WORKING DRAFT #3

KPMG Letter to the Independent Electricity System Operator

An Accounting Opinion on the Application of PSAS to the Consolidation of a Trust and to the Recognition and Derecognition of a Variance Account in Relation to the Proposed *Ontario Fair Hydro Plan Act, 2017*

<u>NOTICE OF NON RELIANCE</u>

This Notice is regarding our Letter to provide an accounting opinion on the application of Public Sector Accounting Standards to the consolidation of a trust and to the recognition and derecognition of a variance account in relation to the proposed *Ontario Fair Hydro Plan Act, 2017* (the "**Letter**") prepared by KPMG LLP for the Independent Electricity System Operator ("Client").

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Yours very truly,

KPMG LLP

KPMG LLP
Chartered Accountants
Bay Adelaide Centre
Suite 4600
333 Bay Street
Toronto ON
M5H 2S5

Telephone (416) 777-8500
Fax (416) 777-8818
www.kpmg.ca

May 2, 2017

CONFIDENTIAL

120 Adelaide Street West
Suite 1600
Toronto, ON
M5H 1T1

The Board of Directors

Dear Sirs,

We have been engaged to provide you with an accounting opinion on the application of Public Sector Accounting Standards to the consolidation of a trust and to the recognition and derecognition of a variance account in relation to the proposed *Ontario Fair Hydro Plan Act, 2017* ("the proposed Act") (Appendix A to this letter). This letter is being issued to the Independent Electricity System Operator ("IESO" or the "Company") for assistance in evaluating the consolidation requirements and the accounting for the variance account under Canadian Public Sector Accounting Standards ("PSAS"). Our engagement has been conducted in accordance with generally accepted standards for such engagements. The adoption of the proposed Act (including the subsequent amendments of the Electricity Act, 1998 ("the Electricity Act") and the Ontario Energy Board ("OEB" or the "Board") Act ("the OEB Act")), and the finalization of the financing structure (including the bylaws and regulations of the OPG Trust) and other agreements will take several weeks. Accordingly, the finalization of the legislation, regulations, financing structure and other agreements may impact the comments and conclusions set out herein.

The following three issues are addressed in this letter:

Issue #1: Can the IESO recognize a regulatory asset related to the variance account created by the proposed Act?

Issue #2: Is the trust to be established by Ontario Power Generation (the "OPG Trust") controlled by the IESO according to the guidance issued under PSAS 1300 *Government Reporting Entity* and therefore subject to consolidation by IESO?

Issue #3: What is the accounting treatment for the derecognition of the regulatory asset upon transfer of the variance account to the OPG Trust?

Background for issue #1

The facts, circumstances, and assumptions relevant to the specific transactions as provided to us by the management of the Company (responsible party) 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. IESO is classified as an Other Governmental Organization and prepares its financial statements in accordance with PSAS.

2. IESO is rate regulated by the OEB in accordance with the Electricity Act and the OEB Act.

3. *Extract from the 2016 IESO financial statements, note 3 New Accounting Policies,* audited by KPMG *"*As of January 1, 2016, the IESO changed its accounting policy regarding the recognition of assets and liabilities subject to rate regulation. The change was made to better reflect the economic substance of certain types of expenses that may not be directly recovered through the normal revenue requirement model. This change has been applied retroactively and has increased amounts previously unrecorded for regulatory assets and decreased amounts previously reported for accumulated deficit."

4. *Extract from the 2016 IESO financial statements, note 2(d) Summary of Significant Accounting Policies, Regulatory assets and liabilities.* "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 applies guidance from United States Generally Accepted Accounting Principles (US GAAP) Topic 980, *Regulated Operations ("ASC 980")*, in this policy."

5. *Extract from Section 78(3.3) of the OEB Act:* 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.

6. Currently, IESO recognizes two regulatory assets for unrecovered smart metering expenses and unrecovered PSAB transition items as permitted by rates approved by the OEB. In addition, in accordance with section 25.33 of the Electricity Act, IESO also recognizes variance accounts (eg. OESP, RPP and RRRP variance accounts) to record all amounts payable or receivable by it in connection with the amounts paid to generators, the Ontario Electricity Financial Corporation ("OEFC"), distributors and to entities with whom the IESO has a procurement contract.

7. The Electricity Act, OEB Act and other regulations will be amended to reflect the following *extracts of the proposed Act:*

   Section 1xx Definitions

   (3) In this Act, a reference to the transfer of a specified portion of the regulatory asset is a reference to the following, as provided for in subsection 22xx (3):

      1. The amount of the IESO funding shortfall for each month.
      2. The adjustment of the regulatory asset.
      3. The acquisition by a financing entity of the investment interest corresponding to the specified portion of the regulatory asset.

   Section 20.1xx Variance account to be established

   (1) The IESO shall establish and maintain a variance account for the purposes of this section.

   (2) The IESO shall record the following in the variance account:

      1. The amount of the IESO funding shortfall for each month.
      2. All payments received by the IESO resulting from the exercise of the right of recovery under section 21xx and any transfer under section 22xx.
      3. Such other adjustments as may be prescribed, including adjustments in respect of the period that commences after May 1, 2017 and before the day this section comes into force.

