2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

a) Basis of financial statement preparation

The accompanying financial statements have been prepared on a going concern basis and in accordance with Canadian public sector accounting standards and the financial statements reflect the following significant accounting policies.

a) Revenue recognition

System fees earned by the IESO are based on approved rates for each megawatt of electricity withdrawn from the IESO-controlled grid (including scheduled exports) and embedded generation. System fees are recognized as revenue at the time the electricity is withdrawn. Rebates are recognized in the year in which the regulatory deferral account, before such rebates, exceeds regulated limits.

For 2015, the system fee for the then newly amalgamated IESO was comprised of the combined rate calculations of the respective pre-amalgamation entities. Specifically, the former IESO rate base was calculated on electricity withdrawn from the IESO-controlled grid (including scheduled exports and embedded generation), whereas the former OPA rate base only considered Ontario electricity consumers. The OEB approved the continued use of this combined rate calculation for 2016 in an interim order issued on December 22, 2015.

These financial statements do not include the revenue and expenses of the financial transactions of market participants within the IESO-administered markets (IAM).

Other revenue represents amounts that accrue to the IESO relating to investment income on funds passing through market settlement accounts, as well as application fees. Such revenue is recognized as it is earned.

Interest and investment income represents realized interest income and investment gains or losses on cash, cash equivalents, short-term investments and long-term investments.

Market sanctions represent funds received to offset payments disbursed related to penalties, damages, fines and payment adjustments arising from resolved settlement disputes.

b) Financial instruments

The IESO records cash and cash equivalents, investment portfolio and foreign currency exchange forward contracts at fair value. The cumulative change in fair value of these financial instruments is recorded in accumulated surplus as remeasurement gains and losses and is included in the value of the respective financial instrument shown in the statement of financial position and the statement of remeasurement gains and losses. Upon disposition of the financial instruments, the cumulative remeasurement gains and losses are reclassified to the statement of operations and all other gains and losses associated with the disposition of the financial instrument are recorded in the statement of operations. Transaction costs are charged to operations as incurred.

Cash and cash equivalents comprise cash, term deposits and other short-term, highly rated investments with original maturity dates of less than 90 days.

The IESO records accounts receivable, accounts payable and debt at amortized cost.

d) Regulated assets and liabilities

As a rate-regulated entity, the IESO, in appropriate circumstances establishes regulated assets or liabilities, and thereby defers the impact on the statement of operations of certain expenses or revenues because it is probable to be collected or refunded to market participants through future billings. The IESO has applied guidance from United States (US) Generally Accepted Accounting Principles (GAAP) Topic 980, *Regulated Operations* in this policy.

e) Market accounts – assets and liabilities

The IESO records the market accounts assets, liabilities and amounts due to and from market participants held on behalf of the IESO-administered markets in its statements of financial position. The IESO-administered markets is a balancing system, and as such, the net position of market accounts will settle to a $nil balance in accordance with market rules.

f) Tangible capital assets

Tangible capital assets are recorded at cost, which includes all amounts directly attributable to the acquisition, construction, development or betterment of the asset. The IESO capitalizes applicable interest as part of the cost of tangible capital assets.

g) Assets under construction

Assets under construction generally relates to the costs of physical facilities, hardware and software, and includes costs paid to vendors, internal and external labour, consultants and interest related to funds borrowed to finance the project. Costs relating to assets under construction are transferred to tangible capital assets when the asset under construction is deemed to be ready for use.

h) Amortization

The capital cost of tangible capital assets in service is amortized on a straight-line basis over their estimated service lives.

The estimated service lives in years, from the date the assets were acquired, are:

Class	Estimated Average Service Life 2016	Estimated Average Service Life 2015
Facilities	37	37
Market systems and applications	4 to 12	4 to 12
Infrastructure and other assets	4 to 10	4 to 7
Meter data management/repository	10	10

Gains and losses on sales or premature retirements of tangible capital assets are charged to operations.

The estimated service lives of tangible capital assets are subject to periodic review. The effects of changes in the estimated lives are amortized on a prospective basis. The most recent review was completed in fiscal 2016.

i) Pension, other post-employment benefits and compensated absences

The IESO's post-employment benefit programs include pension, group life insurance, health care, long-term disability and workers' compensation benefits.

