NOTICE OF NON RELIANCE

This document has been prepared by KPMG LLP ("KPMG") for the use of the Independent Electricity System Operator ("Client") pursuant to the terms of our engagement agreement with Client (the "Engagement Agreement"). This document is being provided to Client on a confidential basis and may not be disclosed to any other person or entity without the express written consent of KPMG and Client. KPMG neither warrants nor represents that the information contained in this document is accurate, complete, sufficient or appropriate for use by any person or entity other than Client or for any purpose other than set out in the Engagement Agreement. This document may not be relied upon by any person or entity other than Client, and KPMG hereby expressly disclaims any and all responsibility or liability to any person or entity other than Client in connection with their use of this document.

Yours very truly,

KPMG LLP

PRIVATE AND CONFIDENTIAL – NOT FOR FURTHER DISTRIBUTION

Memo to file to address the issues raised by the AG, dated July 25, 2017

This memorandum addresses the issues raised by the Office of the Auditor General in its email sent to John Gordon on June 20, 2017. We have summarized the issues raised into 17 issues, each individually discussed in more detail in the balance of this memorandum. The comments set out herein are specific to the accounting by IESO and do not relate to the accounting by another entity, including the Province of Ontario.

Summary of the conclusions reached in this memorandum

The IESO changed its accounting policies to permit the recognition of the economic effects of rate regulation as from the 2016 financial year. IESO adopted the guidance of ASC 980 *Regulated Operations ("ASC 980")* to better reflect the economic substance of its operations and enhance the relevance, transparency and accountability of its financial reporting.

As further discussed in this memo, we believe that a rate-regulated entity reporting under PSAS is allowed to use the GAAP hierarchy under Public Sector Accounting Standards ("PSAS") to adopt ASC 980. We note that rate-regulated entities that were reporting under Part V of the CPA Handbook before they transitioned to IFRS recognized the economic effects of rate regulation using the GAAP hierarchy in Part V of the CPA Handbook, which is substantially consistent with the GAAP hierarchy in PSAS. These rate-regulated entities and their auditors concluded that the concepts in the other GAAP source (i.e. ASC 980) are compatible with the qualitative characteristics of financial information, the elements of financial statements (including the definitions of assets and liabilities), and the recognition and measurement criteria in Section 1000 of Part V of the CPA Handbook.

Based on the analyses performed in this memorandum, we concur with the following conclusions by management of the IESO:

- The IESO believes that the recognition of regulatory assets and liabilities better reflects the economic substance of IESO's operations and enhances the relevance, transparency and accountability of its financial reporting (see IESO's 2016 financial statements, note 3; issue 3, page 5);
- PSAS neither explicitly permits, nor prohibits, the recognition, measurement, presentation or disclosure of rate-regulated activities (see issue 1, page 2);
- The IESO is similar to the other eight ISO entities across North America and the recognition of the market accounts and the economic effects of rate regulation improved the comparability of the IESO with its peers (see issue 2, page 4);
- The GAAP hierarchy was properly applied by the IESO (see issue 3, page 5);
- The GAAP hierarchy under PSAS does not prohibit the use of US GAAP, especially when US GAAP is the only accounting framework in North America that provides detailed guidance on rate-regulated operations (see issue 4, page 10);
- The IESO did not in its 2016 financial statements apply an exemption to recognize the economic effects of rate regulation, but used the GAAP hierarchy to do so (see issue 5, page 10);
- When the exemption from applying the GAAP hierarchy contained in Section 1100 of Part V of the CPA Handbook by rate-regulated entities was removed in 2009, rate-regulated entities continued to recognize the economic effects of rate regulation under Part V using the GAAP hierarchy in Section 1000 (see issue 5, page 12);
- The adoption of regulatory accounting under Part V of the CPA Handbook was not based on industry practice but was permitted through the application of the GAAP hierarchy (see issue 5, page 12);
- ASC 980 is not an exemption from, but an application of, US GAAP (see issue 6, page 13);
- Regulatory assets meet the definition of an asset under US GAAP, Part V of the CPA Handbook and PSAS (see issue 7, page 15);
- The IESO is a rate-regulated entity by the OEB and has a number of variance accounts approved by the OEB that meet the criteria for recognition under ASC 980 (see issue 8, page 19);
- IESO does not have to give precedence to IFRS over other accounting frameworks. It is appropriate for the IESO to reference the private sector guidance when applying the GAAP hierarchy as PSAS does not provide detailed guidance on rate-regulated accounting (see issue 9, page 20);
- The financial statements for the market accounts have included regulatory assets and liabilities for a number of years (see issue 10, page 21);
- IESO is a self-sustaining entity as it does not receive transfers or subsidies from the government and all its costs are recovered from customers through the market participants (see issue 11, page 22);

- Regulatory assets are neither considered intangible assets nor deferred costs (see issues 12, 14, pages 23, 25);
- The OEB meets the criteria of independent, third-party regulator (see issue 13, page 24);
- The transactions related to the market accounts should be recorded in the IESO's books as they meet the criteria in paragraphs 9 and 11 of PS 3450 *Financial Instruments*. The assets and liabilities should be recorded on a gross basis and revenue and expenses should be recorded on a net basis (see issue 15, page 27);
- The Ontario Fair Hydro Plan, Act 2017 is not considered to be a price controls regime as defined by ASC 980 (see issue 16, page 29); and
- Rate-regulated entities reporting under PSAS, which receive substantial subsidies from their governments, do not meet the scope criteria in ASC 980-10-15-2 (b) as their rates are not designed to recover the specific entity's costs of providing the regulated services or products (see issue 17, page 30).

1. Does PSAS provide explicit guidance on rate-regulated activities?

PSAS

No. PSAS neither explicitly permits, nor prohibits, the recognition, measurement, presentation or disclosure of rate-regulated activities. In the absence of specific guidance in PSAS, an entity is permitted under PSAS Section 1150 to apply the identified GAAP hierarchy in determining the appropriate accounting for the specified transactions. As analyzed below, the IESO believes that it met the criteria in PS 1150 when it adopted the recognition and measurement principles of ASC 980 for the economic effects of rate regulation.

Specifically, PS 1150.18 and 19 state:

> *"Paragraphs PS 1150.19-.24 identify some of the other sources that a public sector reporting entity might consult to assist in selecting accounting policies and disclosures that comply with paragraph PS 1150.05.*
>
> *Pronouncements issued by other bodies authorized to issue accounting standards may be useful sources to consult. For example, accounting pronouncements published with the authority of the Canadian Accounting Standards Board (AcSB), International Accounting Standards Board (IASB), US Federal Accounting Standards Advisory Board (FASAB), US Governmental Accounting Standards Board (GASB), or International Public Sector Accounting Standards Board (IPSASB) are often important sources to consult on matters not covered by primary sources of GAAP or for assistance in applying a primary source of GAAP to specific circumstances." (Emphasis added)*

Since the subject of rate regulation is not covered in the PSAS defined "primary sources of GAAP", in accordance with PSAS we have considered these additional sources.

We note that the sources listed in paragraph 19 are highlighted as examples of important sources to consult rather than being an exhaustive list of sources that should be considered by a public sector reporting entity when selecting an accounting policy. This view is supported by paragraph 18, which states that PS 1150.19-.24 *"identify some of the other sources"*. The frameworks referenced in paragraph 19 include frameworks from other jurisdictions, including frameworks for profit oriented enterprises, as well as frameworks specifically developed for public sector entities, which indicates that PS 1150 does not restrict public sector entities from consulting frameworks that were primarily developed for entities other than public sector reporting entities as long as the criteria in PS 1150 are met.

