WHITE PAPERS – WORKING DRAFT #9

Independent Electricity System Operator ("IESO" or the "Company") is considering making changes in its accounting policies to reflect the balances of market participants within the IESO-administered markets (see separate technical analysis) and the economic impacts of rate regulation, as the Company believes that the changes would result in a more appropriate presentation of events or transactions in its financial statements.

Issues being considered in this document are:

Issue #1: Can the IESO adopt the guidance in ASC 980 *Regulated Operations (US GAAP in FASB)*?

Issue #2: Can the IESO recognize deferral or variance accounts related to the deferral of the annual Global Adjustment account as a regulatory asset on its statement of financial position?

Issue #3: Can the IESO derecognize the variance accounts related to the deferral of the annual Global Adjustment account upon sale to OPG Trust**?**

1. Adoption of the guidance in ASC 980 Regulated Operations

Background and Assumptions for issues #1 and #2

The facts, circumstances, and assumptions relevant to the specific transactions are as follows:

1. The IESO's legal status is a not-for-profit, non-taxable, corporation established pursuant to Part II of the *Electricity Act, 1998*. IESO is classified as an Other Governmental Organization and prepares its financial statements in accordance with Canadian public sector accounting standards (PSAB).
2. The IESO is required to submit its proposed expenditures, revenue requirements and fees yearly to the OEB for review and approval.
3. IESO is rate regulated by the OEB in accordance with the Electricity Act, 1998 and the Ontario Energy Board ("OEB") Act, 1998 but currently does not recognize the economic impacts of rate regulation in its general purpose financial statements. The IESO is required to obtain approval from the OEB under s. 25(1) of the Electricity Act, 1998 for the approval of its own expenditures, revenue requirement and fees. The last rate approval was obtained on December 29, 2016[1].
4. The OEB issued a Decision and Order on March 28, 2013 that permits IESO to recover the MDMR costs (the Smart Metering Charge) (see Appendix B). *(i.e. Costs incurred in the past will be fully recovered through future rates)*
5. Furthermore, in accordance with the *Electricity Act, 1998* and the *OEB Act, 1998*, the IESO has approved variance accounts to record all amounts payable or receivable by it in connection with the amounts paid to generators, the Financial Corporation, distributors and to entities with whom the IESO has a procurement contract. (i.e. costs incurred in the past will be fully recovered through future rates)
6. The province is contemplating deferring the recovery of a portion of the annual Global Adjustment account (comprised primarily of the electricity costs paid to the generators) over a period of 25-30 years, so that costs incurred would be fully recovered through future rates.
7. The *Electricity Act, 1998* and the *OEB Act, 1998* would be amended through legislation to require the deferral of the recovery of the Global Adjustment account and the future recovery in rates charged to customers.
8. The OEB would grant generic deferral or variance accounts to capture the difference between the amounts paid to generators and others, and the amounts collected in rates. Furthermore, the interest and ancillary costs related to the contemplated transaction would also be included in future rates charged to customers. In summary, the legislation would create a right to collect the incurred cost.

Commented [CV1]: To clarify what parts of the IESO's operations are regulated.

Commented [CV2]: To determine if this assumption remains

Commented [m3]: Based on today's discussion, I believe it is correct.

[1] http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/556699/view/Dec_Order_IESO_20161229.PDF

9. The IESO would change its accounting policies to permit the recognition of the economic impacts of rate regulation as from the 2016 financial year. IESO would adopt the guidance of ASC 980 *Regulated Operations* to better reflect the economic substance of its operations and enhance the transparency and accountability of its financial reporting.

Appropriate Accounting Principle for issue #1

PSAS requires

PS2120.02, "*a change in an accounting policy may be made… if it is considered that the change would result in a more appropriate presentation of events or transactions in the financial statements of the government.*"

PS1150.05 "*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 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."

PS1150.19 "*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 (FASB), 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*."

PS1150.08 "A public sector reporting entity consults sources other than primary sources of GAAP to assist in selecting accounting policies and disclosures only when these sources comply with paragraph PS1150.05. The public sector reporting entity evaluates sources in selecting the appropriate accounting policies and disclosures based on all of the following criteria:

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

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

(c) The continued relevance of the source — The passage of time may diminish the relevance of certain sources.

(d) The development process for the source — A source developed after extensive consultation and debate is likely to be more relevant than a source developed without such discipline."

