May 23, 2017

OPG DAY 2 ACCOUNTING CONSIDERATIONS OF ONTARIO FAIR HYDRO PLAN

Purpose:

The purpose of this document is to summarize the preliminary views of Ontario Power Generation (OPG) on the subsequent accounting impacts of the Ontario Fair Hydro Plan (GA Transaction) on OPG's accounting. Please refer to separate memo 'OPG Accounting Considerations of Fair Hydro Plan' for discussion of the ability for OPG to consolidate the Financing Entity Trust associated with the Ontario Fair Hydro Plan.

Background:

For background information, please refer to separate memo 'OPG Accounting Considerations of Fair Hydro Plan'.

Process:

The IESO will effectively sell the 'right to collect' deferred future revenue from ratepayers (GA Intangible asset) to the Trust in return for cash proceeds.

Accounting Analysis:

A. How should this asset be classified and recognized?

It is our understanding that the IESO and KPMG have concluded that the sale of this 'right to collect' future revenue (or regulatory asset) is not a financing transaction and will not be recorded as a financial liability.

ASC 825-10-20 defines a financial instrument as 'cash, evidence of an ownership interest in an entity, or a contract that both'

A. Imposes on one entity a contractual obligation either:
    1. To deliver cash or another financial instrument to a second entity
    2. To exchange other financial instruments on potentially unfavorable terms with the second entity.

B. Conveys to that second entity a contractual right either:
    1. To receive cash or another financial instrument from the first entity
    2. To exchange other financial instruments on potentially favorable terms with the first entity.

In PwC Power and Utilities Guide, Chapter 17, *Question 17-18, 'Are securitized stranded costs financial assets':*

PwC response

No. Reporting entities may sometimes securitize their enforceable right to impose a surcharge or tariff. When a reporting entity securitizes its stranded costs, it obtains cash from investors in exchange for future regulated cash flows representing the surcharge or tariff. Such securitizations are typically set up through a trust that sells the securities and administers the ongoing cash flows related to those securities. *ASC 860, Transfers and Servicing,* provides specific guidance on securitized stranded costs and states that they do not meet the definition of a financial asset. ASC 860-10-55-7 through 55-8 indicate that securitized stranded costs are not financial assets because they *are imposed on ratepayers through the surcharge or tariff (i.e., imposed by the government) and do not represent a right to receive payments from another party as a result of a contract.* Therefore, reporting entities should evaluate transfers of stranded costs in a securitization transaction as a borrowing and consider consolidation requirements related to the securitization trust.

OPG also concludes that this asset is not a regulatory asset. The Trust is not a rate-regulated operation and is not in scope of *ASC – 980 Regulated Operations* and the costs are not directly incurred by OPG.

Because the asset is not a financial asset or a regulatory asset, the right to collect will be accounted for as an intangible asset in the Trust.

US GAAP Guidance:

ASC 350 – Intangibles – Goodwill and Other
PwC Manual of Accounting

Accounting Discussion:

1) Can OPG recognize an intangible asset?

Analysis:

1) Can OPG recognize an intangible asset?

Relevant Guidance

ASC 350-30-25-1 An intangible asset that is acquired either individually or with a group of other assets shall be recognized.

ASC 350-30-25-2 As indicated by paragraph 805-50-30-3, the cost of a group of assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity shall be allocated to the individual assets acquired based on their relative fair values and shall not give rise to goodwill.

ASC 350-30-25-4 Intangible assets that are acquired individually or with a group of assets in a transaction other than a business combination or an acquisition by a not-for-profit entity may meet asset recognition criteria in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises (definitions, measurability, relevant and reliability) , even though they do not meet either the contractual-legal criterion or the separability criterion (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). Such transactions commonly are bargained exchange transactions that are conducted at arm's length, which provides reliable evidence about the existence and fair value of those assets. Thus, those assets shall be recognized as intangible assets.

OPG Analysis

OPG will be entitled to a future cash flow stream from the IESO once customers start making payments on the deferred amounts from the Global Adjustment. In addition, OPG will be entitled to interest payments and management fees on the funding provided to the IESO from the date the funding is provided.

The potential Intangible Asset(s) that OPG has rights to include:

- The future cash flow stream from the IESO (on principal payments)
- The interest component of the funding provided to the IESO **[UPDATE]**

- The management fee component (variable and fixed) **[UPDATE]**

OPG meets the criteria for an intangible asset for the future cash flow stream relating to principal repayments as the future cash flow stream:

- Is a resource controlled by OPG as OPG contractually has a legal right to receive these payments and OPG will control this asset once it is purchased from the IESO in accordance with *Part VI, Section 31 of Bill 132 - Ontario Fair Hydro Act, 2017* which states that 'a transfer that by its terms is intended to constitute a sale or absolute transfer shall be treated for all purposes as an absolute transfer of an investment interest owner's right, title and interest in, to and under an investment interest, and not merely as a security interest, and upon such absolute transfer the transferor shall retain no right, title or interest in the investment interest subject to the transfer, including all rights to the investment interest arising after the transfer.'
- It lacks physical substance;
- The cash flow stream is identifiable as will be evidenced by OPG having a Legislated right to it; and
- The cost is reliable as the amount of the funding by OPG to the IESO will be known since it will be paid in cash.

[Update for interest rate expenses and management fees when finalized]

<u>Conclusion</u>

OPG will obtain an intangible asset from the IESO related to future cash streams associated with principal amounts.

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