

- 1. To Independent Electricity System Operator (IESO), how did IESO come to the conclusion that it was acceptable to use US Generally Accepted Accounting Principles (GAAP) instead of Public Sector Accounting Standards (PSAS) for rate regulated activities?**

And, is there a clause or section of PSAS that permits the use of GAAP in a given scenario?

Response

Independent Electricity System Operator's Approach to Accounting

Peter Gregg:

Thanks for your question. My name is Peter Gregg, I'm the President and CEO of the Independent Electricity System Operator. Before we dive into the accounting policies we follow, it might be helpful for me to provide the committee with an overview of our role and responsibility in Ontario's electricity sector.

The Independent Electricity System Operator is the public agency at the heart of Ontario's electricity system. We have a broad mandate that includes:

- planning to meet Ontario's electricity needs in the near- and long-term;
- reliable operation of the provincial electricity grid;
- administering Ontario's wholesale electricity market;
- fostering a culture of conservation; and in doing all of this
- engaging with stakeholders and communities across the province.

In our role as market administrator, we oversee all wholesale electricity market transactions. Through this market, money is constantly flowing to and from market participants, such as generators, like OPG and distributors, like Toronto Hydro.

As a not-for-profit entity, our role is to efficiently manage and facilitate these market transactions.

This may sound fairly straightforward, but to give you an idea of the value of transactions in our market, last year we settled about 17 billion dollars of financial transactions.

Now I'd like to invite my colleague Kimberly Marshall to address the question you have related to the IESO's accounting policies. Ms. Marshall is the IESO's Chief Financial Officer and Vice President and Corporate Services.

Kim Marshall:

Thanks Peter.

The Independent Electricity System Operator (IESO) follows Public Sector Accounting Standards (PSAS) for its accounting.

The PSAS neither explicitly permits, nor prohibits, the recognition, measurement, presentation or disclosure of rate-regulated activities. In absence of a clear position on an issue, standard accounting practice dictates that an entity is entitled to consult another accounting standard. If I may cite from the PSAS Handbook, Section 1150.18 and 19:

“Paragraphs PS 1150.19-24 identify some of the other sources that a public sector reporting entity might consult to assist in selecting accounting policies and disclosures that comply with paragraph PS 1150.05. Pronouncements issued by other bodies authorized to issue accounting standards may be useful sources to consult.

For example, accounting pronouncements published with the authority of the Canadian Accounting Standards Board (AcSB), International Accounting Standards Board (IASB), US Federal Accounting Standards Advisory Board (FASAB), US Governmental Accounting Standards Board (GASB), or International Public Sector Accounting Standards Board (IPSASB) are often important sources to consult on matters not covered by primary sources of GAAP or for assistance in applying a primary source of GAAP to specific circumstances.”

In this case, IESO consulted US GAAP, the only auditing framework in North America that provides guidance on rate regulated operations. The IESO has since adopted aspects of the US GAAP auditing framework allowing IESO to recognize a regulatory asset.

This decision was supported by an accounting opinion from our external auditors at KPMG and aligns IESO with six of the eight other independent system operators in North America.

It's a decision IESO made after careful consideration and extensive consultation with external experts. In fact, more than one of the big-four accounting firms agree with our decision on this matter. The IESO regularly reviews its accounting policies to ensure our financial reporting best represents our operations and the substance of the accounts we oversee.

Prompted by conversation with government about Ontario's Fair Hydro Plan (OFHP) and recognizing the need to consider impacts of future government policy, IESO revisited its options for reporting market accounts and recognizing regulatory assets.

Working with its audit partner KPMG, IESO determined that there were reporting options for market accounts and regulatory assets and that a choice was required as to whether or not to report these in IESO financial statements.

By analyzing the nature of the accounts, IESO's economic relationship to them, legislative requirements and market rules it was concluded that an appropriate position for either treatment was acceptable.

Organizations in Other Jurisdictions

When we started looking into changes to our accounting policies, we wanted to look at other organizations that have similar mandates to us.

Including IESO, there are 9 independent system operators in North America; seven in the U.S. and two in Canada: The IESO and Alberta's AESO.

We had discussions with these organizations about their operations and accounting practices.

We looked at their location, the accounting framework they follow, the type of organization they are (either not-for-profit or otherwise), whether they are subject to income tax, their capital structure, how they are governed, by which body they are regulated, and finally, whether they recognized balances of market participants and regulatory assets in their financial reporting.

From this research, we found that 7 of the other 8 ISOs recognize the balances of the market participants. They are:

1. **ISO New England;**
2. **NYISO**, in New York;
3. **MISO**, Midcontinent ISO which covers Midwest United States, Manitoba, and much of Arkansas, Mississippi and Louisiana;
4. **PJM**, covering the eastern U.S. states: Delaware, Illinois, Indiana, Kentucky, Maryland, Michigan, New Jersey, North Carolina, Ohio, Pennsylvania, Tennessee, Virginia, West Virginia and the District of Columbia;
5. **CAISO**, in California;
6. **ERCOT**, in Texas; and
7. **Southwest Power Pool**, in central US.

