IFRS IRM Working Group
Board Staff Revised Proposals for Discussion
February 18, 2011

The recommendations below are provided as a starting point for discussion, and do not necessarily represent Board staff's final views on the issues.

Issues arising on transition to IFRS

1. Does the Board policy provide sufficient guidance as to when to begin to use modified IFRS in a rates application for a rebasing year that precedes an IRM rate setting period? If not, what additional guidance is required?

Board staff recommends that the Board consider updating paragraph 9.1.2 of the November 8, 2010 Amendment to encourage electricity distributors to rebase in MIFRS for test year 2012. Utilities unable to file rebasing applications in MIFRS for that test year should be required to provide an explanation for that inability. New wording for paragraph 9.1.2 is suggested below.

In addition, Board staff submits that the Board should make it clear that rates will be set based on MIFRS for all rebasing applications for test year 2013 and subsequent years by adding at the end of section 9.1.3 "Rates will be based on modified IFRS accounting".

Suggested wording: 9.1.2 Electricity distributors filing cost of service applications for rates for 2012 must provide the forecasts for the 2012 test year (and any other subsequent test years) in modified IFRS accounting format. In addition, the electricity distributor must provide the required actual years, the bridge year and the forecasts for the test year(s) in CGAAP-based format. Further, the electricity distributor must identify financial differences and resulting revenue requirement impacts arising from the adoption of modified IFRS accounting. If a distributor is unable to file the forecasts for the 2012 test year in modified IFRS accounting format, the distributor must provide an explanation for this inability and a strategy for the transition to modified IFRS accounting as a basis for setting rates.

Rationale: as all utilities must transition to IFRS in 2012, it is considered preferable to have all utilities rebase in 2012 on MIFRS wherever possible..

Staff note*: this is a departure from the Board's original requirements that may have significant impacts for utilities rebasing in 2012. We will need to consider how to implement this change, if it is to be pursued, and whether this proposal needs to fast-tracked to the Board for consideration. Some utilities will be already well into preparation for 2012 rebasing filings.*

References:

- November 8, 2010 Amendment to Board Policy
- Report of the Board: Transition to International Financial Reporting Standards ("Board Report") p. 29 - 32

Alternatives:

Staff submits that Board policy set out in the November 8, 2010 amendment provides sufficient guidance. However, the following clarification (in bold) to section 9.1.2 is recommended:

9.1.2 Electricity distributors filing cost of service applications for rates in the year they choose to adopt IFRS for financial reporting must provide the required actual years, the bridge year and the forecasts for the test year(s) in CGAAP based format**, and the rates will be set based on the CGAAP filing.** An electricity distributor may choose…

Staff notes: Not sure if we captured the clarification sought by the group. Our notes suggest that we discussed setting rates on CGAAP even if the distributor filed in IFRS, but that's not what 9.1.2 says.

2. 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[1]. What level of audit assurance, if any, should the Board require for reconciliation of CGAAP to modified IFRS for these calculations in IRM applications?

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

- **seeks an adjustment through**
    - **a Z-factor,**
    - **incremental capital module (ICM),**
    - **off-ramp (IRM2),**

[1] Earnings sharing calculation covered by Board Report.

- **seeks disposition of Group 2 deferral and variance account balances above the preset disposition thresholds, or**
- **reports an instance of ROE exceeding the deadband (IRM3),**

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 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[2].

Staff recommends that the Board not <u>require</u> any additional level of audit assurance to be filed as part of a rate case application, 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.

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

Alternatives regarding audit assurance:

From Randy Pugh:

Board Staff understands that the reconciliation of differences between modified IFRS and CGAAP for certain specific issues (e.g. capitalization) may involve numerous transactions. To avoid the record-keeping burden on utilities,

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[2] 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 adopts IFRS for financial reporting. First modified IFRS RRR filing is due March 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.

distributors may provide third party assurance as evidence to support the integrity of the reconciliation in lieu of a transactional reconciliation[3].

Staff notes:
Randy's proposal is similar to ours, but we don't think that third party assurance will convince all intervenors and the Board to not examine some of the transactions. So we are not sure that "in lieu" is accurate.

This issue should probably be considered along with issue 12.

References:
- Board Report Appendix 2, section 10.5
- CICA Handbook Section 8100

3. Included in issue 2

4. 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?

Proposal from Staff:

Staff proposes that in general, any such difference, when properly calculated, should be recoverable from, or refundable to, ratepayers.