The IESO accrues obligations under pension and other post-employment benefit (OPEB) plans and the related costs, net of plan assets. Pension and OPEB expenses and obligations are determined annually by independent actuaries using the projected benefit method and management's best estimate of expected return on plan assets, salary escalation, retirement ages of employees, mortality and expected health-care costs. The discount rate used to value liabilities is based on the expected rate of return on plan assets as at the measurement date of September 30.

The expected return on plan assets is based on management's long-term best estimate using a market-related value of plan assets. The market-related value of plan assets is determined using the average value of assets over three years as at the measurement date of September 30.

Pension and OPEB expenses are recorded during the year in which employees render services. Pension and OPEB expenses consist of current service costs, interest expense on liabilities, expected return on plan assets and the cost of plan amendments in the period. Actuarial gains/(losses) arise from, among other things, the difference between the actual rate of return on plan assets for a period and the expected long-term rate of return on plan assets for that period or from changes in actuarial assumptions used to determine the accrued benefit obligations. Actuarial gains/(losses) are amortized over the expected average remaining service life of the employees covered by the plan.

The expected average remaining service life of employees covered by the pension plans is 15 years (2015 – 15 years) and OPEB plan is 16.2 years (2015 – 14.7 years).

The IESO sick pay benefits accumulate but do not vest. The IESO accrues sick pay benefits based on the expectation of future utilization and records the accrual within accounts payable and accrued liabilities.

j) Foreign currency exchange

Transactions denominated in foreign currencies are translated into Canadian dollars at the rate of exchange prevailing on the date of the transaction. Items on the statement of financial position denominated in foreign currency are translated to Canadian dollars at the rate of exchange as of the financial statements date. The cumulative unrealized foreign currency exchange gains and losses of items continuing to be recognized on the statement of financial position are recorded in accumulated deficit as remeasurement gains and losses and shown in the statement of financial position and the statement of remeasurement gains and losses. Upon settlement of the item denominated in a foreign currency, the cumulative remeasurement gains and losses are reclassified to the statement of operations, and all other gains and losses associated with the disposition of the financial instrument are recorded in the statement of operations.

k) Use of estimates

The preparation of the financial statements in conformity with Canadian public sector accounting standards requires management to make estimates and assumptions that affect the reported amounts of revenues, expenses, assets and liabilities and the disclosure of contingent assets and liabilities as at the date of the financial statements. The IESO's accounts that involve a greater degree of uncertainty include the carrying values of tangible capital assets, accrued pension liability and accrual for employee future benefits other than pensions. Actual results could differ from those estimates.

3. NEW ACCOUNTING POLICIES

As of January 1, 2016, the IESO changed its accounting policy regarding the recognition of assets and liabilities subject to rate regulation. The change was made to better reflect the economic substance of certain types of expenses which may not be directly recovered through the normal revenue requirement model. This change has been applied retroactively and has increased amounts previously unrecorded for regulatory assets and decreased amounts previously reported for accumulated deficit.

The IESO recognizes two regulated assets; 1) unrecovered smart metering expenses and 2) unrecovered PSAB transition items.

The smart metering expenses result from the IESO's role as the Smart Metering Entity. As such, the IESO funds its SME operating costs and capital investment in the meter data management/repository through fees from users of smart meters in Ontario. The OEB approves the Smart Metering Entity charge and the charge is intended to cover the costs of developing and operating the MDM/R.

The unrecovered PSAB transition items result from the IESO's adoption of Canadian public sector accounting standards effective January 1, 2011. The adoption of PSAB was accounted for by retroactive application with restatement of prior periods subject to the requirements in Section PS 2125, *First-time Adoption by Government Organizations*. The corresponding change to pension and other post-employment benefits resulted in previously unrecognized actuarial losses and past service costs of $80,617 thousand at the date of transition.

Regulated assets consist of the following:

As of December 31 (in thousands of Canadian dollars)	2016	2015
	$	$
Unrecovered smart metering expenses	21,623	40,849
Unrecovered PSAB transition items	43,441	47,353
Closing balance	**65,064**	**88,202**

In addition, as of January 1, 2016 the IESO changed its accounting policy regarding the recognition of market accounts assets and liabilities on the statement of financial position. The change was made to better reflect the assets and liabilities and amounts due to and from market participants held by the IESO on behalf of the IAM at year end. This change has been applied retroactively and has increased amounts previously unrecorded for market accounts assets and liabilities. There is no impact to the accumulated deficit or revenues and expenses as the IESO is not party to these transactions as per the market rules.