   (3) Subject to the correction of any obvious error, a recording by the IESO in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time.

(4) No change made by IESO to the balance in the variance account shall, if the previous balance was relied upon by an investment interest owner in the context of a transfer under section 22x, affect the rights of the investment interest owner acquired under the transfer.

Section 21xx Regulatory asset established

(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.

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

(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.

(4) The Board's powers under subsection (3) shall be exercised in accordance with the regulations.

Section 30xx Board's Authority

(2) Despite anything to the contrary in the OEB Act, the Board may exercise any of its responsibilities under this Act without a hearing.

8. It is expected that the funding shortfall recorded by the IESO in the variance account (the regulatory asset) will be transferred to an investment asset owner (ie a trust to be established by OPG) on a monthly basis and cash collected within a short period of time. The total IESO funding shortfall for the period from May 1, 2017 to April 30, 2047 is estimated at $28 billion plus interest.

Appropriate Accounting Principle for issue #1

ASC 980 Regulated Operations

- For general-purpose financial reporting, an incurred cost for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursement-type contract. [980-10-05-6]
- 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. [980-10-05-8]
- 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.
  (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. [980-10-15-2]
- 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. [980-10-20] Glossary

- Failure of an entity's operations to continue to meet the criteria in paragraph 980-10-15-2 can result from different causes. Examples include the following:
  (a) Deregulation.
  (b) A change in the regulator's approach to setting rates from cost-based rate-making to another form of regulation.
  (c) Increasing competition that limits the entity's ability to sell utility services or products at rates that will recover costs (as used in paragraph 980-10-15-2).
  (d) Regulatory actions resulting from resistance to rate increases that limit the entity's ability to sell utility services or products at rates that will recover costs if the entity is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts. [980-20-15-2]
- 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. [980-340-25-1]
- Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs, the carrying amount of any asset recognized pursuant to paragraph 980-340-25-1 shall be reduced to the extent of the excluded cost. Whether other assets have been impaired shall be judged the same as for entities in general and the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10 shall apply. [980-340-35-1]
- 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. [980-340-40-1]
- 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. [980-340-55-2]
- 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. [980-340-55-3]

Issue #1: Can the IESO recognize a regulatory asset related to the variance account created by the proposed Act?

As noted above, as of January 1, 2016, the IESO changed its accounting policy to recognize the economic impacts of rate regulation and now applies guidance from US GAAP Topic 980, *Regulated Operations,* as PSAS does not have any guidance for entities with rate-regulated activities.

IESO concluded that it met the requirements of PS2120.02, which allows them to reflect the impacts of rate regulation, as it is considered that the change of accounting policy in its 2016 financial statements resulted in a more appropriate presentation of transactions in the financial statements. The change was made to better reflect the economic substance of certain types of expenses that may not be directly recovered through the normal revenue requirement model.

The regulatory framework in Ontario relating to the generation and sale of electricity will be significantly impacted by the proposed Act. Currently, a substantial amount of the energy purchased from the generators is collected by IESO from the local distribution companies through the customer billing, with the remaining being recovered through variance accounts over a period of 12 months maximum. As mentioned above, the effect of the proposed Act is to defer the collection of a total estimated amount of $28 billion (plus interest) of energy purchased from the generators over a period of 30 years. The proposed Act will not permit IESO to collect the funding shortfall before May 1, 2021 and the recovery process will be established through regulations. Such a long-term deferred recovery plan requires IESO to consider whether the uncollected energy costs qualify for deferral as a regulatory asset and whether it continues to meet the criteria that allow IESO to use the guidance for regulated operations of Topic 980. These two accounting issues are analyzed in the two tables below.

Criteria for the recognition of regulatory assets

ASC 980-340-25-1 states that 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:

Criteria	Comment	Evaluation
(a) It is probable 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 <u>to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs.</u> 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.	The proposed Act states that, • *A recording by the IESO in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time.* • *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.* • *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.* • *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.* Based on the proposed Act, IESO has the right to recover the balance recorded in the variance account. As a result, it is clear that IESO will be able to recover the amount previously incurred rather than to provide for expected levels of similar future costs.	Met

Criteria for the adoption and continued use of ASC 980 guidance

Deferred recovery plans are plans adopted by regulators or legislations in response to significant increases in costs (e.g. purchased power costs). These plans typically provide for rates to remain fixed or increase moderately with a variance account mechanism to capture costs in excess of the level allowed in current rates. A regulated utility subject to such plans is required to consider whether it continues to meet the criteria that allow it to use the guidance for regulated operations of Topic 980, especially criteria ASC 980-10-15-2 (b).

The proposed plan for the recovery of purchase power costs over a 30 year period is considered a deferred recovery plan as the rates for the first four years will remain fixed and subsequently the rates will increase moderately with a variance account to capture energy costs in excess of the level allowed in current rates. As required, the following is an analysis of the ASC 980-10-15-2 criteria.

