Building a better working world

Ernst & Young LLP
Ernst & Young Tower
222 Bay Street, PO Box 251
Toronto, ON M5K 1J7

Tel: +1 416 864 1234
Fax: +1 416 864 1174
ey.com

Mr. Phil Bosco
Manager, Technical Services Conservation & Corporate Relations
Independent Electricity System Operator
120 Adelaide Street West, Suite 1600
Toronto ON, M5H 1T1

February 17, 2017

Dear Mr. Bosco:

We have completed our engagement to assist you with understanding the accounting treatment for conservation and demand initiative costs. Our engagement was performed in accordance with our Statement of Work dated January 10, 2017 under our Agreement during the period January 13 to February 17, 2017. You requested that we amend the original Report to include consideration of the application of the US Governmental Accounting Standards Board guidance. This Report replaces the previously issued report dated January 19, 2017.

Results of our work

Based on our procedures performed during the period January 13 to February 17, 2017, we prepared the attached Report for your use. Management of the Company reviewed these documents for completeness, accuracy and reasonableness. Decisions regarding the Company's application of CPA Public Sector Accounting Standards ("PSAS") were made solely by the Company's management.

Background

Under the Statement of Work, our scope of services was to assist you with understanding the accounting for conservation incentive costs. The Ministry of Energy is currently exploring a potential financing arrangement for conservation and demand management ("CDM") initiative programs that would see the IESO borrow funds from the Ontario Financing Authority ("OFA") to fund eligible CDM costs.

Scope of our work

In connection with our engagement, we held discussions with and made inquiries of the IESO's personnel. We also obtained and read the Company's financial statements, certain limited accounting records, and certain computations prepared by the IESO.

The procedures performed by us is included in our Statement of Work. There were no differences between the procedures set forth in this Report and those set forth in our Statement of Work.

Our work was performed under the direction of yourself and was based on inquiries of, and discussions with, you. We have not sought to confirm the accuracy of the data or the information and explanations provided by management.

We did not provide a professional opinion on the application of accounting principles pursuant to Chartered Professional Accountants of Canada ("CPA Canada") or the AICPA's Standards for Reports on the Application of Accounting Principles (as amended and interpreted).

The procedures that we performed were advisory in nature and do not constitute an audit or review in accordance with CPA Canada, PCAOB or AICPA auditing or attestation standards, nor do they constitute an examination of prospective financial statements in accordance with standards established by the American Institute of Certified Public Accountants. Additionally, the procedures do not address the effectiveness of internal controls over financial reporting under National Instrument 52-109 issued by the Canadian Securities Administrators or Section 404 of the Sarbanes-Oxley Act. Accordingly, we express no opinion or any other form of assurance on the historical or prospective financial statements, management representations or other data of the Company included in or underlying the accompanying information. While we believe the information obtained is substantially responsive to your request, we are not in a position to assess its sufficiency for your purposes. In addition, we have no responsibility to update the Report for events or circumstances occurring after the date of the Report.

Our work has been limited in scope and time, and more detailed procedures may reveal issues that this engagement has not.

Restrictions on the use of our Report

This Report is intended solely for the information and use of the management of the IESO, and is not intended to be and should not be used by anyone other than these specified parties. EY therefore assumes no responsibility to any user of the Report other than IESO. Any other persons who choose to rely on our Report do so entirely at their own risk.

We appreciate the cooperation and assistance provided to us during the course of our work. If you have any questions, please call Nadira Singh at (416) 943-3896 or me at (416) 943-2094.

Sincerely,

[Signature will be inserted when report is final]

Shannon O'Mahony, CPA, CA
Partner

IESO – Accounting for Conservation Costs

i. Background

The Independent Electricity System Operator ("IESO") is in the process of evaluating the accounting implications of a potential change to the recovery method of conservation costs.

The IESO is a non-profit entity, owned by the government of Ontario, and is governed by the Ministry of Energy ("Minister") and operates pursuant to a license granted by the Ontario Energy Board ("OEB"). As part of the IESO's operations, it is required to submit its proposed expenditures, revenue requirements and fees for the coming year to the OEB for review and approval. The submission may be made only with the approval of the IESO business plan by the Ministry of Energy.

