Specifically (see Appendix C):

OESP: the OESP Reg, O. Reg 314/125 S 6, sets out that the IESO shall establish a variance account.

RPP: Section 25.33 (5) of the Electricity Act sets out that the IESO shall establish and maintain such variance accounts as may be necessary. Section 79.16 (3) of the OEB Act, which deals with the commodity price for electricity for low volume consumers, sets out that the Board shall take into account balances in variance accounts established under section 25.33 of the Electricity Act, 1998 and make adjustments with a view to eliminating those balances within 12 months or such shorter time periods as the Minister may direct.

RRRP: The RRRP Reg, O. Reg 442/01 S 5(9), sets out that the IESO shall establish a variance account.

It should be noted that the financial statements of the market accounts have included variance accounts for a number of years before the market accounts were recognized in the IESO's financial statements. These variance accounts, which relate to the RRRP, RPP and OESP costs, met and continue to meet the recognition criteria in ASC 980.

9. The private sector is driven by the generation of profit. In our view, the organization should have been analogized to PSAS first and then to more current standards on the issue.

Because IESO is an OGO, it has a choice between following PSAS or IFRS. IESO has chosen PSAS as the accounting framework it will follow in preparing its financial statements. Since IFRS is designated as an alternative to PSAS for OGOs, we considered whether IFRS needs to be given precedence when applying the PSAS GAAP hierarchy.

As noted in the discussion under issue 3, there are a number of criteria in PS 1150 that should be considered when assessing sources other than the primary source of GAAP. However, there is no hierarchy or ordering of sources set out in PS 1150. Instead, PS 1150 establishes an overall framework for the exercise of professional judgment. In our view, as long as ASC 980 meets the criteria in PS 1150, we believe that it is an acceptable alternative source that may be considered by the IESO in establishing its accounting policy for rate-regulated activities. Different entities reporting under PSAS thus may reasonably choose different paths under PS 1150 when dealing with transactions or events that are not addressed with in the primary source.

Accordingly, we believe that there is no requirement for IESO to consider IFRS as the only alternative source other than the primary source of GAAP in its application of PS 1150.

Paragraph 11 of the *Introduction to Public Sector Accounting Standards ("Introduction")* states:

"These standards apply to all public sector entities that issue general purpose financial statements unless:

(a) specifically directed or permitted to use alternative standards by PSAB, or

(b) limited in applicability as outlined in the individual Sections.

When applying the CPA Canada Public Sector Accounting (PSA) Handbook, where the standards are silent on an issue, public sector entities should apply GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150."

Based on PS 1150.08 (a) and (b), in the absence of a specific source in Canada that provides alternative guidance for the accounting for the economic effects of rate-regulated activities, the management of IESO and we have concluded that a Canadian rate-regulated entity is permitted to use ASC 980 as a source that deals with the specific circumstances is likely to be more relevant than one from which the public sector reporting entity must analogize.

"PS1150.08 *"A public sector reporting entity consults sources other than primary sources of GAAP to assist in selecting accounting policies and disclosures only when these sources comply with paragraph PS 1150.05. The public sector reporting entity evaluates sources in selecting the appropriate accounting policies and disclosures based on all of the following criteria:*

(a) The specificity of the source — A source that deals with the specific circumstances is likely to be more relevant than one from which the public sector reporting entity must analogize.

(b) The authority of the issuer or author — A source issued by an accounting standard setter in its own jurisdiction is likely to be more relevant than a source issued by others in the same jurisdiction."

As noted above, management of the IESO and we believe it is appropriate for the IESO to reference the private sector guidance when applying the GAAP hierarchy as PSAS does not provide detailed guidance on regulatory accounting. It should also be noted that the IESO's activities and mandate, including its regulated activities, are commercial in nature and IESO derives all of its revenue from those activities.

The CPA Handbook, Accounting has two accounting frameworks for commercial oriented organizations: IFRS and ASPE. ASPE defines a rate-regulated entity, provides guidance on certain aspects of the disclosure and presentation of information in the financial statements of rate-regulated entities through AcG 19 *Disclosures by entities subject to rate regulation*, and provides specific guidance under four Sections (3061, 3465, 3475 and 3850). ASPE provides no guidance on the recognition of regulatory assets and liabilities, though in accordance with AcG 19 par. 7 entities must disclose such balances if they are recognized. IASB has not completed their project on rate-regulated activities and current standards only include an interim standard allowing an entity within its scope to continue to account for rate-regulated activities in a manner consistent with its pre-IFRS accounting framework. See the further discussions on Canadian accounting standards at issue 1.

