

Ontario Energy Board



EB-2008-0408

Addendum to Report of the Board:

**Implementing International Financial Reporting
Standards in an Incentive Rate Mechanism
Environment**

June 13, 2011

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Introduction

This Addendum sets out additional regulatory policy regarding the transition to International Financial Reporting Standards (“IFRS”) in the circumstances where utilities rates are rebased using cost of service rate setting methods and where rates are subsequently set for a period of years using an incentive rate-setting mechanism (“IRM”).

As required by the Canadian Accounting Standards Board (“AcSB”), Canadian Generally Accepted Accounting Principles (“CGAAP”) for publicly accountable enterprises will be replaced by 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 28, 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. Amendments to the policy were issued on November 8, 2010 and March 15, 2011 to address delay in implementing IFRS until January 1, 2012, and regarding use of IFRS in Cost of Service applications for 2012 rates. In addition, the Board sponsored a depreciation study to assist electricity distributors in determining the service lives and componentization for their in-service property, plant and equipment. The depreciation study 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. Using the input from the Working Group, Board staff delivered proposals to the Board in a Board Staff Discussion Paper dated March 31, 2011. Comments on the Discussion Paper were invited from all interested stakeholders, and six stakeholders provided comments. The lists of Working Group participants and commentators are provided below. All materials relating to the Working Group and the subsequent recommendations and comments are available on the Board’s website.

The Board continues to monitor the development of accounting standards and will further amend its regulatory instruments to reflect IFRS at the appropriate time. Certain uncertainties continue regarding the application of accounting standards and the ultimate treatment of deferral and variance accounts approved by the Board. These uncertainties affect the timing and nature of the specific amendments to the

Board's regulatory instruments and are discussed under "External Uncertainties" below.

The Board believes that the 2009 Report of the Board as amended, this Addendum and the depreciation study referred to above provide the guidance necessary for distributors to implement IFRS effective January 1, 2012 in the Ontario regulatory environment.

This Addendum, consistent with the 2009 Report, focuses on electricity distributors and rate-regulated natural gas utilities. However, the Board will have regard to the policy and rationale for the policy in this Addendum when considering similar issues for other regulated entities.

This Addendum uses the term "modified IFRS" or "MIFRS" to refer to IFRS accounting as modified for regulatory purposes consistent with the Board Report and this Addendum.

The Board thanks all Working Group participants for the time and effort that they have dedicated to this policy development initiative. The Board has benefitted from their excellent participation and contributions.

This Report is structured around the issues list developed in the Working Group process, and provides, in Appendix A, a summary listing of Board policy structured in accordance with the issues list. The issues are addressed in two broad categories: issues arising on transition to IFRS and issues arising after adoption of MIFRS.

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.

It became apparent during the Working Group discussions that most issues relate to cost of service rate applications as well as IRM applications.

The Board does not prescribe financial reporting for regulated utilities. The accounting principles required for financial reporting in Canada are prescribed by the AcSB and

other accounting standards bodies. The Board *does* set the requirements for regulatory accounting, reporting and filing. The policy in this Addendum applies only to regulatory accounting, regulatory reporting and rate application filing.

External Uncertainties

The interpretation of IFRS accounting standards is still evolving. More definitive decisions were expected from accounting standards setters since the Board's IFRS Transition Project began in 2008 and in most areas they have been provided. In the area of regulatory deferral and variance accounts, clear standards have not yet emerged. This uncertainty led to the decision of the AcSB to delay implementation of IFRS by one year for rate-regulated activities until January 1, 2012. The Board chose to proceed with the transition work in the absence of final decisions from the accounting standards bodies, to provide necessary 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 the most significant sources of uncertainty, and their status at the date of this report.

| 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, unless they are qualified to adopt USGAAP (see below). |
| 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. |

| | |
|---|---|
| <p>Emergence of USGAAP as a viable alternative for some utilities to mitigate effects caused by the adoption of IFRS. In particular:</p> <ul style="list-style-type: none"> • Canadian securities regulators have granted approval to reporting issuers with rate-regulated activities to use USGAAP if they have a listing on a US exchange. • Canadian securities regulators may also allow reporting issuers with rate-regulated activities that do not have securities listed on a US exchange to use USGAAP for a time-limited period¹. | <p>Resolved: Eligibility to use USGAAP established for rate-regulated reporting issuers with securities listed on a US exchange. Rate-regulated reporting issuers without a US listing may also receive leave to use USGAAP, although a time limit may be imposed.</p> <p>Unresolved: Extent to which this option will be adopted by eligible utilities is not known. All the potential implications of adoption are not yet known, although it appears that adoption of USGAAP, which permits continued recognition in financial statements of regulatory assets and obligations, would minimize differences from CGAAP.</p> |
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Working Group Participants:

Utility Representatives

- Brantford Power Inc.
- Cornerstone Hydro Electric Concepts Association Inc.
- Electricity Distributors Association
- Enbridge Gas Distribution Inc.
- Enersource Hydro Mississauga Inc.
- Hydro One Networks Inc.
- Ontario Power Generation Inc.
- PowerStream Inc.
- Union Gas Limited
- Veridian Connections Inc.
- Waterloo North Hydro Inc.

