WHITE PAPERS – WORKING DRAFT

Independent Electricity System Operator ("IESO" or the "Company") is considering making changes in its accounting policies to reflect the balances of market participants within the IESO-administered markets (see separate technical analysis) and the economic impacts of rate regulation, as the Company believes that the changes would result in a more appropriate presentation of events or transactions in its financial statements.

Issues being considered in this document are:

Issue #1: Can the IESO adopt the guidance in ASC 980 *Regulated Operations*?

Issue #2: Can the IESO recognize deferral or variance accounts related to the deferral of the annual Global Adjustment account as a regulatory asset on its statement of financial position?

Issue #3: Can the IESO derecognize the variance accounts related to the deferral of the annual Global Adjustment account**?**

1. Adoption of the guidance in ASC 980 Regulated Operations

Background and Assumptions for issues #1 and #2

The facts, circumstances, and assumptions relevant to the specific transactions are as follows:

1. IESO is rate regulated by the OEB in accordance with the *Electricity Act, 1998* and the *Ontario Energy Board ("OEB") Act, 1998.*
2. The province is contemplating deferring the recovery of a portion of the annual Global Adjustment account (comprised primarily of the electricity costs paid to the generators) over a period of several25-30 years.
3. The *Electricity Act, 1998* and the *OEB Act, 1998* will be amended through legislation to require the deferral of the recovery of the Global Adjustment account and the future recovery in rates charged to customers. The deferred amount will start to be recovered from year 5.
4. The OEB will grant generic deferral or variance accounts to capture the difference between the amounts paid to generators and others, and the amounts collected in rates. Furthermore, the interest and ancillary costs related to the contemplated transaction will also be included in future rates charged to customers. In summary, the legislation will create a right to collect the incurred cost.
5. Currently, in accordance with the *Electricity Act, 1998* and the *OEB Act, 1998*, the 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.
6. IESO may change its accounting policies to permit the recognition of the economic impacts of rate regulation as from the 2016 financial year. IESO will adopt the guidance of ASC 980 *Regulated Operations*.

Appropriate Accounting Principle for issue #1

PS1150.05 "*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."

PS1150.19 "*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 (FASB), 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.*"

PS1150.08 "A public sector reporting entity consults sources other than primary sources of GAAP to assist in selecting accounting policies and disclosures only when these sources comply with paragraph ***Error! Hyperlink reference not valid.****. The public sector reporting entity evaluates sources in selecting the appropriate accounting policies and disclosures based on all of the following criteria:*

(a) The specificity of the source — A source that deals with the specific circumstances is likely to be more relevant than one from which the public sector reporting entity must analogize.

(b) The authority of the issuer or author — A source issued by an accounting standard setter in its own jurisdiction is likely to be more relevant than a source issued by others in the same jurisdiction.

(c) The continued relevance of the source — The passage of time may diminish the relevance of certain sources.

(d) The development process for the source — A source developed after extensive consultation and debate is likely to be more relevant than a source developed without such discipline."

PS1150.10 "PSAB considers a source to be consistent with the concepts in paragraph PS 1150.05(b) when the guidance in that source is compatible with the (i) qualitative characteristics of financial information, (ii) the elements of financial statements, and (iii) the recognition and measurement criteria in paragraph PS 1150.05(b)."

Issue #1: Can the IESO adopt the guidance in ASC 980 *Regulated Operations*?

PSAS does not address accounting concepts in a rate regulated environment. Since there is no guidance in PSAS regarding the recognition and measurement of regulatory assets and liabilities, IESO may consider other sources based upon PSAS 1150.05 in the GAAP hierarchy to determine appropriate accounting policies in a rate regulated environment.

Within AcSB, Accounting Standards for Private Enterprises (ASPE) defines a rate regulated entity but provides no guidance on regulatory assets and liabilities, however requires disclosure of such balances if they are recognized. IASB has not completed their project on rate regulation and current standards only include a holding standard based upon what was done under previous GAAP. Both FASB and GASB have guidance on accounting in a regulatory environment. IPSASB does not provide any guidance on accounting by rate regulated entities.