It is important to note that rate-regulated entities that prepare their general purpose financial statements in accordance with ASPE (e.g. the three Fortis subsidiaries in Ontario), as well as those rate-regulated entities that are eligible to elect to apply the requirements of IFRS 14 and elected to do so when they adopted IFRS, generally all recognize the economic effects of rate regulation in accordance with ASC 980, through the GAAP hierarchy in Section 1100 in ASPE and IFRS 14 in IFRS.

The relevance of private sector regulatory accounting principles to a government entity, was also identified in the basis of conclusions for the issuance of FAS 71. Paragraph 64 of the Basis for Conclusions of FAS 71 issued in 1982 noted that a number of U.S. governmental utilities believed that users' emphasis on comparability between investor-owned utilities and governmental utilities supported the continuation of the recognition of the economic effects of rate regulation for governmental utilities. As mentioned earlier, as from 2011 GASB has adopted the guidance of ASC 980 in GASB 62.

> *"A number of governmental utility respondents to the Exposure Draft asked that governmental utilities be included within the scope of this Statement. They noted that many governmental utilities have been guided by the same accounting practices and standards as investor-owned utilities in their general-purpose financial statements, and they expressed the view that users' emphasis on comparability supports continuation of that practice. In their view, the Board's decision not to address governmental utilities in this Statement should not preclude them from applying it. The Board agreed with those respondents and modified paragraph 5(a) so as not to preclude application by governmental utilities with rates set by their own governing board."*

10. While it could have adopted IFRS as an "other government organization", it would be a first-time adopter and does not have a past practice of using rate-regulated accounting so it cannot adopt IFRS 14, Regulatory Deferral Accounts.

We disagree with the above statement as the financial statements for the market accounts have included regulatory assets and liabilities for a number of years.

The IESO's 2016 financial statements included for the first time the assets and liabilities related to the market participants. These assets and liabilities included regulatory assets and liabilities that were also recognized in the market participants' financial statements. These variance accounts, which relate to the RRRP, RPP and OESP programs, met and continue to meet the recognition criteria in ASC 980.

As a result of the inclusion of the market accounts in the IESO's financial statements, which include regulatory assets and liabilities, should the IESO meet the GBE criteria or take the option offered to OGOs to use IFRS, then IESO would then be permitted to adopt IFRS 14 as it also meets the scope criteria in IFRS 14 paragraph 5 as follows:

> *"An entity is permitted to apply the requirements of this Standard in its first IFRS financial statements if and only if:*
>
> *(a) conducts rate-regulated activities; and*
>
> *(b) recognised amounts that qualify as regulatory deferral account balances in its financial statements in accordance with its previous GAAP."*

11. Has IESO been self-sustaining for the past years?

The management of the IESO believes that IESO is a self-sustaining entity. IESO does not have share capital and does not receive transfers or subsidies from the Province of Ontario. Based on management of the IESO, although the IESO currently has a note payable and a credit facility from the OEFC for corporate purposes, the IESO would be able to obtain similar sized facilities from a third-party financial institution. TD Bank had previously provided a corporate line of credit, which was replaced by the current OEFC line of credit. As the OEFC interest rate was lower than TD's, IESO has decided to utilize the OEFC line based on economic considerations. It should also be noted that the IESO currently has third party credit ratings from Moody and DBRS, which provide banks/lenders information on the IESO's creditworthiness status. The following is an extract from the note 7 of the IESO's 2016 annual report:

"Note payable to Ontario Electricity Financial Corporation (OEFC)

In April 2014, the IESO entered into a three-year note payable with the OEFC. The note payable is unsecured, bears interest at a fixed rate of 2.046% per annum and is repayable in full on April 30, 2017. Interest accrues daily and is payable in arrears semi-annually in April and October of each year. As at December 31, 2016, the note payable to the OEFC was $90.0 million (December 31, 2015 – $90.0 million).

For the year ended December 31, 2016, the interest expense on the note payable was $1,841 thousand (2015 – $1,841 thousand).

Credit facility

The IESO has an unsecured credit facility agreement with the OEFC, which will make available to the IESO an amount up to $95.0 million. Advances are payable at a variable interest rate equal to the Province of Ontario's cost of borrowing for a 30-day term plus 0.50% per annum, with draws, repayments and interest payments due monthly. The credit facility expires April 30, 2017. As at December 31, 2016, no amount was drawn on the credit facility (December 31, 2015 – $nil).

For the year ended December 31, 2016, the interest expense on the credit facility was $nil (2015: $279,000)."

We set out below our consideration of the criteria to meet under PSAS for a self-sustaining entity.

