2018–2019 Consolidated Financial Statements of the Province of Alberta

Auditor General
OF ALBERTA

Report of the Auditor General
November 2019

Introduction

This year, we issued an unqualified (clean) audit opinion on the Province's Consolidated Financial Statements. Based on our work, we have concluded the 2018–2019 financial statements are fairly presented in accordance with Canadian Public Sector Accounting Standards (PSAS). We have prepared this chapter to help readers of the Province's Consolidated Financial Statements understand:

- key items in the financial statements like debt and net debt
- our auditor's report
- key audit matters or items that in our professional judgement were most significant to the audit of the Province's Consolidated Financial Statements like environmental liabilities

Background

The Province's Consolidated Financial Statements account for the full nature and extent of the financial affairs and resources that the government controls. The statements provide a comprehensive view of the revenues that the province earned, its spending on various programs for 2018–2019, and its financial position at March 31, 2019.

The Office of the Controller prepares the Province's Consolidated Financial Statements in accordance with Public Sector Accounting Standards. These standards ensure the financial information is presented fairly and on a comparable basis to prior years and to other governments. The statements include the financial results of all organizations the government controls, such as departments; regulated funds; school boards; and agencies, boards, and commissions, such as Alberta Health Services and ATB Financial.

Under the *Financial Administration Act,* deputy heads of departments are responsible to:

- implement internal controls to ensure appropriate individuals authorize transactions
- ensure transactions comply with applicable legislation and regulations
- ensure transactions are properly recorded in the department's financial systems

Management uses judgement to prepare estimates included in the financial statements. The significant estimates include, for example, income taxes and non-renewable resource revenue.

Effective 2018–2019, the government no longer publishes ministry and department financial statements. Instead, ministry annual reports now include more detailed variance analysis of ministry revenues and expenses, comparing actual results to the budget approved by the legislature and to prior-year results. These amounts in ministry annual reports agree to amounts in the Province's Consolidated Financial Statements. The annual reports also include financial information about significant programs and information required by legislation, such as reporting payments under agreements.

To ensure key information previously contained in ministry and department financial statements is still available, management enhanced the disclosures in the Province's Consolidated Financial Statements. For example, a schedule showing revenues by ministry was added.

Understanding the financial statements

The Province's Consolidated Financial Statements have important information for Albertans and Members of the Legislative Assembly. They tell an important story about the province's financial health. For example:

- Where do the province's revenues come from? What is the degree of uncertainty in estimating some of these revenues, such as income taxes and non-renewable resource revenue?
- How much does the government spend in various areas, like health care, education, and social services?
- How much debt does the province have? How much interest is the province paying? In which currencies is the debt issued?
- How much money has the province committed through contracts with third parties to deliver goods and services to the government?

What is debt, gross debt, net debt and net assets?

The financial statements include important information on debt, gross debt, net debt and net assets. Questions often arise about what these terms mean. On the following page, we explain these terms and factors that readers and decision makers should consider when analyzing the information.