In the absence of guidance in an accounting framework, preparers and auditors are required to apply judgment in the development of accounting policies. Until AcSB, GASB and FASB issued their guidance on rate regulation, utilities and their auditors were solely required to apply judgment. Currently, FASB requires, and IASB (through IFRS 14), ASPE and GASB permit, the recognition of the economic effects of rate regulation when an entity meets defined criteria. PSAS is silent on the application of rate regulation and, as a result, utilities and their auditors are required to apply professional judgment in considering other aspects of the GAAP hierarchy.

AcSB

Within AcSB, Part I - IFRS and Part II - Accounting Standards for Private Enterprises (ASPE) provide limited guidance on the accounting for the economic effects of rate regulation as discussed further below.

– IFRS

IASB has not completed its current project on rate-regulated activities and current standards only include an interim standard (i.e. IFRS 14 *Regulatory Deferred Accounts*) that allows an entity within its scope to continue to account for rate-regulated activities in a manner consistent with its pre-IFRS accounting framework. The pre-IFRS accounting framework for those Canadian rate-regulated entities that have adopted

IFRS 14 is the legacy Canadian GAAP included in Part V of the CPA Handbook. As Part V did not include a separate section on the recognition and measurement of regulatory assets and liabilities, entities reporting under Part V have utilized the GAAP hierarchy in accordance with Sections 1100.04, .24 and 32B to adopt ASC 980 guidance for rate-regulated activities.

– ASPE

ASPE defines a rate-regulated entity, provides guidance on certain aspects of the disclosure and presentation of information in the financial statements of rate-regulated entities through AcG 19 *Disclosures by entities subject to rate regulation*, and provides specific guidance under four Sections (3061 *PPE*, 3465 *Income Taxes*, 3475 *Disposal of long-lived assets and discontinued operations* and 3850 *Interest capitalized*). While ASPE provides no specific guidance on the recognition of regulatory assets and liabilities, it clearly allows such accounting for entities that are subject to rate regulation. For example, AcG 19 par. 7 requires disclosure of assets and liabilities recognized solely as a result of the effects of rate regulation which would not be a possible disclosure if such effects could not be recorded in the entity's financial statements.

Rate-regulated entities reporting under ASPE have used the GAAP hierarchy to adopt the recognition and measurement guidance for regulatory assets and liabilities of ASC 980.

FASAB

The "*FASAB Handbook of Federal Accounting Standards and Other Pronouncements, as Amended ("FASAB Handbook")*" contains the body of accounting concepts and standards for the U.S. Federal Government. FASAB does not provide accounting guidance for entities with rate-regulated activities. However, we understand from our communication with FASAB that the FASAB GAAP hierarchy of accounting standards allows federal entities to apply FASB standards for matters not addressed in FASAB standards.

As an example, the U.S. Department of Energy ("DOE") reports under the Statement of Federal Financial Accounting Standards (SFFAS, which is an aspect of FASAB) and recognizes regulatory assets in its financial statements[1]. Extracts from the note 1.A Basis of presentation and note 5 Regulatory Assets are as follows:

Note 1.A: *These consolidated and combined financial statements have been prepared to report the financial position and results of operations of the United States (U.S.) Department of Energy (the Department or DOE). The statements were prepared from the books and records of the Department in accordance with generally accepted accounting principles applicable to federal entities.*

Note 6: "The Department's PMAs record certain amounts as assets in accordance with the Financial Accounting Standards Board's Accounting Standards Codification (FASB ASC) 980, Regulated Operations. The provisions of this standard require that regulated enterprises reflect rate actions of the regulator in their financial statements, when appropriate. These rate actions can provide reasonable assurance of the existence of an asset, reduce or eliminate the value of an asset, or impose a liability on a regulated enterprise. In order to defer incurred costs under this standard, a regulated entity must have the statutory authority to establish rates that recover all costs, and those rates must be charged to and collected from customers." (Emphasis added)

We note the DOE's regulatory assets include balances arising from a variety of transactions, including debt financings, repayments towards previous funding of generation assets, and provisions for costs incurred to be funded through future operations.

GASB

GASB 62 permits (i.e. provides a choice to) a governmental entity to recognize the economic effects of rate regulation in financial statements for periods beginning after December 15, 2011. Before the issuance of GASB 62, preparers and auditors were required to apply judgment as to whether a governmental entity could apply ASC 980 (previously called FAS 71). GASB 62 section "How the Changes in This Statement Will Improve Financial Reporting" states that:

"The requirements in this Statement will improve financial reporting by contributing to the GASB's efforts to codify all sources of generally accepted accounting principles for state and local governments so that they derive from a single source. This effort brings the authoritative accounting and financial reporting literature

[1] https://www.energy.gov/sites/prod/files/2016/11/f34/DOE_FY2016_AFR.pdf

together in one place, with that guidance modified as necessary to appropriately recognize the governmental environment and the needs of governmental financial statement users. It will eliminate the need for financial statement preparers and auditors to determine which FASB and AICPA pronouncement provisions apply to state and local governments, thereby resulting in a more consistent application of applicable guidance in financial statements of state and local governments." (Emphasis added)

GASB 62 par. 149 states that *"If some of a business-type activity's operations are regulated and meet the criteria of paragraph 476 and the entity elects to apply paragraphs 476–500, those provisions should be applied to only that portion of the business-type activity's operations." (Emphasis added)*

IPSAS

IPSAS does not provide accounting guidance for entities with rate-regulated activities.

FASB

The recognition of the economic effects of rate regulation dates back to the early 1900s. FAS 71 required an entity to recognize the economic effects of rate regulation in financial statements for fiscal years beginning after December 15, 1983. Before the issuance of FAS 71, preparers and auditors were required to apply judgment with respect to the development of accounting policies to recognize the economic effects of rate regulation.

ASC 980 must be applied by entities that meet certain criteria. Section 10-15-2 of ASC 980 states that *"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..."*

2. How does IESO compare to other ISO entities in North America?

There are nine ISO entities in North America; seven in the U.S. and two in Canada (IESO and AESO). It is important to note that, similar to IESO, 7 of the 8 other ISO entities across North America are not-for-profit organizations (the 8th one is an LLC, non-stock company), 7 of the other 8 entities recognize the balances of the market participants and 6 of the other 8 entities recognize the economic effects of rate regulation (see Appendix D for a summary of these nine entities). All these entities state in the notes to their financial statements that their activities include the recovery of administrative fees for collecting amounts from the distributors of electricity and paying the contracts of the generators of electricity.

The two entities that do not recognize the economic effects of rate regulation are California ISO ("CAISO") and Southwest Power Pool ("SPP"). CAISO's accounting framework is GASB, which permits the recognition of regulatory assets and liabilities while SPP's accounting framework reporting is FASB, which requires the recognition of regulatory assets and liabilities that meet the criteria under ASC 980. Based on the communication between IESO and CAISO, we understand that the latter concluded that the need to recognize regulatory assets and liabilities (under FAS 71) was no longer necessary since it has other mechanisms in place to adjust its rates (under certain conditions) up or down, to ensure their revenue requirement for the year is met and, as a result, it does not have any variance accounts that would qualify as regulatory assets or liabilities under ASC 980. Based on the communication between IESO and SPP, we understand that the latter does not have any variance accounts that would qualify as regulatory assets or liabilities under ASC 980.

