act, 2017* made amendments to the *Electricity Act, 1998* and the *Ontario Energy Board Act, 1998*. The Fair Hydro Plan (which includes both aspects of the plan provided for in the Act as well as other policy decisions) implemented a 25% reduction in ratepayers' electricity bills and had three parts:

- a Harmonized Sales Tax (HST) rebate, effective January 1, 2017;
- a transfer of certain electricity relief programs (the Ontario Electricity Support Program and the Rural or Remote Rate Protection program) from electricity ratepayers to taxpayers, effective July 1, 2017; and
- a further 16% reduction of ratepayers' electricity bills for a period of four years, effective July 1, 2017, for which the government planned to borrow cash to pay electricity generators.

UNDERSTANDING THE FAIR HYDRO PLAN

Most residential and small business consumers in Ontario are billed using time-of-use rates. Between 2006 and 2016, the off-peak price for electricity rose from 3.5 cents to 8.7 cents per kWh (kilowatt hour), a 149% increase. A typical residential electricity bill is comprised of electricity charges, delivery and regulatory charges, and sales tax.

Electricity Charge = Electricity Market Price + Global Adjustment

The electricity charge on ratepayer electricity bills is composed of two parts: the electricity market price and the Global Adjustment. The Global Adjustment is added mainly to cover the guaranteed prices paid to contracted power generators in Ontario. The previous government introduced the Fair Hydro Plan (FHP) in 2017 which had several measures that, taken together, proposed to reduce electricity bills for all residential customers by an average of 25%. The majority of this discount was a 16% reduction of the Global Adjustment which would last for four years and gradually be reduced over a further six years, for a total of 10 years of discounts.

However, all of the discount was still owed to power generators. To pay the contracted power generators what they were owed, in 2017 the previous government set up a Fair Hydro Trust (Fair Hydro Trust/OPG Trust) to borrow cash, which was administered by the Ontario Power Generation (OPG). In 2028, after the 10 years of discounts were up, customers would have to pay the full electricity charge as well as the principal and interest accumulated on the borrowed debt of $18.4 billion for a total of $39.4 billion.

Under the *Ontario Fair Hydro Plan Act, 2017* the Independent Electricity System Operator (IESO) called the amount that customers will pay back after 2028 to be a “regulatory asset”. This was a controversial application of an accounting practice called “rate-regulated accounting.” This regulated asset represented the difference between the bills for power generation and the amounts collected from electricity distributors (from ratepayers).

In broad terms, rate-regulated accounting is a form of price control (typically by deferring costs throughout the life of capital assets) imposed by an independent regulator on utilities with natural monopolies, such as electric, gas, and telecommunications. Ontario Power Generation is one such rate-regulated entity in Ontario. Depending on the circumstances, an independent regulator may give a rate-regulated entity the right to charge future consumers for the costs of goods or services incurred in a past period. For example, a power generator, such as OPG, may need to incur significant upfront capital costs (e.g., to build a nuclear power plant) in order to supply power generation many years into the future. In the case of the Fair Hydro Plan, no independent regulator was involved in holding public hearings on decisions to defer costs. The Standing Committee on Public Accounts expressed concern as to why the Ontario Energy Board did not raise this issue or act on it.

The Auditor General determined that the use of what was being publicly labeled as rate-regulated accounting by the IESO was not in accordance with Canadian Public Sector Accounting Standards (PSAS). In 2017 the government of the day had made a policy decision to reduce electricity rates, which would normally be reflected as an expense in the government's consolidated financial statements. In this case, the previous government passed legislation, legislating an accounting treatment which the Auditor General stated was not in accordance with Canadian Public Sector Accounting Standards.

The current government accurately reflected the electricity rate reduction in the 2018 consolidated financial statements. In 2019, the current government introduced and passed the *Fixing the Hydro Mess Act, 2019* which among other things, established a framework under which the costs and benefits associated with specified government policies are allocated among present and future consumers of electricity.

MAIN POINTS OF AUDIT

The audit report (special report) stated the accounting substance of the Fair Hydro Plan was straightforward and transparent in theory, if the transactions had been recorded in the Budget and the Province's consolidated financial statements, in accordance with Canadian Public Sector Accounting Standards (PSAS). However, the audit report noted that the Fair Hydro Plan became more complex in form and costly (e.g., higher borrowing and consulting costs) because of the previous government's implementation of the plan. The audit report indicated that the previous government's direction to senior officials and external advisors was that the Fair Hydro Plan should not show any deficit incurred from the cash shortfall between the amount collected from ratepayers and the amount paid to generators plus the cost of required borrowing for this difference, nor should it add to the amount the government would report as Ontario's net debt.

