Ontario Energy Board

EB-2008-0408

Staff Discussion Paper

Transition to IFRS – Implementation in an IRM Environment

March 31, 2011

Introduction

This Board staff Discussion Paper sets out staff recommendations on the issues arising from the transition to International Financial Reporting Standards (“IFRS”), particularly for utilities in an IRM environment.

Background

As required by the Canadian Accounting Standards Board (“AcSB”), Canadian Generally Accepted Accounting Principles (“CGAAP”) for publicly accountable enterprises will transition to IFRS. The required effective date for rate-regulated enterprises is January 1, 2012.

The Board provided policy guidance on this topic in *Report of the Board, Transition to IFRS* dated July, 2009 (EB-2008-0408) (“Board Report”). The Board issued a clarification letter regarding the capitalization of overhead costs on self-constructed assets in February 2010 and an amendment to the policy on November 8, 2010. In addition the Board sponsored a depreciation study to assist electricity distributors in determining the service lives for their in-service property, plant and equipment. The depreciation report was issued in July of 2010.

The Board Report stated that the Board would convene a working group at an appropriate time to address the complications of implementing IFRS in an IRM environment.

The Working Group was established on December 15, 2010 and the group met several times during January and February, 2011. The list of Working Group participants is provided below.

Board staff considered the input of all Working Group participants in developing its recommendations. Alternatives identified by the Working Group are included in this paper.

Board staff thanks all the IFRS IRM Working Group Participants for their excellent participation and contributions.

Participants in the IFRS IRM Working Group:

1. Brantford Power
2. Canadian Manufacturers & Exporters
3. Cornerstone Hydro Electric Concepts Association Inc.
4. The Electricity Distributors Association

5. Enbridge Gas Distribution Inc.
6 Enersource Hydro Mississauga Inc.
7. Hydro One Networks Inc.
8. Ontario Power Generation Inc.
9. PowerStream Inc.
10. School Energy Coalition
11. Union Gas Limited
12. Veridian Connections Inc.
13. Vulnerable Energy Consumers Coalition
14. Waterloo North Hydro Inc.

Scope

Board staff, assisted by the Working Group, identified the IRM related issues that required consideration. The issues included the matters identified in the Board Report that were to be considered by the Working Group, and other matters Working Group participants identified. As the work progressed, several issues were merged or found not to require a decision from the Board.

The Board does not prescribe the financial reporting for regulated utilities. The accounting principles required for financial reporting are prescribed by the AcSB and other accounting standards bodies. The Board does set the requirements for regulatory accounting, reporting and filing. The material developed in this report applies only to regulatory accounting, regulatory reporting and rate application filing.

External Uncertainties

IFRS is an evolving set of accounting standards, and the interpretation of those standards is also evolving. More definitive decisions were expected from accounting standards setters since the Board's IFRS Transition Project began in 2008 and in certain areas they have been provided. In other areas they have not. The Board chose to proceed with the transition work in the absence of final decisions from these bodies, to provide early guidance on the Board's regulatory accounting and rate application filing requirements. The Board Report acknowledged that the Board's policy determinations might need to be modified if an unanticipated ruling were received.

The table below sets out what the most significant sources of uncertainty are, or have been.

Uncertainty	Status
Potential exemption from the requirement for retrospective or fair value restatement of PP&E on first time adoption of IFRS for rate-regulated enterprises. International Accounting Standards Board (IASB) to decide.	Resolved: Granted by IASB
Whether Canadian Public Sector Accounting Board will require municipal and provincial government-owned distributors to adopt IFRS	Resolved: Municipal and provincial government-owned distributors are required to adopt IFRS.
Recognition in the body of published financial statements of regulatory assets and liabilities, e.g., deferral and variance accounts. The IASB had circulated a draft standard recommending recognition.	Unresolved: International and Canadian accounting standards setters abandoned this initiative and left the issue to accounting practitioners and their clients to work out. Potential for inconsistent interpretations and lack of recognition of regulatory assets and liabilities in published financial statements.
Emergence of USGAAP as a viable alternative for some utilities to mitigate problems with adopting IFRS. Those eligible are reporting issuers with a listing on a US exchange. Some utilities have approached Canadian securities regulators for blanket approval to use USGAAP without listing on a US exchange.	Unresolved: Extent and viability of this option still evolving.

Board Staff Recommendations on Issues

Issues Arising on Transition to IFRS

Issue 1

> ***For distributors that have rebased under CGAAP but who have subsequently adopted IFRS, what, if any, additional guidance does the Board need to provide as to how to recognize accounting changes between CGAAP and modified IFRS in an IRM application? Examples of problem areas include calculations for off-ramps, Z-factors, and the incremental capital module. What level of audit assurance, if any, should the Board require for reconciliation of CGAAP to modified IFRS for these calculations in IRM applications?***

Staff Proposal

For distributors who rebased under CGAAP and are filing an IRM application in which the distributor:

- **seeks an adjustment through**
  - **a Z-factor or Y factor,**
  - **incremental capital module (ICM),**
  - **off-ramp (IRM2); or**
- **seeks disposition of electricity distributor Group 2 deferral and variance account balances above the preset disposition thresholds as part of the annual review process; or**
- **reports an instance of ROE exceeding the deadband (positive or negative) as required in the Report of the Board on 3rd Generation Incentive Regulation for Ontario's Electricity Distributors,**

Staff recommends that the financial information supporting this aspect of the application must be provided under CGAAP, and that the adjustment to rates be made on the basis of the CGAAP filing.