Alberta's Debt, Net Debt and Net Assets as at March 31, 2019

Balance	What it means	What to consider
Debt **$77.8 billion**	This is the money the government borrows and must repay. Government borrows money to pay for programs and capital expenditures and to lend to: • various entities such as cities, towns, villages, and regional airport authorities through the Alberta Capital Finance Authority • entities and farmers in the agriculture sector through the Agriculture Financial Services Corporation The financial statements, Schedule 11, disclose the province's debt.	Debt can be broken down into: • Debt for which the government must raise revenues and surpluses to repay the debt. Government refers to this as "Total debt for the capital and fiscal plans". This totals $59.7 billion. Government must generate enough revenues and surpluses to pay off this debt. Alternatively, government can also "roll-over" the debt when it borrows money again to pay off a debt that has come due. • Debt that government issues to lend the money to various entities, such as cities, towns, villages, regional airport authorities, and entities in the agriculture sector who are required to repay their loans. This totals $18.1 billion. This debt is mostly offset by the loans receivable from the above entities. The loans receivable that are included in Loans and Advances on the statement of financial position with further details in Schedule 9 to the financial statements.
Gross debt **$83 billion**	This is the $77.8 billion in debt described above, plus $5.2 billion of debt of government business enterprises, such as ATB Financial ($3.6 billion), the Balancing Pool ($827 million), and the Alberta Petroleum Marketing Commission ($704 million).	The Department of Treasury Board and Finance issues debt on behalf of these government business enterprises. These entities generate revenues from their commercial operations to pay off the debt.
Net debt **$27.5 billion**	This is the difference between the province's financial assets and liabilities. When the difference is negative, it means that the government must generate future surpluses to pay for past transactions and events (net debt). When the difference is positive, it means the province has financial resources available to pay for future programs and capital expenditures (net financial assets).	Financial assets include endowment investments of $2.6 billion. Entities must maintain endowments in perpetuity, and can only use the income from the endowment investments for specific purposes that donors specify. Post-secondary institutions hold most of the province's endowments.
Net assets **$23.3 billion**	This is the province's net debt plus tangible capital assets and other non-financial assets.	The government often incurs debt to build or buy tangible capital assets. Thus, while there is an increase in debt, there is also often an increase in the province's assets, and the province will use these assets over a long period of time.

Contractual Obligations

Note 6 to the financial statements provides information about the province's contractual obligations. Government enters into contracts with third parties for goods and services. These contracts commit government to future payments when the contracts' terms are satisfied. Contracts can give government cost certainty over the life of the contracts. These contracts usually also carry penalties if government wants to cancel or change them.

Contractual obligations represent a legal obligation of the province to others and will become liabilities in the future when the terms of the contract are met.

	2019	2018
	In millions	
Obligations under operating leases, contracts and programs	$ 19,430	$ 13,210
Obligations under capital leases and public private partnerships		
Operations and maintenance payments	4,073	4,014
Capital payments	312	439
Interest payments	193	273
	$ 24,008	$ 17,936

Contractual obligations do not include:

- contracts that only specify a rate that government will pay but not the minimum amount that it must pay. For example, a contract with consultants may set an hourly rate without a minimum amount. Thus, if no consulting services are provided, then government is not required to pay anything.
- grant agreements for which government determines the amount of funding to provide
- government's obligations for ongoing programs and services, such as healthcare or education, since the government retains full discretion on the level and quality of services

Audit Opinion on 2018–2019 Consolidated Financial Statements

The Office of the Auditor General, under the *Auditor General Act*, is responsible for the annual audit of the Province's Consolidated Financial Statements. The objective of our audit is to provide reasonable assurance that the consolidated financial statements are free of material misstatements.

On June 18, 2019, we issued an unqualified (clean) audit opinion on the Province's Consolidated Financial Statements for the year ended March 31, 2019. A clean audit opinion means that we concluded, based on obtaining sufficient and appropriate audit evidence, that the financial statements are free of material misstatements and are presented fairly in accordance with Public Sector Accounting Standards.

Our audit opinion on the Province's Consolidated Financial Statements provides confidence to readers about the financial statements because we:

- are independent of government
- have a professional obligation to comply with Canadian Auditing Standards when auditing the financial statements

As part of our audit, we are required by Canadian Auditing Standards to:

- understand the entities and business activities included in the Province's Consolidated Financial Statements
- assess the risks of material misstatement
- perform appropriate audit procedures to obtain sufficient and appropriate audit evidence to support our conclusion
- evaluate and conclude whether the Province's Consolidated Financial Statements fairly present the financial position, results of operations, cash flows, and changes in net debt

Key Audit Matters

Our audit of the *2018–2019 Consolidated Statements of the Province of Alberta* focused on the following key risks—or those matters that, in our professional judgement, were of most significance—during our audit:

- Government’s contracts with the North West Redwater Partnership
- Environmental liabilities
- Pension liabilities

Government's Contracts with the North West Redwater Partnership

Overview of Risk

The Alberta Petroleum Marketing Commission (APMC) is a government business enterprise that manages contracts with the North West Redwater Partnership (NWRP) on behalf of the government. The NWRP owns and operates the Sturgeon refinery. The refinery will refine bitumen to produce low-sulfur diesel, among other refined products. The partnership acquired the financing and will own, construct, and operate the refinery. Under a 30-year tolling agreement, once the refinery reaches commercial operation date, APMC will provide 75 per cent of the bitumen, share 75 per cent of the refinery revenue, and pay 75 per cent of the monthly cost of service toll. This toll includes a component for the operating cost of the refinery, NWRP’s debt and debt servicing costs, and equity for financing the refinery.