PSAS, Section 1300	**Criteria met?**
.30 A government business enterprise should, in the normal course of its operations, be able to maintain its operations and meet its liabilities from revenues received from sources outside of the government reporting entity. These revenues include not only amounts from the sale of goods and services, but also transfers received from other governments or sources outside of the government reporting entity. PS 3410.04 defines government transfers as follows: *"Government transfers are transfers of monetary assets or tangible capital assets from a government to an individual, an organization or another government for which the government making the transfer does not:* *(a) receive any goods or services directly in return, as would occur in a purchase / sale or other exchange transaction;* *(b) expect to be repaid in the future, as would be expected in a loan; or* *(c) expect a direct financial return, as would be expected in an investment."* (Emphasis added)	Met. IESO does not receive government transfer payments, as defined in PS 3410.04, from the Province. All its costs are to be recovered from the customers through the market participants after IESO's budget's review and approval has been obtained from the Ministry of Energy and the OEB. For each credit facility with the OEFC, the IESO has a credit agreement document with commercial term clauses. As noted in the note 7 to the IESO's 2016 annual report, these facilities are subject to repayment terms and provide a direct financial return to the OEFC.
.31 When determining if an organization can maintain its operations and meet its liabilities with revenues received from outside of the government reporting entity, the	

PSAS, Section 1300	Criteria met?
following factors should be considered:	
(a) the organization's history of maintaining its operations and meeting its liabilities;	Met. IESO does not rely on the Province. Similar to all other rate-regulated entities, IESO relies on its ability to recover all its costs from the customers through the market participants.
(b) whether the organization would continue to maintain its operations and meet its liabilities without relying on sales to, or subsidies in cash or kind from, the government reporting entity;	Met. IESO does not receive subsidies in cash or in kind, nor does it sell any goods or services to the Province of Ontario.
(c) past, present and future economic conditions within which the organization operates; and	Met. The FHP allows IESO to recover all its costs incurred related to the FHP from the customers through the market participants.
(d) whether the organization has realistic and specific plans that show how it expects to be able to maintain its operations and meet its liabilities in the future.	Met. The FHP allows IESO to recover all its costs incurred related to the FHP from the customers through the market participants. The variance account related to the FHP will be sold, on a monthly basis, to a Trust to be established by the OPG. Any variance accounts not sold to the Trust, will be kept in the IESO's variance account and be recoverable in the future via OEB approved rate.

12. Are regulatory assets considered intangible assets?

No. There are two fundamental bases for this conclusion.

First, we note that the economic impacts of rate regulation are not recognized under US GAAP as intangible assets since the FASB has specific guidance dealing with this type of asset. An entity that meets the recognition criteria in ASC 980-10-15-2 applies ASC 980, not the intangible assets standard under US GAAP. The guidance in ASC 980-10-15-2 requires an entity to apply ASC 980 in its general-purpose external financial statements if its regulated operations meet all of the following criteria:

"*(a) 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.*

(b) 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.

(c) 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. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."

Since IESO's regulated operations meet the criteria mentioned in 980-10-15-2, it can apply ASC 980. Within ASC 980, there are no references that indicate that the assets recognized under the topic are intangible assets. Furthermore, there are no references in ASC 350 *Intangibles-Goodwill and Other* that indicate that assets recognized under ASC 980 are intangible assets. Within IFRS and Parts II and V of the CPA Handbook, there are no references that indicate that regulatory assets are considered intangible assets.

Second, and following from the discussion and conclusions at issue 7 above, we considered the definitions of financial and non-financial assets under PSAS. An intangible asset would need to be a non-financial asset. The definitions of financial assets and non-financial assets in PS 1000.39 and .42, respectively, are:

*"**Financial assets** are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations."*

*"**Non-financial assets** are acquired, constructed or developed assets that do not normally provide resources to discharge existing liabilities, but instead:*

(a) are normally employed to deliver government services;

(b) may be consumed in the normal course of operations; and

(c) are not for sale in the normal course of operations."

Regulatory assets cannot be consumed in the normal course of operations. However, by virtue of the fact that they represent a financial claim on customers that has arisen due to the fact that the OEB requires the amount to be collected in a future period, a regulatory asset will be used to discharge existing liabilities either to the generators of electricity or the financial institution financing the obligation to the generators of electricity. Therefore, we believe that regulatory assets meet the definition of financial assets under PSAS. This is also supported by PS 1000.42(b), which states that "*a financial asset is any asset that is a realizable asset that is convertible to cash.*"

Although intangible assets are mentioned in PSAS, it does not offer a definition. As mentioned in PS 1150.25 and PS 1000.57 and .58, intangible assets are considered non-financial assets and since PSAS has no appropriate public sector recognition and measurement criteria for their recognition, they are not recognized as assets. The costs, benefits and economic value of regulatory assets can be reasonably and verifiably quantified, as they represent the difference between the amount paid to a supplier for goods or services received and the amount collected from the customers through the market participants.