In addition, a reconciliation of the CGAAP-based financial information mentioned above to the relevant information in the last annual RRR reporting under modified IFRS is required. Where the distributor has adopted IFRS for financial reporting but has not yet made an annual RRR reporting under modified IFRS, the financial information mentioned above must be provided in both CGAAP and modified IFRS format, and a reconciliation provided between the two accounting standards[1].

[1] Example of where distributor has adopted IFRS for financial reporting, but has not yet made an annual RRR filing under modified IFRS: Distributor rebased in 2010 under CGAAP. In 2012 the distributor

Staff recommends that the Board not require any additional level of audit assurance to be filed for the required reconciliations, recognizing that the Board and stakeholders will need to examine some of the numbers during the IRM proceeding or the next cost of service rates case. Therefore, staff recommends that no third party assurance be required for the reconciliations, although an applicant can choose to file such assurance as part of its evidence supporting the reconciliation.

Note: The earnings sharing mechanism applicable to gas utilities was covered by the Board Report.

Rationale

Board staff submits that rate adjustments during an IRM period should be based on information prepared on the same basis of accounting as was used in the most recent rebasing. This is consistent with the Board's approach to earnings sharing mechanisms at page 32 of the Board Report of July 2009.

Staff submits that the recommended reconciliation is necessary to provide the Board with a trail that links the filed information to audited financial information reported to the Board under the Reporting and Record-keeping Requirements ("RRR") for electricity distributors.

Because of the extended period involved and the increasing difficulty over time in maintaining accounts under two sets of standards, Board staff does not recommend that the Board require additional audit assurance for the reconciling differences. This does not preclude an applicant from filing such assurance in support of their reconciliation. Applicants must consider how to maintain records to a sufficient level of detail to provide information to support the reconciliation of differences between CGAAP and MIFRS in their various rates applications.

References:

- Chapter 3 of the Filing Requirements for Transmission and Distribution Applications updated July 9, 2010
- November 8, 2010 Amendment to Board Policy section 9.1.2, 9.1.3, 9.1.4 and 9.2.2
- Board Report p. 29 – 31, 34
- Board Report Appendix 2, section 10.5
- CICA Handbook Section 8100

adopts IFRS for financial reporting. First modified IFRS RRR filing is due in 2013. However, in fall 2012, the distributor seeks an adjustment under the ICM. Financial information supporting the ICM application must be provided in both CGAAP and modified IFRS, with a reconciliation between the two.

Alternative

The financial information must be filed in CGAAP format as described above, but no reconciliation to MIFRS information filed as part of RRR is required.

The reconciliation may be unnecessary for many of the circumstances described, as the information the Board needs is a comparison back to the original basis of existing rates. A reconciliation to information filed under RRR can be sought through interrogatories where necessary.

Issue 2

Should any differences between costs recorded in the balance sheet accounts and costs built into rates that:

- ***arise in the time period between rebasing in CGAAP and the first rebasing under MIFRS, and***
- ***are driven by changes in accounting for capital or operating costs, prompted by the adoption of MIFRS,***

be recovered from or refunded to ratepayers? If yes, on what basis?

Staff Proposal

Staff proposes that differences relating only to the Property, Plant and Equipment components of rate base, including the rate base related intangible assets (referred to collectively hereafter as "PP&E"), when properly calculated, should be recoverable from, or refundable to, ratepayers.

Staff recommends that the Board approve a deferral account to capture this difference associated with these PP&E items. Staff does not recommend the creation of a generic deferral account to capture differences arising from the transition to IFRS in any other costs over the IRM period.

The proposed PP&E deferral account is to cover differences arising only as a result of the accounting policy changes caused by the transition from CGAAP to MIFRS. It is not to capture performance differences during the IRM period.

Staff recommends the following mechanism for recovery or refund of changes in costs for PP&E items:

1. **Utilities should maintain records using CGAAP of the amounts in the PP&E accounts that will be included in rate base, commencing at their last rebasing under CGAAP, and continuing until their first rebasing under MIFRS. This will produce a figure for the PP&E accounts that is consistent with their last rebasing.**

2. **Utilities should also calculate "adjusted rate base" values for the PP&E components of rate base using the accounting system applicable in each year between rebasing under CGAAP and the first rebasing under MIFRS. For example, if a utility rebased on CGAAP in 2010, and continued with CGAAP in 2011, and then moved to IFRS for financial reporting for 2012 and 2013, it would calculate the PP&E components of rate base using CGAAP in 2010, and MIFRS in 2011, 2012 and 2013. (2011 must be included because the year before the move to IFRS has to be restated under IFRS.)**