As at March 31, 2019, the contracts commit the government to $26.7 billion in toll payments over 30 years. APMC has the option to renew the processing agreement for successive five-year terms.

What We Examined

We examined the disclosures within the Province's Consolidated Financial Statements to ensure the nature of the arrangement, including future toll commitments and loans by government to the NWRP, were properly described.

We also audited management’s process to assess whether the unavoidable costs of meeting the obligations under the processing agreement exceed the economic benefits expected to be received (that is, has the contract become onerous). To do this, we examined management’s financial model and the key assumptions used to estimate the net present value of the arrangement.

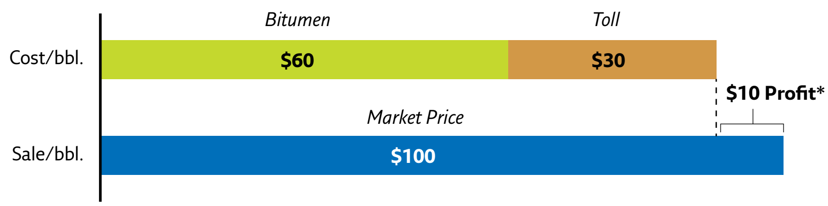
What We Found

We found that the disclosures contained within the Province's Consolidated Financial Statements of the agreements, term loan, and contractual obligation to pay a monthly toll over the 30-year contract terms are reasonable. We also found management's assessment and conclusion that the NWRP processing agreement is not an onerous contract to be reasonable.

Context

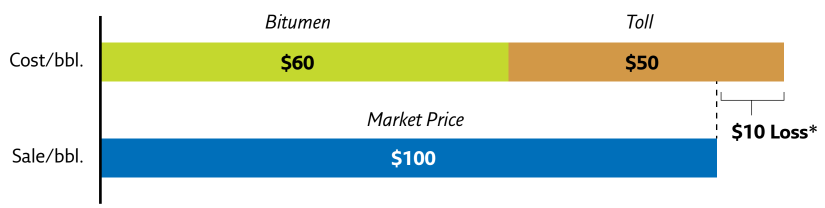
Using an example[1] we illustrate below the financial benefits and risks to the government. The refined product will typically have a higher market value than the bitumen the government supplies to the refinery. For the government to make money, the difference between the market price of refined product and the cost of bitumen (the value-add of the refinery) must be higher than the toll the government is required to pay. However, this potential benefit is uncertain because the market price of refined products and cost of bitumen are hard to forecast. In addition, the debt toll the government is required to pay also increases as the capital cost of the refinery increases.

Refined Product at Profit to Albertans (Benefits)



*The government is entitled to a portion of this profit calculated based on terms of the agreement

Refined Product at Loss to Albertans (Risks)



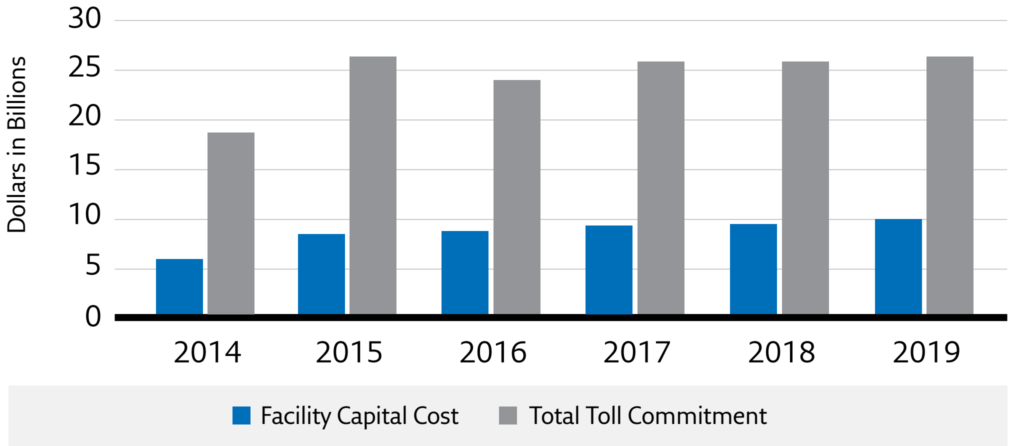
*The government is obligated to pay for 100 per cent of the loss