PS1150.10 "PSAB considers a source to be consistent with the concepts in paragraph PS 1150.05(b) when the guidance in that source is compatible with the (i) qualitative characteristics of financial information, (ii) the elements of financial statements, and (iii) the recognition and measurement criteria in paragraph PS 1150.05(b)."

PS1000.58 "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."

PS3210.03 "*Assets are economic resources controlled by a public sector entity as a result of past transactions or events and from which future economic benefits are expected to be obtained.*"

PS3210.04 "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.

(c) The transaction or event giving rise to the public sector entity's control has already occurred."

Issue #1: Can the IESO adopt the guidance in ASC 980 *Regulated Operations*?

In accordance with PS2120.02, the IESO can reflect the economic impacts of rate regulation only if it is considered that the change of accounting policy would result in a more appropriate presentation of events or transactions in the financial statements of the government. As mentioned in the Agenda ref. 9A of the IASB meeting of February 2017[2], rate regulated entities have long argued that, without recognizing regulatory assets and regulatory liabilities, the entity's performance is distorted by the rate regulator's intervention in the imposition of performance obligations on the entity and the timing of cash flows from the ratepayers. The recognition of regulatory assets and liabilities would better reflect the economic substance of IESO's operations and enhance the transparency and accountability of its financial reporting. For example, in 20XX the IESO incurred a cost relating to the smart meter program amounting to $ _________ million. The cost was expensed and is included in the accumulated deficit, as the IESO did not have the ability to recognize a regulatory asset despite receiving a rate order to recover it over a period from May 1, 2013 to October 31, 2018. As a result of adopting ASC 980, a regulatory asset for the Smart metering Charge would be recognized at December 31, 2016 for an amount of approximately $_______.

Commented [CV4]: Are there any documents to reference here – is the AcSB document from September helpful?

Michel- Done

PSAS does not address accounting concepts in a rate regulated environment. Since there is no guidance in PSAS regarding the recognition and measurement of regulatory assets and liabilities, IESO may consider other sources based upon PSAS 1150.05 in the GAAP hierarchy to determine appropriate accounting policies in a rate regulated environment.

Within AcSB, Accounting Standards for Private Enterprises (ASPE) defines a rate regulated entity but provides no guidance on regulatory assets and liabilities, however requires disclosure of such balances if they are recognized. IASB has not completed their project on rate regulated activities and current standards only include a holding standard based upon what was done under previous GAAP. It will be important for the IESO to monitor the IASB's ongoing project on rate regulated activities as this may affect the recognition, measurement, presentation and disclosures of the regulatory assets and liabilities. Both FASB and GASB have guidance on accounting in a regulatory environment. IPSASB does not provide any guidance on accounting by rate regulated entities.

It is important to note that rate regulated entities in Canada that prepare their general purpose financial statements in accordance with US GAAP, ASPE (e.g. the three Fortis subsidiaries in Ontario), as well as those rate regulated entities that are eligible to elect to apply the requirements of IFRS 14 and elected to do so when they adopted IFRS, generally all recognize regulatory deferral and variance accounts in accordance with US GAAP accounting principles set out ASC 980 *Regulated Operations*.

Commented [CV5]: Should we also add a comment that many rate regulated entities prepare there f/s in accordance with US GAAP and therefore, also follow ASC 980.

Michel Done

Statement 62 issued by GASB in December 2010 is effective for financial statements for periods beginning after December 15, 2011. The objective of the Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the Financial Accounting

[2] http://www.ifrs.org/Meetings/MeetingDocs/IASB/2017/February/AP09-Rate-regulated-Activities.pdf

Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements. Paragraphs 476–500 may be applied to activities reported in business-type activities that have regulated operations that meet all of the three criteria in paragraph 476 as follows:

(a) The regulated business-type activity's rates for regulated services 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 regulated business-type activity's costs of providing the regulated services.

(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 regulated business-type activity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs.

The criteria above and the guidance in paragraphs 476-500 are based on ASC 980 *Regulated Operations*.

It is also important to note that in its statement of financial position, the Ontario Electricity Financial Corporation ("OEFC") recognizes a net unamortized liability balance for power purchase contracts, as detailed in the summary of significant accounting policies:

"The liability for power purchase contracts was originally calculated by discounting estimated losses over the life of the contracts. Under the *Electricity Restructuring Act, 2004*, OEFC began receiving actual contract prices for power from electricity consumers, effective January 1, 2005, and no longer incurs losses on these power purchase contracts. At that time, the Ministry of Finance estimated that the bulk of the liability would be eliminated over 12 years as existing electricity contracts expire. As a result, the bulk of the liability is being amortized to revenue over that period."