Staff recommends that two deferral accounts be established in which the utility records certain differences between costs recorded in the balance sheet accounts and costs built into rates arising from the adoption of modified IFRS. These accounts are intended to cover differences arising

[3] I was asked on behalf of the working group to provide some wording to address concerns utilities would have in situations where the difference between MIFRS and CGAAP is comprised of many transactions. The concern expressed was that utilities would not be able to provide a transactional reconciliation after the fact, if the OEB required additional evidence beyond a "top-down" reconciliation at a future hearing. Utilities would therefore either keep "two sets of ledgers" in the event they had to provide additional evidence, or accept the risk of non-recovery of differences between MIFRS and CGAAP.

only as a result of the accounting policy changes caused by the transition from CGAAP to MIFRS. They are not to capture performance differences during the IRM period. A deferral account to cover rate base related items associated with Property, Plant and Equipment is described under this issue. A deferral account to cover one category of operating expenses is proposed under issue 6.

Staff recommends that, at each utility's first rebasing after it has adopted IFRS, the PP&E components of rate base be re-set to reflect MIFRS accounting treatment. This will minimize the differences between rate base for regulatory purposes and audited balance sheets. The deferral account would capture this difference associated with rate base.

Staff recommends the following:

1. **Regulated entities should maintain records using CGAAP of the average 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. **Regulated entities should also calculate adjusted 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 utility should record the difference between items 1 and 2 above in the deferral account. The balance in this account (which does not accrue interest), 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 adjustment up or down will be recorded as a balance to be recovered from, or refunded to, ratepayers as an offset to rate base. That is, if the rate base adjustment is up, the Board will require the utility to reflect an offset to rate base going forward, and amortize that offset over a period similar to the average useful life of assets, or such other period as the Board may consider appropriate**

> **in the circumstances. Similarly, if the rate base adjustment is down, the reduction will be treated as a special class of rate base asset, amortized over that same useful life. The amortization of the adjusting amount, up or down, will on a going forward basis be reflected as 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 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.

Staff notes:

We are attempting to create three accounts throughout this paper: two deferral accounts to track discrepancies arising from a change in policy, i.e. the transition to MIFRS (issues 4, 5, 6, and 15), and a variance account to deal with ongoing volatility created by IFRS rules (issue 9 and what was originally the 2nd part of issue 6). The accounts can be found under revised issues 4, 6 and 9.

The policy transition accounts (issues 4 and 6) are based on Jay Shepherd's proposal, but with a deferral account added to avoid issues of retroactive rate-making and to provide for a recorded and auditable trail (should audit be found necessary for any reason).

We have removed the requirement for a materiality threshold given the reality of the situation: if utilities are recording these amounts, particularly if there are multiple sources for the entries, it does not reduce the work to set a materiality threshold.

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

Alternatives:

Proposal from Jay Shepherd:

Issue #4
The Board has established in the Board Report that changes to utility costs during IRM that arise because of IFRS will not be reflected in rates except on the basis of the existing mechanisms in the 3rd Generation IRM regime (e.g. Z factors).

However, Staff recommends that, at each utility's first rebasing after they have adopted IFRS, their rate base be re-set to reflect IFRS accounting treatment. This will minimize the differences between rate base for regulatory purposes and audited balance sheets.

To accomplish this adjustment, Staff proposes the following:

1. Regulated entities should maintain records of rate base using CGAAP, commencing at their last rebasing under CGAAP, and continuing until their first rebasing under IFRS. This will produce an opening rate base figure for their first IFRS rebasing that is consistent with their last rebasing.

2. Regulated entities should also calculate "adjusted rate base" using the accounting system applicable in each year of IRM. For example, if a utility rebased on CGAAP in 2010, and continued with CGAAP in 2011, and then moved to IFRS for 2012 and 2013, it would calculate rate base using CGAAP in 2010, and IFRS 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 will, as a matter of general policy, adjust opening rate base up or down in the first IFRS rebasing year to match the "adjusted rate base" figure above. For that rebasing year, and every subsequent year, rate base will be calculated on an IFRS basis.

4. The amount of the adjustment up or down will be recovered from, or refunded to, ratepayers as an offset to rate base. That is, if the rate base adjustment is up, the Board will require the utility to record an offset to rate base going forward, and amortize that over a period similar to the average useful life of assets. This will work like the "contributions and grants" line in rate base today. Similarly, if the rate base adjustment is down, the reduction will be treated as a special class of rate base asset, amortized over that same useful life. The adjusting amount, up or down, will on a going forward basis affect depreciation expense (the refund or recovery of the amount of the adjustment over time) and cost of capital (the time value of the period of refund or recovery), in the same way as any other component of rate base.