Although the IESO and 7 of the other 8 ISO entities are not-for-profit organizations, none have adopted the accounting for not-for-profit organizations as they do not meet its criteria. PSAS defines a government not-for-profit organization as a government organization that has all of the following characteristics:

(a) It is a separate entity with the power to contract in its own name and that can sue and be sued.
(b) It has counterparts outside the public sector as defined in paragraph .02.
(c) It is an entity normally without transferable ownership interests.
(d) It is an entity organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose.
(e) Its members, contributors and other resource providers do not, in such capacity, receive any financial return directly from the organization.

The IESO does not meet either criteria (d) or (e), as it provides services for the fees it receives which would be considered a financial return.

3. Was the GAAP hierarchy appropriately applied?

In accordance with PS 2120.02, the IESO can adopt a new accounting policy, to reflect the economic effects 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. PS 2120.02 states that

> *"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."*

As stated in the IESO's 2016 financial statements, the IESO believes that the recognition of regulatory assets and liabilities better reflects the economic substance of IESO's operations and enhances the relevance, transparency and accountability of its financial reporting.

PSAS does not explicitly address the accounting for transactions in a rate-regulated environment. Since PSAS is silent regarding the recognition of the economic effects of rate regulation, in accordance with PS 1150.05 IESO may consider other sources in the GAAP hierarchy to determine appropriate accounting policies for transactions in a rate-regulated environment. Using the GAAP hierarchy is a choice, not a requirement. As from 2016, the IESO chose to use the GAAP hierarchy to adopt the recognition and measurement principles of ASC 980. Said differently, the decision to adopt regulatory accounting in March 2017 for its 2016 financial statements is not prohibited as the choice was made by the IESO Board at that time based on its view that the financial statement presentation better reflects the economic effects of rate regulation. PS1150.05 states:

> *"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, <u>the selection of an appropriate accounting policy requires the exercise of professional judgment.</u> In these circumstances, a public sector reporting entity should adopt accounting policies and disclosures that <u>are consistent with</u>:* (Emphasis added)
>
> *(a) the primary sources of GAAP; and*
>
> *(b) the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section PS 1000."*

Based on PS 1150.05 above, the selection of an appropriate accounting policy requires the exercise of professional judgment and these policies have to be consistent with the primary sources of GAAP and the concepts in PS 1000.

Primary sources of GAAP

As mentioned above, PSAS does not explicitly address the accounting for transactions in a rate-regulated environment.

Although PS 3210 *Assets* applies for fiscal years beginning on or after April 1, 2017, we have considered and concluded that this new standard does not provide any guidance on the accounting for the economic effects of rate regulation.

If the concepts of the other source of GAAP (i.e. ASC 980) are in conflict with PSAS then PSAS prevails (PS 1150.12). For example, PSAS does not recognize intangible assets (PS 3150.03 and PS 1000.58). So if regulatory assets are considered to be intangible assets, they would not be allowed to be recognized through the other source of GAAP. As discussed in response to issue 12, management of the IESO and we concluded that ASC 980 is not in conflict with PS 3150.03 and PS1000.58 with respect to intangible assets.

Application of the concepts in PS 1000

As required by PS 1150.05 (b), we need to analyze whether the concepts in the other source (i.e. US GAAP and 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. Based on the analysis below and in response to issue 7, we believe that these concepts under US GAAP are consistent and comparable to those under PSAS.

(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)	This Section describes the concepts underlying the development and use of accounting principles in government financial statements (par. 01).	Similar as FASB also 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 Regulatory assets meet the definition of asset as discussed in response to issue 7. FAS 71.75 states that the Board concluded that, for general-purpose financial reporting, the principal economic effect of the regulatory process is to provide assurance of the existence of an asset or evidence of the diminution or elimination of the recoverability of an asset.
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 FAS 71.11 states that rate actions of a regulator can impose a liability on a regulated enterprise. Such liabilities are usually obligations to the enterprise's customers.
Revenues		
Inflows from delivering or producing goods, rendering services or other	Increases in economic resources resulting from operations,	Although PSAS is based on the change in the balance

FASB	PSAS	Evaluation
activities that constitute the entity's central operations. (Concept #6.78-.79)	transactions and events of the accounting period. (par. 46)	sheet assets/liabilities model, the revenue recognized for regulatory assets would not be contradictory to this concept.
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)	Essential characteristics 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)	To be recognized, an 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) 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. (par. 58)	Essential characteristics similar Regulatory assets have an appropriate basis of measurement (i.e. historical cost). A reasonable estimate can be made of the regulatory assets as they represent the difference between the amount paid to a supplier for goods or services received and the amount collected from the customers through the market participants. As the regulatory assets are approved by the OEB for future recovery in rates, the IESO is the only party that will realize the economic benefits (i.e. the receipts of cash). As discussed in response to issue 12, regulatory assets are not considered intangible assets. Intangible assets are non-financial assets. Regulatory assets are financial assets as defined in PS 1000 as they will be used to discharge existing liabilities to the generators of electricity. FAS 71.75. The Board concluded that, for general-purpose financial reporting, the principal economic effect of the regulatory process is to provide assurance of the

FASB	PSAS	Evaluation
		existence of an asset or evidence of the diminution or elimination of the recoverability of an asset. The regulator's rate actions affect the regulated enterprise's probable future benefits or lack thereof. Thus, an enterprise should capitalize a cost if it is probable that future revenue approximately equal to the cost will result through the rate-making process.

(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)	Essential characteristics similar Regulatory assets are measured at historical cost.

Evaluation whether regulatory assets under ASC 980 meet the definition of Assets as per Section PS 3210

Management of the IESO and we concluded that ASC 980 is not an exemption from the application of US GAAP (see discussion in response to issue 6) and regulatory assets under ASC 980 meet the definition of assets under PS 3210 (see discussion in response to issue 7).

Other sources of GAAP

Since the concepts in US GAAP and ASC 980 are consistent with PS 1000, IESO needs to determine the other sources of GAAP that it can use in reference to the criteria in PS 1150. It should be noted that US GAAP is the only widely applied accounting framework that provides detailed guidance on rate-regulated accounting to be applied to general-purpose external financial statements.

Criteria of PS 1150.08

Application of PS 1150.08 is required, in the absence of a source in Canada that specifically provides guidance on the accounting for rate-regulated transactions, to ensure that the alternative source of GAAP is consistent with PS 1150.05.

> *"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 PS 1150.05. 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."*

As discussed in response to Issue 1, Part I - IFRS and Part II – ASPE only provide limited guidance on the accounting for the economic effects of rate regulation. As stated there:

- ASPE defines a rate-regulated entity, provides guidance on certain aspects of the disclosure and presentation of information in the financial statements of rate-regulated entities through AcG 19 *Disclosures by entities subject to rate regulation*, and provides specific guidance under four Sections (3061, 3465, 3475 and 3850). While ASPE does not provide specific guidance on the recognition of regulatory assets and liabilities, it clearly allows such accounting for entities that are subject to rate regulation. For example, AcG 19 par. 7 requires disclosure of assets and liabilities recognized solely as a result of the effects of rate regulation which would not be a possible disclosure if such effects could not be recorded in the entity's financial statements. Entities reporting under ASPE have used the GAAP hierarchy to adopt ASC 980.
- IASB has not completed their current project on rate-regulated activities and current standards only include an interim standard (i.e. IFRS 14) based upon what was done under previous GAAP. Entities reporting under IFRS, which meet the criteria in IFRS 14 have also previously adopted ASC 980.