Although this liability is not defined as a regulatory liability in the OEFC's financial statements, the argument can be made that it substantively meets the definition under ASC 980 of a regulatory liability, as the OEFC had no further obligation and should have reversed the liability into income. After consultation with the AG at that time, it was decided to amortize the gain over the remaining term of the contracts.

Commented [CV6]: I'm not sure this is totally accurate – my understanding is the liability that remains related to the NUGs corresponds to the NUG contracts that continue to exist. Also, I think that the liability was calculated as the difference between the contractual rate in the NUG contracts and the fair value of the value of electricity being generated and I suspect this was part of the stranded debt that was booked directly to the accumulated deficit of the Province when Ontario Hydro was split up. How is this a regulatory liability?

Kim – can you check this wording with Ken Kandeepan if you haven't already done that.

In summary

Rate regulated entities in North America reporting under ASPE, IFRS (entities which have elected to use IFRS 14) and GASB generally all recognize regulatory deferral and variance accounts in accordance with US GAAP accounting principles based on ASC 980 *Regulated Operations* (see Appendix A for the accounting framework used by the Canadian rate regulated entities).

Evaluation of Other Sources of GAAP

When looking to other sources of GAAP, PSAS requires the other sources of GAAP to be evaluated

1. *as to whether they are consistent with accounting policies and disclosure within PSAS,*
2. *as to whether they are consistent with the application of concepts in PS 1000 and*
3. *as to all of the following criteria:*
   - (a) *Source deals with the specific circumstance*
   - (b) *Source is issued by an accounting standard setter*
   - (c) *Source continues to be relevant*
   - (d) *Source uses a consultative process and deliberation when developing policies*

As required by PS 1150.05(b), we need to analyze whether the concepts in the other source (i.e. ASC 980) are compatible with the (i) qualitative characteristics of financial information, (ii) the elements of financial statements, and (iii) the recognition and measurement criteria in PS 1000.

(i) Qualitative Characteristics of Financial Information

FASB	**PSAS 1000**	**Evaluation**
Concepts and objectives are for both business and non-business organizations as well as governmental units (Concept #4.3 to 4.5)	Public, legislators, councilors, investors, analysts, other governments (par. 14)	FASB considers governmental units
Financial reporting should: – Be useful in making resource allocation decisions – Be useful in assessing services and ability to provide services – Be useful in assessing management stewardship and performance – Provide information about economic resources, obligations, net resources and changes in them (Concept # 4.33-.54)	Financial statements should be relevant to the needs of the users and reliable. Relevance is achieved through timeliness, predictability and accountability value. Reliable information has the following characteristics: representational faithfulness, completeness, neutrality, conservatism and verifiability. (par. 28-29)	Similar

(ii) Elements of Financial Statements

FASB	**PSAS**	**Evaluation**
Assets		
Probable future economic benefits obtained or controlled by the entity as a result of past transactions or events. (Concept #6.25-.34)	Economic resources controlled by a government as a result of past transactions or event and from which future economic benefits are expected to be obtained. (par. 35)	Essential characteristics similar
Liabilities		
Probable future sacrifices of economic benefits arising from present obligations of the entity to transfer assets or provide services in the future as a result of past transactions or events. (Concept #6.35-.43)	Present obligations to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits with little or no discretion to avoid settlement. (par. 44)	Essential characteristics similar
Revenues		
Inflows from delivering or producing goods, rendering services or other activities that constitute the entity's central operations. (Concept #6.78-.79)	Increases in economic resources resulting from operations, transactions and events of the accounting period. (par. 46)	Similar
Expenses		
Outflows from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's central operations. (Concept # 6.80-.81)	Decreases in economic resources resulting from operations, transactions and events of the accounting period. (par. 49)	Similar

(iii) Recognition Criteria

FASB	PSAS	Evaluation
To be recognized, an item must meet the definition of an element of the financial statements, must be measurable with sufficient reliability, be relevant and be reliable. (Concept # 5.64)	Item must have an appropriate basis of measurement, a reasonable estimate can be made of the amount and if the item involves obtaining or giving up future economic benefits, it is expected those benefits will be obtained or given up. (par. 55)	Similar