The effect of this is that, from the point of view of the ratepayers, there will be a gradual transition to an IFRS rate base, rather than a sudden change. From the point of view of the utilities, they are kept entirely whole (including return on debt and equity) with respect to adjustments between capital and operating costs during IRM.

By way of example, Utility A rebases in 2011 and has a closing rate base of $100 million. It adds $7 million of new assets in each of 2012 through 2014. Those assets include $1 million of what would have been capitalized overheads each year. Average depreciation rates in 2011 (under CGAAP) are 6.5%. Under IFRS, average depreciation rates drop to 5.5%. The attached spreadsheet shows the proposed calculation above (including the adjustment for 2011 under IFRS since it will be restated).

Staff note: Do utilities know the average depreciation rates?

5. Proposed to delete as now included in issue 4. (Original wording for reference: On the transition date to modified IFRS, a financial difference may arise between the modified IFRS opening balance sheet and the CGAAP opening balance sheet, due to the adjustment of rate base (PP&E) items upon transition to modified IFRS. Should this difference, if properly calculated, generally be recoverable from or refundable to ratepayers? If so, what mechanism should be used to recover or refund this difference? Is a deferral account necessary to avoid the amount being out of period? Should a materiality threshold be established for the use of the mechanism?)

Covered by account proposed in issue 4.

References:

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

Alternatives:

Covered by the same methodology as alternative in #4.

6. 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 proposes that in general, any such difference, when properly calculated, should be recoverable from, or refundable to, ratepayers.

Staff recommends that two deferral accounts be established in which the utility records certain differences between costs recorded in the balance sheet accounts and costs built into rates arising from the adoption of modified IFRS. These accounts are intended to cover differences arising only as a result of the accounting policy changes caused by the transition from CGAAP to MIFRS. They are not to capture performance differences during the IRM period. A deferral account to cover rate base related items was described under issue 4. A deferral account to cover one category of operating expenses is proposed this issue.

Staff recommends the following:

1. **Regulated entities should maintain records of balance sheet accounts related to pensions and post-retirement benefits using CGAAP, commencing at their last rebasing under CGAAP, and continuing until their first rebasing under MIFRS. This will produce balances that are consistent with their last rebasing.**

2. **Regulated entities should also calculate "adjusted account values" 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 pension and post-retirement balance sheet values 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 utility should record the difference between items 1 and 2 above in the account. The balance in this account (which does not accrue interest), will provide the Board with the evidence to consider an adjustment to opening pension and post-retirement related balances up or down in the first MIFRS rebasing year to match the "adjusted account values" figures above. For that rebasing year, and every subsequent year, the values in the pension and post-retirement related accounts will be calculated on a MIFRS basis.**

4. **The amount of the adjustment up or down will be recorded as a balance to be recovered from, or refunded to, ratepayers as an offset (up or down) to the respective underlying pension and post-retirement related balance sheet account(s) to which they relate and will be amortized over a period approved by the Board based on the average estimated turnover period in years for the underlying balance sheet accounts, or such other period as the Board considers appropriate in the circumstances. The adjusting amount, up or down, will on a going forward basis be recorded as an adjustment to OM&A**

expense (the refund or recovery of the amount of the adjustment over time).

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.

Staff notes:

We are attempting to create three accounts throughout this paper: two deferral accounts to track discrepancies arising from a change in policy, i.e. the transition to MIFRS (issues 4, 5, 6, and 15), and a variance account to deal with ongoing volatility created by IFRS rules (issue 9 and what was originally the 2nd part of issue 6). The accounts can be found under revised issues 4, 6 and 9.

The policy transition accounts (issues 4 and 6) are based on Jay Shepherd's proposal, but with a deferral account added to avoid issues of retroactive rate-making and to provide for a recorded and auditable trail (should audit be found necessary for any reason).

We have removed the requirement for a materiality threshold given the reality of the situation: if utilities are recording these amounts, particularly if there are multiple sources for the entries, it does not reduce the work to set a materiality threshold.

References:

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

Alternatives:

Use a deferral account, but include other operating expense items in addition to pensions and post-retirement benefits.

Staff note: Are there other items that need to be included?

7. 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 reports that no special implications requiring guidance have been identified.

Alternatives:

None identified.

Issues arising after adoption of modified IFRS

8. 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 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[4].

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

Alternatives:

None identified.

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 they 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 consideration is considered necessary.