Criteria	Comment	Evaluation
(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.	Currently, IESO recognizes regulatory assets related to smart meters and PSAS transition costs as permitted by rates approved by the OEB and regulatory liabilities related to the variance accounts (eg. OESP, RPP and RRRP variance accounts) established under section 25.33 of the Electricity Act related to the procurement of energy. It is important to note that both Hydro One and OPG are classified as government business enterprises and are reporting under IFRS for consolidation purposes, are consolidated by the modified equity method into the province's books, are regulated by the OEB, and their respective regulatory assets and liabilities are reported in the province's books.	Met

(b) 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.
	
	As mentioned above, a regulated utility subject to a deferred recovery plan is required to consider whether it continues to meet the criteria ASC 980-10-15-2 (b).
	
	This criterion requires a cause-and-effect relationship between a reporting entity's costs and its revenue. In addition, the timing of cost recovery and the related frequency of ratemaking is important. A reporting entity should consider its rate case experience, including the design of its rates and timing of recovery, when determining whether this criterion is met. These factors are analyzed below.
	
	Frequency of rate case
	
	- Currently, IESO is subject to annual reviews by the OEB.
	
	- Although the recovery of purchase energy costs will be frozen at the approved rate on May 1, 2017 for the first four years, the IESO will be granted a right to recover after May 1, 2021 the funding shortfall recorded in the variance account during the four-year period.
	
	    - *A recording by the IESO in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time. (no prudence review by the OEB)*
	
	    - *Right to recover the balance recorded in the variance account.*
	
	    - *Obligation from the OEB to dispose the variance account in accordance with the regulation.*
	
	- Subsequent to May 1, 2021, the OEB will be required to
		Met

Criteria	Comment	Evaluation
	determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account. - *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.* - *Despite anything to the contrary in the OEB Act, the Board may exercise any of its responsibilities under this Act without a hearing.* *Rates are designed to recover incurred costs* - There is a cause-and-effect relationship between the purchase energy costs and revenue, as IESO will be allowed to recover the costs incurred. - *A recording in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time (no prudence review).* - *Right to recover the balance recorded in the variance account.* - *Obligation from the OEB to allow IESO to recover the balance recorded in the variance account.* *Periods of alternative ratemaking (e.g., rate freezes)* Evaluation of the second criterion requires additional judgment if the regulated utility is subject to any form of ratemaking that introduces uncertainty about the cause-and-effect relationship between costs and rates. A rate freeze period is defined as a fixed rate that is charged to customers during a period of time (more than two years) and the utilities are exposed to increases in operating and energy costs with no ability to recover the variances. This is not the case as IESO will be granted the right to recover fully the funding shortfall recorded in the variance account, including the first four-year period. - *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.* *Costs uncertainty* As the IESO will be granted the right to fully recover the funding shortfall recorded in the variance account, there is no uncertainty about the recovery of the costs. *Disallowances of costs* The OEB has never disallowed the recovery of any material costs incurred by IESO.	

Criteria	Comment	Evaluation
	More importantly, as the IESO will be granted by legislation a right to fully recover the funding shortfall recorded in the variance account, there is no risk of the potential disallowance of the purchase power costs. Based on the analysis of the above factors, there are no indications that this criterion would not be met. It is clear that there would be a direct cause-and-effect relationship between IESO's costs and its future collection.	

(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."	The remaining issue is whether the extent of recovery of the regulatory asset could prevent the IESO from recognizing a regulatory asset for the entire balance in the recovery right granted to the IESO.
	
	The proposed Act mentions that:
	
	- *Effective May 1, 2017, the IESO's right to recover the balance in the variance account is subject to the following:*
	  o *The Board shall, from time to time, determine and set rates payable by specified customers to allow for IESO to recover the balance recorded in the variance account.*
	  o *The IESO shall not be entitled to collect the variance account from specified consumers before May 1, 2021.*
	
	Although the process, especially the timing of the recovery of the regulatory asset has not been established yet by the OEB, the wording and intent of the proposed legislation is clear that it is intended by law to be recoverable over the period of 30 years. Further, 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.
		Met

Management conclusion:

IESO management has concluded that the IESO can recognize a regulatory asset related to the variance account created by the proposed Act.

The variance account created by the proposed Act is subject to rate regulation by the OEB and the variance account will be established with the right to collect funds against the variance amount in the future. In these circumstances, the IESO is able to establish a regulated asset. The IESO financial statements are prepared in accordance with Canadian public sector accounting standards. Although PSAB does not provide specific guidance on rate regulated accounting, it does allow for guidance to be followed from other accounting frameworks. IESO has applied guidance from United States Generally Accepted Accounting Principles (US GAAP) Topic 980, Regulated Operations in its accounting policies.

Our conclusion:

In our opinion, the variance account created by the proposed Act 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.

Background for issue #2

The facts, circumstances, and assumptions relevant to the specific transactions as provided to us by the management of the Company (responsible party), in addition to those described in the background for issue #1, are as follows:

1. The IESO currently has the right to collect the global adjustment (“GA”) monthly from ratepayers through provisions in the Electricity Act. It is proposed that collection of a certain portion of the monthly GA be deferred in a regulatory asset for collection in the future, and that the right to recover the deferred GA from ratepayers be used as the basis for structured financing/ securitization.
2. In connection with the proposed Act, it is proposed that a trust to be created as a financial vehicle by OPG in connection with the deferred GA. The OPG Trust will finance the deferral of the GA by purchasing the regulatory asset from the IESO for the principal amount of the GA being deferred.
3. The OPG Trust is expected to finance these purchases from the IESO through a combination of senior secured financing raised in the capital markets, and subordinated financing from OPG (the funding for which will mostly be from equity injections from the OEFC/Province of Ontario).
4. OPG will be appointed as the Financial Services Manager and will be given the responsibility to direct the activities of the OPG Trust, through a services agreement and/or through the Trust’s constating documents.