(iii) Measurement Criteria

FASB	PSAS	Evaluation
Measurement basis dependent upon nature of item. Historical cost basis, replacement cost, market value. (Concept # 5.65-.70)	Primarily using historical cost basis. Replacement cost and realizable value are also used, but in limited circumstances. (par. 60)	Similar

Criteria of PS 1150.08

Criteria	Evaluation
Source deals with the specific circumstance	Yes, ASC 980 Regulated Operations
Source is issued by an accounting standard setter	Yes, FASB
Source continues to be relevant	Yes, still used by rate regulated entities
Source uses a consultative process and deliberation when developing policies	Yes, comprehensive consultative process and deliberation

Evaluation whether the deferral of the Global Adjustment account meet the definition of Assets as per Section PS3210

PS3210 defines assets as *"economic resources controlled by a public sector entity as a result of past transactions or events and from which future economic benefits are expected to be obtained."* (par. 03)

The analysis of the three essential characteristics as defined by PS3210.4 are analyzed in the next table.

Characteristics	Additional guidance	Comments
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. (par. 4(a))	The essence of assets are their future economic benefits. Assets embody future economic benefits that allow public sector entities to achieve their objectives. The future economic benefits embodied in assets 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. (par. 11) The future economic benefits embodied	The economic benefit embodied in the variance accounts (i.e regulatory asset) is the right to collect the incurred costs from ratepayers in order to settle the liability for the energy already consumed by the ratepayers. The electricity Act, 1998 ("EA") section 25.33(1) states: "*The IESO shall, through its billing and settlement systems, make adjustments in accordance with the*

	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. (par. 13)	*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; and* *b) amounts paid to entities with whom the IESO has a procurement contract, as determined under the procurement contract."*
The public sector entity can control the economic resource and access to the future economic benefits. (par. 4(b))	Economic resources can arise from, but are not limited to, the following: government's own legislation (for example, taxes, fines and penalties); (par. 08(c)) 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. (par.16)	The economic resources is the right created by the legislation that the energy costs IESO incurs will result in future cash flows. In the regulatory environments, incurring costs creates an enforceable right to set rates at a level that permits IESO to recover those costs. The adjustment of future rates is the mechanism the OEB uses to implement the right. Currently, the EA section 25.33(5) states: *"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."* The legislation would be amended to permit IESO to collect specifically the deferral of the energy costs and the related interest and administrative costs.
The transaction or event giving rise to the public sector entity's control has already occurred. (par.4(c))	It is the occurrence of a past transaction or event on or before the financial statement date that distinguishes a present economic resource controlled by a public sector entity from an economic resource that may be controlled by a public sector entity in the future. (par. 25) 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	The past event giving rise to IESO's control occurs as the energy cost is incurred, as IESO has a right to collect it from the ratepayers.

Commented [CV7]: Can we also analyze control from the context of being able to sell the asset – while related party at the initial point, there is private financing that is based on the strength of the legislation which permits the government to monetize the asset (hence control the economic benefits from the asset)

Is there anything in the IFRS14 papers that would be helpful here?

Michel: There is nothing under PSAB, IFRS, US GAAP or conceptual framework that link control and monetize.

	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. (par. 26)	
Conclusion: The right to collect the deferral of the energy costs and the related interest and administrative costs meets the definition of assets.		

When concepts are in conflict with PSAS then PSAS prevails (PS 1150.12). For example, PSAS does not recognize intangible assets (PS 3150.03, .14 and PS1000.58). So if regulatory assets are considered to be intangible assets, they would not be allowed to be recognized through another source of GAAP.

It is worth noting that the economic impacts of rate regulation are not recognized under US GAAP as intangible assets as the FASB has specific guidance to deal with this type of asset. It is also worth noting that the IASB has an ongoing project on rate regulated activities and are currently developing an accounting model based on the principles of IFRS 15 *Revenue from contracts with customers* to provide a principle-based framework for recognizing regulatory assets (see Agenda Ref. 9 for the IASB meeting on February 23, 2017). Furthermore, the Summary Comment Letter Analysis related to the ED/2009/8 on Rate Regulated Activities published by the IASB in July 2009 states on page 2 of 50:

"The International Financial Reporting Interpretations Committee ("IFRIC") observed that it had previously discussed whether a regulatory asset should be recognized in the context of service concession arrangements, either as deferred costs or as an intangible asset to reflect an expectation that the entity will recover these costs as part of the price charged in future periods. It had concluded that entities applying IFRSs should recognize only assets that qualified for recognition in accordance with the IASB's *Framework for the Preparation and Presentation of Financial Statements* and relevant accounting standards, such as IAS 11 *Construction Contracts*, IAS 18 *Revenue*, IAS 16 *Property, Plant and Equipment* and IAS 38 *Intangible Assets*."