Rate-regulated entities in North America reporting under US GAAP, GASB, FASAB, ASPE, IFRS (entities which have elected to use IFRS 14 upon transition to IFRS) and legacy Canadian GAAP before the Canadian entities transitioned to IFRS (or to other accounting frameworks) generally all recognize the economic effects of rate regulation in accordance with ASC 980.

As a result, based on PS 1150.08 (a) and (b), in the absence of a specific source in Canada that provides detailed guidance for the accounting for the economic effects of rate regulation, management of the IESO and we have concluded that ASC 980 is the main source that deals with the accounting for the economic effects of rate-regulated activities and is therefore a relevant source.

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

Accounting for the economic effects of rate regulation under ASC 980 by Canadian rate-regulated entities is a long-standing practice in Canada in a variety of different industries. Although it is clear that industry practice in and of itself is not a sufficient basis for developing accounting policies, we note that this industry practice has continued to be acknowledged and recognized by the AcSB, including by reference to the disclosure and other requirements addressing rate-regulated accounting in ASPE, the AcSB's deferral of the adoption of IFRS in Canada for entities with rate-regulated activities, and the AcSB's continued participation in the IASB's project on rate-regulated activities, including their involvement in drafting IFRS 14.

Based on the judgment exercised by its management, IESO and we believe that the recognition of the economic effects of rate regulation results is a fair presentation of the financial affairs of IESO in accordance with PSAS. Based on discussions with the IESO, we understand that most, if not all, users of IESO's financial statements (including the IESO's Board of Directors, Province of Ontario, OEB and interveners, OPCD, OPG, Hydro One, LDCs, and other ISO entities in North America), exercising professional judgment, believe that the recognition of the economic effects of rate regulation provides better information, is well understood and results in a fair presentation in accordance with GAAP. It further provides users of financial statements with relevant and understandable information that represents faithfully how the impact of rate regulations affect the entity's financial position, performance and future cash flows. As mentioned earlier, 6 of the 8 other ISO entities across North America recognize the economic effects of rate regulation as it is considered to best support the fair presentation, transparency and accountability of their financial reporting and the two that do not do so do not have eligible transactions for recognition under ASC 980. This ensures compliance with PSAS 1150.11 which states:

> *"In selecting appropriate accounting policies and disclosures, interpretations of a source do not constitute evidence that the criteria in paragraph PS 1150.05 have been met if it is likely that most parties, exercising professional judgment, would reject them as not resulting in a fair presentation in accordance with GAAP."*

4. Do the other sources of GAAP under PS 1150 prohibit the use of US GAAP?

No. PS 1150 identifies some of the other sources that an entity might consult. PS 1150.18 and .19 state:

> 18. "*Paragraphs PS 1150.19-.24 identify some of the other sources that a public sector reporting entity might consult to assist in selecting accounting policies and disclosures that comply with paragraph PS 1150.05.*" (Emphasis added)
>
> 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 (FASAB), US Governmental Accounting Standards Board (GASB), or International Public Sector Accounting Standards Board (IPSASB) are often important sources to consult on matters not covered by primary sources of GAAP or for assistance in applying a primary source of GAAP to specific circumstances.*" (Emphasis added)

In response to issue 1 we set out linkages to IFRS, ASPE and GASB and identified that FASAB and IPSASB do not explicitly provide any relevant guidance for the recognition and measurement of regulatory balances. In addition, while FASB is not specifically mentioned as an example of "*important sources to consult*", it is also not prohibited. FASB's guidance is also specifically mentioned in GASB and is the basis on which ASPE and IFRS 14 rate-regulated accounting has been applied. Therefore, through the PSAS GAAP hierarchy, a rate-regulated entity can firstly consult ASPE as a source of GAAP and subsequently through the ASPE GAAP hierarchy, consult US GAAP and use ASC 980 for guidance.

As mentioned earlier, US GAAP is the only widely applied accounting framework that provides detailed guidance on rate-regulated accounting to be applied to general-purpose external financial statements. As stated in PS 1150.08 (a) "*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.*" As a result, the IESO believes that ASC 980 is an important and acceptable source to consult on matters not covered by PSAS provided it complies with PS 1150.05.

5. Did Part V of the CPA Canada Handbook – Accounting (the "legacy Canadian GAAP" or "Part V") provide an exemption to use ASC 980?

It is important to note that the legacy Canadian GAAP under Part V is still relevant as Canadian rate-regulated entities reporting under IFRS 14 are required through IFRS 14.11 to continue to apply their previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory assets and liabilities, which were accounted for under Part V.

The GAAP hierarchy under PSAS, Section 1150 issued in 2005 was effective for fiscal years beginning on or after April 1, 2005, while the GAAP hierarchy under Part V of the CICA Handbook, Section 1100 issued in 2003 was effective for fiscal years beginning on or after April 1, 2005. As analyzed in Appendix F to this document, both GAAP hierarchies are consistent except for an exemption from applying Section 1100 granted to rate-regulated entities between 2003 and 2008 under Part V ("Original Section 1100"). After 2008, the exemption from applying Section 1100 was removed from the GAAP hierarchy under Part V ("Revised Section 1100").

Original Section 1100 under Part V was applicable for fiscal years beginning on or after October 1, 2003, except for rate-regulated entities. An exemption from applying Original Section 1100 was granted to those entities pending resolution of the AcSB project on rate-regulated operations.

> .32 "*This Section applies to fiscal years beginning on or after October 1, 2003, except in the circumstances described in paragraph 1100.34. Earlier adoption is encouraged.*
>
> .34 *Pending completion of a separate project on rate-regulated operations, an entity is not required to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation. Entities are required to apply this Section to all other assets and liabilities for fiscal years beginning on or after October 1, 2003.*
>
> .35 *An entity that chooses not to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation is required to comply with all disclosure requirements of GAAP, and to disclose the nature of the differences between its accounting policies for assets and liabilities arising from rate regulation and those required by the primary sources of GAAP.*" (Emphasis added)

As explained in the Basis for Conclusions of Original Section 1100 of Part V, the AcSB granted an exemption from the application of Section 1100 to the assets and liabilities arising from rate regulation in the GAAP hierarchy pending completion of a separate project on rate-regulated operations.