As part of the IESO's operations, it facilitates conservation and demand management ("CDM") initiatives in Ontario, whereby local distribution companies ("LDC") incur expenditures in accordance with the CDM guidelines prescribed by the IESO. The IESO then reimburses the LDCs on a dollar-for-dollar basis. Currently, the IESO is reimbursed through the global adjustment mechanism in the fiscal year in which the expenditure is incurred as outlined in Ontario regulation 429/04 Adjustments under the Act and as provided by the Minister per the directive dated March 31, 2014, *2015-2020 Conservation First Framework.* The IESO receives this reimbursement from the LDCs who collect the global adjustments directly from ratepayers. The calculation of the global adjustment is the difference between the Hourly Ontario Electricity Price ("HOEP") and:

- Ontario Power Generation's regulated nuclear and hydro generation;
- IESO (including former Ontario Power Authority) contracts with generators and suppliers of conservation;
- Contracted rates administered by the Ontario Electricity Financial Corporation paid to existing generators.

The Ministry of Energy has granted authority to the IESO to collect the CDM incentive costs as part of the global adjustment.

The Ministry of Energy is currently exploring a potential financing arrangement for CDM programs that would see the IESO borrow funds from the Ontario Financing Authority ("OFA") to fund eligible CDM costs. This loan would be recognized as a financial liability by IESO. The CDM costs would then be recovered through the global adjustment over an extended period of time. The accounting alternatives for the underlying CDM costs and the loan interest in accordance with Public Sector Accounting Standards is discussed herein.

ii. Accounting guidance

Presently, the IESO accounts for CDM costs as an asset at the time an invoice is received from the entity that has incurred the CDM expenditure eligible for reimbursement (e.g. DR Asset; CR Accounts Payable to the LDC). At the end of each month, the IESO takes the sum of the amounts requested for reimbursement and includes this sum in its submission in the calculation of the total global adjustment for the month. Once the global adjustment is calculated by the IESO, the amount is charged to customers by the LDCs (on the IESO's behalf) and the IESO receives the funds in the subsequent month.

To address the accounting considerations of the inclusion of the CDM costs in the global adjustment over an extended recovery period (that will be determined by the Minister), the IESO must consider the guidance prescribed by the CPA Public Sector Accounting Standards ("PSAS"). PSAS does not provide specific guidance to address the accounting for assets that will be recovered through rates from various customers over future years

In the absence of PSAS that specifically applies to a transaction, professional judgement is required to apply an appropriate accounting policy that is consistent with primary sources and financial statement concepts of PSAS. Other accounting pronouncements may be useful but are not required to be consulted as noted in paragraphs 18 to 22 of PS 1150 *Generally accepted accounting principles* which addresses other sources that may be referenced:

.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.*

.20 *When a public sector reporting entity chooses to consult a source described in paragraph PS 1150.19, it applies professional judgment and evaluates the source in the context of the relative manner in which the standard setter requires its pronouncements to be applied, as well as in the context of the related pronouncement. When an accounting standard setter does not have a conceptual framework that is similar to the concepts referred to in paragraph PS 1150.05(b), the public sector reporting entity needs to ensure that the selected source is consistent with those concepts.*

Consequently, to evaluate the accounting considerations of the accounting for CDM costs being evaluated by the IESO, other sources of GAAP may be considered. The following sources of GAAP were reviewed to determine whether specific guidance was provided addressing the recognition of assets related to regulatory activities:

1) Accounting Standards for Private Enterprises ("ASPE") as issued by the Canadian Accounting Standards Board ("AcSB")/ CPA provides the following guidance:

   AcG 19 *Disclosures by entities subject to rate regulation* provides guidance related to the presentation of financial information related to entities with rate regulated activities *when a separate asset or liability has been recognized solely as a result of the effects of rate regulation (AcG 19* paragraph 7(c)).

2) The guidance issued by the US Governmental Accounting Standards Board ("US GASB") addresses accounting for regulated operations in GASB S62—*Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA* Pronouncements. The GASB S62 standard provides clear guidance that regulatory assets may be recognized to the extent certain criteria are met.

3) US GAAP, as issued by the Financial Accounting Standards Board ("FASB") does provide guidance to address such activities in ASC 980 *Regulated Operations,* addresses the recognition of regulatory assets.