Entities that are not eligible to elect to apply the requirements of IFRS 14 do not recognize regulatory assets because in 2009 the IFRIC determined they did not meet the criteria for recognition of an intangible asset under IAS 38?

Therefore, we can conclude that ASC 980 is NOT in conflict with PS 3150.03, .14 and PS1000.58 with respect to intangible assets.

Commented [CV8]: Does this paragraph need an ending -- e.g. are we saying that a reg asset is not an intangible under IFRS because in 2009 the IASB determined they did not meet the criteria for recognition of an intangible asset under IAS 38? I think we're missing that last part.

Michel Done

Commented [CV9]: This section causes me some concern – any additional ideas re: strengthening it?

Conclusion:
FASB is appropriate to use as "*other source of GAAP*". FASB standard ASC 980 has extensive guidance for rate regulated entities including the recognition of regulatory assets and use of rate regulated accounting by IESO would be consistent with current reporting practices of H1, OPG and OEFC.

Appropriate Accounting Principle for issue #2

ASC 980 Regulated Operations

– 980-10-15-2 *"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. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."*

- 980-10-20 Glossary, Definition of incurred costs *"A cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for."*
- 980-10-05-8 "*Unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the GAAP applicable to business entities in general. The mere issuance of an accounting order not tied to rate treatment does not change an entity's economic resources or obligations. In other words, the economic effect of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of GAAP.980-340 – Other Assets and Deferred Costs."*
- 980-340-25-1 "*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."
- 980-340-40-1: "*If at any time an entity's incurred cost no longer meets the criteria for the capitalization of an incurred cost (see paragraph 980-340-25-1), that cost shall be charged to earnings."*
- 980-350-50-1: "*In some cases, a regulator may permit an entity to include a cost that would be charged to expense by an unregulated entity as an allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period, the entity shall disclose the remaining amounts of such assets and the remaining recovery period applicable to them."*
- 980-340-55-2: "*In some cases, a regulator may approve rates that are intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period."*
- 980-340-55-3: "*The regulator's action provides reasonable assurance of the existence of an asset (see paragraph 980-340-25-1). Accordingly, the regulated entity would capitalize the cost and amortize it over the period during which it will be allowed for rate-making purposes. That cost would not be recorded at discounted present value. An exception to this general rule is provided for costs of abandoned plants."*

Issue #2: Can the IESO recognize deferral or variance accounts related to the deferral of the annual Global Adjustment account as a regulatory asset on its statement of financial position?

As described in issue #1, US GAAP includes special accounting provisions that are applicable to entities with activities that are subject to rate regulation. The result is that rate regulated entities are required to recognize regulatory assets and liabilities provided the following three criteria are met:

Criteria	Comment	Evaluation
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.	IESO has unrecognized variance accounts related to the MDMR (smart meters), that have been approved by the OEB in accordance with the Electricity Act and the OEB Act (see Appendix B). It is important to note that Hydro One and OPG are both consolidated into the province's books, are both regulated by the OEB and their respective regulatory assets and liabilities are reported in the province's books.	Met
The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products.	Currently, the rates approved by the OEB are designed to recover the IESO's costs of providing the regulated services and the pass-through related to the energy purchased from the generators. The contemplated transaction is based on the fact that the OEB would grant generic deferral or variance accounts to capture the difference between the amounts paid to generators and others, and the amounts collected in rates. Furthermore, the interest and ancillary costs related to the contemplated transaction would also be included in future rates charged to customers. In summary, the legislation would create a right to collect the incurred costs.	Met
In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."	Since the deferral or variance accounts would be sold to the OPG Trust at least on a monthly basis and cash would be received on the same day, this criteria would be met. This criteria would need to be monitored on a yearly basis to ensure that IESO and the OPG Trust would be able to recover the <u>future</u> deferred amount taking into account the levels of demand or competition during the recovery period.	Met
Conclusion: Since the three criteria are met, IESO should be able to adopt the guidance in ASC 980.		

