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To IESO Audit File
IESO Management, Audit Committee, Board of Directors

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From Matthew Betik

Ref

Subject **Regulatory Assets/Liabilities and Market Accounts**

Purpose:

The purpose of this memorandum is to discuss and illustrate the impacts of the proposed changes to accounting policies of the IESO for rate regulated assets/liabilities and Market Accounts.

Background:

Prior to 2016, IESO annual financial statements included the following two accounting policies:

i) Market Accounts – "These financial statements do not include the financial transactions of market participants within the IESO-administered markets" [excerpt from Note 2(b)]

ii) Regulatory assets/liabilities – while not specifically stated, the IESO did not recognize regulatory assets/liabilities, as it, did not follow rate regulated accounting.

At a high level, the reason for i) is that IESO did not view itself as a counterparty to market participant transactions (rather as an administrator or facilitator) and the market rules and legislation clearly set out that it was not to be liable for market participant transactions. The reason for ii) is that Public Sector Accounting Standards (PSAS), which is the accounting framework applied to IESO's financial statements did not have specific standards or guidance relating to regulatory accounting. Additionally, IESO did not follow regulatory accounting in its pre-PSAS accounting framework prior to 2011, and the existing accounting policies met the user needs.

As a result of discussions with the government, including the provincial controller, it was determined that a re-examination of these two policies should be made to ensure that periodic and annual financial reporting was relevant to IESO financial statement users.

Market Accounts:

IESO is contemplating including year-end asset and liability balances of the Market Accounts in its annual audited financial statements. These balances include assets such as cash, market accounts receivable, conservation contracts receivable, generation contracts receivable, regulated price plan variance, etc., and liabilities such as line of credit facility, market accounts payable, prepayments, generation contracts settlements payable, and provisions for future transmission rights, OESP, RRRP and enforcement activity. Revenue and expense activity throughout the year would not be recorded in the financial statements because IESO is not a principal to those transactions.

Working with KPMG, IESO determined that there were reporting options for market accounts and that a choice is required as to whether or not to record Market Accounts assets and liabilities in the IESO financial statements. By analyzing the nature of the accounts, IESO's economic relationship to them, legislative requirements and market rules it was concluded that an appropriate position for either treatment was acceptable.

Should IESO include these balances in its annual financial statements, it would be done via a change in accounting policy, with retroactive application. This means that there would be full disclosure of the change and that the prior year balances in the financial statements would be restated for the effect of the change.

Impact to the proposed change to include Market Accounts in the IESO financial statements:

Pros:	Cons:
- Viewed as being more transparent as it includes assets and liabilities that IESO is holding on behalf of the market - Presents the net position of the market of \$0 at the end of the reporting period - Provides auditing reporting on activities that IESO governance is ultimately accountable for	- Adds additional complexity to the financial statements, including line items and notes (including additional time and cost to prepare/audit) - Potential for some users to misinterpret the nature of assets/liabilities or not fully understand the impact - Financial statement users, including market participants may incorrectly conclude that it has recoveries from/payments to IESO as opposed to the IESO administered market.

A potential unintended consequence of this switch is the potential impact of future government policy initiatives that may or may not have an impact on the Market Accounts. Future (unknown) changes in market rules, policies or other, may result in a situation whereby the assets and liabilities do not equally offset, resulting in unfavourable accounting treatment. However, in the current environment, this seems unlikely. Furthermore, in the short term, there may be questions from financial statement users, stakeholders, and others as to why IESO was "hiding" these assets/liabilities.

Regulatory Assets/liabilities:

A regulatory asset/liability (also referred to collectively as a regulatory deferral account balance) is "The balance of any expense (or income) account that would not be recognised as an asset or a liability in accordance with other Standards, but that qualifies for deferral because it is included, or is expected to be included, by the rate regulator in establishing the rate(s) that can be charged to customers." (IFRS 14, Appendix A). In other words, an entity that applies this type of accounting has been granted a right (normally by an independent regulator) to charge higher rates in the future based on costs that have previously been incurred, and as such, can record an asset for that right. This accounting is most common with utilities (public or private) where the utility has a monopoly over a service territory and a regulator is required to ensure fair treatment of both the customer and supplier of the utility. In Ontario, almost all Local Electricity Distribution Companies (LDCs) and Natural Gas Distribution Companies use rate regulated accounting.

As noted above, IESO has not historically used rate regulated accounting, despite having transactions that may have "fit" into the type of transactions that qualify. Most notably, the Smart Metering Entity incurred millions of dollars in costs between 2007 and 2012 with a commitment from the Minister of Energy to provide for a rate for recovery in the future. This rate was granted in 2013. Rate regulated accounting is not specifically addressed in PSAS, so the decision was made not to use it. However, entities are permitted under PSAS, under certain conditions, to consult other sources of accounting standards (Canadian Private Company Standards ("ASPE"), IFRS, US GAAP, US Government Standards) for guidance when PSAS does not address a specific issue. KPMG and IESO have performed a technical analysis of this and concluded it would be acceptable to consult these other sources. It is important to note that ASPE, US GAAP, and US Government standards all recognize rate regulated accounting. IFRS does not specifically recognize it, but has approved standards permitting entities using IFRS for the first time to continue to use rate regulated accounting until a final determination has been made.

