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The observations relating to accounting matters that EY provided to the OPCD were designed to assist them in reaching their own conclusions and do not constitute our concurrence with or support of the accounting or reporting of the Province or the other entities involved. The Province and the other entities involved are each responsible for the preparation of their own financial statements, including all of the judgments inherent in preparing them.

Introduction

Ontario's consolidated financial reports are prepared in accordance with the accounting principles for governments recommended by the Public Sector Accounting Board (PSAB) of the Chartered Professional Accountants of Canada (CPA Canada). In order to meet the needs of users, including the legislature and the public, for accountability in government reporting and decision making, it is essential that public sector financial statements reflect the economic substance of the government's activities.

In March 2017, the Government of Ontario (the Province) announced its Fair Hydro Plan (FHP). In assessing the appropriate accounting treatment for the Global Adjustment refinancing (GA Refinancing) component of the FHP on Ontario's consolidated financial statements, the Office of the Provincial Controller considered the authoritative guidance issued by PSAB, as well as the accounting assessments of the Independent Electricity System Operator (IESO) and Ontario Power Generation (OPG) management, including the accounting opinions of their external accounting advisors. Given the complexity of the GA Refinancing structure, the exercise of professional judgement is necessary to ensure that key financial reporting objectives of transparency and accountability are best served. This accounting analysis considers currently available information, including efforts underway by the International Accounting Standards Board as related to rate regulated accounting. It also draws upon publicly available information including previous studies and bases for conclusions dealing with rate-regulated accounting, both in the public sector and the private sector.

Background

The FHP will reduce electricity bills for Regulated Price Plan (RPP) customers (as well as those non-RPP consumers who receive the 8% rebate as specified in the Ontario Rebate for Electricity Act, 2016) by approximately 25% for a period of one year, starting in the summer of 2017, and limit the increase in electricity bills to the rate of inflation over the following four years.

Commented [LAP1]: This is my understanding after speaking to Jeannette, but it would be good to reconfirm.

Because distribution rates vary across the province and customers use different amounts of electricity, the goal in calculating the new RPP electricity prices is to achieve a 25% reduction for a "proxy" customer, which is established under the Fair Hydro Act, 2017 (FHP Act) as a residential customer of Toronto Hydro who uses 750 kWh of electricity a month, pays time-of-use RPP electricity prices and has the time-of-use consumption profile of a typical residential customer.

The measures that make up the 25% average reduction include:

1. Spreading the cost of Ontario's clean energy investments over the expected lifecycle of the generation infrastructure assets. This is expected to account for 15-17% of the overall reduction.
2. Shifting the cost of the Ontario Electricity Support Program (OESP) and Rural or Remote Rate Protection (RRRP) program from ratepayers to taxpayer-funded programs.
3. An 8% rebate equal to the provincial portion of the HST, which took effect on January 1, 2017.

Commented [LAP2]: To confirm/correct.

Under the first measure, the Province will borrow funds to pay a portion of current electricity costs, thereby temporarily reducing the amount paid by eligible ratepayers. The deferred amounts, including interest and other costs, will be recoverable from ratepayers through future rates over an estimated 18-

year period starting in approximately 2028. In other words, the impact of #1 above is fully borne by the ratepayers – it is a shift in the timing of payment for the clean energy investments, while the impacts of #2 and #3 are reducing the cost to the ratepayer, but at the cost of the taxpayer.

Objective

The objective of this memo is to assess the impact of the first measure of the FHP (i.e. deferred recovery of clean energy costs) on the consolidated financial statements of the Province. **[NTD – Consider if document should discuss #2 and #3. This would contrast the different treatment by the Province]**

Background

The Ontario Energy Board (OEB) has been established by the Province to be Ontario's independent energy regulator.

In accordance with Section 78(3.1) of the Ontario Energy Board Act, 1998 (the OEB Act), the OEB is responsible for determining electricity commodity prices for RPP consumers. Section 78(3.3) of the OEB Act requires the OEB to forecast the cost of electricity used by RPP consumers and ensure the prices they are charged reflect that cost. The rate setting process is highly complex and involves numerous forecasts and estimates. As a result, the OEB regulatory framework allows for variances between the actual cost of supplying electricity and the amount collected from RPP consumers.

In setting the rates for RPP consumers, Section 78(3.3) of the OEB Act requires the OEB to settle any such variances through rates over a 12-month period. This is achieved through a price adjustment charged or credited to RPP consumers. This adjustment forms part of the Global Adjustment paid by consumers.

The IESO is the administrator of Ontario's wholesale electricity market. The IESO settles the market with all participants, as an agent.

As part of its role as market administrator, the IESO calculates the market price for electricity (the Market Clearing Price, or MCP) by running the bids and offers of the market participants through an algorithm. The actual cost of supplying electricity, however, is greater than the MCP as certain generators are paid additional amounts relating to the cost of clean energy initiatives they have undertaken. From a government policy perspective, decisions as to what is in the best interest of the public regarding electricity generation in Ontario are not based solely on economics, they are also influenced by environmental, social and political factors. Accordingly, generators receive compensation for investing in clean energy infrastructure when it is relatively less economical. In these instances, the IESO (and previously the XXX) entered into contracts to pay the generators the excess costs (plus a reasonable rate of return thereon) over an extended period of time, typically 20 years. The amounts paid to the generators under the terms of these contracts are currently included in the rates set by the OEB (as part of the Global Adjustment) with the intention they will be recovered from consumers in the same period they are paid to the generators. As previously noted, the complexity of the rate setting process results in variances between the amount paid to the generators and the amount collected from RPP consumers.

Under existing legislation, the IESO is required to fund any cash shortfall relating to differences arising between the actual cost of supplying electricity and the amount collected from RPP consumers. In accordance with Section 25.33(5) of the Electricity Act, 1998 (the Electricity Act), the IESO has established and maintains a variance account to track these temporary differences (the original variance account) for subsequent settlement with ratepayers. Cash shortfalls in the IESO arising from the original variance account are funded through financing provided by the OFA.

As described below, once the FHP is implemented, the cost of supplying electricity to RPP consumers that is paid to generators will no longer be fully collected over a 12-month period, but over a longer period defined by legislation.

Commented [LAP3]: Does the legislation define a specific period?

Under the FHP, while generators would continue to be paid over a twenty year period as contracted, the amounts paid by the IESO to the generators would be recovered from ratepayers over a thirty year period. Deferring the recovery of these costs from the consumers on a longer-term basis would create a significant interim cash shortfall for the IESO.

Section 24(1) of the Ontario Fair Hydro Plan Act (the FHP Act) requires the IESO to establish and maintain a variance account (separate from the original variance account described above) to track the cash shortfall specifically resulting from the implementation of the FHP (the FHP variance account). Due to the longer recovery period, and additional recoverable financing and management fee costs, the balance in the account is forecast to increase significantly. The balance in this variance account is defined in Section 1(1) of the FHP Act to be a regulatory asset[1]. The IESO is entitled under Section 25 of the FHP Act to recover the regulatory asset from RPP consumers in the future, which will be achieved through the OEB setting rates to allow for such recovery. Section 26 of the FHP Act also permits the IESO to transfer or sell the regulatory asset to a financing entity to fund its cash shortfall, thus commoditizing the future cash flow stream.

Commented [NPP4]: Confirm consistent with IESO analysis

The Province has requested that OPG administer the deferral of the Global Adjustment under the FHP because of OPG's participation in the market, regulatory knowledge and the potential ability to consolidate the activity and accounting with OPG. To fulfill this role, OPG intends to establish a financing entity (OPG Trust) to purchase the IESO's regulatory asset on a monthly basis and eliminate any cash shortfall in the IESO. Through this arrangement, OPG Trust will finance these purchases through a combination of provincial borrowing (flowed through OPG as an equity investment), amounts advanced from OPG and direct borrowing from capital markets.