Conclusion: Based on the assumptions mentioned above, IESO should be able to recognize a regulatory asset for the deferral of the annual Global Adjustment account. As mentioned in the ASC 980 guidance above, it is important that an accounting order be issued by the OEB which indicates the way the incurred costs would be handled for rate-making purposes as the OEB's action provides reasonable assurance of the existence of a regulatory asset.

Commented [CV10]: May need to think about this wording given how OPG Trust views the interest revenue

Michel Not sure what to write. I believe this is generic enough to cover all the costs.

Commented [CV11]: Is this an issue for IESO if the structure remains in place? I'm not sure it's clear what risk IESO has.

Yes for the future deferred amount. IESO may not be able to sell them to OPG if the level of demand has decreased.

2. Derecognition of the regulatory assets

Background and Assumptions for issue #3

The facts, circumstances, and assumptions relevant to the specific transactions are as follows:

1. The annual Global Adjustment account that would be deferred in the deferral or variance accounts (the "Asset") would be significant.
2. The IESO does not currently have the financial capability to finance the Asset and is contemplating selling the Asset to a Trust to be set-up by OPG (the "OPG Trust").
3. The OPG Trust would be consolidated by OPG.
4. Proposed terms of the sale agreement between the IESO and the OPG Trust:
   - The sale contract would be structured as an absolute sale, which would assign future economic benefits or cash flows related to the Asset exclusively to the OPG Trust.
   - The arrangement would be structured whereby there is no recourse or obligations remaining of IESO related to the Asset.
   - The arrangement is not considered to be a financing transaction as IESO would have no obligations to the OPG Trust after the Asset is sold to the OPG Trust.
   - IESO would not retain any rights or benefits from the Asset.
   - IESO would not have any rights to interest or penalties on the Asset once it has been transferred to the OPG Trust.
   - The contract would be clear that IESO cannot pledge the Asset as collateral to obtain future cash flows or financing.
   - IESO would continue to collect related cash flows on the OPG Trust's behalf and remit those cash flows to the OPG Trust without material delay. In addition, IESO would not be entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the OPG Trust, and interest earned on such cash and cash equivalents is passed to the OPG Trust. The contract would define IESO's role strictly as that of agent, under a pass-through arrangement.
   - Servicing, origination, and arrangement fees, would be collected by IESO in rates charged to ratepayers as part of its market dealings.
   - The Asset would be sold to the OPG Trust at least, on a monthly basis and cash would be received on the same day.

Appropriate Accounting Principles for issue #3

Public Sector Accounting Standard ("PSAS") 3210, *Assets*, defines an asset as "…*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*." [par. 3]

.04 *"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."*

.22 *"Control of an economic resource and of access to the future economic benefits are essential characteristics of an asset, whereas possession or ownership is not*."

.24 *"A public sector entity may act as trustee when it administers trusts on behalf of the beneficiaries specified in the agreement or statute. As trustee, the public sector entity merely administers the assets, following the terms and conditions set out in the agreement. It does not control the asset because it does not have access to the future economic benefits. Those benefits flow to the beneficiaries."*

As noted in PS1000 Financial statement concepts:

.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."

As noted in PS3450, derecognition of a financial liability:

.042 *"A government should remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished (i.e., when the obligation specified in the contract is discharged or cancelled, or expires)."*

.043 *"A financial liability (or part of a financial liability) is extinguished when the debtor either:*

(a) discharges the liability (or part of it) by paying the creditor, normally with cash, other financial assets, goods or services; or

(b) is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (When the debtor has given a guarantee, this condition may still be met.)"

.046 "*Payment to a third party, including a trust (sometimes called "in-substance defeasance"), does not, by itself, relieve the debtor of its primary obligation to the creditor in the absence of legal release."*

.047 "*If a debtor pays a third party to assume an obligation and notifies its creditor that the third party has assumed its debt obligation, the debtor does not derecognize the debt obligation, unless the condition in paragraph PS 3450.043(b) is met. If the debtor pays a third party to assume an obligation and obtains a legal release from its creditor, the debtor has extinguished the debt. However, if the debtor agrees to make payments on the debt to the third party or direct to the original creditor, the debtor recognizes a new debt obligation to the third party."*

Issue #3: Can the IESO derecognize the variance accounts related to the deferral of the annual Global Adjustment account upon sale to OPG Trust?

PS3210 does not specifically address the derecognition of a regulatory asset as the concept of a regulatory asset does not exist under PSAS.