Ratepayer Representatives

- Canadian Manufacturers & Exporters
- School Energy Coalition
- Vulnerable Energy Consumers Coalition

¹ For example, Ontario Securities Commission decision dated February 25, 2011, which granted leave to Enbridge Gas Distribution Inc. to report to the Commission using USGAAP until December 31, 2014. The Commission conditioned the decision on the requirements, inter alia, that the distributor continue to be wholly owned by Enbridge Inc., a company that has securities listed on a US exchange, and that the financial statements of the distributor continue to be consolidated into the financial statements of Enbridge Inc.

Comments on the Board staff recommendations were received from:

- Brantford Power Inc. (“BPI”)
- Coalition of Large Distributors (“CLD”) (Enersource Hydro Mississauga Inc., Horizon Utilities Corporation, Hydro Ottawa Limited, PowerStream Inc., Toronto Hydro-Electric System Limited and Veridian Connections Inc.)
- Electricity Distributors Association (“EDA”)
- Enbridge Gas Distribution Inc. (“EGD”)
- Fortis Ontario (“Fortis”); and
- Hydro One Networks Inc. (“Hydro One”).

Issues and Board Policy

This Addendum presents the Board's policy determinations by issue in a similar order and format to that used in the Board staff recommendations paper. In developing this Addendum, the Board has considered the staff recommendations, the material from the Working Group process and the comments received on the staff recommendations. These materials are referenced where necessary to give context to the Board's policy determinations.

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?

The staff proposal on this issue read as follows:

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.

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.

There was general support for this recommendation from the Working Group and the commentators. However, the EDA and the CLD both recommended that the Board specify the level of detail required within the reconciliation referred to in the third paragraph of the recommendation. These stakeholders submitted that maintaining records for several years at a transactional level, and providing a reconciliation at that level of detail would be impractical and “prohibitively expensive”. The EDA recommended that the financial records be maintained and the reconciliation provided at the account level of detail.

The Board will require that the information supporting adjustments during an IRM period be provided in the same basis of accounting as the information upon which the rates were set, to allow a meaningful evaluation of the proposed rate adjustment. The Board notes that the staff recommendation is consistent with the Board’s requirements regarding earnings sharing for gas distributors found at pages 31 and 32 of the July 2009 Board Report, wherein results in an IRM environment must continue to be provided under the same basis of accounting as that under which the earnings sharing mechanism was approved. The Board will not require third party audit assurance of the required reconciliations, though the Board notes that the filing of such an assurance could simplify the application process.

The Board also notes that the annual review process for Group 2 accounts, as set out in the Report of the Board for Electricity Distributor Deferral and Variance Account Review, and the review of reported instances of the ROE exceeding the established IRM deadband occur separately from an IRM rate application.

With respect to the question of the level of detail raised by the CLD and the EDA, it is necessary to balance the Board's need for accurate and comprehensive information with the effort and costs for both the utilities and the regulatory process of requiring detail that may or may not be truly needed by the Board. The Board recognizes that transactional-level information will not be available at the time of a rate application if the distributors are not required to keep records at that level prior to the application.

The Board notes that the level of detail available in utility records will vary for the different adjustments listed in this issue. For example, information at the asset level may be available to support an incremental capital module calculation while information to support a deadband calculation may be available only at the financial statement level.

The Board will not specify in advance the level of detail at which information supporting a reconciliation must be provided. The necessary level of detail will vary with the nature of the application, and the Board considers that utilities should be able to assess the level of detail necessary to support a proposed adjustment. That said, it is not the Board's intention to require the maintenance of two sets of books of original entry² for both CGAAP and IFRS, particularly as the requirement for reconciliation between the two standards is a response to a transitional problem.

² A "book of original entry" is a book of account in which individual transactions are recorded preparatory to summarization and/or posting to ledger accounts – *Terminology for Accountants*, 4th edition, Canadian Institute of Chartered Accountants, 1992

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?

The staff proposal on this issue read as follows:

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.

The Working Group identified two areas where significant difference could arise at the date of transition: PP&E and Pension and Other Post-Employment Benefits (“P&OPEB”) costs.