Commented [LAP5]: To discuss.

Commented [LAP6]: Diagram to be added.

Basis of Accounting

In accordance with PSAS 1300.07, the government reporting entity (GRE) for the Province comprises government components and those organizations that are controlled by the government.

As defined in the Introduction to PSAS, the following types of organizations are controlled by the government: (a) government business enterprises (GBE), government non-for profit organizations (GNPO), and other government organizations (OGO).

[1] To avoid confusion in the remainder of this document, the term regulatory asset will refer to the defined term in the FHP Act and the term regulated asset or rate-regulated asset (RRA) will refer to an asset recognized for accounting purposes.

GNPOs and OGOs are considered government units and, in accordance with PSAS 1300.27, are consolidated in the GRE on a line-by-line basis. For consolidation purposes, the financial information of government units is required to be prepared in accordance with PSAS.

GBEs, on the other hand, are accounted for in the GRE using the modified equity method as prescribed by PSAS 1300.35. Under the modified equity method, which is described in detail in PSAS 3070, INVESTMENTS IN GOVERNMENT BUSINESS ENTERPRISES, the equity method of accounting is modified only to the extent that the GBE's accounting principles (which are required to be IFRS in accordance with paragraph 17 of the Introduction to PSAS) are not adjusted to conform to those of the government.

As documented in Schedule 8 to the consolidated financial statements of the Province, the IESO is an OGO and OPG is a GBE. The current accounting for these entities is as follows:

		ENTITY STATEMENTS	GRE STATEMENTS	
ENTITY	**CLASSIFICATION**	**GAAP**	**ACCOUNTING METHOD**	**GAAP**
IESO	OGO	PSAS[1]	Consolidation	PSAS
OPG	GBE	US GAAP[2]	Modified equity method	IFRS[3]

1. For purposes of preparing general purpose financial statements, an OGO applies PSAS unless those standards do not meet the needs of its financial statement users. In that situation, IFRS should be considered and the most appropriate set of standards applied.
2. Although a GBE is required to apply IFRS for purposes of preparing general purpose financial statements, the Ontario Securities Commission has approved an exemption that allows OPG to apply US GAAP up to January 1, 2019 for purposes of filing its financial statements with the OSC.
3. OPG applies IFRS 14, which permits it to continue to account for rate-regulated activities using US GAAP guidance for its general purpose financial statements.

This memo does not reconsider the classification of these existing entities.

As discussed in detail in a subsequent section, OPG expects that it will control OPG Trust. If this is the case, OPG Trust will be consolidated by OPG and, therefore, reflected in the GRE through the modified equity accounting of OPG under IFRS. If, however, it is determined that OPG Trust is controlled by the Province, OPG Trust will either (a) be consolidated in the GRE on a line-by-line basis under PSAS if determined to be an OGO, or (b) reflected in the GRE through modified equity accounting under IFRS if determined to be a GBE.

Example

For simplicity, the following example will be used in this document to illustrate the accounting impact of the FHP on the various entities involved:

- Ratepayer bill is currently $588, and the 17% reduction related to the FHP is $100.
- The Province directly borrows 44%, or $44, to make an equity contribution to OPG, which OPG then loans to OPG Trust.
- OPG directly borrows 5%, or $5, and loans it to OPG Trust.
- OPG Trust directly borrows 51%, or $51, from capital markets.

Analysis

IESO

The IESO is presently classified as an OGO and prepares its standalone, general purpose financial statements in accordance with PSAS, which is consistent with the basis of presentation required for purposes of consolidating the IESO into the GRE. Under PSAS, the IESO would also have the option of reporting based on IFRS. If the IESO were classified as a GBE, it would also report based on IFRS. Since the IESO has rate regulated balances, it would likely report using IFRS14, consistent with the IFRS related information provided by both Hydro One and OPG which are rate regulated.

<u>*Current State*</u>

Effective January 1, 2016, the IESO adopted on a retrospective basis a new accounting policy that requires its market-settlement activities to be reflected in the financial statements. Under the new policy, the IESO's financial statements do not include the revenue and expenses of the financial transactions of market participants within the IESO-administered markets. This indicates IESO management has taken the position that the IESO is an agent, not a principal, in the IESO-administered markets and, accordingly, records revenue on a net basis.

Commented [LAP7]: To describe in more detail

PSAS doesn't provide any specific guidance as to how it should be determined whether an entity is acting as a principal or an agent in the context of revenue recognition, but both IFRS and US GAAP do. The relevant guidance in IFRS is as follows:

IAS 18.8

Revenue includes only the gross inflows of economic benefits received and receivable by the entity on its own account. Amounts collected on behalf of third parties such as sales taxes, goods and services taxes and value added taxes are not economic benefits which flow to the entity and do not result in increases in equity. Therefore, they are excluded from revenue. Similarly, in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.

IAS 18.IE21

Determining whether an entity is acting as a principal or as an agent (2009 amendment).

Paragraph 8 states that 'in an agency relationship, the gross inflows of economic benefits include amounts collected on behalf of the principal and which do not result in increases in equity for the entity. The amounts collected on behalf of the principal are not revenue. Instead, revenue is the amount of commission.' Determining whether an entity is acting as a principal or as an agent requires judgement and consideration of all relevant facts and circumstances.

An entity is acting as a principal when it has exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. Features that indicate that an entity is acting as a principal include:

- *a) the entity has the primary responsibility for providing the goods or services to the customer or for fulfilling the order, for example by being responsible for the acceptability of the products or services ordered or purchased by the customer;*
- *b) the entity has inventory risk before or after the customer order, during shipping or on return;*
- *c) the entity has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services; and*
- *d) the entity bears the customer's credit risk for the amount receivable from the customer.*

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or the rendering of services. One feature indicating that an entity is acting as an agent is that the amount the entity earns is predetermined, being either a fixed fee per transaction or a stated percentage of the amount billed to the customer.

Application of the above IFRS guidance supports the conclusion that the IESO is an agent in the market-settlement process and, therefore, recognizing revenue on a net basis is appropriate. IESO has completed a more thorough analysis of their position that it is an agent in the settlement of the market and reconsideration of that decision is not the topic of this memo.

The IESO is required by legislation to carry out its operations without the purpose of gain or profit, making the IESO a self-sustaining entity. Other than the amounts the IESO is permitted to keep in accordance with its own rate order from the OEB to cover its internal operating costs, all amounts the IESO receives from market participants must be paid out to other market participants who have regulatory or contractual rights to receive payments from those collected amounts.

In the context of applying the principal vs. agent guidance, the amounts the IESO is permitted to keep in accordance with its own rate order from the OEB to cover its internal operating costs are recorded as system fee revenue in the IESO's financial statements. System fees are not characterized as being part of the IESO-administered markets. Accordingly, any references to the IESO-administered markets in this document exclude system fees.

As stated in the IESO financial statements, the IESO-administered markets is a balancing system, and as such, the net position of market accounts will ultimately settle to a nil balance in accordance with market rules. However, due to settlement timing differences, the net position of market accounts will not be in a nil position from a cash flow perspective at the end of any reporting period.

Commented [LAP8]: CV - We need to deal with its ability to recover costs and not incur a lost re: the addition of the concept of self-sustaining.

Commented [npp9]: I had understood that the IESO was recovering for costs already incurred vs. pre-collecting.

Commented [LAP10R10]: Is it possible to have the IESO review this memo (or selected excerpts) to confirm accuracy?

Commented [npp11]: IESO earns revenue from outside parties (not within the e GRE except for OPG and then it is at commercial terms). The definition of a GBE does not require independence nor profit, but rather self-sustaining. In fact, a case might be made for the IESO to be accounted for as a GBE.