The audit report highlighted several key concerns regarding the Fair Hydro Plan:

- The previous government created a needlessly complex accounting/financing structure for the electricity rate reduction to avoid showing a deficit or an increase in net debt in its budgets and in the Province's consolidated financial statements.

- From 2028 on, ratepayers would be charged more than the actual cost of the electricity being produced in order to pay back the borrowings. The total borrowings to be repaid would be an estimated $39.4 billion ($18.4 billion borrowed to cover the current rate reduction shortfall and $21 billion in accumulated interest over the term of the borrowings).

- The government's complex accounting/financing structure could result in Ontarians incurring extra interest costs over 30 years that could total up to $4 billion more than necessary.

- The government should apply the same accounting treatment to the debt that will accumulate as a result of the *Fair Hydro Act, 2017* as it did for the electricity sector's stranded debt in 1999/2000.

- The creation of a regulatory asset legislated in the *Fair Hydro Act, 2017* violates the government's own accounting policies that state it follows the Canadian Public Sector Accounting Standards.

- The IESO inappropriately reversed a five-year old transaction to create a regulatory asset in its 2016/17 financial statements. This action and the use of rate-regulated accounting for the first time on its financial statements in that same year was done to set the stage for the accounting needed under the legislated Fair Hydro Plan.

- The 2017/18 Provincial Budget should include the costs of the electricity rate reduction. The 16% reduction is estimated to cost an average of $2.5 billion per year (over 10.5 years) through to 2027.

ISSUES RAISED IN THE AUDIT REPORT AND BEFORE THE COMMITTEE

A number of issues were raised in the audit report (special report) and before the Committee. The Committee considers the issues below to be of particular importance.

The Treasury Board Secretariat told the Committee that the Province has taken a number of steps to address the Auditor General's recommendations in the special report. The Committee heard that the government has adopted Canadian PSAS as proposed by the Auditor General, for the accounting treatment of the Global Adjustment refinancing. The Treasury Board explained that the updated accounting treatment is captured in the 2017-18 public accounts as a $1.8-billion expense related to the Global Adjustment refinancing (under $1.7 billion was deemed a transfer payment to cover the amounts financed by the Fair Hydro Trust/OPG Trust and the remaining $150 million reclassified to expense from the reporting in the IESO).

The Office of the Provincial Controller Division (OPCD) explained that rate-regulated accounting is an accounting concept which allows a regulated entity to recognize an asset for an expenditure made today to be recovered through rates at a later date. The OPCD told the Committee that "Rate-regulated accounting is still used in the accounting for Ontario Power Generation and Ontario Hydro. These organizations are classified as government business enterprises under Public Sector Accounting Standards, which are brought into the consolidated financial statements using International Financial Reporting Standards [IFRS]..." The Auditor General clarified that OPG and Ontario Hydro use IFRS and are brought into the consolidated financial statements in accordance with PSAS.

The Committee voiced concerns about the Ontario Public Service's workplace culture, in particular whether or not public servants felt comfortable expressing their trepidations concerning the Fair Hydro Plan with the government-of-the-day. The Committee heard that public servants' concerns were raised with that government on a regular basis. Representatives from the Ministry of Energy stated that their comments were provided to Cabinet Office through submissions which were direct about the potential risks of the Fair Hydro Plan, including that the implementation of the plan posed risks for the OPG and the IESO. The Ontario Financing Authority told the Committee it also expressed concerns specifically about the cost of borrowing. The Treasury Board stated it was under the impression that there would be note disclosure and information regarding the Fair Hydro Plan provided through the public accounts.

The Ministry of Energy stated that the *Fixing the Hydro Mess Act, 2019* enables the wind-down of the original Global Adjustment refinancing framework (including the reallocation of costs between present and future electricity consumers) and replaces it with a new on-bill rebate as of November 2019. The Ministry said the Act increases transparency around the cost of providing a reduction on electricity bills.

Complex Accounting/Financing Structure of Fair Hydro Plan

The Auditor found that the previous government created a needlessly complex accounting/financing structure for the electricity rate reduction in order to avoid showing a deficit or an increase in net debt in its budgets and the Province's consolidated statements. In particular, the Auditor found that the plan was driven by a mandate to avoid recording an annual deficit and an annual increase in net debt from borrowings.

