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WORKING DRAFT #2

May 1, 2017

CONFIDENTIAL

120 Adelaide Street West
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The Board of Directors

Commented [m1]: Is this correct?

Dear Sirs,

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

The following two issues are addressed in this letter:

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

Issue #2: If so, what is the accounting treatment for the derecognition of the regulatory asset upon sale of the variance account to the OPG Trust?

Background for issue #1

The facts, circumstances, and assumptions relevant to the specific transactions as provided to us by the management of the Company (responsible party) are as follows:

1. The IESO's legal status is a not-for-profit, non-taxable, corporation established pursuant to Part II of the Electricity Act. IESO is classified as an Other Governmental Organization and prepares its financial statements in accordance with Public Sector Accounting Standards ("PSAS").

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

3. *Extract from note 2(d) Summary of Significant Accounting Policies, Regulatory assets and liabilities of the 2016 IESO financial statements.* "As a rate-regulated entity, the IESO, in appropriate circumstances establishes regulated assets or liabilities and thereby defers the impact on the statement of operations of certain expenses or revenues because they are probable to be collected or refunded to market participants through future billings. The IESO applies guidance from United States Generally Accepted Accounting Principles (US GAAP) Topic 980, *Regulated Operations ("ASC 980")*, in this policy."

4. Currently, in accordance with the Electricity Act and the OEB Act, IESO has approved variance accounts to record all amounts payable or receivable by it in connection with the amounts paid to generators, the Financial Corporation, distributors and to entities with whom the IESO has a procurement contract (i.e. costs incurred in the past will be fully recovered through future rates).

5. *Extract from Section 78(3.3) of the OEB Act:* In approving or fixing rates under subsection (3.1),

   (a) the Board shall forecast the cost of electricity to be consumed by the consumers to whom the rates apply, taking into consideration the adjustments required under section 25.33 of the Electricity Act, 1998 and shall ensure that the rates reflect these costs; and

   (b) the Board shall take into account balances in the IESO's variance accounts established under section 25.33 of the Electricity Act, 1998 and shall make adjustments with a view to eliminating those balances within 12 months or such shorter time periods as the Minister may direct.

6. The Electricity Act, OEB Act and other regulations will be amended to reflect the following *extracts from Part V, The regulatory asset of the proposed Act:*

   Commented [m2]: True?

   Section 20xx:

   (1) The IESO funding shortfall for each month shall be determined in accordance with the regulations.

   (2) Electricity vendors shall provide to IESO such information as IESO may reasonably request for the purposes of determining the IESO shortfall under subsection (1) and such further information as may be prescribed.

   (3) IESO may rely on information provided by electricity vendors for the purposes of the determination under subsection (1).

   Section 20.1xx:

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

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

      1. The amount of the IESO funding shortfall for each month.
      2. All payments received by the IESO resulting from the exercise of the right of recovery under section 21xx and any transfer under section 22xx.
      3. Such other adjustments as may be prescribed.

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

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

Section 21xx.

(1) The IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.

(2) Despite subsection (1), the IESO shall not be entitled to collect all or part of the balance recorded in the variance account from specified consumers before May 1, 2022.

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

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

7. It is expected that the funding shortfall recorded by the IESO in a variance account (the regulatory asset) will be transferred (defined in the proposed Act as disposed or sold) to an investment asset owner (ie OPG Trust) on a monthly basis and cash collected within a short period of time. The total IESO funding shortfall for the period from May 1, 2017 to April 30, 2047 is estimated at $28 billion plus interest of $25 billion.

Commented [m3]: What is the new definition?

Appropriate Accounting Principle for issue #1

ASC 980 Regulated Operations

- 980-10-05-6 For general-purpose financial reporting, an incurred cost for which a regulator permits recovery in a future period is accounted for like an incurred cost that is reimbursable under a cost-reimbursement-type contract.
- 980-10-05-8 "Unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the GAAP applicable to business entities in general. The mere issuance of an accounting order not tied to rate treatment does not change an entity's economic resources or obligations. In other words, the economic effect of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of GAAP."
- 980-10-15-2 "The guidance in the Regulated Operations Topic applies to general-purpose external financial statements of an entity that has regulated operations that meet all of the following criteria:

  (a) The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates that bind customers.

  (b) The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products. This criterion is intended to be applied to the substance of the regulation, rather than its form. If an entity's regulated rates are based on the costs of a group of entities and the entity is so large in relation to the group of entities that its costs are, in essence, the group's costs, the regulation would meet this criterion for that entity.

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(c) In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."

– 980-10-20 Glossary, Definition of incurred costs "A cost arising from cash paid out or obligation to pay for an acquired asset or service, a loss from any cause that has been sustained and has been or must be paid for."

– 980-10-05-8 "Unless an accounting order indicates the way a cost will be handled for rate-making purposes, it causes no economic effects that would justify deviation from the GAAP applicable to business entities in general. The mere issuance of an accounting order not tied to rate treatment does not change an entity's economic resources or obligations. In other words, the economic effect of regulatory decisions—not the mere existence of regulation—is the pervasive factor that determines the application of GAAP 980-340 – Other Assets and Deferred Costs."