25. *"Certain non-financial resources are, however, not given accounting recognition as assets in government financial statements. For example, all government intangibles, and all natural resources and Crown lands that have not been purchased by the government, are not given accounting recognition in government financial statements. A government's non-financial assets, as defined in FINANCIAL STATEMENT CONCEPTS, Section PS 1100, comprise the recognized non-financial resources of a government."*

57. *"Purchased natural resources and Crown lands are recognized in government financial statements. However, when natural resources and Crown lands have been inherited by the government in right of the Crown and have not been purchased, they are not given accounting recognition as assets in government financial statements. <u>These items are not recognized as assets because the costs, benefits and economic value of such items cannot be reasonably and verifiably quantified using existing methods.</u> Similarly, art and historic treasures are also not recognized as assets."*

58. *"<u>In the absence of appropriate public sector recognition and measurement criteria for intangibles</u>, all intangibles, including those that have been purchased, developed, constructed or inherited in right of the Crown, are not recognized as assets in government financial statements. The intangible often called "human capital" that embodies the talent or intellectual capital of government employees is not recognized as an asset under existing accounting principles."* (Emphasis added)

It is worth noting that the IASB has an ongoing project on rate-regulated activities and are currently developing an accounting model to provide a principle-based framework for recognizing regulatory assets (see discussion under issue 7 above).

13. Does the IESO meet the first criteria in ASC 980-10-15-2 related to the regulator?

Yes. The criteria for the regulator (i.e. the OEB) is included in the first criteria of ASC 980-10-15-2 which states:

"The enterprise'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."

Although the Basis for Conclusions included in FAS 71 have not been incorporated into the Accounting Standards Codification, they provide useful information for the understanding of the Standard.

Paragraphs 60 to 64 of FAS 71 relate to the scope and, in particular, to the role of the regulator.

"60. The Discussion Memorandum discussed regulation of various industries, and it asked whether a Board pronouncement should identify specific industries that are affected. Most respondents indicated that

applicability of an FASB Statement on rate regulation should be specified by clearly describing the nature of the regulated operations to which it applies rather than by attempting to delineate specific industries. Some noted that changes in the political environment can cause changes in the nature of regulation. Accordingly, whether an industry meets the criteria for applicability might change over time. The Board agreed with those respondents and, accordingly, specified criteria that focus on the nature of regulation rather than on specific industries.

61. This Statement specifies the economic effects that result from the cause-and-effect relationship of costs and revenues in the rate-regulated environment and how those effects are to be accounted for. The nature of those effects led to the criteria for applicability of this Statement (paragraph 5).

62. The first criterion is the existence of third-party regulation. That criterion is intended to exclude contractual arrangements in which the government, or another party that could be viewed as a "regulator," is a party to a contract and is the enterprise's principal customer. For example, the normal Medicare and Medicaid arrangements are excluded from the scope of this Statement because they are contractual-type arrangements between the provider and the governmental agency that is responsible for payment for services provided

63. Some respondents to the Exposure Draft indicated that cooperative utilities should be included in the scope of this Statement. They observed that some cooperative utilities' rates are subject to third-party regulation, but others' rates are set by their own governing board. The governing board is elected by the members of the cooperative, and it has the same authority as an independent, third-party regulator. In their view, the difference between cooperative utilities that are subject to third-party regulation and those that are not does not justify different accounting. The Board agreed with those respondents, and modified the first criterion to include enterprises with rates established by their own governing board providing that board is empowered by statute or by contract to establish rates that bind customers.

64. A number of governmental utility respondents to the Exposure Draft asked that governmental utilities be included within the scope of this Statement. They noted that many governmental utilities have been guided by the same accounting practices and standards as investor-owned utilities in their general-purpose financial statements, and they expressed the view that users' emphasis on comparability supports continuation of that practice. In their view, the Board's decision not to address governmental utilities in this Statement should not preclude them from applying it. The Board agreed with those respondents and modified paragraph 5(a) so as not to preclude application by governmental utilities with rates set by their own governing board."

It is also important to note that both Hydro One and OPG are classified as Government Business Enterprises and are reporting under IFRS in their consolidated financial statements, are consolidated by the modified equity method into the province's books, are regulated by the OEB, and their respective regulatory assets and liabilities are reported in the province's books.

In considering the applicability of this guidance, management of the IESO and we have concluded that the IESO's regulated operations meet the first criteria related to the regulator.