It is important to note that regulated entities that prepare their general purpose financial statements in accordance with ASPE (e.g. the three Fortis subsidiaries in Ontario), as well as those regulated entities that are eligible to elect to apply the requirements of IFRS 14 and elected to do so when they adopted IFRS, generally all recognize regulatory deferral and variance accounts in accordance with US GAAP accounting principles set out ASC 980 *Regulated Operations.*

Statement 62 issued by GASB in December 2010 is effective for financial statements for periods beginning after December 15, 2011. The objective of the Statement is to incorporate into the GASB's authoritative literature certain accounting and financial reporting guidance that is included in the Financial Accounting Standards Board (FASB) Statements and Interpretations issued on or before November 30, 1989, which does not conflict with or contradict GASB pronouncements. Paragraphs 476–500 may be applied to activities reported in business-type activities that have regulated operations that meet all of the three criteria in paragraph 476 as follows:

(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.

The criteria above and the guidance in paragraphs 476-500 are based on ASC 980 *Regulated Operations*.

In summary,

Canadian rate regulated entities reporting under ASPE, IFRS and GASB generally all recognize regulatory deferral and variance accounts in accordance with US GAAP accounting principles based on ASC 980 *Regulated Operations*.

Evaluation of Other Sources of GAAP

As required by PS 1150.05(b), we need to analyze whether the concepts in the other source (i.e. ASC 980) are compatible with the (i) qualitative characteristics of financial information, (ii) the elements of financial statements, and (iii) the recognition and measurement criteria in PS 1000.

When looking to other sources of GAAP, PSAS requires the other sources of GAAP to be evaluated

1. *as to whether they are consistent with accounting policies and disclosure within PSAS (PS 1150.05(a)),*
2. *as to whether they are consistent with the application of concepts in PS 1000 (PS 1150.05(b)) and*
3. *as to all of the following criteria (PS 1150.08):*
   - *(a) Source deals with the specific circumstance*
   - *(b) Source is issued by an accounting standard setter*
   - *(c) Source continues to be relevant*
   - *(d) Source uses a consultative process and deliberation when developing policies*

(i) Qualitative Characteristics of Financial Information

FASB	**PSAS 1000**	**Evaluation**
Concepts and objectives are for both business and non-business organizations as well as governmental units	Public, legislators, councilors, investors, analysts, other governments (par. 14)	FASB considers governmental units
Financial reporting should: – Be useful in making resource allocation decisions – Be useful in assessing services and ability to provide services – Be useful in assessing management stewardship and performance – Provide information about economic resources, obligations, net resources and changes in them	Financial statements should be relevant to the needs of the users and reliable. Relevance is achieved through timeliness, predictability and accountability value. Reliable information has the following characteristics: representational faithfulness, completeness, neutrality, conservatism and verifiability. (par. 28-29)	Similar

(ii) Elements of Financial Statements

FASB	PSAS	Evaluation
Assets		
Probable future economic benefits obtained or controlled by the entity as a result of past transactions or events.	Economic resources controlled by a government as a result of past transactions or event and from which future economic benefits are expected to be obtained. (par. 35)	Essential characteristics similar
Liabilities		
Probable future sacrifices of economic benefits arising from present obligations of the entity to transfer assets or provide services in the future as a result of past transactions or events.	Present obligations to others arising from past transactions or events, the settlement of which is expected to result in the future sacrifice of economic benefits with little or no discretion to avoid settlement. (par. 44)	Essential characteristics similar
Revenues		
Inflows from delivering or producing goods, rendering services or other activities that constitute the entity's central operations.	Increases in economic resources resulting from operations, transactions and events of the accounting period. (par. 46)	Similar
Expenses		
Outflows from delivering or producing goods, rendering services or carrying out other activities that constitute the entity's central operations.	Decreases in economic resources resulting from operations, transactions and events of the accounting period. (par. 49)	Similar