Appropriate Accounting Principle for issue #2

PS1300 *Government Reporting Entity*:

PSAS refer to government or government organizations. For the purpose of this analysis, the PSAS guidance below relating to government or government organizations should be read and understood as being the IESO.

– The government reporting entity should comprise government components and those organizations that are controlled by the government. [PS 1300.07]

– Control is the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities. [PS 1300.08]

– Whether a government controls an organization is a question of fact that must be determined by reference to the definition of control established in paragraph PS 1300.08 and the particular circumstances of each case. The determination of the fact that control exists will require the application of professional judgment. Government achieves its objectives through a wide range of organizations which individually will fall somewhere along a continuum. At one end of the continuum, it will be clear that an organization does not have the power to act independently and is controlled by the government. At the other end, the organization will have the power to act independently and, while government will have a level of influence on the organization, it will be clear that it does not have control. Along the continuum, consideration needs to be given to the nature of the relationship between the government and the organization in order to determine whether control exists. This Section provides guidance intended to assist in this assessment. [PS 1300.10]

– In applying this guidance, it is necessary to determine the substance of the relationship between the government and the organization. The true nature of certain relationships may not be completely reflected by their legal form. All relevant aspects and implications of the relationship would be considered in determining whether or not the government controls the organization. Where various aspects of the relationship are designed, in effect, to achieve an overall objective, they would be viewed as a whole. [PS 1300.11]

- Financial and operating policies are principles and practices that determine how an organization conducts its activities. The ability to govern these policies is an important element of government control because it establishes the fundamental basis for the conduct of the organization's operations and the achievement of its mission and mandate. [PS 1300.13]
- There are a variety of ways to govern the financial and operating policies of an organization. For example:
  (a) a government may establish an organization's fundamental purpose and eliminate or significantly limit the ability of the organization to make future decisions by predetermining the financial and operating policies of the organization;
  (b) a government may direct the financial and operating policies of an organization on an ongoing basis; or
  (c) a government may veto, overrule or modify the financial and operating policies established by an organization. [PS 1300.14]
- A government does not need to manage an organization's activities on a day-to-day basis to control the organization. It is the government's existing authority to determine the policies governing those activities that is important. [PS 1300.15]
- For the purposes of this Section, it is assumed that where the government has the power to govern the financial and operating policies of an organization, it expects to derive a financial or non-financial benefit. The government may also be exposed to the risk of loss. [PS 1300.16]

Issue #2: Is the trust to be established by Ontario Power Generation (the "OPG Trust") controlled by the IESO according to the guidance issued under PSAS 1300 *Government Reporting Entity* and therefore subject to consolidation by IESO?

In determining whether or not the OPG Trust should be consolidated by IESO, it must first be determined whether or not the IESO exercises control over their financial and operating policies resulting in expected benefits to the IESO of the risk of loss from its activities.

Under PSAS, IESO is required to consolidate all entities that are considered to be part of its reporting entity, applying the guidance provided in *Section PS 1300 Government Reporting Entity.* Under PS 1300, IESO must consolidate all entities it "controls".

PS 1300.17 indicates that "whether a government controls an organization is a question of fact that requires the application of professional judgment based on the definition of control in this Section and the substance of the relationship in each case." Under PS 1300.08 control is defined as "the power to govern the financial and operating policies of another organization with expected benefits or the risk of loss to the government from the other organization's activities". Therefore, the determination of whether IESO will consolidate the OPG Trust will be based on an assessment of whether IESO is considered to control the OPG Trust based on the indicia of control set out in PS 1300. The assessment of the IESO's control of the OPG Trust is made based on the proposed Act, facts and nature of the relationship between the IESO and the OPG Trust and based on facts and assumptions provided by IESO. PS 1300.18 and .19 set out potential indicia of control. Several of these indicia have been categorized as more persuasive of a finding of control (see the four indicators in the table below). For each indicator that applies, the degree of government influence would determine its importance as evidence of control. Finally, the indicia are considered both collectively and individually.

A detailed analysis of the 11 Indicators of control is provided in the following table.