When we talked to our counterparts across North America about regulatory assets, we found out that 6 of the other 8 entities recognize the economic effects of rate regulation, they are:

1. **AESO**, in Alberta;
2. ISO New England;
3. NYISO;
4. MISO;
5. PJM; and
6. ERCOT.

I should mention that the two ISOs that do not recognize the effect of rate regulation are California ISO (CAISO) and Southwest Power Pool (SPP).

When we talked to CAISO, we found out that their accounting framework actually allows for the recognition of regulatory assets and liabilities, but that it had concluded the need to recognize regulatory assets was no longer necessary.

When we talked to Southwest Power Pool, we learned that they simply do not have any variance accounts that would qualify as regulatory assets or liabilities.

So, when we looked at making the accounting change we considered that:

1. Including **market accounts** on our financial statements would provide increased transparency into the value of transactions that flow through Ontario's \$17 billion electricity market;
2. That **regulatory accounting** better reflected the economic substance of certain types of IESO expenses (like Smart Metering Entity expenses) which are recovered through a rate regulated by the OEB;
3. That the change would **enhance the relevance, transparency and accountability of our financial reporting**;
4. That this change would **bring IESO in line with its peers** across North America; and
5. Finally, that this accounting change would in **no way affect IESO's costs, or have any financial impact on electricity ratepayers** – all these factors confirmed our decision to make the accounting change.

Ultimately, IESO felt the public reporting of market accounts was relevant to the needs of its financial statement users and enabled greater transparency into the market transactions it oversees, which amounted to \$17 billion last year.

We also felt that recognizing regulatory assets would provide more transparency into the substance of the variance accounts we oversee.

As we just covered, this change to recognize regulated assets and market accounts brings IESO in line with accounting practices followed by other independent system operators in North America.

I should also mention, that in the past, the Ontario Power Authority, a predecessor organization of IESO, reported a subset of the market accounts on its financial statements – so this isn't new.

Role of an Independent Audit Firm

To confirm our view that the change was appropriate, IESO engaged independent audit firm KPMG for accounting research on the matter.

KPMG conducted its own research into the issue. KPMG subsequently issued a white paper on the accounting change, supporting IESO's decision to change its accounting policy. The changes were also reviewed with and supported by the Office of the Provincial Controller.

The accounting change was reviewed by IESO's Board of Directors, and approved.

As part of our regular 2016 year-end audit, KPMG issued an accounting opinion on our financial reporting. The accounting firm issued an unqualified or "clean" accounting opinion, meaning they supported the decision.

Finally, when publishing our 2016 financial statements, in order to communicate the change of accounting policy, IESO added additional notes in its 2016 financial statements to explain the changes in the Summary of Significant Accounting Policies section of its 2016 annual report.

These changes in no way affect IESO's costs, or have any financial impact on electricity ratepayers.

Ultimately, IESO made these changes because it will provide the users of its financial statements greater transparency into the market transactions it oversees, which amounted to \$17 billion last year, and better reflects the economic substance of IESO expenses that are recovered through rate-regulation.

It is KPMG's responsibility to express an opinion on the financial statements based on their audit.

In our case, KPMG conducted their audit in accordance with Canadian generally accepted accounting standards.

Those accounting standards require that the auditors comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the entity's financial statements are free from material misstatement.

Here are some of the things an audit looks into:

- An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.
- The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.
- In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

In addition, an audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

In IESO's 2016 financial statements, KPMG stated: "We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion".

This was followed by a statement of their unqualified opinion:

- In our opinion, the financial statements present fairly, in all material respects, the financial position of IESO as at December 31, 2016, and its results of operations and the changes in its new debt and its cash flows for the year then ended in accordance with Canadian public sector accounting standards.

This is taken directly from our 2016 financial statements, which are publically available.

So the "unqualified opinion" is basically accounting-speak to say that the audit partner undertook the thorough audit process, applied the appropriate standards and believes the financial statements follow the appropriate accounting standard and fairly and accurately represent IESO's financial position at year-end.

KPMG also found that US GAAP was an appropriate accounting framework to look to for guidance on rate-regulated operations, since PSAS was silent on the issue. And that regulatory assets under ASC 980 is not an exemption from the application of US GAAP.

Finally, KPMG's research also found that the accounting change would bring IESO in line with the majority of its ISO peers across North America.

When we considered the results of our own and KPMG's research, along with the fact that the change would have no impact on IESO's costs, or have any financial impact on electricity ratepayers, we went ahead and made the accounting change.

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