3. **The Board creates a deferral account in which utilities record the cumulative difference between items 1 and 2 above. The calculations for the balance in this account (which does not accrue carrying charges), will provide the Board with the evidence to consider an adjustment to the opening values of the PP&E components of rate base up or down in the first MIFRS rebasing year to match the "adjusted rate base" figure above. For that rebasing year, and every subsequent year, rate base will be calculated on a MIFRS basis.**

4. **The amount of the cumulative adjustment up or down (unamortized balance of the deferral account) will be recorded as a balance to be recovered from, or refunded to, ratepayers and as an adjustment to rate base (with rate base calculated on an MIFRS basis).**

5. **The Board will require the utility to reflect an adjustment to MIFRS calculated rate base going forward, and amortize that adjustment over a period of time approved by the Board. The PP&E portion of rate base, upon which the utility return on rate base calculation will be based in the cost of service application, will include two components: the MIFRS based elements of PP&E; and, the unamortized balance in the deferral account.**

Board staff recommends that the Board's determination of the period of time for amortization be on a case-by-case basis and that it be guided primarily by such considerations as the impact on rates, implications of any other IFRS transition matters and any requirements for rate mitigation. Board staff recommends that the average remaining useful life of underlying assets generally be used as an upper limit to the choice of amortization period.

The amortization of the adjusting amount, up or down, will be reflected as an adjustment to depreciation expense (the refund or recovery of the amount of the adjustment over time) and the return on rate base calculation on the unamortized balance will be recovered in rates in the same way as for any other component of rate base.

Staff proposes that disposition of the amounts in the account would be considered by the Board in the next cost of service application, and staff further

recommends that the account be closed to further posting of differences at that time.

An example of the calculation described in this proposal is attached as Appendix A to this Discussion Paper.

Rationale

Board staff and the Working Group reviewed the balance sheet accounts to identify those where there could be significant differences caused by the transition from CGAAP to IFRS that are relevant in the rate-setting environment. The two areas identified as having the most potential for material impacts were the PP&E components of rate base, including the rate base-related intangible assets and Pension and Other Post Employment Benefits (“P&OPEB”).

Need for PP&E Account

The PP&E deferral account is recommended to address the unique circumstance of a change in accounting standards and provide a means of assuring continuity of rate base. The account will allow utilities to avoid the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates. The deferral account also allows for monitoring of the extent of potential impact during the IRM period, and the opportunity to identify any unusual circumstances requiring attention before completion of the IRM period.

The effect of the recommended account and its clearance is that at a utility’s first rebasing after it has adopted IFRS, the PP&E components of rate base are re-set to reflect MIFRS accounting treatment. This will minimize the differences between rate base for regulatory purposes and audited balance sheets. Staff recommends this proposal because, through a single mechanism, it addresses the impact of transition over the full period of IRM after rebasing. It is flexible in that it accommodates adoption of MIFRS at any time during the IRM period.

While the differences are recorded annually, the rate base is adjusted to MIFRS only at the next rebasing. The rate base then being adjusted is the opening rate base in the year of rebasing.

By including the amount of the amortization of the adjusting amount in depreciation expense, the utility recovers the original capital cost of the assets over time. By including the amount of the unamortized balance in rate base, the utility receives a return on the unamortized balance.

The use of a deferral account to accomplish what is in essence a one-time adjustment is proposed for two main reasons: to avoid any potential for costs being considered out of period; and, to allow tracking of amounts in the account through the annual RRR reporting. However, the use of the proposed deferral account to accomplish these purposes may lead to the account being treated differently than a traditional deferral account. The recording of amounts in the deferral account, with an offsetting charge/(credit) to depreciation expense in the regulatory books of account, has the effect of continuing to state PP&E related balances and associated regulatory income in line with CGAAP throughout the IRM period. It allows the utilities to track the differences from MIFRS for regulatory purposes given there would be no effect on rates under IRM until rebasing. Whether this deferral account would qualify for recognition in reported financial statements is a matter outside the Board's jurisdiction.

One example of a potential difference in treatment is staff's proposal (opposed by some members of the Working Group) that the amounts in the account not attract carrying charges while being held in the account. This proposal is explained below. A second potential difference in treatment is that the amount recorded in the account may be approved by the Board for clearance despite the fact that some portion of the amount is based on a forecast. An example of this second issue is as follows.

Suppose a distributor rebases under CGAAP in 2011, and returns for a cost of service application in 2014 for 2015 rates. The 2015 application will be based on MIFRS. During the time between cost of service applications, the distributor has recorded differences in PP&E in the deferral account as proposed with an offsetting entry in depreciation expense in the current period. Actual results for the bridge (2014) and test (2015) years are not yet available at the time of filing. The staff recommendation as drafted indicates that the account could be cleared in full, including 2014 forecasted amounts. Arguably, the actual data recorded for 2012 and 2013 might be sufficiently informative to allow a reasonably accurate forecast for 2014. The advantage of this approach is that the rate base is set in MIFRS, the adjustment to rate base is made, and there is no further need to record amounts in the account.

Alternatively, the amounts in the account for the 2012 and 2013 actual differences could be cleared, and the utility required to record the actual differences for 2014 once the actual numbers are available. These amounts would be cleared at the time of the next rebasing after 2015.

