IESO Position Paper

Market Account Transactions

The purpose of this position paper is to document the analysis, rationale and conclusions reached by the IESO in preparing its annual audited financial statements (also referred to as the Corporate Accounts) as it relates to the accounting for market account transactions.

In the IESO's 2015 audited financial statements, the third paragraph of its revenue recognition policies states that "These financial statements do not include the financial transactions of market participants within the IESO-administered markets". The effect of this policy is that transactions between market participants (excluding IESO and former OPA system fees, market sanctions, and Smart Metering Entity fees) are excluded from both the statement of operations and the statement of financial position. This is a policy and position that was adopted by IESO at market inception when it reported its financial statements under what is now referred to as Part V of the CPA Canada Handbook and was maintained when IESO adopted Public Sector Accounting Standards ("PSAB") in 2011.

Prior to the adoption of PSAB in 2011, IESO concluded that it was not party to the market account transactions and that these should not be recorded in the Corporate Accounts. The primary basis for this conclusion was that IESO acted as an agent in accordance with the guidance in CICA Handbook Section 1000, para .21 and EIC-123: Reporting Revenue gross as a principal versus net as an agent. (see attached report prepared by PriceWaterhouseCoopers ("PWC Report").

While the accounting literature referred to in the PWC report provided the basis for IESO's conclusion under its previous accounting framework, the report did not necessarily address the accounting for asset and liability balances in the market accounts at period end, more specifically at December 31.

Description of Market Transactions

The market rules provide a framework for the operation of the market and the determination of charges payable or receivable from market participants or market program participants. IESO's role, as per Ontario Regulation 288/14 includes, amongst other matters, is to:

- Operate the IESO-administered markets to promote the purposes of this Act [Electricity Act, 1998]
- Engage in activities related to settlements, payments under a contract entered into under the authority of this Act and payments provided for under the Act or the Ontario Energy Board Act, 1998

Transactions settled through market accounts generally include physical energy transactions, transmission services, legislated charges and settlements, and global adjustment.

The framework established by the market rules creates a type of clearing house or trust whereby IESO performs the function of a facilitator for the efficient settling of transactions between market participants, rather than market participants settling transactions directly with each other. IESO is not an agent to these transactions as it has no role in promoting the interests of one party over another party, is not specifically engaged as an agent on behalf of any party, and does not have an economic interest in the ultimate consummation of any transaction. By IESO's own definition, it is the independent administrator of the market.

IESO collects and recognizes as revenue, amongst other things, system fees and Smart Metering Entity Charges. These fees are not in relation to transactions within the market (i.e., not a commission or fee). While it is recognized that system fees are generally calculated based on electricity drawn from the IESO-controlled grid, the system fees are not a commission. The calculation method used is merely a reasonable mechanism to allocate the cost of IESO operations to the ultimate consumer of electricity (as the IESO system fees are charged to Local Distribution Companies who in turn recover that cost through their OEB approved distribution fees). A fee based on electricity transactions could be replaced with a different measure such as customer numbers, as is the case with the Smart Metering Entity charge. Furthermore, IESO has no economic interest as an agent, as it operates on a not-for-profit basis, with any excess of system fees collected over allowable expenses is rebated to market participants.

Furthermore, IESO's market rules contain terms that specify IESO's relationship to market participants and its exposure to financial risks within the market accounts. Specifically,

Chapter 9, Section 6.9.2 "The IESO shall not be a counter-party to any trade transacted through the real-time markets[1]." In this term, "trade" is not specifically defined, but is meant to be generic to refer to all transactions between market participants that are facilitated by the IESO.

Chapter 9, Section 6.16.2 "Subject to the provisions of section 6.14, IESO shall not be liable to make payments in excess of the amount it receives for transactions in the real-time markets."

Section 6.14 address remedies of default of a market participant. In summary, the IESO has recovery mechanisms for a default of payment by a market participant, and if those recoveries cannot be made by the specific defaulting market participant, then the creditors owed funds from the real-time market will be paid on a pro-rata basis.

The above items from the market rules demonstrate that IESO has no financial position on the market account transactions as it has **<u>no</u>** [emphasis intended] risk or reward based on the transactions.

While the transactions, assets, and liabilities of the market accounts are not legally in the form of trust[2], their activities are akin to a trust, whereby there is not beneficial or equitable right that IESO has to the assets (in substance, where the IESO is trustee and the market participants are the beneficiaries).

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[1] Chapter 11 of the Market Rules defines real-time market as "any one of the markets operated by the IESO for energy, operating reserve pursuant to Chapter 7"

[2] Black's Law Dictionary defines a trust as "An equitable or beneficial right or title to land or other property, held for the beneficiary of another person, in whom resides the legal title or ownership, ..."

Application of PSAB Principles

In PSAB's financial statement concepts, PSAB 1000.29(a), the reliability of financial information is achieved through, amongst other things, Representational faithfulness, which "… is achieved when transactions and events affecting the entity are presented in financial statements in a manner that is in agreement with the actual underlying transactions and events. Thus, transactions and events are accounted for and presented in a manner that conveys their substance rather than necessarily their legal or other form. The substance of transactions and events may not always be consistent with that apparent from their legal or other form."