14. Are regulatory assets considered deferred costs under PSAS?

No. The regulatory assets recorded by IESO are not deferred costs. Costs that meet the recognition of an expense are recorded as such, and costs that meet the definition of a tangible capital asset have been recorded as such. A deferral model would have IESO capitalize costs rather than expense or record as other assets. Regulatory assets record an asset based on the right to collect rates in the future.

While IFRS 14 refers to these as "regulatory deferral accounts", they are not consistent or synonymous with what is being discussed by the Framework Task Force or a deferral model. See discussion below related to the conceptual framework under PSAS.

The proposed conceptual framework under PSAS

That being said, even if regulatory assets were considered deferred costs, the concept of deferrals is supported in PSAS under both existing standards and the Board's conceptual framework for future standards. PSAB's conceptual framework Discussion Paper 3, Conceptual Framework Fundamentals and the Reporting Model, indicated that stakeholder feedback "*noted that the asset and liability definitions should allow some deferral/matching, in particular, in relation to transfers received*".

The discussion paper noted that developing a "solid, objective basis for deferring inflows and outflows to future periods" was a key objective influencing stakeholder views on an appropriate financial reporting model, and suggested that deferrals that meet the definitions of assets and liabilities should be allowed.

In support of the conceptual framework, a report from PSAB's Joint Working Group comprised of selected PSAB members and deputy ministers of finance recommended that:

> *"...expansion of the description/definition of liabilities will address liabilities associated with exchange transactions that originate from deferred income which are not currently addressed in the PSA Handbook. Alternatively, if these changes cannot be accommodated, new financial statement elements for deferred inflows and outflows (i.e., deferred revenue/expense) should be considered without recording the deferral directly to accumulated surplus/deficit as a means to avoid impacting the statement of operations."*

Consistent with the principles of the conceptual framework, the concept of deferrals is presently incorporated within certain sections of the PSAS, including:

– ***Development fees accounted for in accordance with Section PS 3100, Restricted Assets and Revenues.***

.11 Externally restricted inflows should be recognized as revenue in a government's financial statements in the period in which the resources are used for the purpose or purposes specified. An externally restricted inflow received before this criterion has been met should be reported as a liability until the resources are used for the purpose or purposes specified.

.12 Income on externally restricted assets may or may not be restricted, depending on the terms of the agreement or legislation. If the provisions of the relevant agreement or legislation require that the income be restricted, then the revenue recognition principle in paragraph PS 3100.11 would apply. For example, governing legislation may stipulate that income on unspent development contributions also has to be used for development. Such income would be recorded as a liability until used for the purpose or purposes specified.

– ***Government transfers meeting the three characteristics of liabilities in accordance with Section PS 3410, Government Transfers and Section PS 3200, Liabilities.***

.19 A transfer with or without eligibility criteria but with stipulations should be recognized by a recipient government as revenue in the period the transfer is authorized and all eligibility criteria have been met, except when and to the extent that the transfer gives rise to an obligation that meets the definition of a liability for the recipient government in accordance with LIABILITIES, Section PS 3200.

.20 The determination under paragraph PS 3410.19 as to whether a liability would arise for a recipient government in relation to a transfer would be influenced by:

(a) the stipulations of the transfer alone; or,

(b) the stipulations of the transfer taken together with the actions and communications of the recipient government before the financial statement date;

and whether either set of circumstances would create an obligation that meets the definition of a liability in LIABILITIES, Section PS 3200. Paragraph PS 3410.08 provides guidance for evaluating the extent to which transfer terms meet the definition of stipulations for the purposes of this Section.

– ***Accounting for retirement and postretirement benefits using an accrued benefit method under PS 3250 and PS 3255***

PS 3250

.022 Accounting for retirement benefits on the basis of employee services reflects the fact that there is no obligation for an employee when hired and that an obligation for retirement benefits exists as the employee renders service. The accounting task is to determine how to attribute the cost of the total retirement benefits promised to each period of employee service.

.023 For defined benefit plans, there are two main groups of actuarial cost methods. They are level cost methods and accrued benefit methods. Under the level cost methods, retirement benefit expenses are computed in such a manner as to produce a total current period benefit cost that remains constant, either in absolute dollars or as a percentage of salary, throughout an employee's service life. However, level cost

methods are not recommended for accounting purposes because they do not reflect the cost of benefits earned by employees to the financial statement date.

.024 Under the accrued benefit methods, a distinct unit of retirement benefit is associated with each year of employee service rendered to the financial statement date. The actuarial present value of that unit of benefit is computed separately for the period during which it accrued. These methods are recommended because they reflect more directly the cost of retirement benefits earned by employees to the financial statement date.

.025 An accrued benefit method should be used to attribute the cost of retirement benefits to the periods of employee service.