INDICATOR OF CONTROLS	EVIDENCE OF CONTROL	CONTROL EXIST?
Primary (more persuasive) indicators (PS 1300.18):		
Government has the power to unilaterally appoint or remove a majority of the members of the governing body of the organization	- The proposed Act states: - *OPG is appointed as the Financial Services Manager for the purposes of this Act. (Section 13xx)* - *The Financial Services Manager shall perform the duties assigned to it under this Act and may administer the investment asset on behalf of the investment interest owners. (Section 14xx (1))* - *Subject to any prescribed limitations, the Financial Services Manager may establish and charge fees to recover, the costs of doing anything the Financial Services Manager is required or permitted to do under this or any other Act; and any other type of expenditure, the recovery of which is permitted by the regulations. (Section 14xx (3))* - The Electricity Act, 1998 (EA) will be amended as follows: - *In addition to the objects mentioned in subsection (1), the objects of OPG include exercising the powers and rights and performing the duties and obligations assigned to it under the Ontario Fair Hydro Plan Act, 2017 and engaging in activities to facilitate the implementation of that Act, including entering into contracts and undertakings on behalf of financing entities and performing other services on behalf of financing entities, subject to the right to be paid by the financing entities for those services." (Section 53.1 (1.1))* - *"OPG may create or invest in one or more subsidiaries, trusts, partnerships or special purpose entities in order to more efficiently conduct its activities or achieve its objects." (Section 53.1 (1.2))* - OPG will establish a trust to manage the collection of the regulatory asset and related financing and administrative expenses. The Board of Trustees will be the governing body of the Trust and will be appointed by OPG. OPG will have the power to unilaterally appoint or remove all members of the Board of Trustees. - The IESO will not control the appointment or replacement of the Board of Trustees.	No

INDICATOR OF CONTROLS	EVIDENCE OF CONTROL	CONTROL EXIST?

Government has ongoing access to the assets of the organization, has the ability to direct the ongoing use of those assets, or has ongoing responsibility for losses	- Section 23 of the proposed Act states:
	  - *A transfer of a specified portion of the regulatory asset under section 22xx constitutes a valid and enforceable absolute assignment, conveyance and sale of the corresponding investment interest to the transferee.*
	  - *Without limiting subsection (1), any transfer agreement that states an intention of the parties for IESO to dispose of a specified portion of the regulatory asset and to assign, convey or sell a corresponding investment interest shall be treated for all purposes as an absolute assignment, conveyance, disposition and sale of IESO's right to recover the corresponding amount in the variance account and not merely as a security interest.*
	  - *At the time a transfer of the regulatory asset is made under section 22xx, the transfer shall be deemed to have been and shall be perfected, vested, valid and binding as against the transferor and all other persons who have claims of any kind against the transferor.*
	- Based on the proposed Act, *upon transfer by IESO of a portion of the regulatory asset to the OPG Trust, the investment asset resulting from the transfer is immediately vested in the OPG Trust, free and clear of any adverse claim.* (Section 24xx (1.1))
	- Therefore, upon transfer of the regulatory asset to the OPG Trust, IESO will no longer have access/ability to direct the regulatory asset nor have the ongoing responsibility for losses.
	- The credit risk related to the collection of the investment asset is borne by the OPG Trust.
		No

Government holds the majority of the voting shares or a "golden share" that confers the power to govern the financial and operating policies of the organization	- IESO will not have any ownership in the OPG Trust and will not have the power to govern the financial and operating policies of the OPG Trust.	No
Government has the unilateral power to dissolve the organization and thereby access its assets and become responsible for its obligations	- IESO will not have the power to dissolve the organization.	No

INDICATOR OF CONTROLS	EVIDENCE OF CONTROL	CONTROL EXIST?
Other indicators that may provide evidence of control exist when government has the power to (PS 1300.18):		
Provide significant input into the appointment of members of the governing body of the organization by appointing a majority of those members from a list of nominees provided by others or being otherwise involved in the appointment or removal of a significant number of members	- OPG will have the power to unilaterally appoint or remove all members of the Board of Trustees. - IESO will not provide input in the appointment of members of the Board of Trustees.	No
Appoint or remove the CEO or other key personnel	- OPG will have the power to unilaterally appoint or remove all members of the Board of Trustees and other key personnel.	No
Establish or amend the mission or mandate of the organization	- The Trust will be established by OPG and the mandate of the Trust will be set based on the proposed Act.	No

Approve the business plans or budgets for the organization and require amendments, either on a net or line-by-line basis	- The proposed Act states:
	  - *OPG is appointed as the Financial Services Manager for the purposes of this Act." (Section 13xx)*
	  - *"The Financial Services Manager shall prepare a written plan entitled the Financing Plan to be used by the Financial Services Manager to evaluate whether potential funding obligations should be incurred for the purposes of acquiring and financing an investment asset in accordance with this Act or for the purposes of refinancing a funding obligation." (Section 16 (1))*
	- OPG is the Financial Services Manager, not IESO.
	- IESO is not involved in the preparation or approval of the business plans or budget of the OPG Trust.
		No

Establish borrowing or investment limits or restrict the organization's investments	- Section 17 of the proposed Act states: - *The Financial Services Manager shall ensure that funding obligations incurred for the purposes of this Act are incurred in a manner that is consistent with the applicable Financing Plan.* - OPG is responsible for the borrowing, not IESO.	No

INDICATOR OF CONTROLS	EVIDENCE OF CONTROL	CONTROL EXIST?
Restrict the revenue-generating capacity of the organization, notably the sources of revenue	- N/A	No
Establish or amend the policies that the organization uses to manage, such as those relating to accounting, personnel, compensation, collective bargaining or deployment of resources	- As mentioned above, OPG will be granted by legislation the power to establish or amend the policies of the OPG Trust and the ability to appoint and remove all members of the Board of Trustees.	No

Management Conclusion:

IESO management has concluded that the OPG Trust to be established would not be controlled by the IESO and therefore is not subject to consolidation by the IESO.