PP&E Account

All Working Group participants supported the provision of the deferral account to capture changes in costs for PP&E items. The PP&E deferral account would capture the difference in the January 1, 2012 opening balance arising on adoption of IFRS caused by restating the prior year figures in accordance with IFRS (the 2011 comparative figures are required to be restated on adoption of IFRS January 1, 2012). Hydro One submitted that in the absence of such an account, there could be a significant and unresolved discontinuity between the CGAAP and MIFRS rate bases upon transition between the two accounting methods. Stakeholders agreed that it is appropriate that the differences caused by the transition be recovered by the utility or refunded to ratepayers.

The Board will approve the proposed PP&E deferral account. The account addresses the unique circumstance of a change in accounting standards and provides for the continuity of rate base. The account allows 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 facilitates monitoring of the extent of potential impact during the IRM period, and provides the opportunity to identify any unusual circumstances requiring attention before completion of the IRM period.

The Board therefore authorizes a generic deferral account to capture PP&E differences arising only as a result of the accounting policy changes caused by the transition from CGAAP to MIFRS. It is for use by utilities to record PP&E differences arising during the period since their last rebasing under CGAAP up to their first rebasing under MIFRS, including utilities using IRM rate-setting methodology.

The operation of the deferral account is based on the staff proposal, and set out in detail in Appendix A. The Board reminds stakeholders that the amounts recorded in the deferral account will be subject to Board approval prior to disposition.

Several issues were raised through comments on the Board staff recommendation for the PP&E account. P&OPEB balances at the date of transition are discussed later in this section.

Carrying charges

Several members of the Working Group suggested that carrying charges should be applied to the balance in the PP&E account. Board staff recommended that carrying charges should not accrue on the balance, and that recommendation was supported by all those who commented on this issue (Hydro One, EDA and the CLD). Staff and the CLD pointed out that, until MIFRS is adopted as the basis for setting rates, no under or over collection has occurred.

The Board will not provide for carrying charges to be added to the balance accruing in the account. This deferral account is primarily a mechanism to allow tracking and recovery (or refund) of amounts through a one-time adjustment to rate base. The Board agrees that, until MIFRS is adopted as the basis for setting rates, no under or over collection has occurred. No recompense to either the utility or the ratepayer for the time value of the amounts in the account is required in this circumstance.

Any amount approved by the Board for disposition as part of the first cost of service application under MIFRS will form an adjustment to rate base on which the Board-approved cost of capital will apply on a go-forward basis.

Level of Detail Required

The CLD suggested that the CGAAP records required to support the entries in the PP&E deferral account, if the account is approved, should be required to be kept at a high level, rather than at a transactional level of detail. This is in order to avoid the significant administrative burden of maintaining two detailed fixed asset ledgers throughout an IRM period after adoption of IFRS.

The Board will not specify the level of detail for keeping CGAAP records after the adoption of IFRS to support entries in the PP&E deferral account. The Board regards it a matter for individual utility judgment to determine a level of detail sufficient to support the analysis and justification of amounts that it intends to bring before the Board.

The Board also notes that utilities will already have a level of detailed information available to support the external audit of the opening balances as at January 1, 2011, the activity for 2011 and the closing balances as at December 31, 2011 using both CGAAP and IFRS. That level of information would be a good starting point for management to judge the level of detail necessary to support the requirements of the deferral account. In addition, the Board anticipates that the information to support additions, deletions and the depreciation calculation in CGAAP for each year beginning with 2012 can be derived analytically from the underlying acquisition, disposal and depreciation calculations otherwise recorded using IFRS, and provided in the same asset categories, as required in the Board's prescribed Uniform System of Accounts.

Use of Forecast Amounts

In its discussion of the rationale for issue 2, Board staff raised the question of whether it would be appropriate to allow clearance of the PP&E transition account on the basis of forecast numbers for some years. When a utility applies for rates, bridge and test year numbers necessarily include forecasted amounts. Staff recommended that the account be cleared in full, despite the fact that the bridge and test year numbers are not final. Alternatively, the account could remain open for the purpose of truing up the bridge and test year numbers at the time of the next rebasing.

Both the EDA and the CLD supported the proposal to allow full clearance at the first rebasing under IFRS. The CLD pointed out that forecasts of other PP&E components of rate base are accepted by the Board in cost of service rate applications.

Clearing an account on the basis of forecast numbers is a departure from the Board's standard practice. The Board recognizes that this is a unique account, which is "cleared" through an adjustment to rate base, which itself includes components that are forecasted for the bridge and test years, for example capital additions and working capital allowance.