Commented [LAP12R12]: Based on our conversation, I have not expanded the memo to address whether it can be supported that the IESO is a GBE.

This raises a question as to how a cash flow deficit related to the market-settlement process should be accounted for in the financial statements of the IESO. Two approaches are as follows:

1. The cash flow deficit is recognized as an asset when it occurs and then derecognized in the period in which it is settled. Under this approach, the net position of market accounts will always be in a nil balance in the IESO's balance sheet and there is no impact on the IESO's income statement.
2. The cash flow deficit is recognized as a charge to income when it occurs and then reversed through income in the period in which it is settled.

IESO management has concluded it is appropriate to recognize existing cash flow deficits arising from the market-settlement process as an asset. This is evidenced by the fact the components of the market accounts net to a nil closing balance at year end in the IESO's financial statements for the year ended December 31, 2016. These financial statements also explicitly state there is no impact to the accumulated deficit or revenues and expenses as the IESO is not party to these transactions as per the market rules.

Although the IESO's financial statements include the following accounting policy on regulated assets and liabilities, the asset relating to the cash flow deficit discussed above has not been specifically labeled as a regulated asset:

As a rate-regulated entity, the IESO, in appropriate circumstances establishes regulated assets or liabilities and thereby defers the impact on the statement of operations of certain expenses or revenues because they are probable to be collected or refunded to market participants through future billings. The IESO has applied guidance from United States Generally Accepted Accounting Principles (US GAAP) Topic 980, Regulated Operations, in this policy.

The only two balances specifically labeled as being recognized in the IESO's financial statements under the above policy are (i) unrecovered smart metering expenses, and (ii) unrecovered PSAB transition items. IESO management has, however, indicated in discussions that the cash flow deficit/surplus associated with the original variance account is also considered to be a regulated asset/liability under ASC 980 even though it has been presented as part of the Market Accounts balances in the statement of financial position.

Impact of FHP

The implementation of the FHP results in the IESO establishing and maintaining the FHP variance account to track the resulting cash flow deficit, the balance of which is defined for the purposes of the FHP Act to be a 'regulatory asset'.

The act of legislating the balance in the FHP variance account to be a regulatory asset does not, in and of itself, result in its recognition as an asset for accounting purposes. Accordingly, the primary issue at hand is whether the legislated regulatory asset is eligible for recognition as an asset in both the standalone financial statements of the IESO and the consolidated financial statements of the GRE.

When the standalone financial statements of the IESO are considered in isolation, the impact of the conclusion reached on this issue would be eliminated to the extent the regulatory asset has been sold to OPG Trust by the end of the reporting period. The conclusion remains significant, however, due to its impact on the consolidated financial statements of the GRE, which is discussed in a later section.

Commented [LAP13]: Full excerpt from the IESO statements is as follows:

In addition, as of January 1, 2016, the IESO changed its accounting policy regarding the recognition of market accounts assets and liabilities on the statement of financial position. The change was made to better reflect the assets and liabilities and amounts due to and from market participants held by the IESO on behalf of the IAM at year end. This change has been applied retroactively and has increased amounts previously unrecorded for market accounts assets and liabilities. There is no impact to the accumulated deficit or revenues and expenses as the IESO is not party to these transactions as per the market rules.

Commented [npp14]: Could include reference that this same basis is used by OPG, H1 and many other rate regulated entities in Canada (including those which report based on IFRS14).

Commented [LAP15R15]: Should a section be added to document that not only is the basic PSAS definition of an asset met, the recognition of regulatory assets best meets the users' needs? If so, maybe that is the best place to refer to other entities that are also recognizing regulated assets.

Commented [LAP16]: To discuss.

As noted above, the IESO has adopted a policy to apply the U.S. GAAP guidance in ASC 980 in connection with accounting for rate regulated assets. IESO management has applied this guidance and concluded the regulatory asset created by the FHP can be recognized as a regulated asset for accounting purposes in the financial statements of the IESO. The IESO's auditors, KPMG, concur with this position, as evidenced from the following excerpt from a draft letter issued by KPMG on May 16, 2017 (the KPMG Letter):

We have considered the foregoing analysis and management's conclusion. We concur that the variance account created by Bill 132 will meet the criteria for the recognition of a regulatory asset stated in ASC 980-340-25-1. Furthermore, we have also considered the criteria stated in ASC 980-10-15-2 and believe that IESO should be allowed to continue to use the guidance for regulated operations of Topic 980.

Recognizing the regulatory asset as a regulated asset for accounting purposes in the financial statements of the IESO in accordance with ASC 980 is appropriate only if all of the following conditions are met:

a) the operations of the IESO (or the relevant portion thereof) are within the scope of ASC 980 based on the criteria in ASC 980-10-15-2,
b) the FHP variance account meets the criteria in ASC 980-340-25-1 for capitalization as a regulatory asset, and
c) ASC 980 is an appropriate source of GAAP under PSAS.

Each of these items is addressed in turn:

a) Scope of ASC 980

ASC 980-10-15-2 states the following:

The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that 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. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.
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.

The Office of the Auditor General of Ontario (OAGO) does not believe the IESO meets the criteria to be within the scope of ASC 980. This is evidenced by the following statement included in *Legislated Accounting Included in Bill 132, Including the Proposed Ontario Fair Hydro Plan Act, 2017 – Submission to Standing Committee on Justice Policy* dated May 25, 2017 (OAGO Submission):

Moreover, IESO is not engaging in rate-regulated activities, and the contracts under its administration were never subject to rate regulation.

Commented [NPP17]: Insert ref to GAAP hierarchy.

Commented [LAP18R18]: I haven't added the reference because this doesn't get addressed until (c) below.

Commented [npp19]: The OPA had also accounted for the balances as assets (consistency w.r.t. the CFS treatment).

OPA Accounting Treatment for Regula

Commented [LAP20R20]: To discuss.

Commented [NPP21]: Insert reference to consistency with previous treatment of OPA (2013 Terry Gabriel email).

Commented [LAP22R22]: Is a copy of this e-mail available?

Ontario's electricity industry is rate-regulated. Rates paid by electricity consumers are regulated by the OEB such that over time rates equal cost plus, where applicable, a reasonable rate of return. Providing electricity to consumers involves several different parties, including generators, transmitters, distributors and the IESO. Some of these parties engage in rate-regulated activities, some do not.

The IESO serves an important and active role in Ontario's electricity market, irrespective of the fact that it records market transactions on net basis in the financial statements. The IESO balances the supply of and demand for electricity in Ontario and directs its flow across the province's transmission lines, oversees the wholesale electricity market, where the price of energy is determined, and administers the rules that govern the market. In determining whether the IESO has regulated operations, the focus is on whether the rates the IESO charges its customers are regulated and not whether the costs incurred by the IESO are regulated (although a number of them are).

The following supports the position of IESO management that the above criteria are met and the IESO's operations are within the scope of ASC 980:

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.

As noted in a research paper issued in 2001 by a taskforce established by the CICA (the CICA Research Report), there is a view held by some that, with respect to rate regulation in the public sector, there is usually no *independent, third-party regulator* because the government controls both the enterprise and the regulatory agency. Accordingly, it is important to point out that independence is not required to meet the criteria in ASC 980-10-15-2(a). The requirement is an *independent, third-party regulator* <u>or</u> *its own governing board empowered by statute or contract*. In fact, paragraph 64 of the Basis for Conclusions for FAS 71, ACCOUNTING FOR THE EFFECTS OF CERTAIN TYPES OF REGULATION (which is the pre-codified version of ASC 980), specifically states that the criteria in ASC 980-10-15-2(a) was modified so as not to preclude application by government utilities with rates set by their own governing board.