<u>No Accrual of Carrying Charges on the Account</u>

While carrying charges are added to many deferral accounts granted by the Board, the Board considers the appropriateness of adding carrying charges when approving accounts on an account by account basis. In the case of the deferral account proposed for PP&E differences on adoption of IFRS, Board staff recommends that carrying charges not be added to the balance accruing in the deferral account.

As explained above, Board staff submits that this deferral account is not a "traditional" deferral account, but is primarily a mechanism to allow tracking and recovery (or refund) of amounts through a one-time adjustment to rate base. The amounts in the deferral account reflect a policy change (adoption of MIFRS) that has effect <u>for accounting purposes</u> at January 1, 2012, but has no effect for rate-setting purposes until the utility's rates are rebased under MIFRS. The existence of the deferral account during an IRM period is not an acceptance of MIFRS as the basis for setting rates. It is a means of keeping track of the differences during the period of an IRM otherwise based on CGAAP so that the disposition of such differences can be considered at the time rates are set based on MIFRS. In Board staff's view, until MIFRS is adopted as the basis for setting rates, no under or over-collection has occurred, and it is not appropriate to compensate the utility or the ratepayer through carrying charges applied to the balance in the account.

Board staff does recommend providing a return on the deferred balance once rates are set on an MIFRS basis. The unamortized balance in the deferral account arose from in-service PP&E, and this PP&E itself would be included in rate base upon which a return is granted.

Need for P&OPEB Account

Board staff submits that a generic account to capture P&OPEB differences driven by the transition to IFRS is not required.

The majority of utilities rate-regulated by the Board are participants in the OMERS pension plan. This is a multi-employer plan, treated as a defined contribution plan for accounting purposes, to which the major changes associated with IFRS accounting are not applicable. Some of these utilities also have Post-Employment Benefit Plans that are not expected to exhibit major change on the adoption of IFRS. Utilities with defined benefit pension plans and significant post-employment benefit plans will be most affected by IFRS adoption. While these utilities are large entities with many customers, the number of these utilities is relatively small.

Board staff is aware that the values associated with P&OPEB assets and obligations as reported in published annual reports of the largest Ontario utilities are very substantial. Board staff recognizes that the effects of adopting the pension-related rules in IFRS could indeed be large for some utilities. However, as the changes in the context of P&OPEB are likely of significance to only a few large utilities, Board staff does not recommend that the Board approve a generic deferral account for P&OPEB related items.

Utilities who expect to experience a large cost impact upon transition to IFRS for non-PP&E related items may apply to the Board on an individual basis for appropriate relief.

References:

- Board Report pages 19, 26, 28
- Chapter 3 of the Filing Requirements for Transmission and Distribution Applications updated July 9, 2010, pages 12 - 13

Alternatives

1. Carrying charges should accrue on the balance in the account.

Rationale for this alternative:

The reason for the creation of the deferral account is that as a result of changes arising from the adoption of IFRS for accounting purposes, there is the potential for material out-of-period costs (or over recovery) that might not be eligible for inclusion in the current period determination of rates. In such a situation, it is appropriate that those affected by the over or under recovery be compensated for the time value of money, as is usually the case for Board approved deferral accounts, for the period from the time when the over or under recovery occurs, until the time when the IFRS-related changes are incorporated into rate base.

If the Board were to agree that carrying charges are appropriate, Board staff recommends that an approach similar to the deferral accounts for smart meters is appropriate. With this approach, the utility's tax-adjusted weighted average cost of capital (WACC), is applied to the rate base items.

Staff acknowledges that the adoption of this alternative could increase the complexity of this deferral account.

2. The Board should approve a generic deferral account for differences during an IRM period associated with P&OPEB arising due to the transition to IFRS. Such deferral account should be structured in the same fashion as the deferral account proposed for PP&E items.

As noted above, some utilities will experience large impacts in the costs related to P&OPEB as a result of the transition to IFRS. Rather than require these utilities to approach the Board individually for relief, the Board could establish a generic account to capture these impacts.

3. No generic accounts are granted to recognize differences between costs recorded in the balance sheet or income statement accounts and costs built into rates that are driven by the transition to MIFRS and occur during an IRM period. Any differences occurring during the prior IRM period attributable to the transition to IFRS would be neither recoverable by the utility nor returnable to rate payers.

The use of deferral accounts to capture differences during an IRM period could be seen as a departure from a main premise of incentive regulation – utilities and ratepayers are generally not compensated for differences arising during the IRM period. The argument could also be made that utilities receive compensation for this type of risk through their allowed return on equity.

In addition, it will likely be complicated to isolate the differences attributable to the transition to IFRS from differences caused by other factors. The requirement to record the differences as described will increase the workload of utilities for regulatory accounting and rate case preparation, and increase the workload for the Board, its staff and intervenors in reviewing cost of service applications in which the utility first rebases under MIFRS.

If the accounts were not granted, at the time of an applicant's initial rebasing under IFRS, changes attributable to IFRS would be reflected in rates on a going-forward basis only, just as for any other occurrence during an IRM period.