4) IFRS as issued by the IASB no longer precludes the recognition of regulatory assets and liabilities a rate-regulated entity's financial statements. Rather, the IASB issued a standard, IFRS 14 *Regulatory deferral accounts*, which provides the following relevant guidance:

Paragraph 2(a) of IFRS 14 notes that the objective of the Standard was to:

> *limit changes to the accounting policies that were applied in accordance with previous generally accepted accounting principles (previous GAAP) for regulatory deferral account balances, which are primarily related to the presentation of these accounts;*

Additionally, paragraph 10 of IFRS 14 notes:

> *Paragraphs 11–12 of IAS 8 specify sources of requirements and guidance that management is required or permitted to consider in developing an accounting policy for an item, if no relevant Standard applies specifically to that item. This Standard exempts an entity from applying paragraph 11 of IAS 8 to its accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral account balances. Consequently, entities that recognise regulatory deferral account balances, either as separate items or as part of the carrying value of other assets and liabilities, in accordance with their previous GAAP, are permitted to continue to recognise those balances in accordance with this Standard through the exemption from paragraph 11 of IAS 8, subject to any presentation changes required by paragraphs 18–19 of this Standard.*

This IFRS was issued in response to North American entities potentially transitioning to IFRS, because there was a lack of guidance that permitted the continued separate accounting treatment for regulatory assets and liabilities recognized as a result of rate regulated activities. The guidance above, permits rate-regulated entities upon first-time adoption of IFRS to continue to recognize regulatory assets and liabilities in accordance with the framework that was applied previously (i.e. generally, entities recognized assets in accordance with the guidance of ASC 980 (US entities) or AcG 19 (Canadian entities)).

Given the above-noted guidance, an entity can look to the other accounting frameworks while also ensuring that when judgment is applied, the resulting accounting policy is not inconsistent with the accounting guidance of PSAS. For this reason, the evaluation of accounting considerations in the development of the proposed accounting treatment for the recovery of CDM costs, is considered in the following order:

1) Can an asset be recognized in accordance with PS 1000 *Financial statement concepts* as prescribed by PSAS?

2) Can the IESO reference the guidance of other accounting frameworks to support the recognition of the reimbursement of CDM costs as an asset?

3) Failing the above, is the most appropriate accounting treatment to recognize the reimbursement of CDM costs as an expense of the current period and simply recognize revenue in future periods when the cost is recovered?

1. Qualification of reimbursement of CDM costs as an asset in accordance with PSAS:

Although PSAS does not specifically address the recognition of costs incurred that will be recovered through regulatory operations in future periods, this does not result in the conclusion that such costs cannot be recognized as an asset. In particular, paragraph 5 of PS 1150 notes:

> *.05 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, the selection of an appropriate accounting policy requires the exercise of professional judgment. In these circumstances, a public sector reporting entity should adopt accounting policies and disclosures that are consistent with:

(a) the primary sources of GAAP; and

(b) the application of the concepts described in FINANCIAL STATEMENT CONCEPTS, Section PS 1000.

In this case, the IESO would consider whether an asset could be supported by the guidance noted in PS 1000 *Financial statement concepts*, as follows:

Recognition of an asset

Paragraphs 35-37:

.35 Assets are 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.

.36 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;

b) the public sector entity can control the economic resource and access to the future economic benefits; and

c) the transaction or event giving rise to the public sector entity's control has already occurred. [Former paragraph PS 1000.36 retained in Archived Pronouncements.]

.37 An item is not an asset of a government if it lacks one or more of the essential characteristics listed in the preceding paragraph. Thus, for example, an item does not qualify as an asset of a government if the item involves:

(a) no future economic benefit;

(b) future economic benefit, but the government cannot obtain it; or

(c) future economic benefit that the government may obtain, but the events or circumstances that give the government control of the benefit have not yet occurred.

In evaluating the costs incurred by the IESO to reimburse the LDCs, an argument could be made to support the recognition of the costs as an asset as the costs meet the three essential characteristics prescribed by PS 1000. Particularly:

- ***Future economic benefits*** – the CDM costs incurred by the IESO are made to reimburse eligible expenditures from market participants or third-party delivery agents (e.g. an LDC). The IESO can expect to generate future economic benefits from the reimbursement of these expenditures because: a) it has a license with the OEB to operate as a system operator and recover reasonable costs incurred (as noted below) and b) it is mandated by the Minister to charge ratepayers the global adjustment, which results in future cash inflows to recover the reimbursed costs.