9. 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

[4] Staff notes that the deferral accounts approved for Hydro One were created during an application using a two year test period, and were limited to a period of one year.

PP&E or intangible assets included in rate base, and differences in pension and post-retirement benefit expenses should be considered.

Staff recommends that a variance account be established to mitigate the volatility that may be created by the application of IFRS rules for pension and post-retirement related expenses. Utilities will record in the account any discrepancy between costs recorded in the balance sheet accounts and costs built into rates for pension and post-retirement benefit costs.

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

Staff does not recommend the creation of a variance account for depreciation or amortization volatility.

Rationale:

Board staff recognizes that the introduction of IFRS leads to increased volatility in earnings as compared to C-GAAP. An area where this is particularly pronounced is pension and post-retirement benefits where relatively small adjustments in underlying assumptions can cause major swings in cost. Board staff recommends that in this instance, a variance account is appropriate to isolate the variability so that the level and pattern of its recovery in rates can be considered explicitly by the Board. In addition the variability is considered to be significantly influenced by external market conditions such that it is not fair to utilities to bear the increased volatility in an IRM period caused by a change in the accounting treatment without specific review of the variances by the Board at the next cost of service proceeding.

Board staff has not identified other circumstances where increases in volatility under IFRS are such that they require generic consideration of a variance account by the Board at this time. While utilities are required to review asset service lives annually under IFRS, in practice asset service lives are typically reviewed on a priority and cyclical basis. As such, utilities under an IFRS regime are still able to manage the adoption of changes to service lives to coincide with cost of service proceedings and the impacts on cost patterns of changes in service lives are not generally major. Special cases are typically addressed by the Board on their own merit, e.g., smart meter impact on service lives of previous meters Accordingly, a variance account for changes in asset service lives is not considered by Board staff to be necessary.

References:

- Board Report pages 20 - 22

Alternatives:

Staff recommends that a variance account with two sub-accounts be established to mitigate the volatility that may be created by the application of IFRS rules for two types of expenses. In the sub-accounts, utilities will record variances between costs recorded in the balance sheet accounts and costs built into rates during an IRM period.

The first sub-account would cover any discrepancy between costs recorded in the balance sheet accounts and costs built into rates in depreciation or amortization expense caused by changes in estimated useful life of in-service PP&E or intangible assets included in rate base, e.g., computer software costs.

The second sub-account would cover any discrepancy between costs recorded in the balance sheet accounts and costs built into rates for pension and post-retirement benefit costs.

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

10. After adoption of IFRS, a utility may experience gains or losses for financial reporting purposes under IFRS from retirements of PP&E in a pool of like assets. Should these differences, if properly calculated, generally be recoverable from or refundable to ratepayers? If yes, by what mechanism should it be recovered or refunded? Is a deferral account necessary to avoid the amount being out of period? Should a materiality threshold be established for the use of the mechanism?

Staff does not recommend that the Board establish a generic deferral account to capture differences in gains and losses arising after the adoption of IFRS. If, at the time of a cost of service application which follows rebasing under MIFRS, the utility can demonstrate significant ongoing uncertainty regarding the estimates of future gains and losses from retirements to be reflected in its revenue requirement, the utility can seek a variance account as part of its rate application.

Staff notes: Staff believes that for utilities that are now required to change accounting methods that write-off group assets previously remaining in group asset accounts, the forecasting of such gains and losses will improve with time, and the variance account will be unnecessary. Problems with gains and losses upon transition to MIFRS would be covered by the methodology in issue #4.

References:

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

Alternatives:

Staff recommends that the Board establish a generic deferral account to capture any differences arising arising after the adoption of IFRS from these asset retirements, which shall be maintained only until the next cost of service application for the utility. If, at the time of the cost of service application, the utility can demonstrate significant ongoing uncertainty regarding the estimates of future gains and losses from retirements to be reflected in its revenue requirement, the utility can seek a variance account as part of its rate application.

11. Should the Board permit rate applications or RRR reporting using USGAAP?

Staff note: We are still receiving information on US-GAAP as this topic emerges and have not finalized what our position will be. *We have reordered and expanded the proposal to reflect current considerations.*

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 US-GAAP at this time, the Board not encourage its use. There is significant uncertainty regarding accounting standards applicable to rate-regulated activities. Staff suggests that the Board strongly encourage utilities to evaluate substantive business reasons for seeking approval from relevant securities authorities in Canada and/or the United States when deciding to adopt US-GAAP, including the need to raise capital in the United States and assessment of resources required to support ongoing compliance with US-GAAP.