Based on the 11 indicators of control as defined in Section PS 1300 *Government Reporting Entity*, there is no evidence of control by the IESO for the OPG Trust either collectively or individually. The IESO will not have the power to govern the Trust, nor have ongoing access to Trust's assets. The IESO will also not have any voting shares or future rights to the Trust nor the power to dissolve the Trust. Without control, the Trust is not subject to consolidation within the IESO financial statements.

Our Conclusion:

Based on the Proposed Act, none of the four persuasive indicators of control are considered to be met, and none of the seven non-persuasive indicators are met. Based on a collective assessment of these indicators, the IESO does not control the OPG Trust under the proposed Act.

Although the above analysis discusses in detail IESO's assessment of each of the indicators of control, it is important to note that under PS 1300.20 -.21 these are indicators of control, and the degree of importance of the indicators depends on the particular circumstances in each case. Accordingly, the degree of government influence with respect to that would determine the importance of that particular indicator as evidence of control.

Commented [m1]: I propose to delete this paragraph. It does not add anything since it is clear that none of the indicators are met.

The adoption of the proposed Act (including the subsequent amendments of the Electricity Act and the OEB Act) and the finalization of the financing structure (including the bylaws and regulations of the OPG Trust) and other agreements will take several weeks. Accordingly, the conclusion on control may change subject to further analysis of any changes to the terms of the proposed Act or review of the final regulations, financing structure and other agreements.

Background for issue #3

The facts, circumstances, and assumptions relevant to the specific transactions as provided to us by the management of the Company (responsible party), in addition to those described in the background for issue #1 and 2, are as follows:

1. The total IESO funding shortfall for the period from May 1, 2017 to April 30, 2047 is estimated at $28 billion plus interest and will be recorded by the IESO in a variance account recognize as a regulatory asset.
2. The IESO does not currently have the financial capability to finance the regulatory asset and will transfer the variance account to an investment asset owner (i.e. OPG Trust) on a monthly basis.
3. The IESO will obtain a written legal opinion as to the validity of the transfer of the regulatory asset.
4. Based on an assessment of control performed under the issue #2, IESO will not consolidate the OPG Trust. We understand that an assessment of control under IFRS has been performed by OPG and they have concluded that the OPG Trust will be consolidated by OPG.
5. The Electricity Act, OEB Act and other regulations will be amended to reflect the following *extracts from the proposed Act:*

   Section 11xx IESO to receive amounts

   (2) The IESO shall, as an agent of the investment interest owners, receive amounts in respect of the clean energy adjustment paid to it from electricity vendors in accordance with the regulations and the market rules made under section 32 of the *Electricity Act, 1998*.

   (4) All amounts received by the IESO in respect of the clean energy adjustment shall, until paid to or for the benefit of the investment interest owner, be received and held in trust by the IESO for the investment interest owners.

   (5) The IESO shall remit amounts received by it in respect of the clean energy adjustment, inclusive of interest earned on the accounts referred to in subsection (2), to or for the benefit of the investment interest owners in accordance with the regulations.

   Section 12xx Pro rating of payments

   (3) If an electricity vendor receives a payment made by or on behalf of a specified consumer in respect of amounts payable under one or more invoices and the amount paid is less than the total amount payable, the electricity vendor shall allocate the payment on a pro rata basis to the clean energy adjustment and other amounts payable under the relevant invoices in respect of electricity charges in respect of the same invoice period.

   Section 22xx Transfer of regulatory asset

   (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.

   (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.

   (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.

Section 23xx Validity of transfer

(1) A transfer of a specified portion of the regulatory asset under section 22xx constitutes a valid and enforceable absolute assignment, conveyance and sale of the corresponding investment interest to the transferee.

(2) Without limiting subsection (1), any transfer agreement that states an intention of the parties for IESO to dispose of a specified portion of the regulatory asset and to assign, convey or sell a corresponding investment interest shall be treated for all purposes as an absolute assignment, conveyance, disposition and sale of IESO's right to recover the corresponding amount in the variance account and not merely as a security interest.

(3) At the time a transfer of the regulatory asset is made under section 22xx, the transfer shall be deemed to have been and shall be perfected, vested, valid and binding as against the transferor and all other persons who have claims of any kind against the transferor.

(4) Subsection (3) applies regardless of whether the persons who have claims have received notice of the transfer and the property rights and interests acquired by the transferee shall have priority over any liens in favour of those persons.

Section 25xx Investment asset established

(1) The investment asset constitutes a current and irrevocable property right and interest consisting, collectively, of the following rights and interests of investment interest owners:

1. The right and interest to impose, invoice, collect, receive and recover the clean energy adjustment from specified consumers, including the right to determine the clean energy adjustment in accordance with this Act.
2. The right to receive, collect and recover the clean energy adjustment that are imposed, invoiced and recoverable under this Act, including any amounts in respect of the clean energy adjustment that are held by electricity vendors, IESO and other prescribed parties.