(iii) Recognition Criteria

FASB	PSAS	Evaluation
To be recognized, an item must meet the definition of an element of the financial statements, must be measurable with sufficient reliability, be relevant and be reliable.	Item must have an appropriate basis of measurement, a reasonable estimate can be made of the amount and if the item involves obtaining or giving up future economic benefits, it is expected those benefits will be obtained or given up. (par. 55)	Similar

(iii) Measurement Criteria

FASB	PSAS	Evaluation
Measurement basis dependent upon nature of item. Historical cost basis, replacement cost, market value.	Primarily using historical cost basis. Replacement cost and realizable value are also used, but in limited circumstances. (par. 60)	Similar

Criteria of PS 1150.08

Criteria	Evaluation
Source deals with the specific circumstance	Yes, ASC 980 Regulated Operations

Source is issued by an accounting standard setter	Yes, FASB
Source continues to be relevant	Yes, still used by rate regulated entities
Source uses a consultative process and deliberation when developing policies	Yes, comprehensive consultative process and deliberation

When concepts are in conflict with PSAS then PSAS prevails (PS 11050.12). For example, PSAS does not recognize intangible assets (PS 3150.03, .14). So if regulatory assets are considered to be intangible assets, they would not be allowed to be recognized through another source of GAAP. FASB and the IASB have both concluded that regulatory assets are neither financial assets nor intangible assets. Therefore, we can conclude that ASC 980 is NOT in conflict with PS 3150.03, .14 with respect to intangible assets.

Conclusion:

- FASB is appropriate to use as an other source of GAAP.
- FASB standard ASC 980 has extensive guidance for rate regulated entities including the recognition of regulatory assets.

Appropriate Accounting Principle for issue #2

ASC 980 Regulated Operations

- 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.*
  - *(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."*
- 980-340-25-1 *"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."*
- 980-350-50-1: "*In some cases, a regulator may permit an entity to include a cost that would be charged to expense by an unregulated entity as an allowable cost over a period of time by amortizing that cost for rate-making purposes, but the regulator does not include the unrecovered amount in the rate base. That procedure does not provide a return on investment during the recovery period. If recovery of such major costs is provided without a return on investment during the recovery period, the entity shall disclose the remaining amounts of such assets and the remaining recovery period applicable to them."*
- 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 #2: Can the IESO recognize deferral or variance accounts related to the deferral of the annual Global Adjustment account as a regulatory asset on its statement of financial position?

As described in issue #1, US GAAP includes special accounting provisions that are applicable to entities with activities that are subject to rate regulation. The result is that regulated entities are required to recognize regulatory assets and liabilities provided the following three criteria are met:

Criteria	Comment	Evaluation
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.	IESO has unrecognized variance accounts related to the MDMR (smart meters), that have been approved by the OEB in accordance with the Electricity Act and the OEB Act. As IESO and OEB are both consolidated into the province's books, we need to analyze whether the OEB is an independent, third-party regulator. Since Hydro One / OPG are both consolidated into the province's books, are both regulated by the OEB and have both recognized regulatory assets and liabilities, we can conclude that the OEB is an independent, third-party regulator.	Met
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. The contemplated transaction is based on	Met

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	the fact that the OEB will grant generic deferral or variance accounts to capture the difference between the amounts paid to generators and others, and the amounts collected in rates. Furthermore, the interest and ancillary costs related to the contemplated transaction will also be included in future rates charged to customers. In summary, the legislation will create a right to collect the incurred cost.	
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."	Since the deferral or variance accounts will be sold to the OPG Trust at least on a monthly basis and cash will be received on the same day, this criteria will be met. This criteria will need to be monitored on a yearly basis to ensure that IESO and the OPG Trust will be able to recover the deferred amount taking into account the levels of demand or competition during the recovery period.	Met

In order to capitalize an incurred cost as a regulatory asset, a regulated entity is required to assess whether 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. Determining whether it is probable that incurred costs will eventually be included in rates is often the most difficult part of applying the accounting requirements for regulatory assets. Actions by the regulator can greatly influence the recognition of regulatory assets. The level of judgment involved is much more significant for the contemplated transaction as the period of recovering these costs from customers will extend well into the future.