Components of the market accounts are as follows:

As of December 31 (in thousands of Canadian dollars)	2016	2015
	$	$
Cash, restricted for market activities	323,318	271,574
Amounts due from market participants	1,323,061	1,171,389
Interest receivable	186	157
Revolving line of credit	(150,501)	(12,739)
HST receivable	21,622	20,247
Amounts due to market participants	(1,399,290)	(1,380,086)
Other liabilities	(118,396)	(70,542)
Closing balance	-	-

Comparative figures

A detailed reconciliation of the IESO's restated statement of financial position as at December 31, 2015 as follows:

As of (in thousands of Canadian dollars)	December 31, 2015 (as reported)	December 31, 2015 adjustments	December 31, 2015 (as restated)
FINANCIAL ASSETS	**$**	**$**	**$**
Cash and cash equivalents	14,715		14,715
Accounts receivable	33,199		33,199
Long-term investments	37,318		37,318
Regulated assets	-	88,202	88,202
Market accounts - assets	-	1,443,121	1,443,121
TOTAL FINANCIAL ASSETS	**85,232**	**1,531,323**	**1,616,555**
LIABILITIES			
Accounts payable and accrued liabilities	48,868		48,868
Accrued interest on debt	315		315
Rebates due to market participants	9,595		9,595
Debt	90,000		90,000
Accrued pension liability	36,062		36,062
Accrued liability for employee future benefits other than pension	84,501		84,501
Market accounts – liabilities	-	1,443,121	1,443,121
TOTAL LIABILITIES	**269,341**	**1,443,121**	**1,712,462**
NET DEBT	**(184,109)**	**88,202**	**(95,907)**
NON-FINANCIAL ASSETS			
Net tangible capital assets	103,716		103,716
Prepaid expenses	6,197		6,197
TOTAL NON-FINANCIAL ASSETS	**109,913**		**109,913**
ACCUMULATED SURPLUS/(DEFICIT)			
Accumulated surplus/(deficit) from operations	(81,854)	88,202	14,006
Accumulated remeasurement gains	7,658		7,658
ACCUMULATED SURPLUS/(DEFICIT)	**(74,196)**	**88,202**	**21,664**

A detailed reconciliation of the IESO's restated statement of operations for the year ended December 31, 2015 is as follows:

For the year ended (in thousands of Canadian dollars)	December 31, 2015 (as reported)	December 31, 2015 adjustments	December 31, 2015 (as restated)
IESO CORE OPERATIONS	**$**	**$**	**$**
System fees	190,099	(3,912)	186,187
Other revenue	5,377		5,377
Interest and investment income	1,430		1,430
Core operations revenues	**196,906**	**(3,912)**	**192,994**
Compensation and benefits	(104,994)		(104,994)
Professional and consulting	(21,461)		(21,461)
Operating and administration	(35,005)		(35,005)
Core operating expenses	**(161,460)**		**(161,460)**
Amortization	(17,933)		(17,933)
Interest	(1,610)		(1,610)
Core expenses	**(181,003)**		**(181,003)**
Core operations annual surplus before rebates	**15,903**	**(3,912)**	**11,991**
Rebates due to market participants	(9,595)		(9,595)
Core operations annual surplus	**6,308**	**(3,912)**	**2,396**
MARKET SANCTIONS AND PAYMENT ADJUSTMENTS			
Market sanctions and payment adjustment	**6,021**		**6,021**
Compensation and benefits	(3,094)		(3,094)
Professional and consulting	(1,351)		(1,351)
Operating and administrative	(114)		(114)
Customer education and market enforcement expenses	**(4,559)**		**(4,559)**
Market sanctions and payment adjustments annual surplus	**1,462**		**1,462**
SMART METERING ENTITY			
Smart metering charge	**46,215**	**(20,030)**	**26,185**
Compensation and benefits	(2,607)		(2,607)
Professional and consulting	(14,902)		(14,902)
Operating and administration	(4,200)		(4,200)
Smart metering operating expenses	**(21,709)**		**(21,709)**
Amortization	(3,524)		(3,524)
Interest	(952)		(952)
Smart metering expenses	**(26,185)**		**(26,185)**
Smart metering entity annual surplus	**20,030**	**(20,030)**	**-**
ANNUAL SURPLUS	**27,800**	**(23,942)**	**3,858**
ACCUMULATED DEFICIT FROM OPERATIONS, BEGINNING OF PERIOD	(109,654)	112,144	2,490
ACCUMULATED DEFICIT FROM OPERATIONS, END OF PERIOD	**(81,854)**	**88,202**	**6,348**