The OEB has been established by the Province to be Ontario's independent energy regulator and, therefore, is considered the governing board of the IESO. The OEB's mandate and authority come from the *Ontario Energy Board Act, 1998*, the *Electricity Act, 1998*, and a number of other provincial statutes. As described in more detail below, the IESO's rates are established in accordance with these statutes.

In the context of its market-settlement role, the IESO's 'customers' are the Market Participants buying electricity from the IESO-controlled grid. All Market Participants are required to execute a Participation Agreement with the IESO. In accordance with Article 3.1 of the standard Participation Agreement, each Market Participant has agreed to be bound by and to comply with all of the provisions of the Market Rules, which includes the following:

Chapter 9, Section 1.2.3
Notwithstanding any other provision within the market rules, market participants shall remit to the IESO such applicable settlement amounts and other payments as may be required under the relevant provisions of the Electricity Act, 1998, the Ontario Energy Board Act, 1998 and any related regulations, as amended from time to time.

The IESO's operations meet the criteria in ASC 980-10-15-2(a) because the rates charged by the IESO are based on statutes. As discussed in more detail below, the rates are designed to recover the IESO's expenditure for providing the regulated services and the pass-through costs related to the energy purchased from the generators and to government programs.

The main components of invoices issued by the IESO to Market Participants are as follows:

- Commodity Charges
  - Hourly Ontario Energy Price
  - Global Adjustment
- Wholesale Market Service Charges
  - IESO Administration Fee
  - Uplift Charges
  - Rural and Remote Electricity Rate Protection
- Wholesale Transmission Charges
- Debt Retirement Charge

Each component is determined as follows:

<u>Commodity Charges</u>

In accordance with Section 25.33(1) of the Electricity Act, the IESO is required to price electricity to recover costs:

Electricity pricing to reflect costs

IESO to make adjustments

25.33 (1) The IESO shall, through its billing and settlement systems, make adjustments in accordance with the regulations that ensure that, over time, payments by classes of market participants in Ontario that are prescribed by regulation reflect,

a) amounts paid to generators, the Financial Corporation and distributors, whether the amounts are determined under the market rules or under section 78.1, 78.2 or 78.5 of the Ontario Energy Board Act, 1998;

b) amounts paid to entities with whom the IESO has a procurement contract, as determined under the procurement contract; and

c) such amounts as may be prescribed that are paid or incurred by the IESO in relation to the Ontario Fair Hydro Plan Act, 2017*. 2014, c. 7, Sched. 7, s. 8 (1); 2017, c. 16, Sched. 1, s. 43 (2).*

Market Participants are initially invoiced for consumed electricity at the Hourly Ontario Energy Price (HOEP), which is calculated as the average of the twelve market clearing prices set in each hour. In accordance with Section 25.33(5) of the Electricity Act, the IESO is required to track differences between the amounts invoiced to Market Participants at HOEP and actual costs incurred in a variance account:

Variance accounts

(5) The IESO shall establish and maintain such variance accounts as may be necessary to record all amounts payable or receivable by it under this section or under the Ontario Fair Hydro Plan Act, 2017*. 2004, c. 23, Sched. A, s. 37; 2014, c. 7, Sched. 7, s. 8 (5); 2017, c. 16, Sched. 1, s. 43 (5).*

Sections 3.1 and 3.3 of the OEB Act require the variance account to be settled over a twelve-month period, which is done through the Global Adjustment on a Market Participant's invoice:

Annual rate plan and separate rates for situations prescribed by regulation

(3.1) The Board shall, in accordance with rules prescribed by the regulations, approve or fix separate rates for the retailing of electricity,

a) to such different classes of consumers as may be prescribed by the regulations; and

b) for such different situations as may be prescribed by the regulations. 2004, c. 23, Sched. B, s. 14 (1).

Rates to reflect cost of electricity

(3.3) In approving or fixing rates under subsection (3.1),

- *a) the Board shall forecast the cost of electricity to be consumed by the consumers to whom the rates apply, taking into consideration the adjustments required under section 25.33 of the* Electricity Act, 1998 *and shall ensure that the rates reflect these costs; and*
- *b) the Board shall take into account balances in the IESO's variance accounts established under section 25.33 of the* Electricity Act, 1998 *and shall make adjustments with a view to eliminating those balances within 12 months or such shorter time periods as the Minister may direct. 2004, c. 23, Sched. B, s. 14 (1); 2014, c. 7, Sched. 23, s. 6 (2).*

Although the implementation of the FHP involves the deferral of costs over an extended period of time, it does not change the IESO's obligation under the OEB Act to price electricity to recover incurred costs in full. The deferral relating to the FHP is tracked in a separate variance account in accordance with Section 24(1) of the Fair Hydro Plan Act, 2017 (the FHP Act):

Variance account to be established, maintained

24 (1) The IESO shall establish and maintain a variance account in which it records the following:

1. The IESO deferral for each month.

2. All payments received by the IESO resulting from the exercise of the right of recovery under section 25 and any transfer under section 26.

3. Such other adjustments as may be prescribed, including adjustments in respect of the period that commences on or after May 1, 2017 and before the day this section comes into force.

The right for the IESO to recover the variance account is set out in Section 25 of the FHP Act:

Regulatory asset established

25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.

Board to set rates

(2) Subject to subsection (3), the Board shall, from time to time and in accordance with the regulations, determine and set rates payable by specified consumers to allow for the IESO to recover the balance recorded in the variance account.

Limitation

(3) The IESO shall not be entitled to collect all or part of the balance recorded in the variance account from specified consumers before May 1, 2021.

Wholesale Market Service Charges

The IESO charges Market Participants administrative fees to operate the wholesale electricity market and manage the electric power system in Ontario. These fees are required to be approved by the OEB under Section 25(1) of the Electricity Act on an annual basis.

Review of requirements and fees

25 (1) The IESO shall, at least 60 days before the beginning of each fiscal year, submit its proposed expenditure and revenue requirements for the fiscal year and the fees it proposes to charge during the fiscal year to the Board for review, but shall not do so until after the Minister approves the IESO's proposed business plan for the fiscal year under section 24. 2014, c. 7, Sched. 7, s. 3 (1).

Uplift charges

Need details

RRRP charges

Commented [NPP23]: Not sure what these are. Ask IESO?

Commented [LAP24R24]: Uplift charges are comprised of a number of things. Challenge is to summarize succinctly. Would it be possible to ask the IESO to help?

The RRRP program provides a rate subsidy to rural and remote residential customers who face higher distribution costs. Under the FHP Act, the cost of the RRRP program has shifted from ratepayers to provincial revenues and, therefore, is no longer a component of the IESO's invoice. *Wholesale Transmission Charge* This charge to LDCs and some large consumers covers the cost incurred by transmission companies to construct and maintain the high-voltage transmission lines needed to transport electricity from generating stations to LDCs or consumers. In accordance with Section 78(1) of the OEB Act, the rate for this service is approved by the OEB. *Debt Retirement Charge* When the Ontario electricity sector was restructured in April 1999, the Ontario Electricity Financial Corporation (OEFC) took on $20.9 million of stranded debt from Ontario Hydro. The OEFC services and retires the stranded debt with cash flows from a number of sources in the electricity sector, one of those currently being debt retirement charges paid by certain ratepayers (ratepayers cease paying debt retirement charges April 1, 2018). Under Regulation 494/01, DEBT RETIREMENT CHARGE – ADMINISTRATION, the IESO is appointed as a collector of debt retirement charges (Section 2) and is required to collect a debt retirement charge on behalf of the OEFA from every entity who withdraws electricity from the IESO-controlled grid (Section 6(2)). The prescribed rate for the debt retirement charge is set out in Regulation 493/01, DEBT RETIREMENT CHARGE – RATES AND EXEMPTIONS.
The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products.
As discussed in detail above, the IESO is required by statute to set prices to recover costs.
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.
As discussed in detail above, the IESO is required by statute to set prices to recover costs. The majority of the monthly amount invoiced by the IESO to Market Participants represents a direct flow through of costs as they are incurred, but there are certain types of costs for which recovery may be deferred. For those deferred costs, the IESO is dependent on the future consumption of electricity by rate-payers to fully recover costs. Based on relatively short recovery periods, it is reasonable to assume there will be sufficient demand to recover the deferred costs that currently exist. Specifically: • RPP and RRRP variance accounts are recovered over twelve months in accordance with Section 3.3(b) of the OEB Act. *(Note - Under the FHP, responsibility for the cost of the RRRP program is being transferred to the Provincial budget and rate-payers will no longer be directly charged)* • The Smart Metering Entity charge is recovered over the period from May 1, 2013 to October 31, 2018 in accordance with XX.