Board staff is concerned that this alternative, by precluding recovery or refund of differences driven by the adoption of MIFRS, may not result in just and reasonable rates for utilities or ratepayers. Many electricity distributors are expected to have material changes to depreciation rates as a result of adopting IFRS that could result in over-recovery during the IRM period. Other distributors will also have material changes in capitalization policies that could result in under-recovery during the IRM period. These effects are the result of changes in accounting standards that are outside of the control of distributors and not contemplated at the time that the 3rd generation IRM was developed or when the IRM for the gas utilities was approved.

In the absence of a deferral account for PP&E-related items, distributors with an under-recovery might seek relief through a Z factor application. Adoption of this approach would be less likely for over-recoveries. A deferral account would create a symmetrical mechanism for addressing the transition.

Issue_3

Are there special implications associated with IFRS-related corporations tax or PILs impact during an IRM period for which additional IFRS transition related guidance is required from the Board?

Staff Proposal

Staff recommends that no additional IFRS transition guidance relating to corporations tax and PILs taxes be provided by the Board at this time.

Rationale

The different treatment of regulatory assets and obligations under IFRS from the treatment under CGAAP in general purpose financial statements could result in a change in how taxable income is viewed by tax authorities. A utility represented on the working group suggested that the tax impact of such changes be captured in a PILs deferral account. Staff understands the concern to be that the transition to IFRS could increase the difference between tax or PILs amounts allowed in rates and the actual tax or PILs payments.

Staff notes that there would be practical difficulty in isolating the IFRS impacts on statutory taxes payable on a going forward basis and that the particulars and the significance of this potential effect are not yet known. It is Board staff's view that addressing such matters is part of the more fundamental question about whether there should be reconciliation and true up between the tax provision allowed in rates and taxes actually paid for statutory tax purposes. Board staff suggests that reviewing the basis for determining taxes for inclusion in the revenue requirement is outside the scope of the IFRS IRM transition work.

Issue 4

> ***Should the Board permit rate applications or RRR reporting using USGAAP?***

Staff Proposal

In accordance with the second sentence of principle 5 of the Board's Report, staff recommends the Board continue to not require modified IFRS filing and reporting requirements for utilities that are not otherwise required to adopt IFRS for financial reporting purposes.

However, staff recommends that while not prohibiting the use of USGAAP at this time, the Board should not encourage its use. Staff recommends that the Board require a utility that wishes to file a cost of service application under USGAAP to file a letter with the Board, in advance of making the rate application, stating the utility's intention to file using USGAAP. Staff suggests that the letter must demonstrate the eligibility of the utility under the relevant securities legislation to report financial information using USGAAP, and confirm that any leave necessary to do so has been obtained from the appropriate securities authorities. In addition, staff submits that this letter should set out the reasons the utility has chosen USGAAP for financial reporting purposes, and identify the regulatory issues this choice creates.

Note: If use of USGAAP occurs, all references to IFRS or modified IFRS in these recommendations and in the Board Report and amendments to it, including

references to reconciliations, shall be read as including USGAAP. Staff note that this interpretation would mean that reconciliations between USGAAP and MIFRS are not required, but reconciliations between USGAAP and CGAAP are required where a reconciliation is required in the Board Report or suggested in the recommendations.

Rationale

In the Board Report, the Board determined not to require filing under IFRS for utilities that were not otherwise required to adopt IFRS for financial reporting purposes. At that time, the question of whether several large utilities could adopt USGAAP as an alternative to IFRS had not been considered. It is now possible that several entities in Ontario could adopt USGAAP rather than move to IFRS. The United States may adopt IFRS in the future, and it is therefore possible that the transition to IFRS is inevitable even for Ontario utilities that adopt USGAAP.

At the present time, USGAAP appears to provide a more accurate representation for financial reporting purposes of the economic reality of a rate-regulated enterprise than IFRS. Under the current IFRS rules, regulatory assets and liabilities are not recognized in the body of the published financial statements. Under USGAAP (as was the case under the previous Canadian GAAP) regulatory assets and liabilities are recognized, creating more alignment of regulatory accounting to published financial statements and minimizing the earnings volatility that may occur under IFRS.

However, staff is concerned that the use of USGAAP by some regulated utilities would introduce a second set of standards, increasing the complexity of utility regulation in Ontario. One benefit to adopting IFRS is an increase in consistency of accounting practices among utilities. The use of USGAAP by some utilities may compromise consistency among utilities. Staff recommends that the Board consider the advantages of consistency when evaluating requests to use USGAAP for regulatory accounting. Staff suggests that the Board strongly encourage Enbridge Gas Distribution Inc. and Union Gas Limited to adopt the same accounting standard.

References:

- Board Report page 5

Issues Arising after Adoption of Modified IFRS

Issue 5

> ***Should the Board grant a generic deferral account, for utilities that have rebased under modified IFRS, for the impacts of changes resulting from new IFRS standards or changes in existing IFRS standards arising during an IRM regime?***

Staff Proposal

Staff recommends that the Board not grant a generic deferral account for these impacts at this time. Any utility that anticipates a large impact arising from a change in IFRS standards after rebasing under MIFRS may apply to the Board for an appropriate mechanism to deal with the impact. In addition, if the Board becomes aware that a change in standards will create a large impact on Ontario utilities, the Board can consider whether to create a generic account at that time.