Section 26xx Transfer of investment interest

(2) An investment interest owner may transfer all or a portion of an investment interest to any other investment interest owner, including by way of a transfer of a divided or an undivided interest, in accordance with the Financing Plan.

Section 28xx Investment interest owner may grant security interest

(1) An investment interest owner may grant a security interest over all or a specified portion of its right, title and interest in, to and under the investment interest to or in favour of any person to secure a funding obligation.

(3) All provisions of the *Personal Property Security Act* shall apply to the investment asset and each investment interest on the basis that it is intangible personal property, except as otherwise provided for in this section, and any granting of a security interest by the investment interest owner to secure a funding obligation shall, subject to the terms of the funding obligation, give rise to a security interest in respect of which that Act applies and may be perfected by filing a financing statement under that Act on that basis.

6. The terms of the transfer agreement between the IESO and the OPG Trust that will be signed and executed upon transfer of the regulatory assets will be in compliance with the dispositions of the proposed Act.

Appropriate Accounting Principle for issue #3

The Derecognition Section provides guidance on determining whether and when an entity should remove an item from the financial statements. For example, the entity would derecognize an asset because it no longer has rights to the asset or it would derecognize a liability because it no longer has any obligation. [ASC 980-20-40]

Failure of an entity's operations to continue to meet the criteria in paragraph 980-10-15-2 can result from different causes. Examples include the following:

(e) Deregulation.

(f) A change in the regulator's approach to setting rates from cost-based rate-making to another form of regulation.

(g) Increasing competition that limits the entity's ability to sell utility services or products at rates that will recover costs (as used in paragraph 980-10-15-2).

(h) Regulatory actions resulting from resistance to rate increases that limit the entity's ability to sell utility services or products at rates that will recover costs if the entity is unable to obtain (or chooses not to seek) relief from prior regulatory actions through appeals to the regulator or the courts. [ASC 980-20-15-2]

PS1000 *Financial statement concepts*:

– This Section is to be used by preparers and auditors of financial statements in exercising their professional judgment as to the application of generally accepted accounting principles and in establishing accounting policies in areas in which accounting principles are developing. [PS1000.03]

– Financial statements should communicate information that is relevant to the needs of those for whom the statements are prepared, reliable, comparable, understandable and clearly presented in a manner that maximizes its usefulness. [PS1000.24]

– An item is not an asset of a government if it lacks one or more of the essential characteristics listed in the preceding paragraph [PS3210.04]. 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. [PS1000.37]

PS3210 *Assets*:

– 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. [PS3210.03]

– 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. [PS3210.04]

– 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. [PS3210.22]

PS3430 *Restructuring transactions* [1]

– Individual assets and liabilities transferred in a restructuring transaction should be derecognized by the transferor if they no longer meet the definitions of assets and liabilities and applicable recognition criteria at the restructuring date. [PS3430.21]

– When a transferor continues to be involved in the individual assets and/or liabilities it transferred to a recipient subsequent to the restructuring date, it would assess the nature and extent of its continued involvement against the definitions of assets and liabilities and applicable recognition criteria to evaluate whether:

(a) derecognition of the asset and liability transferred would be appropriate; and

(b) its continued involvement gives rise to a new asset or new liability that needs to be recognized. [PS3430.24]

– A new asset or new liability may arise from a restructuring due to a transferor's continued involvement in the individual assets and liabilities transferred (for example, if it agrees to guarantee repayment of all or a portion of a transferred liability or leases back a portion of a transferred asset). As the new asset or new liability is not transferred, together with related program or operating responsibilities, they are not part of the restructuring transaction. They would be accounted for in accordance with individual Sections of the PSA Handbook by both the transferors and recipients. [PS3430.25]

1 This Section applies to fiscal years beginning on or after April 1, 2018. […] Earlier adoption is permitted."

Issue #3: What is the accounting treatment for the derecognition of the regulatory asset upon transfer of the variance account to the OPG Trust?

Although ASC 980-20-40 states that

"Derecognition Section provides guidance on determining whether and when an entity should remove an item from the financial statements. For example, the entity would derecognize an asset because it no longer has rights to the asset or it would derecognize a liability because it no longer has any obligation."

Subtopic 980-20 relates to discontinuation of rate-regulated accounting when an entity no longer meets the criteria in paragraph 980-10-15-2. ASC 980-20-15-2 provides examples of when an entity no longer meets the criteria, including deregulation and change of the form of regulation.

In the absence of clear guidance for the derecognition of regulatory asset under ASC 980, guidance from PSAS should be analyzed for the criteria for the derecognition of assets.

It should also be noted that PSASs provide limited guidance on derecognition of non-financial assets and liabilities. Section 3430 *Restructuring transactions,* which is applicable for fiscal years on or after April 1, 2018 with early application permitted, has guidance for the derecognition of assets and liabilities.

- Paragraph 21 states that individual assets and liabilities transferred in a restructuring transaction should be derecognized by the transferor if they no longer meet the definitions of assets and liabilities and applicable recognition criteria at the restructuring date.
- As stated in paragraph 24, when a transferor continues to be involved in the individual assets and/or liabilities it transferred to a recipient subsequent to the restructuring date, it would assess the nature and extent of its continued involvement against the definitions of assets and liabilities and applicable recognition criteria to evaluate whether derecognition of the asset and liability transferred would be appropriate and whether its continued involvement gives rise to a new asset or new liability that needs to be recognized.