.

1 Hypothetical numbers used for illustrative purposes

This graph shows the impact that the increases to the capital costs to construct the facility have on the government's commitment to pay the tolls.

Sturgeon Refinery



In 2014, the APMC agreed to provide a loan to NRWP to support funding of the refinery. As at March 31, 2019, APMC borrowed $704 million from the Department of Treasury Board and Finance and advanced the funds to the partnership. At March 31, 2019, the facility capital costs had increased to $9.9 billion from an original estimate of $5.7 billion in 2014. The APMC received a 25 per cent voting right in the decision-making of the partnership as part of the loan agreement. APMC provided the loan to help NWRP maintain a debt-to-equity ratio at 80:20. The NWRP reported[2] that it expects to process bitumen by the end of 2019 and ramp up to full operations at capacity in 2020.

Debt tolls

In accordance with the processing agreement, APMC had to start paying the debt toll effective June 1, 2018, irrespective of whether the refinery operator accepts delivery of or processes bitumen or not. The debt toll covers the debt and debt servicing costs that the NWRP incurs to finance the construction of the refinery. APMC started paying the debt tolls in June 2018 and had paid $261 million by March 31, 2019. APMC expensed these payments in accordance with International Financial Reporting Standards. As the refinery is not yet in operation, APMC has not received any significant revenue, resulting in APMC incurring a net loss for the year.

Until the refinery is operational, APMC will not receive any significant revenue from its arrangement with NWRP but will be required to continue to pay the debt toll.

Onerous contract assessment

The contracts with NWRP entitle APMC to a share of the revenues from the sale of refined products but also require APMC to pay a monthly cost-of-service toll. International Financial Reporting Standards require APMC to determine if the unavoidable costs of meeting the obligations under the processing agreement exceed the economic benefits expected to be received. If the contract is onerous, APMC must record an expense and a corresponding liability in its financial statements to recognize a loss. In subsequent years, APMC will adjust the liability based on future annual assessments.

[2] https://nwrsturgeonrefinery.com/news/behind-the-scenes-status-update/

APMC is using a complex cash-flow valuation model to determine the future economic benefits. The model calculates the net present value (NPV) of cash flows spanning 40 years. The model is inherently complex because the NPV calculation depends on a number of variables, such as crude oil prices (WTI), heavy light differentials, ultra-low-sulphur diesel-WTI premiums, exchange rates, capital and operating costs, interest and discount rates, and the operating performance of the refinery compared to its capacity.

Management determined that at March 31, 2019, the NPV of future cash flows is positive. This means the contract is not onerous and management did not need to record a liability for the contract.

There is significant uncertainty related to this calculation as management needed to apply its professional judgement to predict what will happen over a period of 40 years. For example, what will oil prices be 40 years from now and at what capacity will the refinery operate over the 40 years. It should be recognized that the discount rate used in the calculation compensates for some of this uncertainty.

Environmental Liabilities

Overview of Risk

The province is responsible to clean up contamination on sites that it owns and operates. Government has also accepted responsibility to clean up contamination on orphan sites[3] created by industrial activity over the last century before current environmental laws and standards existed. There are also contaminated orphan sites that exist after the current environmental laws and standards were enacted. The operators of these sites no longer exist. Sites were not always cleaned up and remaining contamination often exceeds current environmental standards.