.90 *"The AcSB considered whether to grant temporary relief from the application of Section 1100 to any type of entity. Given the AcSB's active project on rate-regulated operations, members were sympathetic to the fact that such an entity may make changes to adopt Section 1100 and then have to make further changes (perhaps reversing previous decisions) to adopt the future requirements of any CICA Handbook - Accounting amendments related to rate-regulated operations. However, the AcSB expressed concern with a blanket exclusion of rate-regulated operations from Section 1100. The AcSB noted that the specific issues that rate-regulated operations face in applying Section 1100 appear to apply only to those assets and liabilities that are affected by rate regulation. The AcSB did not see a need to provide an exemption from the requirements of Section 1100 for any other aspect of accounting by a rate-regulated operation. Furthermore, the AcSB did not have sufficient information to develop a robust definition of a "rate-regulated operation". Many entities undertake both rate-regulated activities, and other activities that are unaffected by rate regulation. The AcSB did not see validity in exempting those activities unaffected by rate regulation.*

.91 *Accordingly, the AcSB granted temporary relief from the application of Section 1100 only to the recognition and measurement of assets and liabilities arising from rate regulation, pending completion of a separate project on rate-regulated operations. Entities are required to apply Section 1100 to all other assets and liabilities for fiscal years beginning on or after October 1, 2003. Entities that choose not to apply Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation must nonetheless comply with all disclosure requirements of GAAP, and disclose the nature, but not necessarily the effect, of the differences between its accounting policies for assets and liabilities arising from rate regulation and those required by the primary sources of GAAP."* (Emphasis added)

As the AcSB's project for rate-regulated operations was stopped in 2007, the AcSB amended Section 1100 to remove the temporary exemption granted to rate-regulated entities. Handbook revision release no. 47, dated December 2007, stated:

"Deleted paragraphs 1100.34-.35 to remove the temporary exemption from the requirement to apply this Section to the recognition and measurement of assets and liabilities arising from rate regulation, and a disclosure requirement relating to this exemption."

"Added paragraph .32B to specify the effective date of this Section as it pertains to the recognition and measurement of assets and liabilities arising from rate regulation." (Emphasis added)

As a result of the 2007 amendment, rate-regulated entities were required to apply Revised Section 1100 to the recognition and measurement of assets and liabilities arising from rate regulation. Paragraph 32B was added to Section 1100 as follows:

".32B This Section applies to the recognition and measurement of assets and liabilities arising from rate regulation in interim and annual financial statements relating to fiscal years beginning on or after January 1, 2009. Rate regulation exists when all of the following criteria are present:

(a) The rates for regulated services or products provided to customers are established by or are subject to approval by a regulator or a governing body empowered by statute or contract to establish rates to be charged for services or products.

(b) The regulated rates are designed to recover the cost of providing the services or products.

(c) It is reasonable to assume that rates set at levels that will recover the cost can be charged to and collected from customers in view of the demand for the services or products and the level of direct and indirect competition."

Commencing in 2009, rate-regulated entities reporting under Part V used Section 1100 and concluded that while the primary source of GAAP did not provide specific guidance on the recognition and measurement of regulatory assets and liabilities, impacted entities were able to apply the GAAP hierarchy to reach a conclusion that ASC 980 (then FAS 71) was in accordance with Canadian GAAP.

It is useful to analyze how other sources of GAAP under Section 1100 of the legacy Canadian GAAP have been applied in 2009 by Canadian entities with rate-regulated activities, as the temporary exemption for the measurement and recognition of assets and liabilities arising from rate-regulated activities was removed from Section 1100.

.03 "An entity should apply every primary source of GAAP that deals with the accounting and reporting in financial statements of transactions or events encountered by the entity.

.04 When the primary sources of GAAP do not deal with the accounting and reporting in financial statements of transactions or events encountered by the entity, or additional guidance is needed to apply a primary source to specific circumstances, an entity should adopt accounting policies and disclosures that are:

(a) consistent with the primary sources of GAAP; and

(b) developed through the exercise of professional judgment and the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section 1000."

As examples, we have provided below extracts from the consolidated financial statements of Ontario Power Generation, Toronto Hydro Corporation and Fortis Inc. for the year ended December 31, 2009 on the accounting policies adopted for the recognition and measurement of assets and liabilities arising from rate regulation under the legacy Canadian GAAP. OPG and Fortis are audited by EY and Toronto Hydro by KPMG.

Ontario Power Generation

"The CICA revised its guidance on accounting for rate-regulated operations, effective January 1, 2009, with amendments to Handbook Section 1100, Generally Accepted Accounting Principles, ("Section1100"), Handbook Section 3465, Income Taxes, ("Section 3465"), and Accounting Guideline 19, Disclosures by Entities Subject to Rate Regulation, ("AcG-19") as follows:

- *To remove the temporary exemption pertaining to the application of Section 1100 to rate-regulated operations, <u>including the elimination of the opportunity to use industry practice as an acceptable basis for recognition and measurement of assets and liabilities arising from rate regulation</u>"*

"In addition, effective January 1, 2009, <u>with the removal of the temporary exemption in Section 1100, the Company must now apply Section 1100 to the recognition of assets and liabilities arising from rate regulation</u>. Certain assets and liabilities arising from rate regulation continue to have specific guidance under a primary source of Canadian GAAP that applies only to the particular circumstances described therein, including those arising under Handbook Section 1600, Consolidated Financial Statements, Handbook Section 3061, Property, Plant and Equipment, Section 3465, and Handbook Section 3475, Disposal of Long-Lived Assets and Discontinued Operations. Other assets and liabilities arising from rate regulation do not have specific guidance under a primary source of Canadian GAAP. Therefore, <u>Section 1100 directs the Company to adopt accounting policies that are developed through the exercise of professional judgment and the application of concepts described in Handbook Section 1000, Financial Statement Concepts.</u> In developing these accounting policies, the Company may consult other sources including pronouncements issued by bodies authorized to issue accounting standards in other jurisdictions. Therefore, in accordance with Section 1100, <u>the Company has determined that these assets and liabilities qualify for recognition under Canadian GAAP and this recognition is consistent with the Financial Accounting Standards Board Accounting Standards Codification Topic 980, Accounting for the Effects of Certain Types of Regulation (formerly Financial Accounting Standards No. 71).</u> As a result, there is no effect on the Company's financial statements for the year ended December 31, 2009, with the exception of the impact of the amendment to Section 3465, as discussed above." (Emphasis added)

Toronto Hydro Corporation

"<u>Following the removal of the temporary exemption for rate-regulated operations included in Handbook Section 1100, the Corporation developed accounting policies for its assets and liabilities arising from rate regulation using professional judgment and other sources issued by bodies authorized to issue accounting standards in other jurisdictions.</u> Upon final assessment and in accordance with Handbook Section 1100, the <u>Corporation has determined that its assets and liabilities arising from rate-regulated activities qualify for recognition under Canadian GAAP and this recognition is consistent with U.S. Financial Accounting Standards Board Accounting Standards Codification 980 – "Regulated Operations"</u>. Accordingly, the removal of the temporary exemption had no effect on the Corporation's results of operations as of December 31, 2009." (Emphasis added)

Fortis Inc.

"Effective January 1, 2009, the Canadian Accounting Standards Board (the "AcSB") amended the Canadian Institute of Chartered Accountants ("CICA") Handbook: (i) Section 1100, Generally Accepted Accounting Principles, removing the temporary exemption providing relief to entities subject to rate regulation from the requirement to apply the Section to the recognition and measurement of assets and liabilities arising from rate regulation; and (ii) Section 3465, Income Taxes, to require the recognition of future income tax liabilities and assets, as well as offsetting regulatory assets and liabilities, by entities subject to rate regulation.