Recognizing the proposed transaction is not a restructuring transaction, Section 3430, which has recently been issued by PSAB, provides current thinking in the application for the recognition and derecognition of assets and liabilities which is consistent with derecognition guidance in other aspects of GAAP. Accordingly, the analysis as to whether the regulatory asset transferred to the OPG Trust can be derecognized is based on the guidance in paragraph 21.

Commented [m2]: Phil. Are you referring to US GAAP or IFRS? Is this important?

Criteria for the recognition of an asset

PS3210.03 states that 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. More generally, PSAS PS1000.37 suggests that an asset would no longer be recognized when it fails to meet the definition of an asset:

Criteria	Comment	Evaluation
Assets (PS3210.04/ PS1000.36): 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. (c) The transaction or event giving rise to the public sector entity's control has already occurred. *Financial statement concepts (PS1000.37):* An item is not an asset of a government if it lacks one or more of the essential characteristics listed in the preceding paragraph [see above]. Thus, for example, an item does not qualify as an asset of a government if the item involves:	Based on the guidance, the regulatory asset does not qualify as an asset of IESO if it cannot obtain the future economic benefits. Upon transfer of the regulatory asset, IESO will have no further rights or obligations in connection with the asset transferred. - *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.* - *Upon receipt by the IESO of the payment by the financing entity, the IESO shall retain no further right, title or interest in the corresponding investment interest.* - *A transfer of a specified portion of the regulatory asset under section 22xx constitutes a valid and enforceable absolute assignment, conveyance and sale of the corresponding investment interest to the transferee.* - *Without limiting subsection (1), any transfer agreement that states an intention of the parties for IESO to dispose of a specified portion of the regulatory asset and to assign, convey or sell a corresponding investment interest shall be treated for all purposes as an absolute assignment, conveyance, disposition and sale of IESO's right to recover the corresponding amount in the variance account and not merely as a security interest.* - *At the time a transfer of the regulatory asset is made, the transfer shall be deemed to have been and shall be perfected, vested, valid and binding as against the transferor and all other persons who have claims of any kind against the transferor."* Upon transfer of the regulatory asset, the OPG Trust will have the right to sell the asset to another party or to grant a security interest in favour of any person to secure a funding obligation. - *Upon transfer, the financing entity becomes an investment asset owner and acquires an investment interest."* - *An investment interest owner may transfer all or a portion of an investment interest to any other investment interest owner, including by way of a transfer of a divided or an undivided interest, in accordance with the Financing Plan.* - *An investment interest owner may grant a security interest over all or a specified portion of its right, title and interest in, to and under the investment interest to*	Not Met

Criteria	Comment	Evaluation
(a) no future economic benefit (b) future economic benefit, but the government cannot obtain it.	*or in favour of any person to secure a funding obligation.* Based on the proposed Act, it is clear that IESO will have no more future cash inflows related to the regulatory asset as it will have transferred its right to recover the IESO funding shortfall. Further, it is also clear that IESO will have lost control over the regulatory asset once it is transferred to OPG Trust.	

Management conclusion:

IESO management has concluded that the regulatory asset will be derecognized upon transfer of the variance account to the OPG Trust.

The transfer of the variance account transfers the control and the right to collect funds in the future against the variance amount to the OPG Trust. Through asset definition, this will eliminate the IESO asset by the amount of the transfer as they no longer control an economic resource or have access to future economic benefits for that amount. The funds collected from the transfer will in turn reduce the associated debt held by the IESO, maintaining the IESO's net $ nil balance in the market accounts.

Our conclusion:

In our opinion, the regulatory asset should be derecognized on transfer to the OPG Trust as IESO no longer has rights or obligations to the asset.

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Other Matters

The ultimate responsibility for the decision on the appropriate application of PSAS for the specific transactions rests with management as preparers of the financial statements. Our judgment on the appropriate application of PSAS for the specific transaction is based solely on the facts, circumstances and assumptions provided to us as described above. Should these facts and circumstances differ, our conclusion may change.

We will assume no responsibility to update our accounting advice for any changes subsequent to the finalization of the legislation, regulations, financing structure and other agreements relating to the Ontario Fair Hydro Plan Act or in PSAS as a consequence of pronouncements by the Public Sector Accounting Board, or any other authoritative bodies, that occur subsequent to the date of this letter, unless an update is agreed by both parties in writing through a separate engagement letter.

This letter is intended solely for the information and use of the Board of Directors and management of the Company, and is not intended to be and should not be used, quoted, relied upon by, or otherwise referred to by anyone other than these specified parties or for any other purpose. However, this letter is a matter of public record and its distribution is not limited. We do not accept or assume responsibility for any other purpose or to any other person to whom this letter is shown or into whose hands it may come save where expressly agreed by our consent in writing.

Yours very truly,

Michel Picard
Partner
(416) 777 8414
mpicard@kpmg.ca

Appendix A:

Draft of the Ontario Fair Hydro Plan Act, 2017