The Board believes that in general, the account should be cleared at the first rebasing under MIFRS, while recognizing that some portion of the amount for which clearance is sought is based on a forecast. In individual cases where a real concern exists regarding the reliability of the forecast numbers, the Board may decide to clear only a portion of the balance, and await actual results for the clearance of the remainder of the account.

Applicability of the Account to Cost of Service Applications

Hydro One proposed that the PP&E deferral account should be available to utilities as part of a cost of service application. Hydro One provided the example of a utility that adopts IFRS on January 1, 2012, but has effectively had to adopt IFRS on January 1, 2011, the comparative year. This utility would still be under CGAAP for rate purposes in 2011, and would therefore have differences driven by the IFRS transition in its 2012 opening PP&E balances.

The Board acknowledges that the proposed account has relevance for utilities making cost of service applications and therefore sees no reason to restrict its application to IRM applications.

P&OPEB Account

The staff paper recommended that no generic deferral account for differences in P&OPEB costs should be granted, noting that many of utilities rate-regulated by the Board are participants in the Ontario Municipal Employees Retirement System pension plan, which is not expected to be materially affected by the changes associated with IFRS, and few utilities would have other post-employment benefit plans that would be significantly affected. The staff paper suggested that utilities with defined benefit plans and/or other post-employment benefit plans that expect to experience a large cost impact may apply to the Board on an individual basis for a deferral account.

Contrary to the recommendation in the staff paper, the CLD and the EDA recommended the creation of an additional generic account to capture differences in P&OPEB amounts caused by the transition to IFRS. If such an account were created, it could be structured and operated in much the same fashion as the deferral account for PP&E.

The CLD was concerned that if a generic account is not established, the adjustment to P&OPEB liability at the date of transition to IFRS may never be reflected in rates. The CLD submitted that affected utilities transitioning to IFRS may be required to immediately recognize actuarial gains and losses as an adjustment to opening retained earnings at the date of transition. The CLD agreed that only a few large distributors will experience a large change in their P&OPEB balances, but the impact may be significant for some distributors. The EDA pointed out that the creation of a generic account would reduce the administrative burden on the Board of dealing with applications for such an account from individual utilities.

No ratepayer representative supported the creation of a P&OPEB deferral account. Hydro One and EGD supported the Board staff recommendation that individual utilities could apply for such an account if they anticipate large impacts in P&OPEB accounts on transition to IFRS. Hydro One submitted that given the different P&OPEB plan types, utility sizes and accounting methods in use, a generic approach is not warranted.

The Board will not approve the creation of a generic account for IFRS related impacts on P&OPEB accounts occurring at the date of transition. As acknowledged by the CLD, the impacts are anticipated to be significant for only a few large utilities. The option remains for these utilities to seek an individual account if they can demonstrate the likelihood of a large cost impact upon transition to IFRS.

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?**

The staff proposal on this issue read as follows:

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

Most Working Group participants supported the staff proposal. A few suggested that the Board should monitor this issue for future developments. Hydro One in its comments noted that to date there has been no indication that Canada Revenue Agency will change any of its taxation policies as a result of the adoption of IFRS for accounting purposes. The EDA agreed with Board staff that there would be practical difficulties in isolating the IFRS impacts on statutory taxes payable.

BPI submitted a comment recommending that the Board authorize an expansion of the scope of deferral account 1592 (PILs and Tax Variance for 2006 and Subsequent Years account), to allow inclusion of any differences between the PILs provision included in rates and actual taxes paid that result from the adoption of IFRS. BPI reminded the Board that it had sought such a redefinition of account 1592 in its 2008 cost of service application, and the Board had found that this was a generic matter that would apply to all distributors, and would be discussed in this consultation on the transition to IFRS. BPI stated that the staff proposal had not addressed this issue.

BPI agreed with a point made by staff in its rationale on this issue, that the fundamental question about whether there should be reconciliation and true up between the tax provision allowed in rates and taxes actually paid for statutory purposes is an issue outside the scope of the IFRS-IRM transition work. However, BPI submitted that changes to taxable income caused by the transition to IFRS are analogous to deviations attributable to statutory or non-discretionary events such as changes to tax rates. Account 1592 allows these latter impacts to be recorded and corrected.

The Board acknowledges that while there could be changes in the way taxable income is calculated arising from adopting IFRS, there as yet is no clarity as to what these changes might be. The Board also notes that there could be practical difficulties

isolating tax-related IFRS impacts, a concern identified by staff and the EDA. The Board is not prepared to broaden the definition of account 1592 at this time.