Alternatives:

1. The Board will not permit filings under USGAAP. It is important for utility regulation in Ontario that financial information be universal and standardized for all utilities.

2. The Board will require all electricity utilities and agencies (including OPG) to file rate applications and perform RRR reporting using modified IFRS, except those utilities who are not required to adopt IFRS for financial reporting purposes due to their not-for-profit status. For gas utilities, the Board will require Enbridge Gas Distribution Inc. and Union Gas Limited to file rate applications and report to the Board using the same accounting standard, as approved by the Board (e.g. modified IFRS or USGAAP). It is important for utility regulation in Ontario that utilities within an energy sector report financial information on a common basis.

Note: If use of USGAAP or another accounting system is approved, all references to IFRS or modified IFRS in these recommendations shall be read as including any other accounting standard approved by the Board for regulatory purposes, unless otherwise indicated.

References:

- Board Report page 5

Rationale

US-GAAP became an alternative standard that could be considered by some utilities only after the Board Report was issued, and as a means of addressing recent concerns about the appropriateness of IFRS in a rate-regulated environment. Accordingly, the significant use of alternative standards was not considered at the time of the Board Report.

The use of US-GAAP for those that are eligible under securities legislation does currently provide continuity for regulatory assets and liabilities. However, it introduces another set of standards that will require understanding by the utilities, rate-regulators and intervenors in addition to understanding the requirements of IFRS. To arrive at rates decisions from two different starting points (IFRS based financial statements for most and US-GAAP for some larger utilities) will increase the regulatory workload. One objective in adopting IFRS was to streamline standards. Adding US-GAAP does not accomplish this. In addition, the Board had other objectives that it wished to pursue in affirming the adoption of IFRS, in particular in creating greater uniformity in accounting treatment for the costing of self-constructed assets among Ontario utilities.

Board staff acknowledges that, at the present time, US-GAAP may provide a more realistic representation of the economic reality of an enterprise subject to rate-regulation than occurs under IFRS. Under IFRS regulatory assets and liabilities are not recognized in the body of the published financial statements. Yet these accounts are required by the regulator and are used as instruments in establishing the rates that are charged to consumers. Under IFRS, there are two views of economic reality of a rate-regulated enterprise – the IFRS view in published financial statements and the rate-regulator's view incorporating regulatory assets and liabilities. The existence of two views may lead to confusion in the financial community and among stakeholders as they try to interpret the significance of the differences. Under US-GAAP (as was the case under the previous Canadian GAAP) the regulator's view of financial information was the same as reflected in published financial statements.

While it may seem attractive to those that are eligible to obtain the necessary US and Canadian approvals to adopt US-GAAP Board staff recommends caution in doing so for the following reasons:

While US-GAAP is very parallel to Canadian GAAP, particularly in its recognition of the impact of decisions of regulators, it is intensely rules based. If a utility wishes to apply any provisions of US-GAAP, or is required to adopt ongoing changes emerging in US-GAAP, knowledge of the rules is required.

It may be that securities regulators in the US and Canada that have favourably considered ad hoc applications by Canadian entities in the past, may not be as comfortable in granting approval if a significant number of applicants emerge across the gas and electricity sectors where the primary substantive motivation is to avoid adoption of IFRS. It is important that any utility considering US-GAAP evaluate all the substantive business reasons for doing so (e.g., significant US operations elsewhere in their business, real intent to raise capital in US or global markets) and not make application that is more form than substance.

Governments are significant owners of rate-regulated enterprises in many jurisdictions in Canada.   Governments are concerned about more accurate representation of underlying economic reality, but as at the date of writing, government owners have not declared a common position.

Canadian accounting standards setters may yet have something to say about this situation as adoption of IFRS is technically still in the future for most enterprises (January 1, 2012).

In summary there is considerable uncertainty at this time about the appropriateness of US-GAAP and about the final selection of standards that will be applicable to rate-regulated enterprises in Canada. Thus, Board staff recommends that the Board not prohibit US-GAAP but not encourage it and urge entities to exercise caution in choosing it while ensuring they have sound business reasons for doing so. At the end of the day it is in the interest of electricity and gas consumers, the utilities, their regulators and stakeholders to work within one set of accounting standards and staff encourages solutions which minimize departure from a common framework.

12. 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 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.

Staff recommends that:

- **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**
- **A reconciliation between CGAAP and modified IFRS for all accounts be performed and filed with the RRR annual performance filing for the first year in which modified IFRS is used for regulatory accounting.**

Staff recommends that the Board require assurance for the reconciliation provided by an external auditor to the "review level of assurance" specified in the CICA Handbook.