Rationale

In the past the Board has responded to the needs arising from changes in accounting policy as well as other business changes with the creation of deferral accounts if, as and when such needs arise. Board staff considers that there is no reason to change this approach after the adoption of IFRS has been completed. Sufficient lead time is generally provided for the adoption of changes in accounting standards such that no generic account is considered necessary.

A similar account was granted to each of Hydro One Networks Distribution and Transmission in recent cost of service cases. However, Board staff notes that these accounts were created in the context of applications for two year test periods, and were limited to a period of one year.

References:

- Board Report pages 10 -11
- EB-2010-0002 Decision of the Board Hydro One Transmission
- EB-2009-0096 Decision of the Board Hydro One Distribution

Issue 6

Should the Board grant a generic variance account, for utilities that have rebased under modified IFRS, to mitigate volatility in certain expenses that may arise from the application of IFRS rules? In particular, differences in depreciation or amortization expense caused by changes in estimated useful life of in-service PP&E or intangible assets included in rate base, gains and losses arising from early retirement of in-service assets and differences in pension and post-employment benefit expenses should be considered.

Staff Proposal

Staff recommends that no generic variance account be established at this time to mitigate the volatility that may be created by the application of IFRS rules. Utilities that experience, or can demonstrate a likelihood of, significant ongoing volatility can apply to the Board for utility-specific relief.

Rationale

Board staff recognizes that the introduction of IFRS leads to increased volatility in earnings as compared to CGAAP. However, at present the Board has no data as to the materiality of this volatility. With respect to potential volatility arising from changes in depreciation expense, staff suggests that for many utilities, once the transition to MIFRS is complete and new service lives have been adopted, the annual review required under IFRS may not materially change service lives. If significant volatility does become a problem for many utilities, the Board can consider a remedy with the benefit of actual data.

Another issue considered was whether there should be a variance account to capture losses arising on early retirement of in-service assets required for recognition under IFRS and accounted for under CGAAP using group depreciation methods. The account was suggested as a generic account on the basis that utilities have no experience in forecasting the extent of such losses and, as such, rebasing in the short term would be inaccurate. Staff submits that such a variance account would likely be a temporary measure that reduces the risk to utilities and ratepayers until the forecasting of the gains or losses improves with experience. However, staff recommends that no such generic account be considered at this time, as the Board has no information as to whether most utilities will encounter material difficulties in forecasting these amounts.

Staff notes that for pension and other post-employment benefits relatively small adjustments in underlying assumptions can cause major swings in cost for utilities with certain types of employee benefit plans. However, such volatility would generally be a problem only for larger employers with their own defined benefit pension plans and significant other post-employment benefit plans. In Board staff's view, this type of variability is not sufficiently pervasive across the utility community to justify the Board creating an ongoing generic variance account.

References:

- Board Report pages 20 - 22

<u>**Alternative**</u>

A variance account is established to mitigate the volatility that may be created by the application of IFRS rules for early retirements of assets. Utilities will record in the account any discrepancy between costs recorded in the balance sheet accounts and costs built into rates for these assets.

Disposition of the amounts in the account would be considered by the Board in the next cost of service application for the utility.

As noted above, it may be difficult for utilities to forecast gains and losses arising from the application of IFRS rules relating to the retirement of in-service assets. The removal of the group depreciation method available under CGAAP will require an amount to be recorded for the retirement of assets on a more specific basis. A generic variance account could be established as a temporary measure to allow for the potential recovery of unforecasted losses or refund of unforecasted gains. If the Board adopts this alternative, Board staff recommends that the Board consider a defined sunset date of 2016 for recording further asset retirement amounts in the account. Staff submits that by this date, utilities should have more information on which to base accurate forecasts of these gains and losses.

Note:
Working Group participants noted the possibility of IFRS adoption creating irreconcilable differences between regulated rate base and the audited net book value of property, plant and equipment ("PP&E") items. This can occur where a utility is required under IFRS to immediately recognize a change in the useful life of an asset for accounting purposes. Under CGAAP, the utility could delay such recognition for accounting purposes until the change was approved by the Board. However, under IFRS, a divergence will occur between the value of rate base set by the Board in the last rates hearing, and the value for financial purposes, which is affected immediately by the change in useful life.

As Board staff understands the issue, the divergence will disappear with the next rebasing for the utility, as the rate base values upon which rates are set will be brought in line with the values in the financial statements. However, any gain or loss that arose from the divergence during the IRM period in which the change to useful life was made is not recovered or refunded.

Board staff recommends that the Board not prescribe any generic solution to this potential problem at this time. If the gains or losses prove to be significant, the Board can consider generic or individual mechanisms to address the problem.

Issue 7

> ***The Board Report in issue 10.4 states "Utilities under incentive regulation are required to include in their annual RRR filing a reconciliation of reported annual performance to the same basis of accounting as that upon which the incentive framework was approved". Does this mean that a reconciliation from modified IFRS, as reported under RRR, to CGAAP must be performed and filed each year of an IRM period? Or is a reconciliation for the first year of RRR reporting under modified IFRS sufficient? What level of audit assurance should the Board require for this reconciliation?***

Staff Proposal

Staff recommends that the reconciliation in section 10.4 of the Board's Report not be required every year of an IRM period for all reported items required under RRR.