– 980-20-15-2 "Failure of an entity's operations to continue to meet the criteria in paragraph 980-10-15-2 can result from different causes. Examples include the following:

(a) Deregulation.

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

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

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

– 980-340-25-1 "Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

(a) It is probable (as defined in Topic 450) that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

(b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.

A cost that does not meet these asset recognition criteria at the date the cost is incurred shall be recognized as a regulatory asset when it does meet those criteria at a later date."

– 980-340-40-1: "If at any time an entity's incurred cost no longer meets the criteria for the capitalization of an incurred cost (see paragraph 980-340-25-1), that cost shall be charged to earnings."

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- 980-340-55-2: "In some cases, a regulator may approve rates that are intended to recover an incurred cost over an extended period without a return on the unrecovered cost during the recovery period."
- 980-340-55-3: "The regulator's action provides reasonable assurance of the existence of an asset (see paragraph 980-340-25-1). Accordingly, the regulated entity would capitalize the cost and amortize it over the period during which it will be allowed for rate-making purposes. That cost would not be recorded at discounted present value. An exception to this general rule is provided for costs of abandoned plants."

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

Although IESO prepares its general purpose financial statements in accordance with PSAS, it applies guidance from US GAAP Topic 980, *Regulated Operations*, as PSAS does not have any guidance for entities with rate-regulated activities. IESO currently recognizes the economic effects of rate-regulated activities as this better reflects the economic substance of IESO's operations and enhances the transparency and accountability of its financial reporting.

IESO is required to assess, on an annual basis, whether it continues to meet each of the criteria in ASC 980-10-15-2 required to apply the guidance from ASC 980, especially when rate structure change or regulatory developments occur.

The regulatory framework in Ontario relating to the generation and sale of electricity will be significantly impacted by the proposed Act. Currently, a substantial amount of the energy purchased from the generators is recovered by IESO from the LDCs, with the remaining being recovered through variance accounts over a period of 12 months maximum. As mentioned above, the effect of the proposed Act is to defer the collection of a total estimated amount of $28 billion (plus interest) of energy purchased from the generators over a period of 30 years. The proposed Act will not permit IESO to collect the funding shortfall before May 1, 2022 and the recovery process will be similar to the RPP recovery process already in place. Such deferred recovery plan requires IESO to consider whether the uncollected energy costs qualify for deferral as a regulatory asset and whether it continues to meet the criteria that allow IESO to use the guidance for regulated operations of Topic 980. These two accounting issues are analyzed in the next two tables below.

Commented [m4]: IS this true? To elaborate.

Criteria for the recognition of regulatory assets

ASC 980-340-25-1 states that rate actions of a regulator can provide reasonable assurance of the existence of an asset. An entity shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

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Criteria	Comment	Evaluation
(a) It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes. (b) Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.	The proposed Act states that, • *Subject to any finding of [manifest error], a recording by the IESO in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time.* • *The IESO has the right, exercisable in accordance with this Act and the regulations, to recover the balance recorded in the variance account from specified consumers.* • *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.* Based on the proposed Act, it is clear that IESO will be able to recover the amount previously incurred rather than to provide for expected levels of similar future costs.	Met

Criteria for the adoption and continued use of ASC 980 guidance

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

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

Commented [m5]: Provide detail of the mechanism

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Criteria	Comment	Evaluation
(a) The entity's rates for regulated services or products provided to its customers are established by or are subject to approval by an independent, third-party regulator or by its own governing board empowered by statute or contract to establish rates	Currently, IESO recognizes regulatory assets related to smart meters and PSAB transition costs in accordance with Rate Orders issued by the OEB and regulatory liabilities related to the variance accounts established under section 25.33 of the Electricity Act related to the procurement of energy. These regulatory assets and liabilities have been approved by the OEB in accordance with the Electricity Act and the OEB Act (see Appendix A). It is important to note that Hydro One and OPG are both consolidated into the province's books, are both regulated by the OEB and their respective regulatory assets and liabilities are reported in the province's books.	Met

(b) The regulated rates are designed to recover the specific entity's costs of providing the regulated services or products.	Currently, the rates approved by the OEB are designed to recover the IESO's costs of providing the regulated services and the pass-through related to the energy purchased from the generators.
	
	As mentioned above, a regulated utility subject to a deferred recovery plan is required to consider whether it continues to meet the criteria ASC 980-10-15-2 (b).
	
	This criterion requires a cause-and-effect relationship between a reporting entity's costs and its rate base revenues. In addition, the timing of cost recovery and the related frequency of ratemaking is important. A reporting entity should consider its rate case experience, including the design of its rates and timing of recovery, when determining whether this criterion is met. These factors are analyzed below.
	
	Frequency of rate case
	
	- Currently, IESO is subject to annual reviews by the OEB.
	