Paragraph 13 of PS 3210 *Assets* notes:

.13 *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. Benefits in the form of cash inflows relate to resources, such as loans receivable, inventory for resale and portfolio investments. Also, some public sector resources generate cash inflows because they have user fees associated with them.*

The global adjustment that is charged to ratepayers and calculated by the IESO is not subject to the review or approval of the Ontario Electricity Board ("OEB"). Accordingly, there is limited risk with respect to the IESO's ability to recover the reimbursement costs incurred – even if the costs are recovered over an extended period of time, as the OEB does not have the ability to reject the recovery of these costs. While risk is limited, the recovery of the CDM expenditures reimbursed by the IESO is dependent on future transactions with electricity customers.

Also, while not specifically governed by the OEB, the IESO's license with the OEB provides that reasonable costs of its activities will be recovered:

13 *Fees and Charges*

13.1 *The Licensee may impose fees and charges to recover the cost of its activities in accordance with an order of the Board, or as permitted by law.*

14 *Books of Accounts and Financial Reporting*

14.3 *Unless otherwise provided by law, the Licensee shall, no less than 60 days before the beginning of the Licensee's fiscal year submit the Licensee's proposed expenditure and revenue requirements for the following fiscal year and the fees it proposes to charge during that year to the Board for review and approval. The Licensee's submission shall include a copy of the Licensee's annual business plan for the fiscal year as approved by the Minister under section 24 of the Electricity Act.*

Through its mandate from the Ministry of Energy, which provides the IESO with the right to recover costs, in combination with the IESO's license with the OEB, to the extent that CDM costs are incurred (past transaction) in accordance with the IESO's mandate from the Ministry of Energy, these cash inflows (and thus, future economic benefits) are expected to be recovered.

- ***Public sector entity control's economic resource and access to economic benefits*** – The IESO controls access to the future cash inflows that are generated from the incurrence of the CDM expenditures, as it is the IESO who has the mandate from the Ministry of Energy to incur these CDM costs and it is also the IESO who has the directive from this Minister to recover the CDM costs through the global adjustment mechanism charged to rate payers. Specifically, the Electricity Act 1998 notes the following:

Electricity pricing to reflect costs

IESO to make adjustments

25.33 (1) 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. 2014, c. 7, Sched. 7, s. 8 (1).*

Paragraph 16 of PS 3210 provides additional guidance regarding control of an economic resource and access to future economic benefits, which notes that the public entity:

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.*

As outlined previously, the IESO has control over the economic resource, as it is the sole entity that is entitled to the cash inflows from ratepayers[1]. Furthermore, while risk is limited, the IESO is exposed to the risk associated with the economic resource – as the Ministry of Energy could change their directive or calculation of the global adjustment, or there could be a change in the economic environment (as discussed above) and thus, alter the ability of the IESO to recover the costs.

- ***Transaction or event giving rise to public sector entity's control has already occurred*** – When evaluating whether a transaction or event gives rise to control, paragraphs 26 and 27 of PS 3210 provides helpful guidance:

  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.

  Meeting the eligibility criteria under an authorized transfer often determines the past transaction or event giving rise to control of an economic resource in non-exchange contracts or agreements. Shared cost agreements (reimbursement arrangements) are an example where the control of an economic resource arises when the recipient incurs eligible expenditures.

  Consistent with the guidance in paragraph 26, control over the economic benefits of the IESO's reimbursement via the global adjustment mechanism from the LDC occurs once the IESO has distributed funds to the LDC. At this point in time, the IESO has incurred a cash outflow for which it is entitled to recover through the global adjustment as prescribed by the Ministry of Energy and the Electricity Act 1998.

Based on the characteristics, as prescribed by PS 1000 and the additional guidance of PS 3210, the cash outflows disbursed by the IESO to reimburse CDM costs to LDCs could meet the definition of an asset in PS 1000.

In accordance with the principles of PSAS, there are generally two types of assets that the IESO may consider recognizing 1) financial asset; or 2) non-financial asset. To classify the asset, it must fall into one of the two categories.