Effective January 1, 2009, with the removal of the temporary exemption in Section 1100, the Corporation must now apply Section 1100 to the recognition of assets and liabilities arising from rate regulation. Certain assets and liabilities arising from rate regulation continue to have specific guidance under a primary source of Canadian GAAP that applies only to the particular circumstances described therein, including those arising under Section 3061, Property, Plant and Equipment, Section 3465, Income Taxes, and Section 3475, Disposal of Long-Lived Assets and Discontinued Operations. The assets and liabilities arising from rate regulation, as described in Note 4, do not have specific guidance under a primary source of Canadian GAAP. Therefore, Section 1100 directs the Corporation to adopt accounting policies that are developed through the exercise of professional judgment and the application of concepts described in Section 1000, Financial Statement Concepts. In developing these accounting policies, the Corporation may consult other sources, including pronouncements issued by bodies authorized to issue accounting standards in other jurisdictions. Therefore, in accordance with Section 1100, the Corporation has determined that all of its regulatory assets and liabilities qualify for recognition under Canadian GAAP, and this recognition is consistent with the U.S. Financial Accounting Standards Board's Accounting Standard Codification 980, Regulated Operations. Therefore, there was no effect on the Corporation's consolidated financial statements as at January 1, 2009 as a result of the removal of the temporary exemption from Section 1100." (Emphasis added)

Since the application of the GAAP hierarchy (see discussion at issue 3), the financial statement concepts (see discussion at issue 3), and the definitions of assets and liabilities (see discussion at issue 7) under Part V and PSAS are similar, and since all rate-regulated entities in Canada have used the GAAP hierarchy under Part V to adopt ASC 980, we believe that IESO can adopt ASC 980 on the basis that it meets the criteria in ASC 980.

6. Is ASC 980 an exemption from the application of US GAAP?

ASC 980 is not an exemption from US GAAP, it is part of US GAAP. There is no mention in ASC 980 that states that it is an exemption. This issue was addressed in the Basis for Conclusions of FAS 71:

51. *"The FASB Discussion Memorandum, Effect of Rate Regulation on Accounting for Regulated Enterprises, issued in 1982 presented a threshold issue: "Should accounting prescribed by regulatory authorities be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises*

54. *The Board concluded that regulatory-prescribed accounting should not be considered generally accepted per se, but rather that the Board should specify how generally accepted accounting principles apply in the regulatory environment.*

55. *This Statement merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements."*

Note that references to "regulatory prescribed accounting" are references to the accounting in regulatory required reports (e.g., rate applications) not in general purpose financial statements.

ASC 980-10-05-7 allows the recognition of assets in accordance with an order of regulatory authorities provided that the capitalization is appropriate under this section.

"Accounting requirements that are not directly related to the economic effects of rate actions may be imposed on regulated businesses by orders of regulatory authorities and occasionally by court decisions or statutes. This does not necessarily mean that those accounting requirements conform with generally accepted accounting principles (GAAP). For example, a regulatory authority may order an entity to capitalize and amortize a cost that would be charged to income currently by an unregulated entity. Unless capitalization of that cost is appropriate under this Topic, GAAP requires the regulated entity to charge the cost to current income." (Emphasis added)

ASC 980-10-05-7 indicates that only the economic effects of rate regulations that meet the recognition criteria under ASC 980 conform with GAAP. As stated in ASC 980-10-15-1, ASC 980 only provides incremental industry-specific guidance for the entities defined in this Scope Section.

"10-15-1 The Subtopics within the Regulated Operations Topic only provide incremental industry-specific guidance for the entities defined in this Scope Section, or as further defined in the Scope Sections of the individual Regulated Operations Subtopics. Entities within the scope of this Topic shall also comply with the applicable guidance not included in this Topic."

Although the Basis for Conclusions of FAS 71 have not been included to ASC 980[2], they provide useful information for the understanding of the Standard. The Basis for Conclusions of FAS 71, in the Section regarding *Relationship of Regulatory-Prescribed Accounting to Generally Accepted Accounting Principles, paragraphs 51- 55* specified how the effects of different types of rate actions are reported in general-purpose financial statements.

51. "The FASB Discussion Memorandum, Effect of Rate Regulation on Accounting for Regulated Enterprises, presented a threshold issue: "Should accounting prescribed by regulatory authorities be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises?

52. Virtually all respondents to the Discussion Memorandum indicated that accounting prescribed by regulatory authorities should not be considered in and of itself generally accepted for purposes of financial reporting by rate-regulated enterprises. Respondents noted that the function of accounting is to report economic conditions and events. 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 generally accepted accounting principles applicable to business enterprises in general. The mere issuance of an accounting order not tied to rate treatment does not change an enterprise'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 generally accepted accounting principles.

53. Respondents also noted that regulatory-prescribed accounting has not been considered generally accepted per se in the past.

54. The Board concluded that regulatory-prescribed accounting should not be considered generally accepted per se, but rather that the Board should specify how generally accepted accounting principles apply in the regulatory environment.

55. Some respondents to the FASB Exposure Draft, Accounting for the Effects of Regulation of an Enterprise's Prices Based on Its Costs, suggested that the Board clarify the relationship of this Statement to an enterprise's regulatory accounting and to regulators' actions. This Statement does not address an enterprise's regulatory accounting. Regulators may require regulated enterprises to maintain their accounts in a form that permits the regulator to obtain the information needed for regulatory purposes. This Statement neither limits a regulator's actions nor endorses them. Regulators' actions are based on many considerations. Accounting addresses the effects of those actions. This Statement merely specifies how the effects of different types of rate actions are reported in general-purpose financial statements." (Emphasis added)

This issue was addressed during a rate application of OPG (see rate application number OEB-2013-0321, Filed: 2014-03-19, Exhibit L, Tab 1.3, Schedule 1 Staff-006, Page 1 of 2
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/430200/view/OPG_IRR_Issue%201_0_20140326.PDF

Question raised through interrogatory:

"Under ASC 980, please confirm OPG's understanding that the rate regulator has the authority to set and approve regulatory accounting policies which must then be included in the financial statements of the rate-regulated entity. If not, please explain."

Answer provided by OPG:

"OPG confirms that the OEB has the authority to set and approve regulatory accounting policies for the purposes of setting payment amounts and reporting to the OEB. However, the OEB does not have authority to set financial accounting requirements, as noted in the EB-2008-0408 Report of the Board (page 4), nor does ASC 980 mandate the inclusion of regulatory accounting policies in the financial statements of a rate-regulated entity.

[2] In the FASB's codification project Basis of Conclusions from issued standards were not carried forward into the ASCs.

Effective January 1, 2012, OPG is required to prepare its financial statements in accordance with US GAAP pursuant to Ontario Regulation 395/11 under the Financial Administration Act (Ontario). Where applicable under US GAAP, OPG must therefore be in compliance with ASC 980. ASC 980 sets out specific requirements in accounting for the economic effects of rate regulation (i.e., economic benefits or obligations that are required to be obtained from, or settled with, the ratepayers as a result of regulation). ASC 980 does not require OPG to reflect the regulatory accounting policies prescribed by the regulator in its financial statements. In fact, reflecting such policies, other than as part of accounting for the economic effects of regulation in accordance with the specific guidance in ASC 980, would not be in compliance with ASC 980 and therefore US GAAP." (Emphasis added)

PS 1150.13 is very similar to ASC 980-10-05-7 as both prohibit the recognition of assets that do not conform with GAAP.

Similar to ASC 980-10-05-07, management of the IESO and we believe that PS1150.13 allows the recognition of assets in accordance with regulatory or legislative requirements provided these requirements are allowed by Section 1100, otherwise the financial statements cannot be described as being in accordance with GAAP.