PS 3255

.06 Post-employment benefits, compensated absences and termination benefits are liabilities of a government. Accounting for all benefit plans is important because many governments have accumulated significant related liabilities. The fundamental accounting task is to determine the amount of the liability for these benefits and to what periods to attribute the costs.

.24 For a separately measured plan providing post-employment benefits or compensated absences that do not vest or accumulate, a government should recognize any actuarial gain or loss:

(a) immediately, in the period in which it arises; or

(b) over a period linked to the type of benefit.

PSAB's exposure draft on the proposed asset retirement obligation section PS 3280 also incorporates the concept of deferral in the recognition and allocation of asset retirement costs, noting specifically that:

.25 Upon initial recognition of a liability for an asset retirement obligation, a public sector entity should recognize an asset retirement cost by increasing the carrying amount of the related tangible capital asset (or a component thereof) by the same amount as the liability.

.26 <u>The public sector entity should allocate the asset retirement cost to expense in a rational and systematic manner.</u> A rational and systematic manner could include amortization over the remaining useful life of the tangible capital asset (or a component thereof), or some other appropriate period depending on the use of the related asset.

Consequently, PSAS supports deferrals that meet the definition of an asset or liability in accordance with PS 1000, *Financial statement concepts*; PS 3200 *Liabilities*; and PS 3210 *Assets*.

15. Should the transactions related to the market accounts be recorded in IESO's books? If so, should they be recorded on a gross or net basis?

Management of the IESO and we believe that the transactions related to the market accounts should be recorded in IESO's books. Management of the IESO and we believe that the revenue and expenses should be presented on a net basis as IESO is acting as an agent for the market participants, but the assets and liabilities cannot be presented on a net basis and must be presented on a gross basis as they do not meet the netting criteria of 3450 *Financial Instruments* in paragraphs .059 and .066(b).

PS 3450 Financial Instruments

The assets and liabilities relating to the market transactions include cash restricted for the market activities, revolving line of credit, interest receivable and payable, amounts due to and due from market participants, HST receivable, and regulatory assets and liabilities related to the RRRP, RPP and OESP programs regulated by the OEB.

Paragraph 11 of PS 3450 states that *"A government should recognize a financial asset or a financial liability on its statement of financial position when, and only when, a government becomes a party to the contractual provisions of the instrument."*

Paragraph 9 of PS 3450 states that *"A contract establishing a financial instrument creates, at its inception, rights and obligations to receive or deliver economic benefits. The financial assets and financial liabilities portray these rights and obligations in financial statements. The assessment of those benefits is a measurement question and does not affect the timing of recognition. Recognition occurs when a government becomes a party to a financial instrument or non-financial derivative contract."*

Based on the above guidance, since the IESO is responsible for procuring supply, capacity and conservation measures and as the IESO entered into these energy contracts with the generators, management of the IESO and we believe that these contracts meet the definition of financial instruments.

Based on the above guidance, the IESO should recognize these assets and liabilities on the statement of financial position.

Should these assets and liabilities be presented on a gross or net basis? Based on PS 3450, since the counterparties are different and do not realize the asset and settle the liability simultaneously, we believe that these assets and liabilities cannot be presented on a net basis as they do not meet the netting criteria in paragraphs .059 and .066(b).

Paragraph 059 states "A financial asset and a financial liability should be offset and the net amount reported in the statement of financial position when, and only when, a government:

(a) currently has a legally enforceable right to set off the recognized amounts; and

(b) · intends either to settle on a net basis, or to realize the asset and settle the liability simultaneously."

Since the counterparties are different, there are no enforceable right to set off between the counterparties. Paragraph .066 (b) states:

"The conditions set out in paragraph PS 3450.059 are generally not satisfied and offsetting is usually inappropriate when:

(b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure but involve different counterparties."

IFRIC project on Centrally Cleared Client Derivatives

The IFRS Interpretations Committee ("IFRIC") has addressed a similar issue over the past few months. The IFRIC received a request to clarify the accounting for centrally cleared client derivative contracts from the perspective of the clearing member (see Appendix J). The wording for the final agenda decision is as follows:

"The Committee concluded that the clearing member first applies the requirements for financial instruments. More specifically, the Committee observed that:

a) if the transaction(s) results in contracts that are within the scope of IAS 39 Financial Instruments: Recognition and Measurement, then the clearing member applies the recognition requirements in paragraph 14 of IAS 39 to those contracts. The clearing member presents assets and liabilities separately applying IAS 39 in the statement of financial position, unless net presentation is required pursuant to the offsetting requirements in paragraph 42 of IAS 32.

b) If the transaction(s) is not within the scope of IAS 39 and another IFRS Standard does not specifically apply, only then would the clearing member apply the hierarchy in paragraphs 10–12 of IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors to determine an appropriate accounting policy for the transaction(s)."