5. REBATES DUE TO MARKET PARTICIPANTS AND ACCUMULATED ~~DEFICIT~~ SURPLUS

In 2016, the IESO recognized $12,551 thousand in rebates due to market participants of system fees (2015 – $9,595). As at December 31, 2016, rebates due to market participants were $22,146 thousand, with the 2015 portion of $9,595 thousand rebated in January 2017.

The IESO's approved regulatory deferral account balance has been historically maintained at a maximum of $10.0 million. The 2016 approved regulatory deferral account balance at $10.0 million was approved by the OEB on December 1, 2016.

Prior to 2014, unrealized gains and losses from portfolio investments and foreign exchange were included in the balance of the regulatory deferral account (life-to-date total $4,144 thousand). As of January 1, 2014, only realized gains and losses are included in this balance.

As at December 31, the components of the accumulated ~~deficit~~ surplus were as follows:

Accumulated ~~Deficit~~Surplus

As at December 31 (in thousands of Canadian dollars)	2016	2015
	$	$
Regulatory deferral account (a)	10,000	10,000
Accumulated market sanctions and payment adjustments (b)	726	492
~~Smart metering entity – accumulated deficit (c)~~	~~(21,624)~~	~~(40,849)~~
~~PSAB transition items (d)~~	~~(43,441)~~	~~(47,353)~~
Remeasurement gains	3,762	3,514
Accumulated ~~deficit~~ surplus – end of year	**~~(50,577)~~14,488**	**~~(74,196)~~14,006**

a) Regulatory Deferral Account

As at December 31 (in thousands of Canadian dollars)	2016	2015
	$	$
Accumulated surplus – beginning of year	10,000	7,604
Revenues (before rebates due to market participants)	~~194,131~~190,219	~~196,906~~192,994
Rebates due to market participants	(12,551)	(9,595)
Core operation expenses	(177,668)	(181,003)
~~Recovery of PSAB transition items~~	~~(3,912)~~	~~(3,912)~~
Accumulated surplus – end of year	**10,000**	**10,000**

b) Accumulated Market Sanctions and Payment Adjustments

As at December 31 (in thousands of Canadian dollars)	2016	2015
	$	$
Accumulated surplus/(deficit) – beginning of year	492	(970)
Market sanctions and payment adjustments	3,889	6,021
Customer education and market enforcement expenses	(3,655)	(4,559)
Accumulated surplus – end of year	**726**	**492**

~~c) Smart Metering Entity - Accumulated Deficit~~

~~As at December 31 (in thousands of Canadian dollars)~~	~~2016~~	~~2015~~
	~~$~~	~~$~~
~~Accumulated deficit – beginning of year~~	~~(40,849)~~	~~(60,879)~~
~~Smart metering charge~~	~~46,651~~	~~46,215~~
~~Smart metering expenses~~	~~(27,426)~~	~~(26,185)~~
~~Accumulated deficit – end of year~~	**~~(21,624)~~**	**~~(40,849)~~**

~~d) PSAB Transition Item - Accumulated Deficit~~

~~As at December 31 (in thousands of Canadian dollars)~~	~~2016~~	~~2015~~
	~~$~~	~~$~~
~~Accumulated deficit – beginning of year~~	~~(47,353)~~	~~(51,265)~~
~~Recovery of PSAB transition items~~	~~3,912~~	~~3,912~~
~~Accumulated deficit – end of year~~	**~~(43,441)~~**	**~~(47,353)~~**

~~Effective January 1, 2011, the IESO adopted Canadian public sector accounting standards with a transition date of January 1, 2010. The adoption of PSAB was accounted for by retroactive application with restatement of prior periods subject to the requirements in Section PS 2125,~~ *~~First-time Adoption by Government Organizations~~*~~. The corresponding change to pension and other-post employment benefits resulted in previously unrecognized actuarial losses and past service costs of $80,617 thousand at the date of transition being charged to the accumulated deficit.~~

~~The IESO includes a portion of the accumulated deficit resulting from the PSAB transition items in the annual proposed expenditures to the OEB for recovery through system fees.~~