Further, the Board agrees that the issue of capturing differences between taxes included in rates and the amount actually paid is broader than the scope of this consultation. The Board is not prepared, on the basis of the record in this consultation, to undertake a fundamental reconsideration of long-standing Board practice regarding true-up of tax or PILs amounts in rates.

The need for a generic account has not been demonstrated at this time and expansion of the definition of Account 1592 is not approved.

The Board encourages staff and industry participants to monitor developments in this area and notify the Board should a specific need for additional policy from the Board emerge.

Issue 4:***Should the Board permit rate applications or RRR reporting using USGAAP?***

The staff proposal on this issue read as follows:

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.

There was general support for this recommendation from the Working Group and the commentators. Stakeholders agreed that utilities that are not required to adopt IFRS for financial reporting purposes should be able to apply to the Board for approval to use USGAAP for ratemaking purposes. However, the question arose during the Working Group sessions as to whether the use of USGAAP would be a long term solution, as the ability for Canadian reporting issuers to use USGAAP without having a listing on a US securities exchange may be time limited.

Hydro One and Fortis noted Staff's concerns that USGAAP would introduce a second set of standards and Hydro One agreed that there is some potential for an increase in complexity and a reduction in consistency in utility financial information used in the regulatory environment. However, Hydro One pointed out that differences between USGAAP and IFRS are concentrated in specific well-defined areas where the potential impacts can be easily understood. Fortis submitted that the Board can achieve consistency in areas where it is necessary, by requiring utilities to adopt consistent regulatory accounting practices in specific areas, such as overhead capitalization.

The Board reaffirms Principle 5, as enunciated in the 2009 Board Report. In that Report, the Board recognized the need to provide some flexibility to accommodate unique circumstances. While the use of USGAAP as an alternative to IFRS was not contemplated at the time Principle 5 was developed, the Board remains of the view that to require a utility to provide regulatory reporting and filing in IFRS when that utility is performing financial reporting under an entirely different accounting standard is generally not desirable.

The Board notes that the Nova Scotia Utility and Review Board has set rates for Nova Scotia Power based on a USGAAP rate application, and other Canadian regulators have received rate applications filed using USGAAP.

However, the Board must consider the general public interest in ensuring efficiency and consistency in utility regulation in Ontario, and will require utilities to explain the use of an accounting standard other than MIFRS for regulatory purposes.

A utility, in its first cost of service application following the adoption of the new accounting standard, must demonstrate the eligibility of the utility under the relevant securities legislation to report financial information using that standard, include a copy of the authorization to use the standard from the appropriate Canadian securities regulator (if applicable) showing any conditions or limitations, and set out the benefits and potential disadvantages to the utility and its ratepayers of using the alternate accounting standard for rate regulation.

The Board cautions utilities that the adoption of USGAAP as a short term solution may be counter-productive. If a utility is required to transition to IFRS for financial reporting purposes a few years after adopting USGAAP, certain transitional issues may not have been avoided, but delayed, and additional costs may be incurred if the utility changes its accounting standard twice. The Board will carefully scrutinize the costs

incurred to accomplish two successive transitions if the utility seeks to recover these costs from ratepayers.

In addition, the Board emphasizes to utilities that it retains the authority to require specific accounting standards and practices for regulatory purposes in any case where the Board finds that the public interest requires uniformity in those standards and practices among utilities.

Utilities that file and report under USGAAP (or another accounting standard) should, in general, read references to IFRS and MIFRS in the Board Report, amendments to it, and this Addendum to include USGAAP (or other alternate accounting standard). The deferral account authorized in Issue 2 may not be necessary for such utilities.

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?

The staff proposal on this issue read as follows:

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.

There was general support for this proposal. No stakeholder recommended the creation of such an account at this time, although both the EDA and the CLD recommended that the Board continue to monitor the development in IFRS standards so as to identify potential impacts that would affect the electricity distributor community.

The Board will not create a generic account to record the impacts of changes in IFRS standards. The Board will continue to monitor IFRS developments, and, as proposed in the staff recommendation and supported by the Working Group, any individual utility that anticipates a large impact from a change in standards can apply to the Board for relief.

The Board notes that it did create variance accounts for Hydro One Distribution and Transmission in its latest rate decisions. However, as Hydro One pointed out in its comments on the Board staff recommendations, uncertainty regarding standards development was higher at the time those decisions were made. That the level of uncertainty has decreased is confirmed by the fact that no utility stakeholder commenting on the Board staff recommendation suggested that the Board create a generic account for this purpose at this time.

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.

The staff proposal on this issue read as follows:

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.