[1] Although the administrative framework provides that LDCs invoice the global adjustment to ratepayers on the IESO's behalf, the IESO has sole entitlement to the cash inflows that result from the global adjustment. All global adjustment amounts collected by LDCs are required to be submitted to the IESO.

Financial asset

*.39 **Financial assets** are assets that could be used to discharge existing liabilities or finance future operations and are not for consumption in the normal course of operations.*

.40 A financial asset is any asset that is:

a) cash;

b) a realizable asset that is convertible to cash;

c) a contractual right to receive cash or another financial asset from another party;

d) a contractual right to exchange financial instruments with another party under conditions that are potentially favourable to the government;

e) an equity instrument of another entity;

f) an investment in a government business enterprise or government business partnership;

g) a financial claim on an outside organization or individual; or

h) an inventory or item for sale that meets the criteria in FINANCIAL STATEMENT PRESENTATION, paragraph PS 1201.055.

Based on the guidance of PS 1000, paragraphs 39 and 40, it may be difficult to substantiate the IESO's reimbursement of costs is a financial asset. The costs incurred by the IESO creates a right to recover costs as mandated by the Ministry of Energy. However, there is no contract with a specific ratepayer who ultimately reimburses the IESO for the costs incurred if the IESO calculates the global adjustment (i.e. its recovery mechanism) and this amount is then disbursed to all ratepayers in Ontario (regardless of whether an individual ratepayer benefited from the cost incurred). Furthermore, to the extent that a current ratepayer moves outside of Ontario, it could in fact result in a new ratepayer having to incur the additional charge to permit the IESO to recover its costs. It is difficult to argue that there is a contractual right to receive cash from another party, because legislation and the regulatory framework result in the right to future cash inflows from a pool of ratepayers.

An alternative view may be that the LDCs represent the counterparty to the IESO whereby the LDC is responsible for paying the IESO the global adjustment whether or not payment is ultimately received from the ratepayer. In this circumstance, the IESO can argue that a financial asset should be recognized for its contractual right to receive cash is from each specific LDC. An assessment of who is obligated for the global adjustment (e.g. an assessment of whether the LDC is the agent facilitating cash collection or is the entity obligated to pay the amount) would need to support this alternative.

Non-Financial asset

.41 Non-financial assets include tangible capital assets, and other assets such as prepaid expenses and inventories of supplies.

.42 Non-financial assets are acquired, constructed or developed assets that do not normally provide resources to discharge existing liabilities, but instead:

(a) are normally employed to deliver government services;

(b) may be consumed in the normal course of operations; and

(c) are not for sale in the normal course of operations.

Another accounting treatment could be a 'non-financial asset' in accordance with paragraphs 41 and 42 of PS 1000. This accounting treatment may be supportable under the PSAS guidance as an 'other asset'. The reimbursement of CDM costs, results in the incurrence of an upfront cost in which the entity will benefit from economic benefits over a period of time.

Subsequent measurement of a non-financial asset

To the extent that the recognition of an asset is supported under the framework discussed above, the entity would then be required to draw the asset down over the recovery period (i.e. as cash is collected from ratepayers through the global adjustment mechanism). The presentation of the 'draw' down of the asset is dependent upon the IESO's accounting for the global adjustment. To the extent that funds received from the global adjustment are recognized in revenue rather than to directly reduce the asset then the IESO might consider recognizing the draw-down of the asset as a reduction in revenues. Nonetheless, depending on the IESO's view of its role (i.e. principal versus agent) or its view of the nature of costs incurred, an alternative accounting treatment may result. For instance, if the IESO is an agent, then it may reduce the asset balance directly for those amounts collected by way of the global adjustment rather than recording two separate entries for the recognition of revenue (i.e. global adjustment) and reduction of revenue (i.e. over the recovery period). At this time, the IESO has not completed a principal versus agency assessment.

Demonstrating that the CDM costs will meet the definition of a financial or non-financial asset is challenging and the IESO may not be able to support either view and should consider if referencing another accounting framework to inform an accounting policy for these costs may be required as discussed below.