The circumstances are analogous, the relevant guidance on recognition and netting is consistent between IFRS and PSAS in this respect and so the IFRIC conclusion is consistent with IESO's accounting treatment for the recognition and netting of financial assets and liabilities as a result of entering into contractual arrangements.

14. "An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.

42. A financial asset and a financial liability shall be offset and the net amount presented in the statement of financial position when, and only when, an entity:

a) currently has a legally enforceable right to set off the recognised amounts; and

b) *intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.*

Other ISO entities in North America

7 of the other 8 entities recognize the assets and liabilities of the market participants on a gross basis and their revenue on a net basis (see Appendix F). AESO (previously named Power Pool of Alberta) is the only entity that does not recognize the assets and liabilities of the market participants.

PWC's previous analysis

As the first auditor of IESO, PWC performed in 2003 an accounting analysis as to how the transactions with the market participants should be included in the IESO's financial statements. The accounting analysis was performed under Part V and only addressed the revenue recognition related to the market transactions in the corporate accounts of the IESO (previously named IMO). The IESO's accounting analysis was not updated when PS 3450 *Financial Instruments* was released in 2011. The following is an extract from the PWC report dated February 27, 2003:

> *"The principal source of authoritative literature for Canadian GAAP are the Accounting Recommendations issued by the Accounting Standards Board, as set out in the Handbook of the Canadian Institute of Chartered Accountants (CICA). Where an emerging topic is not addressed in a CICA Handbook Section, the Accounting Standards Board may issue guidance by way of an EIC Abstract. While EIC Abstracts are less authoritative than CICA Handbook Sections, financial statements are expected to be prepared in accordance with such guidance.*
>
> *We made specific reference to CICA Handbook Section 1000 "Elements of Financial Statements" and EIC – 123 "Reporting revenue gross as a principal versus net as an agent". Relevant extracts from this guidance are given below"*

The analysis performed by PWC assessed how the revenue related to the market transactions should be recognized using EIC 123 "*Reporting revenue gross as a principal versus net as an agent" ("EIC 123")*. It should be noted that EIC 123 does not address if, when and how the related receivables and payables should be recognized in the financial statements.

PWC provided its conclusion in the Executive Summary:

> *"We agree with management's position that physical electricity sales and purchases as well as legislated charges and rebates are transactions for the account of market participants which should not be reported in the IMO's corporate financial statements."*

PWC also reviewed the following industry precedents:

> *"We examined the publicly available financial statements of the following similar corporations:*
>
> *Power Pool of Alberta (now called AESO)*
>
> *We reviewed the 2001 Annual Report of this entity. The Power Pool of Alberta recognizes as revenue only the equivalent of the systems fees received by the IMO. The Annual Report and financial statements do not disclose the value of market transactions undertaken through the Power Pool.*
>
> *PJM Interconnection LLC (USA)*
>
> *We reviewed the 2001 Annual Report of this entity. PJM recognizes as revenue only service fees and reimbursements of operating expenses, and not the value of market transactions.*
>
> *Although not recognized in the financial statements, PJM has provided disclosure of the value of settlements processed by the market. This disclosure is given in Management's Discussion & Analysis."*

As a result, PWC concluded that transactions in the market accounts should not be reflected on a gross basis in IESO's profit and loss statement.

We note that PJM's assets and liabilities related to the market transactions are shown on their balance sheet, and the revenue and expenses are shown on a net basis in their consolidated financial statements for a number of years. PJM also recognizes regulatory assets and liabilities.

16. Does ASC 980-10-15-7 (a) forbid the IESO to recognize the economic effects of rate regulation in times of price controls imposed by government?

No, management of the IESO and we believe that the Ontario Fair Hydro Plan, Act 2017 ("FHP") is not a price control and hence is not subject to the scope limitation discussed in ASC 980-10-15-7 (a) (or paragraph 8 of FAS 71) and paragraph 70 of the Basis for Conclusions of FAS 71.

> 980-10-15-7 (a) states *"Accounting for price controls that are imposed by governmental action in times of emergency, high inflation, or other unusual conditions, or accounting for contracts in general. However, if the terms of a contract between an entity and its customer are subject to regulation and the criteria of*

paragraph 980-10-15-2 are met with respect to that contract, the guidance in this Topic shall apply."