	- Although the recovery of purchase energy costs will be freeze at the approved rate on May 1, 2017 for the first five years, the IESO will be granted a right to recover after May 1, 2022 the funding shortfall recorded in the variance account during the five-year period.
	
	  - *A recording in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time (no prudence review).*
	
	  - *Right to recover the balance recorded in the variance account.*
	
	  - *Obligation from the OEB to dispose the variance account in accordance with the regulation.*
		Met

Commented [m6]: To obtain rate order related to transition costs in appendix A

Commented [m7]: The AG was saying yesterday that these are not variance accounts of IESO but variance accounts of OPG. Can we discuss?

Are the variance accounts established under section 25.33 subject to rate order as well? If so, do you have the most recent rate order to include in appendix?

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	- IESO will be allowed to recover the financing costs and ancillary costs related to the variance account.
	- Subsequent to May 1, 2022, the OEB will be required to determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.
	  - *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.*
	Rates are designed to recover incurred costs
	- There is a cause-and-effect relationship between purchase energy costs and the revenue as IESO will be allowed to recover the costs incurred.
	  - *A recording in the variance account of the balance is, as of the time of the recording, determinative of the balance at the time (no prudence review).*
	  - *Right to recover the balance recorded in the variance account.*
	  - *Obligation from the OEB to dispose the variance account in accordance with the regulation.*
	- Right to recover the interest and ancillary costs related to the variance account
	Periods of alternative ratemaking (e.g., rate freezes)
	Evaluation of the second criterion requires additional judgment if the regulated utility is subject to any form of ratemaking that introduces uncertainty about the cause-and- effect relationship between costs and rates.
	A rate freeze period is defined as a fixed rate that is charged to customers during a period of time (more than two years) and the utilities are exposed to increases in operating and energy costs with no ability to recover the variances.
	This is not the case as the IESO will be granted the right to recover fully the funding shortfall recorded in the variance account, including the first five-year period.
	- *The Board shall, from time to time, determine and set rates payable by specified consumers to allow for IESO to recover the balance recorded in the variance account.*
	Costs uncertainty
	As the IESO will be granted the right to fully recover the funding shortfall recorded in the variance account, there is no uncertainty about the recovery of the costs.
	Disallowances of costs	

Commented [m8]: True?

Commented [m9]: How will that work?

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	The OEB has never disallowed the recovery of any material costs incurred. More importantly, as the IESO will be granted a right to fully recover the funding shortfall recorded in the variance account, there is no risk of disallowance of the purchase power costs. Based on the analysis of the above factors, there are no indication that this criterion would not be met. It is clear that there would be a direct cause-and-effect relationship between IESO's costs and its future collection.	

(c) In view of the demand for the regulated services or products and the level of competition, direct and indirect, it is reasonable to assume that rates set at levels that will recover the entity's costs can be charged to and collected from customers. This criterion requires consideration of anticipated changes in levels of demand or competition during the recovery period for any capitalized costs."	The remaining issue is whether the timing of recovery of the regulatory asset could prevent the IESO to recognize a regulatory asset.
	
	The proposed Act states:
	
	- *The IESO's right to recover the IESO funding shortfall under subsection (1) is subject to the following:*
	  ○ *The IESO shall not be entitled to collect the IESO funding shortfall from specified consumers before May 1, 2022.*
	  ○ *The process by which the IESO may recover the IESO funding shortfall shall be established by the Board, having regard to the amount of the IESO funding shortfall from time to time and the [fair allocation calculation].*
	  ○ *Such other restrictions as may be prescribed.*
	
	Since the process, including the timing of the recovery of the regulatory asset, has not been established yet by the OEB, it is difficult to assess the impact, if any. It should be noted that IESO expects to sell the regulatory asset to the OPG Trust on a monthly basis.
	
	If, in the future, IESO retains a portion of the regulatory asset, this criteria would need to be monitored on a yearly basis to ensure that IESO would be able to recover the regulatory asset, taking into account the levels of demand or competition during the recovery period.
		Met

Commented [m10]: Is this true? We will need to review the most recent Decisions and Rate Orders issued by the OEB. Can you please assemble the last 5 years?

Management conclusion:

Commented [m11]: To be completed by IESO. Please provide a comprehensive conclusion.

Our conclusion:

Commented [m12]: In our opinion, the variance account created by the proposed Act would meet the criteria for the recognition of a regulatory asset stated in ASC 980-340-25-1. Furthermore, we have also considered the criteria stated in ASC 980-10-15-2 and believe that IESO should be allowed to continue to use the guidance for regulated operations of Topic 980.

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Other Matters

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

We assume no responsibility to update this opinion for any changes in PSAS as a consequence of pronouncements by the Public Sector Accounting Board, or any other authoritative bodies, that occur subsequent to the date of this letter.

This report is intended solely for the information and use of the Board of Directors and management of the Company, and is not intended to be and should not be used, circulated, quoted, or otherwise referred to by anyone other than these specified parties or for any other purpose.

Yours very truly,

Michel Picard
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Appendix A:

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

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

THE BOARD ORDERS THAT:

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

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