Commented [LAP25]: CV - I'm not sure that all of these costs have shifted –certainly the new aspect has – there was an RRRP program previously -- we will confirm with Energy

Commented [LAP26]: CV - To determine if there is anything else to add from IESO's analysis.

Also – to confirm whether we want to add any content re: the regulatory

Commented [LAP27]: CV - See previous comment – we will confirm with Energy whether all of the RRRP is transferred or just some of it.

Commented [LAP28]: To add statute reference.

Under the FHP, responsibility for the cost of the OESP program is being transferred to the Provincial budget and rate-payers will no longer be charged for the cost of this program. The OESP variance account, which is currently in a credit balance, will be used to fund the cost of the program until depleted.

Although the timing of the recovery of the FHP variance account has not yet been established by the OEB, the wording and intent of the proposed legislation is clear that it is intended by law to be recoverable over a period of 30 years. Given the nature and extent of customer demand for the power generated and distributed in Ontario, both at this time and projected in the future, it is reasonable to conclude that there will be sufficient demand to recover the regulatory asset. This conclusion, which is supported by Figure 19: Ontario's Forecast Electricity Production in Achieving Balance – Ontario's Long-Term Energy Plan, will need to be continually evaluated throughout the recovery period. The willingness of unrelated third parties to fund the purchase of the regulatory asset from the IESO by OPG Trust also demonstrates the belief that sufficient demand will exist to permit its future recovery.

In addition to the general scope requirements of ASC 980 discussed above, specific consideration is made as to whether the following scope exception in ASC 980-10-15-7 applies to the FHP:

The guidance in the Regulated Operations Topic does not apply to any of the following transactions:

a) 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.

Based on the discussion below, this scope exemption is not applicable to the FHP.

Electricity cost reductions resulting from the FHP do not represent price controls imposed by the Province in a time of emergency, high inflation, or other unusual conditions. As noted in the 2017 budget speech, the 2017 Ontario Budget – A Stronger, Healthier Ontario, the FHP is a fairer way to share the costs of building a cleaner, more modern and reliable electricity generation system. In particular, the budget speech states:

Commented [NPP29]: Navigant report/other support

Commented [LAP30R30]: Is a copy of this report available?

Recognizing that existing electricity infrastructure is expected to last for decades to come, the Province would refinance the cost of those capital investments to ensure that system costs are more equitably distributed over time.

The following paragraph from the Basis for Conclusion for FAS 71 also provides some insight as to the specific concerns relating to government imposed price controls that resulted in the scope exception in ASC 980-10-15-7(a):

70. 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.*

The implementation of the FHP does not create the type of environment described in FAS 71.BC70 as it is governed by the OEB and there is no concern the OEB will not continue to exist.

The second part of the scope exception in ASC 980-10-15-7(a) relating to the accounting for contracts is further explained in the following paragraph from the Basis for Conclusion for FAS 71:

71. Accounting for contracts in general was also excluded from the scope of the Discussion Memorandum. The economic effects of cost reimbursement contracts are in some respects similar to the economic effects of the type of regulation addressed by this Statement. However, most contracts tend to be relatively short-term, whereas regulation of enterprises covered by this Statement is expected to continue beyond the foreseeable future. The Board noted that other authoritative literature addresses contract accounting and concluded that it should exclude the general issue of contract accounting from the scope of this Statement.

Although the impetus for the FHP relates to term of contracts the IESO has entered into with certain generators, the FHP does not change the existing accounting for these contracts.

Application of ASC 980-340-25-1 to the regulatory asset

ASC 980-340-25-1 states the following:

Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

a) It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

A cost that does not meet these asset recognition criteria at the date the cost is incurred shall be recognized as a regulatory asset when it does meet those criteria at a later date.

The following supports the IESO's position that the FHP variance account meets the above criteria for capitalization:

It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.
The following excerpts from the FHP Act make it clear that the IESO is entitled to recover the regulatory asset through rates in the future: *Variance account to be established, maintained* *24 (1) The IESO shall establish and maintain a variance account in which it records the following:* *1. The IESO deferral for each month.*

2. All payments received by the IESO resulting from the exercise of the right of recovery under section 25 and any transfer under section 26. *3. Such other adjustments as may be prescribed, including adjustments in respect of the period that commences on or after May 1, 2017 and before the day this section comes into force.* *Recording determinative* *(2) Subject to the correction of any obvious error by the IESO, its recording of the balance in the variance account is determinative of the balance as of the time of the recording.* *Regulatory asset established* *25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.* *Board to set rates* *(2) Subject to subsection (3), the Board shall, from time to time and in accordance with the regulations, determine and set rates payable by specified consumers to allow for the IESO to recover the balance recorded in the variance account.* *Limitation* *(3) The IESO shall not be entitled to collect all or part of the balance recorded in the variance account from specified consumers before May 1, 2021.* The recovery of the regulatory asset is, however, dependent on future consumption of electricity by rate-payers. Although the timing of the recovery of the regulatory asset has not yet been established by statute, the recovery period is intended to be 30 years. Given the nature and extent of customer demand for the power generated and distributed in Ontario, both at this time and projected in the future, it is reasonable to conclude that it is probable there will be sufficient demand in the future to recover the regulatory asset. This conclusion, which is supported by Figure 19: Ontario's Forecast Electricity Production in Achieving Balance – Ontario's Long-Term Energy Plan, will need to be continually evaluated throughout the recovery period. The willingness of unrelated third parties (e.g., investors) to fund the purchase of the regulatory asset from the IESO by OPG Trust also demonstrates the belief that sufficient demand will exist to permit its future recovery.
Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.
Based on the above excerpts from the FHP Act, it is clear the IESO will be recovering costs previously incurred rather than providing for expected levels of similar future costs.

Commented [LAP31]: To determine if included as exhibit.

***ASC 980 is an acceptable source of guidance under PSAS*[2]**

In assessing whether ASC 980-340-25-1 is an acceptable source of guidance under PSAS, Paragraph 5 of PSAS 1150, GENERALLY ACCEPTED ACCOUNTED PRINCIPLES, states the following:

When the primary sources of GAAP do not deal with the accounting and reporting in financial statements of transactions or events encountered by the public sector reporting entity, or additional guidance is needed to apply a primary source to specific circumstances, the selection of an appropriate accounting

[2] If the accounting for GBEs were to change in the future such that line by line consolidation is required using PSAS, the importance of this consideration increases significantly.

policy requires the exercise of professional judgment. In these circumstances, a public sector reporting entity should adopt accounting policies and disclosures that are consistent with:

a) *the primary sources of GAAP; and*
b) *the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section PS 1000.*

Related guidance is also provided in PSAS 1150.18-.20:

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.