PS1150.13: *"A public sector reporting entity may be required to prepare financial statements in accordance with regulatory, legislative or contractual requirements. When these requirements are within the range of acceptable choices allowed by this Section, the basis of accounting can be described as being in accordance with GAAP. At times, conflict between GAAP and regulatory, legislative or contractual requirements may exist. In such cases, users of financial statements need to know that the statements are not prepared in accordance with GAAP. Therefore, if the basis of accounting used to prepare such financial statements conflicts with the requirements of this Section, that basis cannot be described as being in accordance with GAAP."*

7. Do regulatory assets meet the definition of asset under US GAAP, Part V and PSAS?

PSAS

PS 1000.35 defines assets 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."* This definition is consistent with the definition of assets in paragraph 3 of the new standard PS 3210. The analysis performed below takes into account the additional guidance in PS 3210 on what is meant by an economic resource, control, future economic benefits and past events and transactions. The analysis of the three essential characteristics as defined by PS 3210.4 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 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)	The economic benefit embodied in the variance accounts (i.e., regulatory asset) is the right to collect the incurred costs from the customers 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 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. The IESO can control the asset or restrict others' access to it. 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 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 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)	The past event giving rise to IESO's control occurs as the customer uses energy and becomes committed to pay. The IESO, through its OEB license, has the right to collect amounts from the customers for the energy consumed. FAS 71.75 states that the Board concluded that, for general-purpose financial reporting, the principal economic effect of the regulatory process is to provide assurance of the existence of an asset or evidence of the diminution or elimination of the recoverability of an asset. The regulator's rate actions affect the regulated enterprise's probable future benefits or lack thereof. Thus, an enterprise should capitalize a cost if it is probable that future revenue approximately equal to the cost will result through the rate-making process.
Conclusion: The right to collect regulatory assets meets the definition of assets.		

US GAAP

The Edison Electric Institute ("EEI")'s letter to the IASB dated November 23, 2011 related to the IASB Agenda Consultation 2011 (see Appendix I) provides analyses of whether regulatory assets and liabilities meet the definitions of asset and liability under US GAAP and whether FAS 71 is consistent with the FASB Conceptual Framework. EEI is the association of the US shareholder-owned electric companies representing 95% of the ultimate customers in the shareholder-owned segment of the industry. Extracts from the letter:

> Page 13: *"The deliberations resulting in SFAS 71 ultimately acknowledged that there is no "special accounting" for rate-regulated activities; there are only generally accepted accounting principles which must account for (among other things) the effects of regulation consistent with the US Financial Reporting Framework. In fact, regulated entities in the US were already accounting for the effects of rate regulation although to varying degrees and not necessarily consistently prior to the issuance of SFAS 71. SFAS 71 did not introduce new accounting for the effects of rate regulation; rather, it narrowed the scope and recognition of those related previous accounting practices in order to provide a consistent framework and refined recognition and measurement criteria consistent with the US Framework."* (Emphasis added)

Pages 16 to 19 provide an analysis which supports that regulatory assets and liabilities meet the general definitions of assets and liabilities under the FASB Conceptual Framework.

> *"Implicit in the issuance of SFAS 71 (now codified within ASC 980), is consistency of that standard with the FASB Conceptual Framework. FASB Concept Statement No. 6 identifies the definitions of elements of financial statements, while Concept Statement No. 5 addresses the relevant recognition and measurement criteria under the FASB's Conceptual Framework. Both are summarized in the table below and further support that regulatory assets and liabilities meet the general definitions of assets and liabilities under the FASB Conceptual Framework."*

Paragraphs 58 and 59 of the Basis for Conclusions of FAS 71 concluded that regulatory assets meet the criteria of Concepts Statement 3 of an asset.

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

> *59. "Most respondents that opposed special accounting for the effects of regulation cited the need for comparability between regulated and unregulated enterprises. Paragraph 119 of FASB Concepts Statement No. 2, Qualitative Characteristics of Accounting Information, indicates that "... the purpose of comparison is to detect and explain similarities and differences." The Board concluded that comparability would not be enhanced by accounting as though regulation had no effect. Regulation creates different circumstances that require* different accounting." (Emphasis added)

As discussed in response to issue 1, GASB and FASB also allow for the application of ASC 980 in financial statements prepared in accordance with their frameworks.

CGAAP (pre-IFRS)

As mentioned earlier, the exemption to not apply section 1100 under Part V by a rate-regulated entity was removed in 2009, and, as a result, those entities were allowed to utilize Section 1100, and particularly paragraph 32B, in their evaluation of the appropriate recognition and measurement of regulatory assets and liabilities. As mentioned earlier, the GAAP hierarchy under Part V was similar to the GAAP hierarchy under PSAS and, when looking to other sources of GAAP, both hierarchies required the other sources of GAAP (which included, or did not preclude, ASC 980) to be evaluated based on the following criteria[3]:

1. whether they are consistent with accounting policies and disclosure within PSAS (or Part V),
2. whether they are consistent with the application of concepts in Section 1000 of PSAS (or of Part V),

[3] See particularly Part V, section 1100.03 and .07 and PSAS 1150.05 and .08.

3. does the source meet all of the following criteria for the other source:
   (a) deals with the specific circumstance
   (b) is issued by an accounting standard setter
   (c) continues to be relevant
   (d) uses a consultative process and deliberation when developing policies

A rate-regulated entity reporting under Part V was required by Section 1000 *Financial statement concepts* to analyze whether the concepts in the other source of GAAP (i.e. ASC 980) were compatible with the (i) qualitative characteristics of financial information, (ii) the elements of financial statements, and (iii) the recognition and measurement criteria in Section 1000 of Part V. These requirements included the evaluation whether regulatory assets and liabilities under ASC 980 met the definitions of asset and liability under Section 1000 of part V.

It is important to note that the publication issued by the Office of the Auditor General of British Columbia *Summary of the Comparison of the Canadian PSAS with the CICA Handbook Part V* states that the framework under Part V is either similar to PSAS or silent in some aspects (see Appendix E).

After the removal of the exemption from Part V, all rate-regulated entities concluded that ASC 980 met all the requirements and continued to recognize regulatory assets and liabilities under Part V until they transitioned to IFRS or other accounting frameworks.

As a result, since rate-regulated entities reporting under Part V recognized the economic effects of rate regulation using the GAAP hierarchy and since PSAS has a consistent GAAP hierarchy and accounting framework, management of the IESO and we believe that a rate-regulated entity reporting under PSAS should also be allowed to adopt ASC 980.

IFRS

IFRS 14 is silent as to whether regulatory assets meet the definition of asset.

However, IFRS has similar a definition of assets as both PSAS and US GAAP, and recent developments at the IASB are proceeding in a direction that suggests support for our view that regulatory assets are consistent with the conceptual definition under PSAS.

In 2012, the IASB has restarted a project on rate-regulated activities. The preliminary discussions that took place over the past several months at the IASB meetings indicate that the IASB's tentative thinking is that regulatory assets and liabilities meet the definitions of an asset and liability in the new Conceptual Framework. This was a combination of years of work at the IASB on the new Conceptual Framework. For example, the IASB staff discussed Agenda Paper 9A (see Appendix H) at the IASB meeting of June 21, 2017.