With one exception, utility commentators did not support staff's proposal, and submitted that a variance account be established in which utilities record differences in the items listed in the issue. The changes in asset useful life and early retirement of assets have impacts on amortization expenses and volatility may be experienced in pension and post-employment benefit expenses. EGD supported staff's proposal.

With respect to changes in asset useful life, the EDA noted distributors will be required to recognize a change in the useful life of an asset for accounting purposes under IFRS. This would lead to a divergence between the rate base and the net book value, which will continue to exist unless and until the rate base values are brought in line with the values in the financial statements at the next rebasing. The EDA submitted that there is a need for an account in order to be able to bring the rate base values in line with the financial statements and enable recovery or refund of the differences.

The EDA also submitted that an account should be established to record any gain or loss that arises from the early retirement of assets as required by IFRS accounting. The EDA stated that utilities have no experience in forecasting the extent of losses arising from early retirement of in-service assets, and most utilities are likely to encounter material difficulties in forecasting the extent of losses.

Hydro One suggested that many utilities will incur premature retirement losses on an ongoing basis after adoption of IFRS that are significant enough to be considered material for regulatory purposes, and that utilities will not be able to forecast premature retirement losses with sufficient precision to justify the inclusion of the losses in forecast revenue requirements.

The CLD submitted that under IFRS, past service costs and actuarial gains or losses likely will be recognized immediately in income. These increases or reductions in costs, which can be material, may never be reflected in rates if not captured in a variance account. The CLD supports the establishment of a variance account to record significant changes in post retirement benefit costs relative to the costs in rates. The EDA concurred and noted that the IASB is in the final stages of issuing an amendment to IAS 19 that will require all entities to immediately recognize actuarial gains and losses.

No ratepayer representative supported the creation of a variance account for these items.

The Board is not persuaded that a generic account is necessary. The Board is not aware of any reliable data at this time to satisfy the Board that the adoption of IFRS accounting changes will apply to all utilities in a similar or consistent manner, or that the adoption that will cause material impacts for all utilities due to ongoing increase in volatility. In addition, the Board believes that it will be difficult to distinguish the differences arising from IFRS accounting policy changes from other differences, and this difficulty will increase with increasing time post-transition.

The Board notes that the deferral account provided for in Issue 2 will give utilities relief during the IRM period immediately following the transition to IFRS for rate base related items. At the first cost of service application after the transition, a utility will be expected to provide a forecast of asset useful lives, and gains and losses from retirements, as part of its application. This forecast will be reviewed by the Board and the likelihood of large variances from the forecast can be assessed. Utilities can apply to the Board for a utility-specific variance account if they can demonstrate the probability of significant ongoing volatility.

With respect to P&OPEB items, the Board is not persuaded that a generic account is necessary. It is not clear that the impact of the transition to IFRS on P&OPEB items

will be consistent among Ontario utilities. Individual utilities that can demonstrate the likelihood of large variances can seek an individual variance account from the Board.

If it becomes apparent over time that utilities are generally experiencing material, unpredictable variances in these items, the Board will consider solutions in its development of rate-setting mechanisms.

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?

The staff proposal on this issue read as follows:

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.

Need for reconciliations

Working Group participants supported the staff proposal that reconciliations not be provided every year for all items required under RRR. However, there was general support for the need for all the individual reconciliations listed in the staff proposal. Hydro One noted the question posed by staff as to whether there would actually be any differences to reconcile for group 1 accounts, and suggested that a generic reconciliation would not be necessary. The CLD stated that they support the reconciliations but, in the case of the fourth reconciliation (regarding the deferral account provided in Issue #2), the reconciliation should be completed only up to the last historic year, not for the bridge and test years, since they are forecasts.

Some commentators suggested clarifications relating to the level of detail to be provided in reconciliations.

The Board will require the reconciliations proposed by staff. The Board recognizes that there may not be differences on adoption of IFRS in the case of Group 1 accounts for some utilities, but where a difference does arise, the Board will need a reconciliation in such circumstances.

The Board does not agree with the CLD’s suggestion that a reconciliation not be provided for the bridge and test years in respect of the fourth reconciliation proposed. The reconciliation proposed is with regard to RRR reporting, not at the time of rebasing, but at the time of reporting actuals for the relevant years.

With regard to the level of detail required in the reconciliations, the Board will not specify in advance the level of detail at which information supporting a reconciliation must be provided. The necessary level of detail will vary with the nature of the accounts being reconciled, and the Board considers that utilities should be able to assess the level of detail necessary to support a reconciliation. However, as the Board stated in Issue 1, it is not the Board’s intention to require the maintenance of two sets of books of original entry for both CGAAP and IFRS, particularly as the

requirement for reconciliation between the two standards is a response to a transitional problem.