As mentioned above, regulatory assets do not meet the definition of intangible asset or financial asset. Specifically, regulatory assets do not meet the definition of financial asset because they are imposed on customers through the tariff (i.e., imposed by the OEB) and do not represent a right to receive payments from another party as a result of a contract.

More generally, PSAS.3210.37 suggests that an asset would no longer be recognized when it fails to meet the definition of an asset.

Based on PS1000.37(b), an item does not qualify as an asset of a government if the item involves future economic benefit, but the government cannot obtain it.

Based on the assumptions mentioned above, the legal title of the Asset would be transferred to the OPG Trust, as well as, ALL risks and rewards, including the following:

– the contract would define IESO's role strictly as that of agent, under a pass-through arrangement;

- all cash flows related to the Asset would be transferred without material delay to the OPG Trust;
- rights to interest or penalties on the Asset would be for the benefits of the OPG Trust;
- IESO cannot pledge the Asset; and
- no recourse or obligations remaining of IESO related to the Asset.

IESO should also evaluate whether the sale of the Asset should in fact be considered as a borrowing arrangement. In the absence of detailed guidance on this subject, we can analogize to the guidance in PS3450 *Financial Instruments* for the derecognition of a financial liability. Par. 43 states that *"A financial liability (or part of a financial liability) is extinguished when the debtor is legally released from primary responsibility for the liability (or part of it) either by process of law or by the creditor. (When the debtor has given a guarantee, this condition may still be met.)"* Based on the assumptions mentioned above, since the legal title of the Asset would be transferred to the OPG Trust, as well as, ALL risks and rewards, it can be concluded that the sale of the Asset is not a borrowing arrangement.

Conclusion: Based on the proposed terms of the sale agreement between the IESO and OPG Trust mentioned above, the deferral or variance accounts would be derecognized at the point where the IESO would derive no future economic benefit from it. This would occur where the IESO ultimately transfers the rights, risk and rewards related to those deferral or variance accounts to the OPG Trust. This would occur on the receipt of cash from the OPG Trust.

Commented [CV12]: Receipt

OK

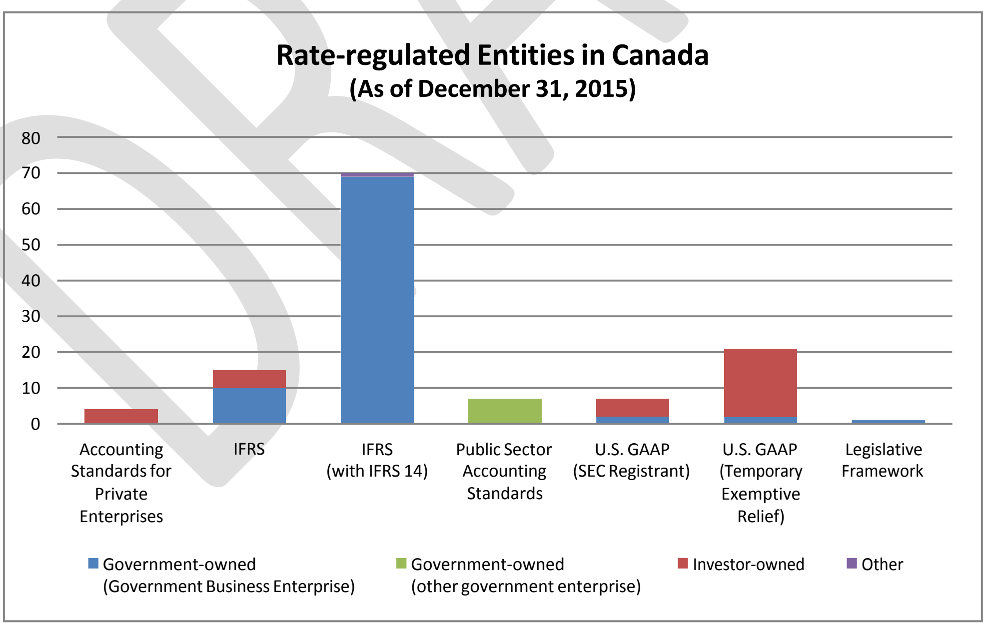
Appendix A:

Extract from the "Accounting Standards Advisory Forum Agenda Ref: 3A dated September 29, 2016" available on the IFRS website