2. Derecognition of the regulatory assets

Background and Assumptions for issue #3

The facts, circumstances, and assumptions relevant to the specific transactions are as follows:

1. As mentioned above, the annual Global Adjustment account that will be deferred in the deferral or variance accounts (the "Asset") will be significant.
2. The IESO does not currently have the financial capability to finance the Asset and is contemplating selling the Asset to a Trust to be set-up by OPG (the "OPG Trust").
3. The OPG Trust will be consolidated by OPG.
4. Proposed terms of the sale agreement between the IESO and the OPG Trust:
   - The sale contract will be structured as an absolute sale, which will assign future economic benefits or cash flows related to the Asset exclusively to the OPG Trust.
   - The arrangement will be structured whereby there is no recourse or obligations remaining of IESO related to the Asset.
   - IESO will not retain any rights or benefits from the Asset.
   - IESO would not have any rights to interest or penalties on the Asset once it has been transferred to the OPG Trust.

- The contract will be clear that IESO cannot pledge the Asset as collateral to obtain future cash flows or financing.
- IESO will continue to collect related cash flows on the OPG Trust's behalf and remit those cash flows to the OPG Trust without material delay. In addition, IESO will not be entitled to reinvest such cash flows, except for investments in cash or cash equivalents during the short settlement period from the collection date to the date of required remittance to the OPG Trust, and interest earned on such cash and cash equivalents is passed to the OPG Trust. The contract will define IESO's role strictly as that of agent, under a pass-through arrangement.
- Servicing, origination, and arrangement fees, will be collected by IESO in rates charged to ratepayers as part of its market dealings.
- The Asset will be sold to the OPG Trust at least, on a monthly basis and cash will be received on the same day.

Appropriate Accounting Principles for issue #3

Public Sector Accounting Standard ("PSAS") 3210, *Assets*, defines an asset 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.*" [par. 3]

.04 *"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."

.22 *"Control of an economic resource and of access to the future economic benefits are essential characteristics of an asset, whereas possession or ownership is not."*

.24 *"A public sector entity may act as trustee when it administers trusts on behalf of the beneficiaries specified in the agreement or statute. As trustee, the public sector entity merely administers the assets, following the terms and conditions set out in the agreement. It does not control the asset because it does not have access to the future economic benefits. Those benefits flow to the beneficiaries."*

As noted in PS1000 Financial statement concepts:

".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."

Issue #3: Can the IESO derecognize the variance accounts related to the deferral of the annual Global Adjustment account?

PS3210 does not specifically address the derecognition of a regulatory asset. The concept of a regulatory asset does not exist under PSAS.

It is also well understood in this industry that regulatory assets do not meet the definition of intangible asset or financial asset. Specifically, regulatory assets do not meet the definition of financial asset because they are imposed on customers through the tariff (i.e., imposed by the OEB) and do not represent a right to receive payments from another party as a result of a contract.

More generally, PSAS suggests that an asset would no longer be recognized when it fails to meet the definition of an asset.

Based on PS1000.37(b), an item does not qualify as an asset of a government if the item involves future economic benefit, but the government cannot obtain it.

Conclusion: Based on the proposed terms of the sale agreement between the IESO and OPG Trust mentioned above, the deferral or variance accounts would be derecognized at the point where the IESO will derive no future economic benefit from it. This would occur where the IESO ultimately transfers the rights, risk and rewards related to those deferral or variance accounts to the OPG Trust.