When a public sector reporting entity chooses to consult a source described in paragraph PS 1150.19, it applies professional judgment and evaluates the source in the context of the relative manner in which the standard setter requires its pronouncements to be applied, as well as in the context of the related pronouncement. When an accounting standard setter does not have a conceptual framework that is similar to the concepts referred to in paragraph PS 1150.05(b), the public sector reporting entity needs to ensure that the selected source is consistent with those concepts.

Since PSAS does not specifically address the treatment of costs incurred that will be recovered through regulatory operations in future periods, the IESO would not be precluded from following the guidance in ASC 980-340-25-1. However, PSAS 1000.05 makes it clear that in order to do so, it must first be demonstrated that such guidance is consistent with the application of the concepts described in PSAS 1000, FINANCIAL STATEMENT CONCEPTS.

The relevant guidance in PSAS 1000 relating to the recognition of an asset is as follows:

PSAS 1000.35

Assets are economic resources controlled by a government as a result of past transactions or events and from which future economic benefits are expected to be obtained.

PSAS 1000.36

Assets have three essential characteristics:

a) *they embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows;*
b) *the public sector entity can control the economic resource and access to the future economic benefits; and*
c) *the transaction or event giving rise to the public sector entity's control has already occurred.*

Commented [npp32]: Economic inflows will be generated through rates, not taxes. Not reflecting the RRA on the books of the government would distort the relevance of the financial reports of the Province.

Commented [LAP33R33]: As mentioned above, should a section be added to document that not only is the basic PSAS definition of an asset met, the recognition of regulatory assets best meets the users' needs?

PSAS 1000.37

An item is not an asset of a government if it lacks one or more of the essential characteristics listed in the preceding paragraph. Thus, for example, an item does not qualify as an asset of a government if the item involves:

a) no future economic benefit;
b) future economic benefit, but the government cannot obtain it; or
c) future economic benefit that the government may obtain, but the events or circumstances that give the government control of the benefit have not yet occurred

The following supports the IESO's position that the regulatory asset possesses the three essential characteristics of an asset:

Embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows
The following excerpts from the FHP Act make it clear that the IESO is entitled to recover the regulatory asset through rates in the future: *Variance account to be established, maintained* *24 (1) The IESO shall establish and maintain a variance account in which it records the following:* *1. The IESO deferral for each month.* *2. All payments received by the IESO resulting from the exercise of the right of recovery under section 25 and any transfer under section 26.* *3. Such other adjustments as may be prescribed, including adjustments in respect of the period that commences on or after May 1, 2017 and before the day this section comes into force.* *Recording determinative* *(2) Subject to the correction of any obvious error by the IESO, its recording of the balance in the variance account is determinative of the balance as of the time of the recording.* *Regulatory asset established* *25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.* *Board to set rates* *(2) Subject to subsection (3), the Board shall, from time to time and in accordance with the regulations, determine and set rates payable by specified consumers to allow for the IESO to recover the balance recorded in the variance account.* *Limitation* *(3) The IESO shall not be entitled to collect all or part of the balance recorded in the variance account from specified consumers before May 1, 2021.* Accordingly, the regulatory asset, by statute, has the capacity to provide future cash inflows. While perhaps obvious, paragraph 13 of PSAS 3210, ASSETS, confirms the generation of future cash flows represents a future economic benefit: *The future economic benefits embodied in an asset may also be in the form of generating future cash inflows. Cash inflows benefit the public sector entity because cash can be used to purchase or to provide goods and services, redistribute wealth or settle liabilities. Benefits in the form of cash inflows relate to resources, such as loans receivable, inventory for resale and portfolio investments. Also, some public sector resources generate cash inflows because they have user fees associated with them.* The ability of the regulatory asset to generate future cash flows is dependent on the future consumption of electricity by rate-payers. Although the timing of the recovery of the regulatory asset

Commented [npp34]: Similarly the Y2K report concluded that the RRA/Ls met the definitions of assets and liabilities.

Commented [LAP35R35]: I included this later on.

has not yet been established by statute, the recovery period is intended to be 30 years. Given the nature and extent of customer demand for the power generated and distributed in Ontario, both at this time and projected in the future, sufficient demand is expected to exist in the future to recover the regulatory asset. This conclusion, which is supported by Figure 19: Ontario's Forecast Electricity Production in Achieving Balance – Ontario's Long-Term Energy Plan, will need to be continually evaluated throughout the recovery period. The willingness of unrelated third parties to fund the purchase of the regulatory asset from the IESO by OPG Trust also demonstrates the belief that sufficient demand will exist to permit its future recovery.

Commented [LAP36]: CV - Are there other examples to provide as analogies – anything in tangible capital assets?

The public sector entity can control the economic resource and access to the future economic benefits

Paragraph 16 of PSAS 3210, ASSETS, states the following:

A public sector entity controls the economic resource and access to the future economic benefits when it:

- *a) can benefit from the economic resource through its capacity to provide goods and services, to provide future cash inflows or to reduce cash outflows;*
- *b) can deny or regulate access to those benefits by others; and*
- *c) is exposed to the risks associated with the economic resource.*

The IESO can benefit from the regulatory asset through its capacity to provide future cash inflows in one of two ways:

1. *Collection through future rates*

Section 25 of the FHP gives the IESO the right to recover the regulatory asset through future rates:

Regulatory asset established

25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.

Board to set rates

(2) Subject to subsection (3), the Board shall, from time to time and in accordance with the regulations, determine and set rates payable by specified consumers to allow for the IESO to recover the balance recorded in the variance account.

2. *Sale to a financing entity*

Section 26 of the FHP Act permits the IESO to sell the regulatory asset:

26 (1) The IESO may from time to time, in accordance with this Act and the regulations, transfer a specified portion of the regulatory asset to a financing entity in accordance with this section.

Agreement

(2) An agreement between the IESO and a financing entity in relation to the transfer of a specified portion of the regulatory asset shall provide for consideration of a payment by the financing entity to the IESO in an amount equal to the amount of the specified portion.

Effect of payment

(3) Upon receipt by the IESO of the payment by the financing entity,

(a) the balance in the variance account shall be reduced by the amount of the payment;

(b) the regulatory asset shall be adjusted accordingly;

(c) the financing entity shall acquire a corresponding investment interest; and

(d) the IESO shall retain no further right, title or interest in the corresponding investment interest.

Since (a) the statutory right to recover the regulatory asset belongs solely to the IESO, and (b) the IESO is permitted, but not required, to sell the regulatory asset, the IESO can deny or regulate access to the future economic benefits of the regulatory asset by others.

The IESO is exposed to the risks associated with the regulatory asset, with the primary risk being that collection through the mechanism set out in Section 25 of the FHP Act is dependent on the future consumption of electricity by rate-payers.

The above analysis supports the position that the IESO controls the regulatory asset and access to the future economic benefits.

In reaching this conclusion, consideration was given to the following excerpt included on Page 37 of the 2008 Annual Report of the OAGO:

With regard to the second characteristic, we simply point again to the legacy of the former Ontario Hydro and its stranded debt. This in our view provides concrete evidence that even in monopoly situations governments do not have sufficient assurance that an enterprise will generate enough profits in future years to recover all of its past costs.

Although there needs to be sufficient assurance regarding the recovery of past costs, all relevant facts and circumstances need to be taken into consideration. Accordingly, the stranded debt of Ontario Hydro can be a relevant to the analysis, but not determinative on its own. As noted in the previous section, the recoverability of past costs will be continually assessed.