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

The IASB staff discussed Agenda Paper 9 (see Appendix H) at the IASB meeting of May 16, 2017, which addressed the new definitions of asset and liability and the related guidance under the new IFRS Conceptual Framework.

> Paragraph 16 states *"Respondents to the Discussion Paper Reporting the Financial Effects of Rate Regulation, published in September 2014 (the Rate regulation DP), and participants in subsequent outreach asked us to explain how the model links to [the forthcoming revisions to] the Conceptual Framework for Financial Reporting (the Conceptual Framework), particularly the definitions of assets and liabilities. We outline, in paragraphs 17-21, the main aspects of the definitions and supporting guidance that we consider most pertinent to understanding the basis for the model. We have used the proposals in the Exposure Draft Conceptual Framework for Financial Reporting (the Conceptual Framework ED), updated when applicable for the Board's tentative decisions in subsequent discussions."*

> Paragraph 18 states *"The definitions of assets and liabilities in the Conceptual Framework focus on rights and obligations. The guidance supporting the definitions highlights the importance of commercial substance and the need for contractual terms to have a discernible effect on the economics of a contract. In particular, paragraph 4.55 of the Conceptual Framework ED indicates that terms that bind neither party have no*

commercial substance and should be disregarded."

Paragraph 17 (a) states *"The Conceptual Framework ED provides the following definitions: An asset is a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits."*

Paragraph 19 states: *"The guidance accompanying the proposed definition of an asset highlights that for an entity to have an asset, it must have a right that both has the potential to produce economic benefits for the entity beyond those available to all other parties and is controlled by the entity. An entity controls an economic resource if it has the right to deploy the economic resource in its activities and if, in addition, any economic benefits from that resource flow to the entity (either directly or indirectly) rather than to another party. Control in this context does not imply that the entity can ensure that the resource will produce economic benefits in all circumstances."*

While these papers are not authoritative, we believe it demonstrates that current thinking around this topic is evolving such that the lack of rate-regulated accounting by entities following IFRS around the world does not undermine our conclusion that regulatory assets are consistent with the conceptual definitions under PSAS.

8. Does the OEB regulate the IESO?

Yes. The IESO is rate-regulated by the OEB in accordance with the Electricity Act, 1998 (the Electricity Act") and the Ontario Energy Board ("OEB") Act, 1998 (the "OEB Act"). The IESO's activities subject to rate regulation by the OEB include the following:

(a) IESO's expenditure, revenue requirements and fees;

(b) Smart metering activities; and

(c) Market accounts.

Although the IESO is rate-regulated by the OEB, in considering ASC 980-10-05-7, the economic effects of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of GAAP. Therefore, it is important to determine whether IESO has a basis to conclude that the OEB approved the future recovery of costs incurred in the past through rate setting policies. The following analysis demonstrates that IESO is a rate-regulated entity by the OEB.

We note that the Report of the Ontario Energy Board on the Pension and OPEB costs issued on May 18, 2017 states on page 9 that "*The OEB is of the view that the IESO is a rate-regulated entity...*" (see Appendix G). As further detailed in the following paragraphs and in appendices 1 to 3, the OEB has permitted the IESO to set-up variance accounts for costs incurred in the past that will be fully recovered through future rates.

IESO's expenditure, revenue requirements and fees

The IESO is required to obtain approval from the OEB under s. 25(1) of the Electricity Act for the approval of its own expenditures, revenue requirement and fees.

Extracts from the Electricity Act noting the OEB's review and approval process for the IESO's expenditures, revenue requirement and fees can be found in Appendix A.1. Extracts from the 2016 Decisions and Orders issued by the OEB related to IESO's expenditure, revenue requirements and fees for the financial year 2016 can also be found in Appendix A.2. For all prior years, the Decisions and Orders issued by the OEB can be found on the OEB website.

Smart metering activities

The OEB Act states that the Smart Metering Entity shall not charge for meeting its obligations under Part IV.2 of the Electricity Act except in accordance with an order of the Board, which is not bound by the terms of any contract.

The OEB issued a Decision and Order on March 28, 2013 that permits IESO to create a variance account to recover the MDMR costs (the Smart Metering Charge) (see Appendix B).

Market accounts

The OEB Act, Electricity Act and associated regulations outline that variance accounts can or will be established for the Ontario Electricity Support Program ("OESP"), Regulated Price Plan ("RPP") and Rural and Remote electricity Rate Protection ("RRRP"). Variance accounts have been approved by the OEB to recover the RPP and RRRP costs that have been deferred. The OESP costs that have been deferred at the request of the OEB should be approved for recovery at the next rate application.

Specifically (see Appendix C):

OESP: the OESP Reg, O. Reg 314/125 S 6, sets out that the IESO shall establish a variance account.

RPP: Section 25.33 (5) of the Electricity Act sets out that the IESO shall establish and maintain such variance accounts as may be necessary. Section 79.16 (3) of the OEB Act, which deals with the commodity price for electricity for low volume consumers, sets out that the Board shall take into account balances in variance accounts established under section 25.33 of the Electricity Act, 1998 and make adjustments with a view to eliminating those balances within 12 months or such shorter time periods as the Minister may direct.

RRRP: The RRRP Reg, O. Reg 442/01 S 5(9), sets out that the IESO shall establish a variance account.

It should be noted that the financial statements of the market accounts have included variance accounts for a number of years before the market accounts were recognized in the IESO's financial statements. These variance accounts, which relate to the RRRP, RPP and OESP costs, met and continue to meet the recognition criteria in ASC 980.

9. The private sector is driven by the generation of profit. In our view, the organization should have been analogized to PSAS first and then to more current standards on the issue.

Because IESO is an OGO, it has a choice between following PSAS or IFRS. IESO has chosen PSAS as the accounting framework it will follow in preparing its financial statements. Since IFRS is designated as an alternative to PSAS for OGOs, we considered whether IFRS needs to be given precedence when applying the PSAS GAAP hierarchy.

As noted in the discussion under issue 3, there are a number of criteria in PS 1150 that should be considered when assessing sources other than the primary source of GAAP. However, there is no hierarchy or ordering of sources set out in PS 1150. Instead, PS 1150 establishes an overall framework for the exercise of professional judgment. In our view, as long as ASC 980 meets the criteria in PS 1150, we believe that it is an acceptable alternative source that may be considered by the IESO in establishing its accounting policy for rate-regulated activities. Different entities reporting under PSAS thus may reasonably choose different paths under PS 1150 when dealing with transactions or events that are not addressed with in the primary source.

Accordingly, we believe that there is no requirement for IESO to consider IFRS as the only alternative source other than the primary source of GAAP in its application of PS 1150.

Paragraph 11 of the *Introduction to Public Sector Accounting Standards ("Introduction")* states:

"These standards apply to all public sector entities that issue general purpose financial statements unless:

(a) specifically directed or permitted to use alternative standards by PSAB, or

(b) limited in applicability as outlined in the individual Sections.

When applying the CPA Canada Public Sector Accounting (PSA) Handbook, where the standards are silent on an issue, public sector entities should apply GENERALLY ACCEPTED ACCOUNTING PRINCIPLES, Section PS 1150."

Based on PS 1150.08 (a) and (b), in the absence of a specific source in Canada that provides alternative guidance for the accounting for the economic effects of rate-regulated activities, the management of IESO and we have concluded that a Canadian rate-regulated entity is permitted to use ASC 980 as 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.

"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 PS 1150.05. 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."