Paragraph 70 of the Basis for Conclusions of FAS 71 states *"The first scope limitation of paragraph 8—excluding accounting for price controls imposed by governmental action in times of emergency, high inflation, or other unusual conditions—was included in the Discussion Memorandum. Price controls imposed in periods of unusual conditions are not expected to be applied consistently over an extended period. Indeed, their duration usually is limited by statute. In that environment, assurance of future benefits cannot be provided by probable future actions of the price control regulator because that regulator may not exist at a given future date."* (Emphasis added)

Therefore, there are two issues – first, are such economic events actually "price controls" and, second, if they are not, do such transactions meet the requirements of ASC 980 to be recognized in the regulated entity's general purpose financial statements.

With respect to the first issue, the OEB's rate setting process does not represent "price controls" as such term is intended to be applied in the standard. We note they have not been imposed in times of emergency, high inflation or other unusual conditions. Rather they have been applied in managing the timing of charging cost increases through to customers for the purchase of energy. To conclude that the instant case is one of "price controls" would result in a conclusion that all rate setting processes are "price controls' which clearly is not the case.

With respect to the second issue, and notwithstanding the conclusion on the first, we note that the regulatory actions result in the criteria in ASC 980 for recognition being met.

In accordance with the Legislation for the FHP, certain costs related to the PPAs in place will be deferred and the recovery of those costs will be included in a period other than the period in which the costs would be charged to expense. In fact, the difference between the amounts paid to the generators and the amounts collected from the customers through the market participants will be recorded by the IESO in a pre-approved variance account. The OEB will regulate the timing of the recovery and set the rates to ensure that the IESO can fully recover the variance account relating to the PPA costs. Since the IESO will have certainty as to the recoverability of the variance account relating to the PPA costs, it is not subject to the scope limitation.

The payment by ratepayers for the PPAs are currently subject to Decisions and Orders issued by the OEB. The variance accounts approved by the OEB for the RRRP, RPP and OESP programs have been discussed earlier. The FHP, will create a variance account similar to the RPP and the rate for the recovery of the PPA costs will continue to be set by the OEB to ensure the IESO can fully recover the variance account.

980-10-05-8: *"Unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the GAAP applicable to business entities in general. The mere issuance of an accounting order not tied to rate treatment does not change an entity's economic resources or obligations. In other words, the economic effect of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of GAAP."* (Emphasis added)

17. Why don't other rate-regulated entities under PSAS record the economic impacts of rate regulation?

Since we do not have access to the facts and circumstances related to the rate-regulated entities reporting under PSAS, it is difficult to provide a definitive view. However, as discussed in response to issue 3, it should be noted that it is a choice whether or not to use the GAAP hierarchy under PSAS to apply ASC 980 which may not have been taken by these entities. In addition, as discussed in response to issue 9, different entities reporting under PSAS may reasonably choose different paths under PS 1150 when dealing with transactions or events that are not addressed with in the primary source. Furthermore, in order to recognize the economic effects of rate regulation, these entities must meet the scope criteria in ASC 980-10-15-2, especially (b) which states *"The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products."*

Based on a review of the financial statements of three rate-regulated entities in the Territories (Northwest Territories Hydro Corporation and its subsidiary Northwest Territories Power Corporation and Qulliq Energy Corporation), it is possible that these entities have concluded that they do not meet the criteria in ASC 980-10-15-2 (b) since they have no certainty of recovering their costs of providing services as they receive significant financial assistance from their government.

Northwest Territories Hydro Corporation and its subsidiary Northwest Territories Power Corporation

Extract from note 1.c) of the 2015 Financial statements of both Northwest Territories Hydro Corporation and its subsidiary Northwest Territories Power Corporation.

> *"Economic dependence*
>
> *NTPC has historically been able to maintain its operations and meet its liabilities through the rate regulation process without receiving any significant financial assistance from the GNWT and has been classified as a government business enterprise (GBE). Over the past few years, in order to mitigate rate increases to customers, the GNWT has provided larger increases in subsidization to customers through rates by providing direct contributions to NTPC to apply against those rate increases. As a result of this government driven policy, NTPC is economically dependent on the GNWT to maintain its operations and meet its liabilities. It is expected that the ongoing operations of NTPC will depend on continued financial support from GNWT. This economic dependence resulted in NTPC being classified as an other government organization (OGO), beginning in fiscal 2015. The financial impacts of this change in classification from GBE to OGO are described in Notes 2 and 24."* (Emphasis added)

Qulliq Energy Corporation

Extract from note 1 of the 2015-2016 annual report of Qulliq Energy Corporation.

> *"Economic dependence – The Corporation is economically dependent on the Government of Nunavut which, directly and indirectly, accounts for the majority of the Corporation's sales of power. The Government of Nunavut also guarantees the Corporation's debt."*

The facts and circumstances of IESO are different as IESO does not receive transfers or subsidies from the Province of Ontario to cover its costs. IESO relies on its ability to recover the costs from the customers through the market participants.