PSAS[4] require the province to account for the environmental liabilities related to:

- government operations, such as highway maintenance yards, government buildings, or heritage sites like the Turner Valley Gas Plant.
- orphan sites where government accepted responsibility to clean up sites because private operators no longer exist or were unable and unwilling to do the work. Operators are responsible under environmental legislation to clean up and restore their sites. Government may become responsible when:
  - it accepts responsibility when operators no longer exist
  - it inherits responsibility for historical industrial sites that predate current legislation
  - operators are not taking appropriate steps at sites that pose an imminent and unacceptably high risk to humans and the environment. The government would then pursue the operator to recover any costs it incurred.

The government is not directly responsible, nor has it accepted responsibility, for sites of private operators and the orphan wells that the industry funded Orphan Wells Association (OWA) is responsible to clean-up. As a result, the Province's Consolidated Financial Statements appropriately exclude the environmental liabilities of private operators and the OWA.

3 Orphan sites are industrial sites where regulators have exhausted every way to identify a responsible party and hold them accountable to clean up a site but could not do so. This includes sites that government cannot transfer to the Orphan Wells Association because the current orphan levy does not cover these sites, or there is no orphan levy. Orphan sites occur across several industries and include oil and gas wells and facilities, pipelines, coal mines, wood treatment plants, and sand and gravel pits.

4 PS 3200—Liabilities, PS 3260—Liability for contaminated sites, PS 3270—Solid waste landfill closure and post-closure liability, and PS 3300—Contingent liabilities.

What We Examined

We examined government's processes to recognize liabilities in the Province's Consolidated Financial Statements.

What We Found

We found that management's estimates and disclosures of environmental liabilities in the Province's Consolidated Financial Statements are reasonable.

Context

Public Sector Accounting Standards requires management to prepare a best estimate of the costs necessary to remediate and reclaim a site to an appropriate level for its specific use as well as the costs for any post-remediation operations, maintenance, and monitoring activities.

An estimate for a liability to remediate and reclaim sites is not necessarily determinable at a specific point in time. The estimate becomes known over time and over various phases. Specialists first determine the type and extent of contamination, then assess the risks to humans and the environment, and then develop appropriate plans to clean up and restore sites. PSAS recognize this, and thus requires disclosure of the reasons why the province did not record a liability.

Sometimes it is uncertain who is responsible to clean up and restore sites. There may be situations where the government might become responsible to clean up and restore sites in the future. This is contingent on the government determining if there are any private parties it can hold responsible. PSAS requires the province to disclose details about when the responsible party is unknown. This tells readers of the province's financial statements there is a risk that taxpayers may have to pay the costs to clean up and restore certain sites in the future.

Note 7(d) of the Province's Consolidated Financial Statements discloses the liabilities that management recorded and information about the nature and extent of environmental liabilities. It also includes the reasons for not recording a liability on certain sites and where there are sites for which the parties responsible for remediating and reclaiming the sites are unknown.

At March 31, 2019, the province recorded the following environmental liabilities:

- $173 million related to the future remediation and reclamation costs for the Swan Hills treatment plant
- $35 million related to contaminated sites, the most significant balance being $16 million for historical sites like the Turner Valley Gas Plant

Pension Liabilities

Overview of Risk

Public Sector Accounting Standards requires the government to account for its pension liabilities. Estimating pension liabilities involves significant judgement. Schedule 12 to the Province's Consolidated Financial Statements shows government's obligation for each public sector plan.