2. Reference to other accounting frameworks:

As previously noted above, other accounting frameworks as issued by the AcSB, GASB, FASB and IASB provide accounting guidance related to the recognition of expenditures as an asset due to rate regulated operations. When referencing the other frameworks, it is important that the costs qualify as an asset under the framework set forth by PSAS to ensure that the principles of PSAS are not violated, and only then can reference to other frameworks be made to record the reimbursement of costs as an asset.

As the IASB and AcSB do not provide detailed guidance, the IESO could explore whether the costs incurred meet the specific criteria established by GASB S62 as note below; however consideration will need to be given to the consistent application of an accounting policy to all similar existing rate regulated assets and whether an established accounting policy is already in place that would require criteria to be met to change this policy:

476. Paragraphs 476–500 may be applied to activities reported in business-type activities that have regulated operations that meet all of the following criteria:

a. The regulated business-type activity's rates for regulated services 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 regulated business-type activity's costs of providing the regulated services.*

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 regulated business-type activity'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.*

To the extent that the criteria of paragraph 476 of GASB S62 are met, paragraph 480 then provides the following guidance:

480. Rate actions of a regulator can provide a business-type activity with reasonable assurance of the existence of an asset. A regulated business-type activity should capitalize all or part of an incurred cost that otherwise would be charged to expense if both of the following criteria are met:

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.*

By referencing the guidance of GASB S62, the IESO must first establish that it meets the criteria of paragraph 476. In doing so, the IESO should consider:

a. Established rates for regulated services (GASB S62.474 (a)) - The IESO's business activity rates are regulated services subject to approval. In this particular instance, the IESO's CDM expenditures are governed by legislation, Electricity Act 1998 as noted above, and by its own governing board, being, the Ministry of Energy. The Ministry of Energy has established the calculation of the global adjustment mechanism[2], which in turn, is charged to the ultimate customer who consumes the energy.

b. Regulated rates are designed to recover specific costs (GASB S62.474 (b)) - One element of the global adjustment mechanism is designed to recover the CDM expenditures that the IESO reimburses to the respective LDCs. As the IESO's regulated business activities support the LDCs delivery of energy to customers, these costs form an integral part of the IESO's regulated services to support the transmission and distribution of energy in Ontario.

c. Demand for regulated activities results in reasonable assumption that established rates will be collected and will recover cost of activities (GASB S62.474(c)) - Given that the structure of the IESO is a not-for-profit entity governed by the Electricity Act of 1998 and regulated by the Ontario Energy Board to support the transmission and distribution of energy to customers in Ontario, rates approved to be charged to customers are designed to recover the IESO's costs. Since the reimbursement of CDM expenditures is a program initiated and mandated by the Ministry of Energy, an entity that also controls the Ontario Energy Board, the IESO would need to examine and support whether the CDM expenditures will be recovered through cash inflows from customers through the global adjustment mechanism. For example, the historic demand and dependency and projected demand for electricity could be used to support a judgment or assertion by the IESO that there is no significant risk that future demand levels decline and diminish to the extent that IESO would not be able to recover the reimbursement of CDM expenditures through rates (i.e. global adjustment mechanism).

---

[2] Section 1.7 of the directive from the Ministry of Energy dated March 31, 2014 titled *2015-2020 Conservation First Framework* provides that the Ontario Power Authority (now merged into the IESO) may "*recover payments made under the Province-Wide Distributor CDM Programs and Local Distributor CDM Programs from the Global Adjustment Mechanism up to the budget established…*"

If the IESO can demonstrate that CDM expenditures meet the criteria as noted above, the fact pattern may support recognition of a regulatory asset in accordance with paragraph 480 of GASB S62. The IESO could consider:

a. Probability of future revenues (GASB S62.480 (a)) - The global adjustment mechanism explicitly includes recovery of the CDM expenditures. The directive from the Ministry of Energy could support the IESO's assertion that it is at least probable that future revenue will be generated in an amount at least equal to the capitalized cost related to the CDM expenditures. The IESO will need to assess if the global adjustment is considered future revenue (i.e. as part of the analysis of principal versus agent).

b. Recovery of previously incurred costs (GASB S62.480 (b)) - The IESO recovers the CDM expenditures through the global adjustment mechanism. The calculation of the portion of the global adjustment mechanism that relates to the CDM expenditures is determined by the amount that the IESO has approved to reimburse the LDC (e.g. the LDC requests reimbursement for costs it has *incurred* related to the CDM Requirement[3] and if all criteria are met, the IESO then approves the costs for reimbursement). For this reason, there is evidence that the future revenue earned from the global adjustment mechanism permits the recovery of previously incurred costs (i.e. not future costs).