Staff recommends that:

- **A one-time reconciliation between the 2011 CGAAP audited financial statements figures and the 2011 IFRS audited financial statements comparative figures that were reported as part of the 2012 IFRS audited financial statements must be performed and submitted with the RRR annual performance reporting for 2012.**
- **A one-time mapping and reconciliation between the 2011 uniform system of account balances and the 2011 IFRS audited financial statements comparative figures that were reported as part of the 2012 IFRS audited financial statements must be submitted with the RRR annual performance reporting for 2012.**
- **Where an electricity distributor has not rebased under modified IFRS, a reconciliation be provided each year during an IRM period for Group 1 deferral and variance accounts between amounts recorded under CGAAP and modified IFRS. This reconciliation must be submitted with the RRR annual performance reporting for each year beginning with the year of adoption of IFRS.**
- **For all utilities, when reporting annually in RRR the balance in the deferral account created to record differences in PP&E arising from the transition from CGAAP to MIFRS, a reconciliation be provided each year between reported amounts calculated using CGAAP and amounts calculated using**

MIFRS. This reconciliation would be required up to and including the year of first rebasing under MIFRS.

Staff recommends that the Board require audit assurance for the first three reconciliations listed, to be provided by an external auditor to the "review level of assurance" specified in the CICA Handbook. For the fourth reconciliation (PP&E transition deferral account) staff recommends that no audit assurance be required.

Rationale

Staff notes that there may be no differences for electricity distributors between Group 1 deferral and variance accounts under CGAAP and MIFRS (or immaterial differences) such that the third reconciliation listed is not required.

Some working group members recommended gathering RRR information in both CGAAP and MIFRS format for several years, in order to maintain the Board's ability to benchmark utility performance over the transitional period. In particular, it was suggested that if accounting classifications change, comparability of results may be compromised. The most explicit example where comparabiliity could be compromised for some utilities was with regard to changes in capitalization policy associated with overheads applied to the cost of self-constructed assets.

However, Board staff is of the view that the reconciliations required in the recommendations above are sufficient, and that requiring more than one year of reconciled data could be onerous for some utilities. While the adoption of IFRS may introduce a one-year discontinuity in data in some cases, the overall result should be improved consistency and improved comparability among utilities.

The extent of the potential for discontinuity in the data is difficult to gauge before the fact. The existing benchmarking methods currently provide a certain amount of smoothing in deriving the conclusions (three year average OM&A costs) and the incentive bands are modest in size (20 basis points band-to-band).

The impacts will be visible in the reporting for 2012 (due April 30, 2013), such that any discontinuities are expected to be relatively easy to identify. Solutions may be required at that time, but until the data are received, it is difficult to anticipate the nature of the solution required.

References:

- Board Report pages 33 – 34
- CICA Handbook Section 8100

Alternative

Utilities are required to file RRR information in both CGAAP and MIFRS format for several years, in order to maintain the Board's ability to benchmark utility performance over the transitional period.

The Board may find such information useful for, among other purposes, the design of the 4th generation IRM mechanism.

Issue 8

> ***Should the Board in some forum consider what adjustments need to be made to the IRM regime itself, if adjustments may be made during an IRM period due to the transition to IFRS?***

Staff Proposal

Board staff recommends that the Board consider potential adjustments to the IRM methodology related to the transition to IFRS in the upcoming work of the Board. For example, the basis for the types of relief listed in Issue 1 in this paper may have to be reconsidered (X and Y factors, ICM, off-ramps, ROE deadbands and thresholds for disposition of deferral and variance accounts).

Rationale

The Board's determination on the recommendations made in this paper, and the implications for utilities and ratepayers, should be considered in both the Board's 4th generation IRM project, and in the Board's assessment of IRM plans proposed by the gas utilities.

Board staff can monitor RRR and other data to identify potential issues associated with changes to capital ratios or any undue over-earning or strain on resources of having to carry the cost impacts of the transition to MIFRS over a four year period under IRM.

Alternative

None identified.

Appendix A

Illustration of Use of Deferral Account in Relation to PP&E Components of Rate Base