The Ministry of Energy explained the Global Adjustment refinancing was developed because the previous government was trying to reconcile two competing priorities: a desire for significantly lower electricity rates and meeting its path-to-balance the Budget commitment. The Ministry explained that accomplishing this involved a number of complicated factors including the accounting treatment, whether or not the Fair Hydro Plan was financeable, and the constitutional implications of reallocating the costs to future ratepayers for the lower electricity rates received by current ratepayers.

The Committee asked a number of questions about how to prevent another such complicated accounting design from being created in the future. The Treasury Board stated it continues to follow Canadian Public Sector Accounting Standards which do not permit legislated accounting (prescribing accounting treatments through legislation). The OPCD said the statement of responsibility for the public accounts process clearly sets out the approach and the application of Canadian PSAS.

The Treasury Board explained another preventative measure is cultivating and maintaining a closer relationship with the Auditor General and legislative Officers who have a platform to speak the truth. The Auditor General noted it is important that the OPCD, as well as entities that consolidate into the Province's consolidated financial statements, ensure that there is disclosure and discussion with the Office of the Auditor General.

The OPCD told the Committee it has implemented a number of different initiatives to rebuild the relationship with the Office of the Auditor General centred on disclosure and discussion. For example, when the OPCD seeks the Auditor's formal opinion, it now prepares technical papers which are shared with the Auditor's Office and discussed. Further, the OPCD now requires ministries and agencies to provide advanced notification to the OPCD regarding the hiring of professional services, and that information will be shared with the Office of the Auditor General. As part of the annual assurance process, the OPCD requires ministries to attest to the fact that they have provided that information to the OPCD, Treasury Board, and Auditor General. The Treasury Board added that the updated process has helped to inform decision-makers by introducing information earlier in the decision-making process as opposed to later as was previously the case.

The Committee asked the IESO what preventative accounting and audit practices it has implemented. The IESO acknowledged that rigour and transparency around its accounting decisions needs to be much greater in the future. The IESO explained it has applied lessons learned from an internal review which examined the original decision-making, the results of which have been shared with the IESO Board and senior management. Representatives from the IESO said that the current government's decision to fund the ongoing Fair Hydro Plan from the tax base rather than from ratepayers was critical to its decision to discontinue rate-regulated accounting in September 2018. In 2018, the IESO asked the Office of the Auditor General to audit its 2018 year-end financials and received a "clean opinion."

The Committee asked OFA representatives to clarify Ontario's current borrowing structure to subsidize electricity costs. The Ontario Financing Authority explained that electricity rate mitigation is now part of the government's expenditure plan, which totals $154 billion. The OFA told the Committee that the deficit is approximately $10 billion, meaning that the government is currently borrowing approximately $10 billion to cover expenditures. The OFA clarified that the government's borrowing covers all government expenditures – borrowing to subsidize electricity costs is only one of the many programs that the government has. The Committee heard that the borrowing expenditures will now be a part of the Ministry of Energy's estimates and will be visible on the electricity bills of ratepayers. The Ministry of Energy explained that this move to a structure of rate mitigation more accurately reflects the cost of electricity rate reduction on the provincial books so that taxpayers and ratepayers know the cost of rate reduction since it will be evident on customers' bills.

Committee Recommendations

The Standing Committee on Public Accounts recommends that:

1. **The Treasury Board Secretariat, Office of the Provincial Controller Division, and the Office of the Auditor General must consistently review and implement best practices and must strive to maintain a collegial and productive relationship.**

2. **The Independent Electricity System Operator should continue to adopt the accounting recommendations outlined by the Auditor General in the *2017 Annual Report* to maintain ongoing transparency in its accounting decisions.**

Additional Cost to Ontarians

The audit report (special report) expressed concerns that the Fair Hydro Plan could result in unnecessary costs for Ontarians. The audit report stated that the Financial Accountability Office of Ontario estimated that Ontarians may pay up to $4 billion more in interest expense as a result of the Fair Hydro Plan. The audit report explained this is because the Fair Hydro Trust/OPG Trust pays a higher interest rate than the Province would have had the Province borrowed through the Ontario Financing Authority.

The Committee asked about the consequences of continuing with the Global Adjustment refinancing as it was originally structured and how a more traditional means of borrowing put Ontario in a better financial position. The Ontario Financing Authority explained that the total cost of borrowing is less than it would have been under the original plan. The OFA told the Committee that there were only two debt issuances under the Fair Hydro Trust/OPG Trust which were approximately 40 basis points (0.4 percentage points) higher in cost than what the Province's cost of borrowing would have been. Interest paid to debtholders (people who invested in the debt) will continue to be paid at a rate 40 basis points higher than what the OFA's rate would have been.