Using the GASB S62 accounting guidance, and the related considerations noted above, the IESO may be able to reference GASB S62 to support the recognition of CDM expenditures as an asset by way of the GAAP hierarchy prescribed by PS 1150, paragraph 19, which explicitly references GASB as a secondary source of GAAP in the event that PSAS does not address a particular transaction. However, the IESO would also need to consider whether it is appropriate to refer to the GASB. First, consideration should be given to whether the GASB accounting guidance to capitalize rate regulated assets is consistent with the primary sources and financial statement concepts of PSAS. This may be challenging as it was noted in a paper prepared by the PSAB Conceptual Task Force *Consultation Paper 2: Measuring Financial Performance in Public Sector Financial Statements,* that the existing model in the PSA Handbook takes predominately an asset and liability view whereas standards set by the GASB is a financial statement presentation model based on a revenue and expense view. That said, the definition of an asset is similar under both the PSAS and GASB standards (GASB Concepts Statement 4[4]) and because rate regulated assets are not classified as deferred outflows of resources (GASB S65) but rather assets, it may be possible to use the GAAP hierarchy to refer to GASB to formulate an accounting policy. GASB S65 *Items Previously Recognized as Assets and Liabilities* was applicable for periods beginning after December 15, 2012. In paragraph 48 of GASB S65, rate regulated assets retained the definition of an asset and these assets were not required to be reclassified as a deferred outflow which is defined as the consumption of net assets by the government that is applicable to a future period. Secondly, any existing policy that the IESO currently applies to any other assets that could be considered rate regulated assets would require an evaluation of whether an accounting policy change from expensing to one that capitalizes rate regulated assets meets the criteria that the new accounting policy results in a more appropriate presentation of events or transactions in the IESO's financial statements (PS 2120, paragraph 2).

An alternative view is that it is inappropriate to reference GASB S62 because GASB has provided a special accommodation to permit the capitalization of rate regulated assets when they would otherwise be expensed. If an entity that applies PSAS, determines that the definition of an asset under PS 1000 is not met then for the IESO to use a special accommodation in another framework to avoid expensing the CDM costs would not be appropriate.

---

[3] The Ministry of Energy issued a CDM Directive as per its letter re: 2015-2020 Conservation First Framework, which instructed the Ontario Energy Board to amend the license of each licensed electricity distributor to add a condition that specifies the distributor would make CDM programs available to customers in its licensed area. The CDM programs are required to achieve reductions in electricity consumption. As part of this, the distributor is required to make province-wide CDM programs, funded by the OPA (now the IESO) available to all customers in its licensed service area.

[4] GASB Concepts Statement 4, paragraph 8, defines assets as '*resources with present service capacity that the government presently controls*.'

If the IESO does adopt an accounting policy to capitalize the CDM costs there are examples of entities that capitalize similar rate regulated assets that prepare their financial statements in accordance with GASB in the United States. For instance, the Long Island Power Authority ("LIPA") is an organization that is responsible for supplying electricity to customers within a specified service area. LIPA recognizes regulatory assets on its statement of net position in accordance with the guidance of GASB S62.

The FASB also includes accounting guidance related to the accounting for regulated activities in ASC 980-340-25-1 as follows:

> *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.*

The guidance provided by US GAAP notes that to the extent that a regulator provides reasonable assurance of the existence of an asset, then the entity should capitalize the incurred cost that would have otherwise been expensed. In this case, the Ministry of Energy has provided that the IESO will be able to recover its costs through the global adjustment mechanism[5]. As a result, the IESO can support meeting criterion a) of 980-340-25-1 that it is probable that future revenue will equal the cost capitalized as the IESO will include those reimbursed CDM costs in its calculation of the global adjustment charged to rate payers. Furthermore, the IESO can support criterion b) is met, because the future recovery relates only to those costs paid by the IESO to reimburse eligible CDM costs.