IESO, in collaboration with KPMG, performed a detailed analysis as to whether or not rate regulated accounting could be applied to IESO and it was concluded that this treatment is an appropriate accounting policy.

Similar to Market Accounts, should IESO include rate regulated accounting in its annual financial statements, it would be done via a change in accounting policy, with retroactive application. This means that there would be full disclosure of the change and that the prior year balances in the financial statements would be restated for the effect of the change. Adopting this change will bring IESO's accounting policies more closely in line with LDCs and other ISOs in North America.

Impact to Financial Statements:

The most significant impact of the above noted matters is for rate regulated accounting. An initial analysis indicates the following areas will be impacted:

- Smart Metering Entity Charges
- PSAS transition amounts for Pension and Other Post Employment Benefits

Smart Metering Entity

As noted above, the SME incurred costs before it was granted a rate order to recover those costs. Assuming these costs qualify as regulatory assets, the initial costs would have been recorded as assets and not expenses (and accumulate deficit).

A simplified example, in 2012, SME costs incurred were $23,734 thousand. The two accounting treatments are as follows:

As previously reported		Pro-form using rate-regulated accounting	
Dr. SME Expenses	23,734	Dr. SME Regulatory Asset	23,734
Cr. Cash	(23,734)	Cr. Cash	(23,734)

In other words, instead of recording net expenses, IESO would have recorded an asset. Similarly, for years subsequent to 2012, where an SME rate was ordered and charged, rather the entire amount be recorded as revenue, only revenue sufficient to recover current year's costs would be presented, with the remainder reducing the regulatory asset.

A simplified example, in 2013, SME costs incurred were $26,531 thousand and SME collections were $30,144 thousand. The two accounting treatments are as follows:

As previously reported		Pro-form using rate-regulated accounting	
Dr. SME Expenses	26,531	Dr. SME Expenses	26,531
Cr. Cash	(26,531)	Cr. Cash	(26,531)
Dr. Cash received	30,144	Dr. Cash received	30,144
Cr. SME Revenues	(30,144)	Cr. SME Revenues	(26,531)
		Cr. SME Regulatory Asset	(3,613)

Under the rate-regulated accounting option, the process would continue until such time as the regulatory asset is reduced to zero. Should it be reduced below zero, a regulatory liability would be recorded.

PSAS Transition Items for Pensions and Other Post-Employment Benefits

In 2011, as the IESO transitioned to PSAS, it moved approximately $80M of unamortized net actuarial losses and past service costs from its asset/liability accounts to its accumulated deficit. This treatment was permitted by the first time adoption rules of PSAS. As these unamortized losses would no longer flow through the statement of operations of IESO, and if left unadjusted the rate setting process would no longer recover the costs. As such, the IESO has included in its annual rate submissions to the OEB to recover a portion of the unamortized losses. Since 2012, this has ranged from $4 million to $6 million annually.

Assuming PSAS transition items qualified as regulatory assets, the initial transaction would have been recorded as assets and not accumulate deficit.

A simplified example of the two accounting treatments are as follows at the date of transition is as follows:

As previously reported		Pro-form using rate-regulated accounting	
Dr. Acc. deficit – PSAS Transition	80,967	Dr. Acc. deficit – PSAS Transition	80,967
Cr. Pension + OPEB Liab.	(80,967)	Cr. Pension + OPEB Liab.	(80,967)
		Dr. Regulatory asset – PSAS Trans.	80,967
		Cr. Acc. deficit – PSAS Transition	(80,967)

A simplified example of the two accounting treatments are as follows at dates following the date of transition to PSAS is as follows:

As previously reported		Pro-form using rate-regulated accounting	
Dr. Cash received	3,912	Dr. Cash received	3,912
Cr. System fees	(3,912)	Cr. Regulatory asset – PSAS Trans.	(3,912)

See attached pro-forma statement of financial position and statement of operations to illustrate the impacts. Furthermore, several of the notes to the financial statements would have to be amended.

Impact to the proposed change to adopt regulatory accounting in the IESO financial statements:

Pros:	Cons:
- Provides a clearer picture of the IESO's financial position with respect to items that have been charged to income or directly to accumulated surplus for which a recovery from market participants will be made - Makes IESO accounting more similar to other market participants, especially LDCs - Future initiatives, for which IESO may be incurring costs but may not have a rate order yet, will not necessarily be recorded as a net loss until such time as the order is received	- Need to ensure OEB understands and appropriately sets rates - Subject to the changing nature of accounting policies by standard setters (i.e., what if IFRS eventually rejects rate regulated accounting and other market participants are required to abandon that accounting)

<u>Conclusion:</u>

IESO has concluded, and KPMG concurred that these contemplated changes are supportable accounting treatments and as such, would be recorded as a change in accounting policy if adopted in the year of effective adoption.