Staff Note: There may be no differences between Group 1 deferral and variance accounts under CGAAP and modified IFRS (or immaterial differences) such that this reconciliation is not required.

References:

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

Alternatives:

Other potential recommendations

13. Should the Board in some forum consider how to deal with irreconcilable disparities between the actual value of rate base and net book value of PP&E in audited financial statements?

From Colin Fraser:

At its February 9, 2011 meeting, the working group determined that potential recommendation #13, included in Staff's January 20, 2011 "straw man" proposal, will not be a specific issue requiring resolution. Potential recommendation #13 dealt with the possibility of IFRS conversion creating irreconcilable differences between rate base and the audited net book value of PP&E. However, it was agreed that it would still be useful to indicate to stakeholders some examples of the causes of such differences and to sensitize them as to why a utility could have difficulty in reconciling its IFRS net book value to its MIFRS rate base. This issue is important because one of the main objectives of the EB-2008-0408 report seems to have been to minimize differences between the financial accounting and regulatory carrying values of PP&E. Some factors that can drive differences between MIFRS rate base and IFRS net book value are generic and some are utility-specific.

The issue of a financial accounting/regulatory timing difference in the adoption of a depreciation change provides an example of a generic issue that could impact any utility. For external reporting purposes, the requirement to immediately change depreciation rates or depreciation method when evidence requires it could arise within either an IRM or CoS period. Such a change could be required in response to a specific business event or as a result of an annual recurring review of the adequacy of depreciation rates and methods. Such an annual review is required by the applicable IFRS accounting standards. Prior to IFRS, Canadian regulatory accounting allowed depreciation changes for external reporting purposes to be scheduled to coincide with the timing of the change in rates. For regulatory purposes, depreciation rates have historically only been changed in line with rate decisions. Under IFRS, changes are made immediately when the new life or method is known. As a result, there is a potential for timing differences in the application of depreciation rates to the same items of PP&E, resulting in differences between net book values in use for external reporting and for regulatory purposes. This would appear to be a generic industry issue for both gas and electric utilities.

An example of a utility-specific issue that would trigger a net book value versus rate base difference would be use of a different interest capitalization rate by the Board versus the IFRS interest rate used by the utility financial accounting purposes. Such a rate difference would result in a different costing basis for individual asset components placed in service as part of a specific project. Another example of an entity-specific costing difference would be the example of a utility that accounts for its pension costs on a cash basis for regulatory purposes but on an accrual basis for external financial reporting. The original installed capital costs of individual components of PP&E (i.e. poles, conductor, transformers etc.) would vary for IFRS and MIFRS purposes due to the inclusion of different pension cost amounts (accrual vs. cash) in the respective asset values. In certain circumstances, as discussed above, these differently costed components could also be subject to different depreciation. The potential for difficulties in reconciling the total rate base with total net book value are apparent.

Utilities with more finely componentized asset sub-ledgers will have more complex and more numerous differences to track and will therefore have more difficulty in arriving at a top-side reconciliation. As time passes, additional depreciation differences could occur and asset components will be retired and replaced. As a result, over time the difficulties in successfully reconciling rate base to net book value will increase. The only realistic possibility to avoid a top-down reconciliation difficulty would be to retain parallel fixed asset sub-ledgers on different bases of accounting. This approach would generally only be available to the larger utilities and it is generally accepted to be too costly in terms of money and labour to justify.

The Working Group can consider whether the solutions proposed at issue #4 may have adequately addressed the concerns identified in issue #13.

References:

- Board Report page 19

14. 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?

Board staff recommends that the Board consider the adjustments proposed relating to the adoption of modified IFRS for regulatory filings and the implications of those adjustments when it reviews the incentive regulation methodology for electricity distributors, or considers incentive regulation plans presented by other utilities.

Board staff is concerned that electricity distributors may have to carry the cost impacts of the transition to MIFRS over a four year period under IRM, and this may strain their resources. Staff recommends the Board consider an adjustment mechanism such as on off-ramp or adjustment module (possibly with a trigger) that would allow electricity distributors to obtain some relief if MIFRS transition impacts are severe.

15. Included in issue 4? Confirm.
Original wording: Should the Board grant a generic deferral account for utilities that will rebase under CGAAP in 2012 to capture any impacts to revenue requirement resulting from the implementation of (modified) IFRS in 2012?