Need for audit assurance

Some commentators did not agree with the need for or level of audit assurance proposed by staff. With respect to the first reconciliation proposed in the list, Hydro One pointed out that this difference is part of the first set of financial statements prepared under IFRS and therefore already audited. The EDA suggested that any such assurance should be provided only at a high level.

Regarding the second item, the CLD and Hydro One pointed out that audit assurance regarding such mapping is not provided by external auditors now, and that the incremental effort and cost required would be significant. Hydro One suggested that accomplishing any such audit may also be difficult as the mapping may not be auditable against a defined external accounting standard.

Some commentators also opposed the proposal of audit assurance for the reconciliation of Group 1 deferral and variance accounts to be filed as part of RRR reporting during the IRM period prior to rebasing under MIFRS. The CLD and the EDA submitted that the value to be gained through audit assurance is not clear, and obtaining the assurance would be expensive.

The Board does not agree with the staff proposal that audit assurance should be provided for all of the first three listed reconciliations above. For the first listed reconciliation, the Board agrees with Hydro One's observation that audit assurance will already be provided for the reconciliation between CGAAP and IFRS financial statements for 2011. Accordingly, additional audit assurance concerning the first reconciliation is not required.

With respect to the second reconciliation listed above, the Board agrees that an audit of the mapping and reconciliation of figures in audited financial statements to uniform system of account reported balances has not been required in the past and the Board does not require audit assurance of this mapping and reconciliation.

With respect to the third reconciliation regarding Group 1 accounts, the Board agrees with the staff proposal that audit assurance should be required.

In its July 2009 Report, the Board stated the following with respect to the requirement for audit assurance:

“The Board notes that regulatory accounts have been subject to audit in virtually all cases as part of the expression of an audit opinion under CGAAP because such accounts are considered to be within CGAAP. The Board intends to continue its reliance on audited financial information for regulatory purposes, and the modified IFRS values would otherwise not be subject to audit because, at the present time, they are not considered to be within IFRS. Accordingly, to maintain the same level of assurance as currently provided, the Board will require supplementary audit assurance provided in accordance with generally accepted auditing standards. The supplementary audit will be required to include an audit of any deferral or variance account balances recorded by the utility.”

In Appendix 2 of that Report, the Board summarized its policy regarding accounts that are not otherwise audited under issue 10.5 as follows:

“10.5 The RRR will include a requirement for supplementary audit assurance regarding regulatory accounting values reported on an annual basis where they differ from IFRS reported values in audited financial statements and that are not otherwise audited, including for example deferral and variance accounts. The supplementary audit assurance will involve audit of regulatory accounting values by a third party auditor in accordance with generally accepted auditing standards.”

The Board notes that while accounting standards setters and practitioners continue to consider the matter, deferral and variance accounts are not presently recognized under IFRS as part of a utility’s financial statements, and would not be audited as part of the financial statements. The Group 1 accounts are a sub-set of the deferral and variance accounts referred to in the Board Report that are “not otherwise audited”. The Board will require an opinion from an external auditor on the reconciliation of these accounts.

However, the Board accepts that an audit for this reconciliation at the “review level of assurance” specified in the Canadian Institute of Chartered Accountants Handbook is sufficient, and recognizes that this is a lower level of assurance than provided to other

items in audited financial statements. Performing an audit to this lower level of assurance should reduce the burden on utilities.

For the fourth reconciliation (PP&E transition deferral account), the Board agrees that no audit assurance is required.

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?

The staff proposal on this issue read as follows:

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).

Hydro One and the EDA, the only stakeholders who commented on this issue, agreed with staff that the Board should consider potential adjustments to the IRM methodology. The EDA emphasized the need for timely consideration, as some distributors will rebase in 2011 for 2012 rates under MIFRS.

The Board agrees that the adoption of MIFRS may require a reconsideration of some aspects of the IRM regime. The Board will take account of MIFRS effects, including evidence of unpredictable variances as noted in Issue 6, in its development of future rate-setting mechanisms.

Appendix A: Summary of Board Policy in this Addendum

Issue 1

Information supporting rate adjustments during an IRM period should be provided in the same basis of accounting as the information upon which the rates were set. This means that if rates were set on CGAAP, the financial information supporting the adjustment must be provided under CGAAP, and the adjustment to rates will 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.

No third party assurance is required for the reconciliations, although an applicant can choose to file such assurance as part of its evidence supporting the reconciliation.