The transaction or event giving rise to the public sector entity's control has already occurred

When evaluating whether a transaction or event gives rise to control, the following guidance from PSAS 3210, ASSETS, provides helpful guidance:

.26
The past transaction or event that gives rise to control of an economic resource resulting from exchange agreements or contracts usually occurs at the point of exchange. This arises when substantially all the benefits and risks of ownership have been transferred to the public sector entity and normally coincides with the disbursement of funds, exchange of other assets or assumption of liabilities.
.28
The existence of a law, by-law or policy in relation to a particular program is not a past transaction or event that gives rise to control of an economic resource. Control does not exist until the underlying event occurs.
.29
The past transaction or event giving rise to control of an economic resource must have occurred by the financial statement date. Legislation having retroactive application cannot create a past transaction or event. Any economic resources related to that legislation would be accounted for in the current and relevant future periods, not in the period of the effective date of the legislation.

In the case of the regulatory asset, the above guidance in PSAS 3210 makes it clear that it is not the statute itself that is the transaction or event giving rise to the asset, it is the incurrence of costs for which recovery is provided for under statute. Accordingly, control over the economic benefits of the regulatory asset occurs when the IESO incurs a cash flow deficit that is recorded in the FHP variance account in accordance with Section 24(1) of the FHP Act:

24 (1) The IESO shall establish and maintain a variance account in which it records the following:

1. *The IESO deferral for each month.*

Commented [LAP37]: More complete excerpt:

Ministry of Finance officials contend that rate-regulated assets and liabilities meet PSAB's standards without reference to any of the rate-regulated provisions in the CICA Handbook. We do not agree with this position. For example, PSAB 1000.36 sets out the three essential characteristics of a government asset:
• it embodies a future benefit that involves a capacity, singly or in combination with other assets, to provide future net cash flows, or to provide goods and services;
• the government can control access to the benefits; and
• the transaction or event giving rise to the government's control of the benefit has already occurred.
In our view, rate-regulated assets are suspect under the second characteristic and fail to meet the test of the third characteristic.
With regard to the second characteristic, we simply point again to the legacy of the former Ontario Hydro and its stranded debt. This in our view provides concrete evidence that even in monopoly situations governments do not have sufficient assurance that an enterprise will generate enough profits in future years to recover all of its past costs.

Commented [npp38]: Similar position in Tory's letter.

Commented [LAP39R39]: Are you looking for a specific reference to the Tory's letter? I looked through it, but couldn't find a good excerpt to include in this memo.

2. All payments received by the IESO resulting from the exercise of the right of recovery under section 25 and any transfer under section 26.

3. Such other adjustments as may be prescribed, including adjustments in respect of the period that commences on or after May 1, 2017 and before the day this section comes into force.

At this point in time, the IESO has incurred a cash outflow for which it is entitled to recover under Section 25 of the FHP Act:

Regulatory asset established

25 (1) Effective May 1, 2017, the IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.

Board to set rates

(2) Subject to subsection (3), the Board shall, from time to time and in accordance with the regulations, determine and set rates payable by specified consumers to allow for the IESO to recover the balance recorded in the variance account.

The following excerpt from the IFRS Staff Paper on Rate-Regulated Activities prepared for discussion at the June 2017 IASB meeting presents a consistent view and dismisses the potential dissenting view that the transaction or event giving rise to the IESO's control is the future consumption of electricity by rate-payers:

A right arises from the rate-adjustment mechanism if the entity has already partially or fully fulfilled a regulatory requirement (past event) but the current regulated rate does not yet reflect the compensation that the entity is entitled to in exchange. Even though the entity cannot compel its customers to buy the regulated goods or services, the entity's right to charge an increased future regulated rate has the potential to produce for the entity an inflow of economic benefits that are not available to other parties. That right will be consumed as the entity includes the rate increase in future regulated rates and will lead to an inflow of economic benefits if customers pay the increased future regulated rate for the future delivery of goods or services.

Another potential dissenting view is contained on page 37 of the 2008 Annual Report of the OAGO:

With regard to the third characteristic, we do not believe that a rate-regulation decision can be considered a transaction or event giving rise to an asset or obligation because, as stated above, from the level of the government's consolidated financial statements such a decision is an internal event between two government-controlled entities. An equivalent analysis for rate-regulated liabilities leads to the same conclusion. PSAB standards preclude the inclusion of both gains and losses from such inter-company transactions. Therefore, our contention is that, at the consolidated financial statement level, rate-regulated assets and liabilities have no place and should be removed upon consolidation of the government's controlled entities.

It should be noted, however, that the OAGO's belief that a rate-regulation decision cannot be considered a transaction or event giving rise to an asset or obligation is not contrary to the IESO's position. As noted above, it is not the statute itself that is being considered the transaction or event giving rise to the asset, it is the incurrence of costs for which recovery is provided for under statute.

In addition, one could argue the creation of the relevant statutes is not an internal event from the point of view of the consolidated government. Statutes must be passed by the Legislative Assembly of Ontario to become law. Since the Legislative Assembly is comprised of elected members, it can be viewed as the government's governing body.

Concluding the regulatory asset possesses the three essential characteristics of an asset in PSAS 1000.05 then begs the question as to whether the application of the guidance in ASC 980 is even necessary in this particular situation. Consistent with the statement in ASC 980 –340-25-1 that *rate actions of a* *regulator can provide reasonable assurance of the existence of an asset,* ASC 980 provides guidance as to how to apply the primary source of PSAS in the regulatory environment.

In a letter from the OAGO to the Board of Directors of the IESO dated June 22, 2017 (the OAGO Letter), the OAGO makes the following statement:

The definitions of an asset in the PSAS and FASB Conceptual Framework are similar. Similar to PSAS, rate regulated deferral accounts do not generally meet the definition of an asset in the FASB's Conceptual Framework.

However, the following excerpts from the Basis for Conclusions for FAS 71 (paragraph 58 in particular), clearly support that ASC 980 is an application of, not an exception from, the basic definition of an asset in the Conceptual Framework:

Economic Effects of Regulation

56. The second threshold issue in the Discussion Memorandum was: "Does rate regulation introduce an economic dimension in some circumstances that should affect the application of generally accepted accounting principles to rate-regulated enterprises?"

57. Most respondents to the Discussion Memorandum indicated that rate regulation does introduce such an economic dimension in some circumstances. Respondents cited the cause-and-effect relationship of costs and revenues as the principal economic effect of regulation that affects accounting for regulated enterprises. They noted that cost might be one factor used by unregulated enterprises to establish prices, but it would often not be the most important factor. Usually, prices are limited by the market. An unregulated enterprise might desire to price its goods or services at a level that would recover all costs and a reasonable profit; however, the market might not permit that price. Alternatively, an unregulated enterprise might be able to increase its prices and its profit if competition does not limit its prices. In either case, cost often is not the principal determinant of prices. In contrast, for an enterprise with prices regulated on the basis of its costs, allowable costs are the principal factor that influences its prices.

58. The economic effect cited by most respondents is the ability of a regulatory action to create a future economic benefit—the essence of an asset. For example, consider a regulated enterprise that incurs costs to repair damage caused by a major storm. If the regulator approves recovery of the costs through rates over some future period or is expected to do so, the rate action of the regulator creates a new asset that offsets the reduction in the damaged asset. The enterprise has probable future economic benefits—the additional revenue that will result from including the cost in allowable costs for rate-making purposes. The future benefits are obtained or controlled by the enterprise as a result of a past event—incurring the cost that results in the rate order. Thus, the criteria of Concepts Statement 3 for an asset are met.