Rebasing in 2011 based on CGAAP, MIFRS in 2015

	2009	2010	2011	2012	2013	2014	2015	2016	2017
			Rebase				**Rebase**		
Basis of Rates	IRM	IRM	**CGAAP**	IRM	IRM	IRM	**MIFRS**	IRM	IRM
Forecast vs Actual Used in Rebasing Year	Actual	Forecast	Forecast	Actual	Actual	Forecast	Forecast		
PP&E Values Under CGAAP									
Opening net PP&E	1000	1,010	1,020	1,030	1,050	1,050			
Additions	40	40	40	50	30	80			
Depreciation	(30)	(30)	(30)	(30)	(30)	(30)			
Closing net PP&E	**1,010**	**1,020**	**1,030**	**1,050**	**1,050**	**1,100**			
PP&E Values Under CGAAP for 2009+10, MIFRS Thereafter (see Key Assumptions and Note below)									
Opening net PP&E	1000	1,010	1,020	1,036	1,059	1,066			
Additions	40	40	36	43	27	65			
Depreciation	(30)	(30)	(20)	(20)	(20)	(20)			
Closing net PP&E	**1,010**	**1,020**	**1,036**	**1,059**	**1,066**	**1,111**			
Difference in Closing net PP&E, CGAAP vs MIFRS (shown as adjustment to rate base on rebasing)	**-**	**-**	**(6)**	**(9)**	**(16)**	**(11)**			
Deferral Account - Rebasing in 2015 Using MIFRS									
Opening balance	-	-	-	(6)	(9)	(16)	(11)	(8.3)	(5.5)
Amount added in the year	-	-	(6)	(3)	(7)	5	NA	NA	NA
Sub-total	**-**	**-**	**(6)**	**(9)**	**(16)**	**(11)**	**(11)**	**(8.3)**	**(5.5)**
Amount of amortization, included in depreciation expense	-	-	-	-	-	-	2.8	2.8	2.8
Closing balance in deferral account	**-**	**-**	**(6)**	**(9)**	**(16)**	**(11)**	**(8.3)**	**(5.5)**	**(2.8)**

Increasingly difficult to calculate CGAAP values as time goes by; once the utility adopts IFRS in 2012 for financial reporting purposes and restated 2011 using IFRS.

Illustrative Effect on Revenue Requirement of Including Deferral Account Amortization on Rebasing

	2015
Amortization of deferred balance as above	2.8
Return on rate base associated with deferred balance at WACC (7% assumed)	0.8
Amount included in Revenue Requirement on rebasing	**3.6**

Continues at $3.6 in rates for 3 more years

Key Assumptions:

1 Beginning in 2011, under IFRS less overhead is included in capital additions than under CGAAP
2 Beginning in 2011, under IFRS useful lives of in-service PP&E are extended meaning depreciation expense is less than under CGAAP
3 Beginning in 2015, the Board provides for amortization of the difference included in the deferral account over a 4 year period and provides an amount of return on the unamortized balance (*Note* : The Board may choose to levelize the amount of return over the amortization period)
4 Presumes clearing the balance on the basis of forecast values in setting rates for 2015

Note : Official date of adoption of IFRS for financial reporting purposes in this illustration is January 1, 2012. Values for 2011 are adjusted to an IFRS basis of accounting to address opening balance issues (prior year comparative figures).

Appendix A
Illustration of Use of Deferral Account in Relation to PP&E Components of Rate Base
Rebasing in 2012 based on MIFRS

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Rebase					
Basis of Rates	IRM	IRM	IRM	**MIFRS**					
Forecast vs Actual Used in Rebasing Year	Actual	Actual	Forecast	Forecast					
PP&E Values Under CGAAP									
Opening net PP&E	1000	1,010	1,020						
Additions	40	40	40						
Depreciation	(30)	(30)	(30)						
Closing net PP&E	**1,010**	**1,020**	**1,030**						
PP&E Values Under CGAAP for 2009+10, MIFRS Thereafter (see Key Assumptions and Note below)									
Opening net PP&E	1000	1,010	1,020						
Additions	40	40	36						
Depreciation	(30)	(30)	(20)						
Closing net PP&E	**1,010**	**1,020**	**1,036**						
Difference in Closing net PP&E, CGAAP vs MIFRS (shown as adjustment to rate base on rebasing)	**-**	**-**	**(6)**						
Deferral Account - Rebasing in 2012 under MIFRS									
Opening balance	-	-	-	(6)	(5)	(3)	(2)		
Amount added in the year	-	-	(6)	NA	NA	NA	NA		
Sub-total	**-**	**-**	**(6)**	**(6)**	**(5)**	**(3)**	**(2)**		
Amount of amortization, included in depreciation expense	-	-	-	1.5	1.5	1.5	1.5		
Closing balance in deferral account	**-**	**-**	**(6)**	**(5)**	**(3)**	**(2)**	**-**		

Note: Even those utilities rebasing in 2012 based on MFIRS will find the use of the proposed deferral account necessary as a means of addressing the opening balance issues (prior year comparative figures).

Illustrative Effect on Revenue Requirement of Including Deferral Account Amortization on Rebasing

	2012
Amortization of deferred balance as above	1.5
Return on rate base associated with deferred balance at WACC (7% assumed)	0.4
Amount included in Revenue Requirement on rebasing	**1.9**

Continues at $1.9 in rates for 3 more years

Key Assumptions:

1. Beginning in 2011, under IFRS less overhead is included in capital additions than under CGAAP
2. Beginning in 2011, under IFRS useful lives of in-service PP&E are extended meaning depreciation expense is less than under CGAAP
3. Beginning in 2012, the Board provides for amortization of the difference included in the deferral account over a 4 year period and provide an amount of return on the unamortized balance (*Note*: The Board may choose to levelize the amount of return over the amortization period)
4. Presumes clearing the balance on the basis of forecast values in setting rates for 2012

Note: Official date of adoption of IFRS for financial reporting purposes in this illustration is January 1, 2012. <u>Values for 2011 are adjusted to an IFRS basis of accounting to address opening balance issues</u> (prior year comparative figures).