PSAB does not specifically address the accounting for market account transactions or the period end balances described in the introduction to this report.

For inflows and outflows of cash, PSAB does address the matter of an agent relationship in PSAB 3510 Tax Revenue, whereby it states in paragraph .14 that "Amounts collected as an agent of the government or other third parties will not give rise to an increase in net assets or revenue of the agent. Thus, except as provided in paragraph PS 3510.12, tax revenue arises only for the government that imposes the tax and not for other entities, such as a tax agency, or another government that collects a tax on behalf of the government imposing the tax." By analogy, IESO views the inflows and outflows of cash in the market accounts being performed on behalf of other entities, and thus should not be recording those inflows and outflows in the statement of financial position.

However, PSAB does not address directly or by analogy the period end balances. As such, we look to the definition of assets and liabilities within PSAB.

PSAB 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". Furthermore, it states that Assets have three essential characteristics:

(a) they embody future economic benefits that involve a capacity, singly or in combination with other assets, to provide goods and services, to provide future cash inflows, or to reduce cash outflows;	At period end, there are typically two types of assets – i) amounts due from market participants (typically physical market transactions), and ii) other variance type accounts or regulatory type assets (i.e., RPP differences, Global Adjustment Mechanism) It is arguable that the amounts due from market participants for physical market transactions will result in a "cash inflow" as cash will be received in the market bank account. However, that cash inflow is not to the IESO Corporation, but an inflow to be used to settle market transactions between market participants. At a period end, there typically would only be a receivable/payable on these transactions, as the receipts are collected during the following month and payables paid shortly thereafter in the same

	month. Other amounts in the market accounts may result in cash inflows to market accounts or may result in lower cash payments to generators and other MPs in the future (depending on the differences between RPP rates, generator cost guarantees, HOEP, etc.). Similar to above, these inflows or reduced outflows do not flow to IESO Corporation and IESO has no legal right or practical ability to utilize the assets for corporate purposes. The only use of these assets is to settle market transactions with MPs.
(b) the public sector entity can control the economic resource and access to the future economic benefits; and	IESO does not control the assets as it cannot direct their use nor are there any future economic benefits to the corporation to be realized. This is clear with respect to amounts due from market participants as when these cash flows are received [generally from LDCs] during a particular month, they are, for the most part, flowed out to the receiving market participants [generally generators and transmitters]. For other amounts in the market accounts such as cash the question of control is less clear. While it recognized that the cash is in a bank account and IESO may make investment decisions, the market rules determine how and when the cash will be flowed to market participants. The one element of control IESO has over these balances is to settle transactions with MPs.
(c) the transaction or event giving rise to the public sector entity's control has already occurred.	While the transaction has occurred, it is arguably a transaction between market participants and not one where the IESO is a counterparty to the transaction.

Conversely, PSAB 1000.44 defines liabilities as "…present obligations of a government to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits."

Furthermore, it states that Liabilities have three essential characteristics:

(a) they embody a duty or responsibility to others, leaving a government little or no discretion to avoid settlement of the obligation;	The IESO market rules require the IESO to settle the transactions between MPs. The Corporation has no duty or responsibility to settle. There exists an obligation to settle amounts amongst market participants, but it is not the Corporation's duty or responsibility to do so. IESO facilitates this settlement with assets from other market participants.
(b) the duty or responsibility to others entails settlement by future transfer or use of assets, provision of goods or services, or other form of economic settlement at a specified or determinable date, on occurrence of a specified event, or on demand; and	MP transactions doe require settlement and IESO is responsible for settling. Having said that, it settles these with amounts collected from other MPs.
(c) the transactions or events obligating the government have already occurred.	As noted above in the asset characteristics, occurring transactions are between market participants and not the IESO.

Conclusion:

There is diversity of practice on the accounting for MP transactions amongst other ISOs in North America. There appears to be consensus that ISOs are not economically exposed to MP transactions (note that detailed analysis has not been performed on the relationships between those ISOs and their market rules and market participants) and as such the revenues and expenses of the market accounts are not included in the statement of operations. PSAB, along with other accounting frameworks are generally silent on statement of financial position requirements. In agency relationships, typically amounts received by and held by the "agent" are recorded and presented as assets (whether in general or segregated accounts) with an equal an offsetting liability recorded to the other principal counter party. Where there is diversity of practice is what amounts, if any reside at year end on the statement of financial position. Arguments can be made and reasonable conclusions can be reached for recording all, some or no market account transactions on year-end financial position.

Based on the analysis of the market transactions vis-à-vis the Corporation's relationship to them, the substance of those transactions and the analysis of the characteristics of assets and liabilities, as defined by PSAB, IESO's conclusion that transactions of the market accounts, including period end balances, should not be recorded in the Corporate Accounts has been appropriate. However, with changes to facts, circumstances, transaction types, alternate views may be appropriate.