The fact that many Canadian rate-regulated entities recognized regulated assets under Part V of the CPA Canada Handbook – *Pre-changeover Accounting Standards* (Part V GAAP) further supports the position that regulated assets do meet the basic definition of an asset under PSAS. Although Part V GAAP refers to rate regulation in several standards, it does not include cost capitalization guidance equivalent to ASC 980-340-25-1. It does, however, specify in paragraph 32B of Section 1100, *Generally accepted accounting principles*, that Section 1100 applies to the recognition and measurement of assets and liabilities arising from rate regulation beginning January 1, 2009. Since Section 1100.04 only permits the use of an alternate source of GAAP if it is consistent with Part V GAAP, regulated assets need to meet the basic definition of an asset under Part V GAAP in order to be recognized. The Part V GAAP definition of an asset in Section 1000, *Financial Statement Concepts* is consistent with the PSAS definition.

Commented [npp40]: And where reporting under IFRS14, ASC980 continues to be the basis for reporting such assets.

Commented [LAP41R41]: I agree ASC 980 is the basis for continuing recognition under IFRS 14, but I didn't think that comment fits into this paragraph. Let's discuss if you feel differently.

The CICA Research Report also concluded regulated assets meet the basic definition of an asset under Part V GAAP:

In the Study Group's view, the economic benefits and obligations created by rate regulation and resulting from past transactions or events, and the changes in these amounts, meet the definition of a financial statement element set out in Handbook Section 1000.

The OAGO Letter suggests that IFRS should be consulted prior to referring to ASC 980 under PSAS's GAAP hierarchy in PSAS 1150 and points out the following:

- In 2005 the International Financial Reporting Interpretations Committee (IFRIC) indicated the US GAAP recognition criteria for regulated assets were not fully consistent with IFRS and could not be applied by analogy.
- When the question of rate regulated accounting was posed to the IFRIC again in 2008, the IFRIC noted the topic had been previously addressed and there was a well-established practice of first time IFRS adopters ceasing rate regulated accounting and removing regulatory deferral accounts from their financial statements.
- In the Basis for Conclusions on IFRS 14, IFRS 14.BC30 noted the differences in the recognition criteria between IFRS and ASC 980 resulted in almost all existing regulatory deferral accounts being derecognized upon transition to IFRS.

It should be noted, however, that the IASB's project on rate-regulated activities is still in progress and the OAGO Letter does not reference more recent and relevant activity. In September 2014, the IASB issued Discussion Paper DP/2014/02, *Reporting the Financial Effects of Rate Regulation*. The Discussion Paper presents the opposing views as to whether regulatory deferral account balances meet the definitions of an asset or a liability and specifically states the following in paragraph 5.09:

Consequently, the IASB has not formed a preliminary view on whether regulatory deferral account balances meet either the current or proposed revised Conceptual Framework definitions of an asset and a liability. It will use the input received from the responses to this Discussion Paper and the Conceptual Framework project to help it assess whether to develop any specific accounting guidance or requirements for rate-regulated activities.

In addition, the most recent paper issued by the IASB staff in June 2017 includes the following:

17. During the May 2017 Board meeting we also considered the interaction between the definitions of assets and liabilities and the characteristics of defined rate regulation (see paragraphs 5 and 6). We concluded that a combination of those characteristics suggested that the rights and obligations created by the rate-adjustment mechanism are assets and liabilities, as those terms are expected to be defined in the forthcoming revised Conceptual Framework for Financial Reporting.

The Exposure Draft ED/2015/3, *Conceptual Framework for Financial Reporting*, defines an asset as follows:

4.5 An asset is a present economic resource controlled by the entity as a result of past events.
4.6 An economic resource is a right that has the potential to produce economic benefits.

This recent activity suggests that it would be premature to assume that the IASB will conclude that regulatory deferral account balances will not meet the definitions of an asset or a liability.

Once it is determined that the regulatory asset meets the basic characteristics of an asset in PSAS 1000.36, consideration also needs to be made as to what type of asset it is. This is important because PSAS 1000.58 does not permit the recognition of intangible assets:

In the absence of appropriate public sector recognition and measurement criteria for intangibles, 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.

PSAS 1000 identifies two types of assets: financial assets and non-financial assets and provides the following commentary:

.39 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.

.40 A financial asset is any asset that is:

- *a) Cash*
- *b) a realizable asset that is convertible to cash;*
- *c) a contractual right to receive cash or another financial asset from another party;*
- *d) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the government;*
- *e) an equity instrument of another entity;*
- *f) an investment in a government business enterprise or government business partnership;*
- *g) a financial claim on an outside organization or individual; or*
- *h) an inventory or item for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1201.055.*

.41 Non-financial assets include tangible capital assets, and other assets such as prepaid expenses and inventories of supplies.

.42 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.*

PSAS 3210, ASSETS, also provides some relevant guidance:

.24 Non-financial resources include all items of a fixed or permanent nature (such as tangible capital property), claims to goods and services (such as prepaid items) and consumable goods (such as inventories of supplies). Non-financial resources also include intangibles, Crown lands and natural resources.

.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 1000, comprise the recognized non-financial resources of a government.

The regulatory asset does not meet the criteria in PSAS 1000.40 to be a financial asset as it does not represent a current contractual right to receive cash. Accordingly, the regulatory asset is a non-financial resource. As noted above, to be recognized as an asset in the financial statements a non-financial resource cannot be an intangible.

Commented [LAP42]: CV - To discuss – non financial assets are quite narrowly defined as well.

Although PSAS does not permit the recognition of intangibles, it also does not provide a definition of intangibles. While PSAS 1000.40 provides a finite list of items that represent financial assets, the guidance in PSAS 1000.41-.42 on non-financial assets is less definitive, using words like “such as” and "normally". In absence of specific guidance in PSAS as to what constitutes an intangible, U.S. GAAP is probably the most appropriate source to consult, in light of the fact that it deals specifically with regulated assets.

Under U.S. GAAP, a regulated asset is not treated as an intangible. ASC 980 contains separate subsections for 'Intangibles – Goodwill and Other' and 'Other Assets and Deferred Costs' and regulated assets are included in the guidance on 'Other Assets and Deferred Costs'. Consistent with the treatment under U.S. GAAP, the regulatory asset is categorized as an other asset under PSAS and recognized in the financial statements as a non-financial asset.

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Debits and Credits

Based on the example provided earlier, the IESO pays the contracted power generator $400 for electricity used by the ratepayer and collects $300 from the ratepayer through their local distribution company (LDC). The $100 recovery shortfall is recorded in a variance account created by Bill 132 and deemed to be a regulatory asset. The IESO sells the regulatory asset to OPG Trust for $100 to obtain cash to make up the shortfall.

The accounting for the above transactions in the financial statements of the IESO, which are prepared in accordance with PSAS, depends on whether the regulatory asset is eligible for recognition as an asset for accounting purposes under PSAS. To avoid confusion in the remainder of this document, the term regulatory asset will refer to the defined term in the FHP Act and the term regulated asset or rate-regulated asset (RRA) will refer to an asset recognized for accounting purposes. The following table illustrates the journal entries to be booked by the IESO under both scenarios:

Scenario A – Regulated Asset			**Scenario B – Not a Regulated Asset**		
Market Settlement					
DR	Cash	300	DR	Cash	300
DR	Asset	100	DR	Expense	100
CR	Cash	(400)	CR	Cash	(400)
Sale of Regulatory Asset to OPG Trust					
DR	Cash	100	DR	Cash	100
CR	Asset	(100)	CR	Gain	(100)

At any given point in time, the accounting result will be the same under both scenarios provided the cash shortfall has been fully funded. If a funding deficit exists, however, the deficit would be recognized as an asset under Scenario A and recognized as an expense under Scenario B. A funding deficit may arise due to, for example, temporary timing differences between the creation and sale of a regulatory asset. A funding deficit may also arise if OPG Trust (or another financing entity) ceases to purchase the IESO's regulatory assets on an on-going basis.