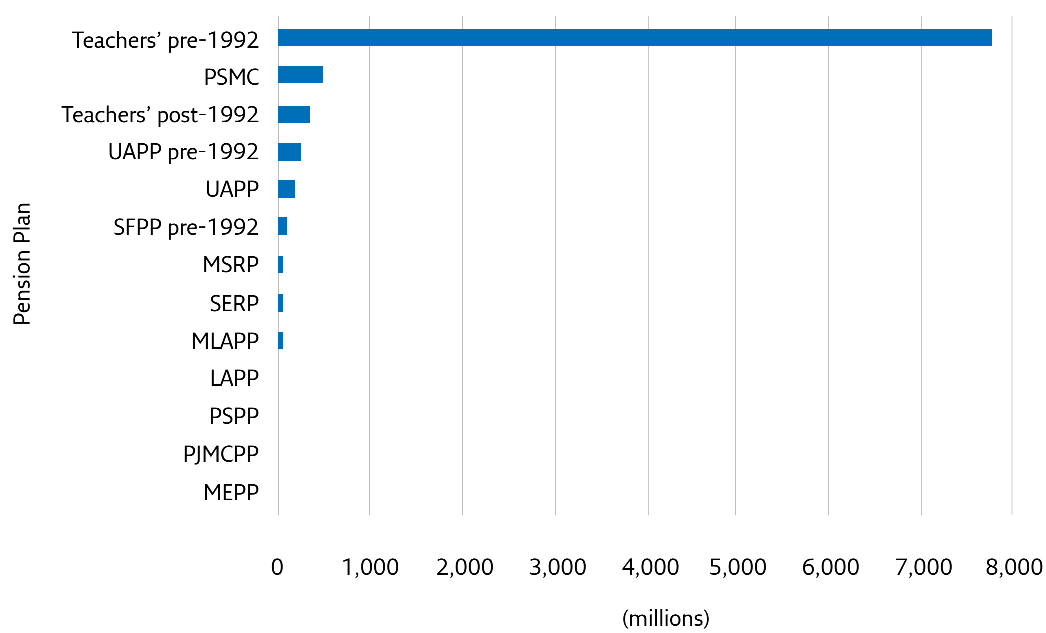
The plans include:

- Local Authority Pension Plan (LAPP)
- Public Sector Pension Plan (PSPP)
- Special Forces Pension Plan (SFPP)
- Management Employee Pension Plan (MEPP)
- Members of the Legislative Assembly Pension Plan (MLAPP)
- Supplementary Retirement Plan for Public Service Managers (MSRP)
- Public Service Management (Closed Membership) Pension Plan (PSMC)
- Provincial Judges and Masters in Chamber Pension Plan (PJMCPP)
- Teachers Retirement Pension Plan (TRP)
- University Academic Pension Plan (UAPP)

At March 31, 2019, the province's liability to pay pension benefits was $9.2 billion. The majority of this balance ($7.7 billion) relates to the government's commitment in 2007 to assume responsibility for the pre-1992 pension obligations to the Teacher's Pension Plan. The government provides monthly payments to the Alberta Teachers Retirement Fund Board to pay these pre-1992 pensions as they become due.

Government also has a liability to pay for certain pension benefits earned before 1992 for PSMC, UAPP, and SFPP. This totals $825 million.

Province's Pension Liabilities



What We Examined

We reviewed independent actuaries' work to estimate the pension obligations, examined management's methodology used to set assumptions for the plans, and performed audit procedures to satisfy ourselves that the assumptions were reasonable. We also audited the valuation of plan investments.

What We Found

We found that the pension liabilities recorded in the Province's Consolidated Financial Statements are reasonable.

Context

As at December 31, 2018, the financial statements of LAPP, PSPP, MEPP, and the PJMCPP show each plan has more assets available than the actuarially determined liability to pay pension benefits. The assets can only be used to provide pension benefits to plan members. The government cannot use or withdraw any surplus funds from the plans, unless the pension boards decide to reduce or suspend the employer contributions to the plan. Thus, the government has not recorded a pension asset for the surpluses in these plans.

Effective March 1, 2019, the Minister of Finance and President of Treasury Board is no longer the trustee for LAPP, PSPP, and SFPP. The Auditor General is also no longer the auditor of these three plans. The respective boards of each plan are now the trustees. The boards are joint-governance boards—meaning the plan employers appoint half of the board members, and employee representatives such as public sector unions and professional associations appoint the other half. This does not change that government, as an employer of these plans, will continue to account for its share of the pension liabilities (if in any year the actuarially determined pension benefits exceeds the pension assets available to pay those benefits).

Similarly, the government accounts for its share of pension liabilities related to UAPP and will do so for MEPP in the future if there are any pension liabilities.