Canadian Rate-regulated Entities

18. The accounting framework landscape for Canadian rate-regulated entities is currently diverse. For annual periods beginning on or after January 1, 2015, rate-regulated entities that are Canadian publicly accountable enterprises are required to apply IFRS. Rate-regulated entities that adopted IFRS for the first time after IFRS 14 *Regulatory Deferral Accounts* was issued continue to recognize these balances. Government Business Enterprises (which operate to generate a profit or on a break-even basis) that are also rate-regulated entities are also directed to apply standards applicable to for-profit entities, and thus apply IFRS. Canadian securities legislation permits dual-listed entities (i.e., Canadian entities also registered with the U.S. Securities and Exchange Commission) to apply U.S. GAAP in the normal course. Temporary exemptive relief is also available from the Canadian Securities Administrators that permits rate-regulated entities that are not dual-listed to apply U.S. GAAP in place of IFRS. If a rate-regulated entity is not a publicly accountable enterprise or a Government Business Enterprise, additional accounting framework options may also include Accounting Standards for Private Enterprises or Public Sector Accounting Standards. A non-GAAP reporting framework is used when legislated by the provincial owner of a government-owned rate-regulated entity.

19. As of December 31, 2015, there were approximately 125 rate-regulated entities in Canada. These entities mainly range in size from small entities owned by municipal governments to large investor-owned entities or entities owned by provincial governments.



Source: Information compiled based on audited financial statements for fiscal year 2015, or information from rate filings that confirmed the accounting framework used by these entities. Due to data collection constraints, the population could be slightly larger.

20. The chart above highlights two key points:

(a) The majority of investor-owned entities have chosen U.S. GAAP over IFRS. A few entities that are not reporting issuers apply Accounting Standards for Private Enterprises. Both U.S. GAAP and Accounting Standards for Private Enterprises permit the recognition of balances arising from rate regulation. Several entities that apply U.S. GAAP have told us this choice was influenced by the need to provide their users with financial statements that accurately reflect the economics of their business. Further, some entities presently using the temporary exemptive relief described in paragraph18 have said they are considering incurring the cost and effort necessary to become a registrant of the U.S. Securities and Exchange Commission in order to have the permanent ability to apply U.S. GAAP. While such a decision could be primarily for business reasons such as the entity expanding its operations into the U.S., it could also be attributed to the continuing uncertainty about the ultimate outcome of the IASB's Rate-regulated Activities project and the approaching expiry date of the securities regulators' exemptive relief.

(b) Public sector entities that are Government Business Enterprises tend to apply IFRS. The majority of these entities is made up of several large provincially-owned utilities, and many small municipally-owned local distribution utilities that do not issue debt or list in the U.S. stock market, and are not subject to Canadian securities legislation. As a result, they cannot apply U.S. GAAP. As shown in the chart, many of these entities adopted IFRS for the first time after the IASB issued IFRS 14, which allowed them to continue their previous accounting practices for rate-regulated activities.

21. Within the pool of government-owned rate-regulated entities, there are entities that do not meet the characteristics of Government Business Enterprises and are required to apply Public Sector Accounting Standards.

22. The data on the different accounting frameworks in Canada is unique. It demonstrates that when given a choice, rate-regulated entities select an accounting framework that captures the effects of rate regulation on their financial position and financial performance in order to communicate more decision-useful information to users.

http://www.ifrs.org/Meetings/MeetingDocs/ASAF/2016/September/1609-ASAF-03A-Rate-regulated-Activities-Canada.pdf

Appendix B:

Extract from the "DECISION and ORDER issued by the OEB on March 28, 2013" available on the IFRS website

Proceeding on the Ontario Energy Board's own motion to review the options for and ultimately determine the appropriate allocation and recovery of the Smart Metering Charge pursuant to section 19 of the Ontario Energy Board Act, 1998.

THE BOARD ORDERS THAT:

Effective May 1, 2013, the Smart Metering Entity charge to be levied and collected by the Smart Metering Entity from all Distributors identified in the Board's annual Yearbook of Electricity Distributors shall be $0.788 per month for each Residential and General Service <50kW customers for each distributor. The Smart Metering Entity charge shall be in effect from May 1, 2013 to October 31, 2018. The number of Residential and General Service <50kW customers to which the Smart Metering Entity charge will be applied to shall be in accordance with the methodology set forth in the Settlement Agreement attached as Appendix A.

http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2012-0100/dec_order_IESO-SME_20130328.pdf