The OFA told the Committee that following the decision to replace the original financing structure, the outstanding debt remains. This comprises $900 million in outstanding "senior debt." At 40 basis points, this amounts to $3.6 million a year in extra costs that will be paid every year over a fifteen-year period (until 2033) that would not have been incurred had the government borrowed through the OFA. There is an additional $400 million that will remain outstanding for an additional five years (until 2038).

Committee Recommendation

The Standing Committee on Public Accounts recommends that:

3. **The Ministry of Finance and Ontario Financing Authority must implement measures to ensure that all provincial borrowing is transparent and structured in a way that is the least costly for Ontarians.**

Canadian Public Sector Accounting Standards

The audit report (special report) noted that the Fair Hydro Plan's creation of a regulatory asset violated the government's own accounting policies, developed in accordance with Canadian PSAS. Further, the audit report stated that the Fair Hydro Plan's accounting design failed the Canadian PSAS substance test and the IESO changed its accounting policies from Canadian PSAS in favour of U.S. accounting to avoid showing an impact on net debt.

The Committee asked if the Fair Hydro Plan followed Canadian PSAS. The Treasury Board explained that the Province's consolidated financial statements are prepared in accordance with Canadian PSAS and that the Province will continue to use Canadian PSAS as set by the Public Sector Accounting Board to prepare the public accounts. The Committee heard that when the government is preparing the consolidated financial statements for the public accounts it uses the audited information as received by the controlled organizations. For the Fair Hydro Plan explicitly, the Treasury Board told the Committee it relied on the accounting advice provided by the OPCD and the IESO at the time. It noted that the OPCD had expressed concerns about the accounting in the Fair Hydro Plan.

The Committee asked the IESO why its financial statements were restated five years after the fact, essentially laying the groundwork for the Fair Hydro Plan's rate-regulated accounting. The IESO explained that the Fair Hydro Plan was a catalyst to the decision to restate the financial statements. The IESO told the Committee that the IESO Board sought the advice of its management, including several accounting firms, to examine the applicability of rate-regulated accounting. Based on this, the Board made the decision in early 2017 to retroactively restate the financials to reflect rate-regulated accounting.

Committee Recommendations

The Standing Committee on Public Accounts recommends that:

4. **To prevent the intentional misrepresentation and falsification of financial information resulting in additional costs as occurred with the Fair Hydro Plan in 2017, the Province and the Independent Electricity Systems Operator (IESO) must always follow Canadian Public Sector Accounting Standards. When questions arise on the application of the Standards regarding a particular accounting issue, the Province and the IESO have a duty to consult with the Auditor General of Ontario.**

5. **The Board of any provincial agency seeking indemnification for its activity, must inform the Legislative Assembly of Ontario through the Standing Committee on Government Agencies as well as the Office of the Auditor General of Ontario.**

Government Accepted Risk of Audit Qualification

The Auditor's review of government emails and other documents found that government officials were aware that the Office of the Auditor General was likely to object to keeping the expense impact and net debt impact of the policy decision off the books by legislating rate-regulated accounting. The Auditor stated the government anticipated and accepted this risk rather than follow Canadian PSAS.

Committee Recommendations

The Standing Committee on Public Accounts recommends that:

6. **The Government must always follow and comply with Public Sector Accounting Standards.**

7. **The Government must always release the Public Accounts financial statements accompanied by the Auditor General of Ontario's opinion to ensure Ontario is following Public Sector Accounting Standards.**

CONSOLIDATED LIST OF COMMITTEE RECOMMENDATIONS

1. **The Treasury Board Secretariat, Office of the Provincial Controller Division, and the Office of the Auditor General must consistently review and implement best practices and must strive to maintain a collegial and productive relationship.**

2. **The Independent Electricity System Operator should continue to adopt the accounting recommendations outlined by the Auditor General in the *2017 Annual Report* to maintain ongoing transparency in its accounting decisions.**

3. **The Ministry of Finance and Ontario Financing Authority must implement measures to ensure that all provincial borrowing is transparent and structured in a way that is the least costly for Ontarians.**

4. **To prevent the intentional misrepresentation and falsification of financial information resulting in additional costs as occurred with the Fair Hydro Plan in 2017, the Province and the Independent Electricity Systems Operator (IESO) must always follow Canadian Public Sector Accounting Standards. When questions arise on the application of the Standards regarding a particular accounting issue, the Province and the IESO have a duty to consult with the Auditor General of Ontario.**

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