Issue 2

The Board authorizes the creation of a generic IFRS transition PP&E deferral account to record differences arising as a result of accounting policy changes caused by the transition from CGAAP to MIFRS as follows (for purposes of this account, PP&E includes rate base related intangible assets.):

1. Utilities shall 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. Records should be kept to at a level of detail sufficient to support the analysis and justification of the entries made to the account.
2. Utilities shall 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 using 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 2011, and MIFRS in 2011, 2012 and 2013. (2011 must be included in MIFRS because the year before the move to IFRS has to be restated under IFRS.)

3. Utilities shall record in the deferral account 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) should be recorded as a balance to be recovered from, or refunded to, ratepayers and as an adjustment to opening rate base in the year of rebasing (with rate base otherwise calculated on an MIFRS basis).
5. Utilities shall reflect the deferral account balance as an adjustment to MIFRS calculated rate base going forward, and amortize that adjustment over a period of time approved by the Board. The rate base, upon which the utility return on rate base calculation is based in the cost of service application, will therefore include two components: the MIFRS based elements of PP&E; and, the unamortized balance in the deferral account. Thus the unamortized balance in the deferral account will attract the same level of return in determining revenue requirement in a cost of service application as other PP&E balances.

The Board will determine the period of time for amortization on a case-by-case basis and will be guided primarily by such considerations as the impact on rates, implications of any other IFRS transition matters and any requirements for rate mitigation.

Amortization of the adjusting amount, up or down, shall be reflected in any applicable rate application 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 shall be included in applicable revenue requirement calculations in the same way as for any other component of rate base.

Utilities must propose the level and pattern of recovery in rates of the amounts in the account for consideration by the Board in their next cost of service application after adopting IFRS. In general, the account will be cleared at the first rebasing under MIFRS. In individual cases, the Board may decide to clear only a portion of the balance, and await actual results for the clearance of the remainder of the account.

The Board will not approve the creation of a generic account for IFRS related impacts on P&OPEB accounts occurring at the date of transition. The option remains for utilities to seek an individual account if they can demonstrate the likelihood of a large cost impact upon transition to IFRS.

Issue 3:

The Board will not create or define a specific account for IFRS impacts on taxes or PILs. Board staff and industry participants should monitor developments in this area and notify the Board should a specific need for additional guidance from the Board emerge.

Issue 4:

The Board requires a utility that adopts USGAAP or an alternate accounting standard other than IFRS, in its first cost of service application following the adoption of the new accounting standard, to:

- demonstrate the eligibility of the utility under the relevant securities legislation to report financial information using that standard;
- include a copy of the authorization to use the standard from the appropriate Canadian securities regulator (if applicable); and
- set out the benefits and potential disadvantages to the utility and its ratepayers of using the alternate accounting standard for rate regulation.

If a utility is required to transition to IFRS for financial reporting purposes a few years after adopting USGAAP, the Board will carefully scrutinize the costs incurred to

accomplish two successive transitions if the utility seeks to recover these costs from ratepayers.

The Board retains the authority to require specific accounting standards and practices for regulatory purposes in any case where the Board finds that the public interest requires uniformity in those standards and practices among utilities.

Utilities that file and report under USGAAP (or another accounting standard) should, in general, read references to IFRS and MIFRS in the Board Report, amendments to it, and this Addendum to include USGAAP (or other alternate accounting standard).

Issue 5:

The Board will not create or define a generic account to record the impacts of changes in IFRS standards. Any individual utility that anticipates a large impact from a change in IFRS standards can apply to the Board for relief.

Issue 6:

The Board will not create or define a generic account to address ongoing volatility after rebasing under MIFRS. Utilities can apply to the Board for a utility-specific variance account if they can demonstrate the probability of significant ongoing volatility after rebasing under MIFRS.

Issue 7:

The Board requires the following with respect to Reporting and Record-keeping Requirements (“RRR”):

- A one-time reconciliation between the 2011 CGAAP audited financial statement figures and the 2011 IFRS audited financial statement comparative figures that were reported as part of the 2012 IFRS audited financial statements to 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 statement comparative

figures that were reported as part of the 2012 IFRS audited financial statements to be submitted with the RRR annual performance reporting for 2012.

- Where an electricity distributor has not rebased under modified IFRS, a reconciliation is to 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.
- All utilities must provide, 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 each year between reported amounts calculated using CGAAP and amounts calculated using MIFRS. This reconciliation is required up to and including the year of first rebasing under MIFRS.

The Board requires audit assurance for the third reconciliation listed (Group 1 deferral and variance accounts), to be provided by an external auditor to the “review level of assurance” specified in the Canadian Institute of Chartered Accountants Handbook. For the other reconciliations listed, no audit assurance is required.

Issue 8:

The Board will take account of MIFRS effects in its development of future rate-setting mechanisms.