To further support this accounting position, there are system operators (i.e. similar to the IESO) in the United States who recognize regulatory assets. As an example, ISO New England Inc., a not-for-profit organization that regulates the flow of transactions in accordance with the Federal Energy Regulatory Commission ("FERC") recognizes regulatory assets for those costs incurred subject to rate recovery mechanisms. The ISO New England Inc. operates in a very similar manner to the IESO, in that both organizations are government regulated, system operators who manage the flow of electricity transactions and are not-for-profit. While ISO New England Inc. prepares its financial statements in accordance with US GAAP, rather than GASB, ISO New England Inc.'s treatment of regulatory items is indicative that the capitalization of expenditures related to regulated activities is not an unreasonable treatment for entities of this nature.

As the application of the hierarchy is a choice and not a requirement, another entity with the same fact pattern could account for the recovery of CDM expenditures differently.

<u>Subsequent measurement of asset</u>

To the extent that the recognition of an asset is supported under one of the frameworks discussed above, the entity would then draw the asset down over the recovery period (i.e. as cash is collected from ratepayers

[5] Section 1.7 of the directive from the Ministry of Energy dated March 31, 2014 titled *2015-2020 Conservation First Framework* provides that the Ontario Power Authority (now merged into the IESO) may "*recover payments made under the Province-Wide Distributor CDM Programs and Local Distributor CDM Programs from the Global Adjustment Mechanism up to the budget established…*"

through the global adjustment mechanism). The presentation of the draw down of the asset is dependent upon the IESO's accounting for the global adjustment. To the extent that funds received from the global adjustment are recognized in revenue then the IESO might consider recognizing the recovery of the asset as a reduction in revenues (contra revenue account). Nonetheless, depending on the IESO's view of its role (i.e. principal vs. agent) or its view of the nature of costs incurred, an alternative accounting treatment may result. For instance, if the IESO is an agent, then it may reduce the asset balance directly for those amounts collected by way of the global adjustment – rather than recording two separate entries for the recognition of revenue (i.e. global adjustment) and reduction of revenue (i.e. recovery of asset).

3. Expensing expenditures as incurred

Failing the ability to support that an asset can be recognized from alternatives (1) and (2) above, the IESO would be required to record the reimbursement of an LDC's eligible CDM expenditures as an expense in the period incurred.

Paragraphs 49 to 51 of PS 1000 provide the following guidance related to expenses:

.49 Expenses, including losses, are decreases in economic resources, either by way of decreases in assets or increases in liabilities, resulting from the operations, transactions and events of the accounting period.

.50 Expenses include the cost of economic resources consumed in and identifiable with the operations of the accounting period. For example, the cost of tangible capital assets is amortized to expenses as the assets are used in delivering government programs (see TANGIBLE CAPITAL ASSETS, Section PS 3150). Expenses do not include debt repayments or transfers to other governmental units in the government reporting entity.

.51 Losses can arise from peripheral or incidental transactions and events affecting a government. Such transactions and events include the disposition of assets purchased for use and not for resale, and the liquidation or refinancing of debt.

By referencing paragraphs 49 to 51, it can be noted that the reimbursement of an LDC's CDM expenditures do indeed result in an immediate decrease in the IESO's economic resources – as noted in paragraph 49. If it cannot be substantiated that an asset can be recorded due to the future economic benefits expected to be received through the global adjustment – these expenditures must be recorded as an expense.

4. Accounting for interest costs

The accounting for interest costs related to the loan being considered to finance the IESO's recovery of CDM costs incurred over an extended period of time would be dependent on how the Ministry of Energy proposes that the IESO will recover these costs. To the extent that the Minister revises the calculation of the global adjustment, then the IESO may be able to recognize an asset for these costs (i.e. see the arguments listed in sections (1) and (2) above).

If the Ministry of Energy proposes that the IESO recover the interest costs through the revenue requirement, the IESO will need to evaluate its ability to recover the interest costs through future rates. To the extent that the there is significant risk associated with recovering these costs, interest costs should be recognized as an expense in the current period. Otherwise, the IESO may be able to capitalize the interest costs as an asset by applying the arguments in sections (1) and (2) noted above.

If a recovery mechanism is not established for the interest costs related to the loan, the interest costs would be recognized as an expense of the current period.