Follow-up questions for Estimates

Q1. In the first session we asked if you could you talk about how the IESO's accounting policy compares to its peers. You said you were looking for trends, and you did some work in terms of how others are defining their rate-regulated assets. Can you elaborate further on this? Did you discuss this method with the other companies who are using it to determine what the overall advantages are?

- Of course. Thanks for the opportunity to revisit this question.
- When we started looking into changes to our accounting policies, we wanted to look at other organizations that have similar mandates to us.
- Including the 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
    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
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 the IESO in line with its peers** across North America; and
  5. Finally, that this accounting change would in **no way affect the IESO's costs, or have any financial impact on electricity ratepayers –** all these factors confirmed our decision to make the accounting change.

Q2. In the first session you stated that "Public Sector Accounting Standards (PSAS) are silent in terms of rate-regulated accounting," which is ultimately what led the IESO in conjunction with KPMG, to look beyond PSAS to US Generally Accepted Accounting Principles (GAAP) in terms rate regulated activities. How did the IESO come to the conclusion that it was acceptable to use GAAP instead of PSAS for rate regulated activities? Is there a clause or section of PSAS that permits the use of GAAP in a given scenario?

- The IESO follows Public Sector Accounting Standards (PSAS) for its accounting.

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

- This decision was supported by an accounting opinion from our external auditors at KPMG and as we've just discussed, aligns the IESO with six of the eight other independent system operators in North America.

- In fact, more than one of the big-four accounting firms agree with our decision on this matter.

Q3. Obviously determining a structure like this requires a lot of comprehensive insight and analysis to ensure that the best interests of Ontario ratepayers are being protected. Who was involved in the decision making process? What experts and outside companies were involved, and is the IESO certain that they left no stone unturned in ensuring the proper accounting process and standards were chosen?

- Definitely. It's a decision we made after careful consideration and extensive consultation with external experts.

- 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 the Fair Hydro Plan and recognizing the need to consider impacts of future government policy, the IESO revisited its options for reporting market accounts and recognizing regulatory assets.
- Working with its audit partner KPMG, the 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 the 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.
- Ultimately, the 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 the 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 the IESO, reported a subset of the market accounts on its financial statements – so this isn't new.
- To confirm our view that the change was appropriate, the IESO engaged independent audit firm KPMG for accounting research on the matter.
- KPMG conducted their own research into the issue.
- KPMG subsequently issued a white paper on the accounting change, supporting the 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 the 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, the 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.
- Now, you asked a question about ensuring the best interests of Ontario rate payers were protected and this is an important point that I want to take the time to address, specifically, because it was a consideration of ours.

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

Q4. You say the IESO received an "unqualified opinion" from its auditor on your 2016 financial statements. What does that mean?

- It is the auditor'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.
- 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.
- **On our 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 the 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 the IESO's financial position at year-end.

Q5. So you received a clean audit on the 2016 financial statements which included regulatory accounting. Why didn't the IESO include these transactions on financial statements prior to 2016?

- The IESO regularly reviews its accounting policies.
- Prompted by a discussion with government about the Fair Hydro Plan, the IESO revisited its options for reporting market accounts and recognizing regulatory assets.
- Working with its auditor, the IESO determined that a choice was required as to whether or not to record Market Accounts and regulatory assets and liabilities in the 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.
- In order to confirm our decision, we asked KPMG to conduct some research on our behalf into the appropriateness of adopting regulated accounting.
- Their research agreed with our view that the recognition of regulatory assets and liabilities better reflects the economic substance of IESO's operations and enhances the relevance, transparency and accountability of its financial reporting.
- It 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 found that the accounting change would bring the IESO in line with the majority of its ISO peers across North America.

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