Office of the Auditor General of Ontario
Bureau de la vérificatrice générale de l'Ontario

INDEPENDENT AUDITOR'S REPORT

To the Independent Electricity System Operator and
The Standing Committee on Public Accounts of Ontario

Report on the Financial Statements

I have audited the accompanying financial statements of the Independent Electricity System Operator (IESO), which comprise the statement of financial position as at December 31, 2017, and the statements of operations and accumulated surplus, remeasurement gains and losses, changes in net debt, and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian public sector accounting standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with Canadian generally accepted auditing standards. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

Management and those charged with governance refused to acknowledge their roles and responsibilities in my audit and they have failed to sign a management representation letter addressed to me to confirm that management has fulfilled their responsibilities for the financial statements. As a result of this refusal, I am unable to obtain assurance over the accuracy and completeness of information provided by and representations made to me by management and those charged with governance.

Disclaimer of Opinion

Because of the significance of the matter described in the Basis for Disclaimer of Opinion, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, I do not express an opinion on the financial statements.

Other Matter

The financial statements of the IESO for the year ended December 31, 2016 were audited by another auditor who expressed an unqualified opinion on those financial statements on March 22, 2017.

20 Dundas Street West
Suite 1530
Toronto, Ontario
M5G 2C2
416-327-2381
fax 416-327-9862
tty 416-327-6123

20, rue Dundas ouest
suite 1530
Toronto (Ontario)
M5G 2C2
416-327-2381
télécopieur 416-327-9862
ats 416-327-6123

www.auditor.on.ca

Report on Matters Arising from Special Audit

Auditor General Act

As the Auditor General, I have a responsibility under the Auditor General Act (Act) to report on matters that are significant to the consolidated financial statements of the Province of Ontario. When something of the magnitude, described below, affects the consolidated financial statements of the Province of Ontario, I am also responsible under the Act to take additional steps to understand and investigate the transactions.

Inappropriate Inclusion of Rate Regulated Assets and Market Accounts

As described in Notes 2d, 2e, 3, 5, 7 and 14c to these financial statements, the IESO has recognized rate regulated and market account assets and liabilities. IESO is considered an "other government organization" under Canadian public sector accounting standards. Rate regulated accounting is not permitted in an "other government organization" under Canadian public sector accounting standards and therefore, the regulated assets recognized by the IESO should not be recognized. The market accounts recognized track mainly buy and sell transactions between electricity market participants (electricity power generators and power distributors). These market accounts, as recorded on the financial statements are not assets and liabilities of the IESO. Under the current Market Rules, the IESO has no access or discretion to use the market account assets for its own benefit, nor does the IESO have an obligation to settle the market account liabilities in the event of default by market participants.

Beginning in July 2017, as part of its legislated role in the *Fair Hydro Plan Act, 2017*, the IESO incurs a shortfall arising from the difference between the amounts it collects from power distributors and it pays to contracted power generators. The electricity price ceiling imposed by the Fair Hydro Plan Act exposes the IESO to financial risk such that it is now responsible for obtaining financing to cover the shortfall in market settlement. To fund this legislated shortfall, the IESO receives advances from Fair Hydro Trust, a related party. At the same time, the IESO records the sale of a rate regulated asset to the Fair Hydro Trust in an amount equal to the shortfall, thereby removing the impact of the shortfall on the annual surplus and eliminating the obligation to the Fair Hydro Trust. This approach constitutes a departure from Canadian public sector accounting standards.

These departures will impact the Province's consolidated financial statements for the year ended March 31, 2018 unless corrected by the Province. Based on the transactions for the period up to December 31, 2017, the estimated impact on the Province's consolidated financial statements is as follows:

- Understatement of Annual Deficit by $1.353 billion
- Overstatement of Total Financial Assets by $2.045 billion
- Overstatement of Total Liabilities by $0.627 billion
- Understatement of Provincial Net Debt by $1.418 billion
- Overstatement of Ending Accumulated Surplus by $1.418 billion

.../3

Inappropriate Discount Rate Used on Unfunded Retirement Benefit Plans

As described in Note 2i to these financial statements, the IESO uses an expected return on plan assets as the discount rate to value all of its pension and other post-employment plan liabilities. IESO provides certain non-registered defined benefit pensions and other employee future benefits through two unfunded non-registered benefit plans. As these unfunded plans have no plan assets, it is inappropriate to use an expected rate of return on plan assets for the discount rate. In accordance with PSAS, the IESO should use a discount rate based on their cost of borrowing for these unfunded plans. If IESO had used a discount rate based on its estimated cost of borrowing, as at December 31, 2017, opening accumulated surplus would decrease by $53.2 million, benefit costs would increase by $1.9 million, and total liabilities would increase by $55.0 million.

Toronto, Ontario
April 5, 2018

Bonnie Lysyk, MBA, FCPA, FCA, LPA
Auditor General