Ontario Energy Board

DRAFT

Staff Recommendations to the Board

Transition to IFRS – Implementation in an IRM Environment

EB-2008-0408 (Continued)
March 14, 2011

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Introduction

This Board staff paper sets out staff recommendations on the issues arising from the transition to International Financial Reporting Standards ("IFRS"), particularly for utilities in an IRM environment. Staff proposes that the Board consider issuing policy guidance on the issues, following the receipt of stakeholder comments.

Background

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

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

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

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

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

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

Participants in the IFRS IRM Working Group:

1. Brantford Power
2. Canadian Manufacturers & Exporters

3. Cornerstone Hydro Electric Concepts Association Inc.

4. The Electricity Distributors Association

5. Enbridge Gas Distribution Inc.

6 Enersource Hydro Mississauga Inc.

7. Hydro One Networks Inc.

8. Ontario Power Generation Inc.

9. PowerStream Inc.

10. School Energy Coalition

11. Union Gas Limited

12. Veridian Connections Inc.

13. Vulnerable Energy Consumers Coalition

14. Waterloo North Hydro Inc.

Scope

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

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

External Uncertainties

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

The table below sets out the most significant sources of uncertainty.

Uncertainty	Resolution/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.	Granted by IASB
Whether Canadian Public Sector Accounting Board will require municipal and provincial government-owned distributors to adopt IFRS	Municipal and provincial government-owned distributors are required to adopt IFRS**.**
Recognition in the body of published financial statements of regulatory assets and liabilities, e.g., deferral and variance accounts. The IASB had circulated a draft standard recommending recognition.	International and Canadian accounting standards setters abandoned this initiative and left the issue to accounting practitioners and their clients to work out potentially leading to inconsistent results. Note: Initiatives underway to develop common position among accounting practitioners in Canada on regulatory assets and liabilities.
Emergence of USGAAP as a viable alternative for some utilities (reporting issuers seeking a listing on a US exchange). Some utilities have approached Canadian regulators for blanket approval to use USGAAP without listing on US exchange.	Extent and viability of this option still evolving.

Recommended Next Steps

1. Board staff recommends that the Board circulate this staff paper to stakeholders for a period of comment.

2. After considering comments received, Board staff recommends that the Board consider issuing a Report stating its policy on the issues.

Board Staff Recommendations on Issues

Issues Arising on Transition to IFRS

Issue 1

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

Staff Proposal

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

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

Note: If use of USGAAP or another accounting system 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 any other accounting standard accepted by the Board for regulatory purposes, unless otherwise indicated.

Rationale

Advantage of USGAAP: continuity for regulatory assets and liabilities:

Board staff acknowledges that, at the present time, USGAAP may provide a more realistic representation for financial reporting purposes 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. This can lead to potential increased earning volatility. 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 USGAAP (as was the case under the previous Canadian GAAP) the regulator's view of financial information was more aligned to those in published financial statements.

Board staff notes that there remains some uncertainty about a possible solution for the lack of recognition under IFRS of regulatory assets and liabilities. 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 rate-regulated enterprises (January 1, 2012).

<u>Disadvantages of USGAAP: complexity and lack of consistency among regulated utilities in Ontario</u>

The use of USGAAP by some regulated utilities would introduce a second set of standards that will require understanding by utilities, rate-regulators and intervenors. In addition, the burden on utilities that use USGAAP may be high, as USGAAP is intensely rules based. If a utility wishes to apply any provisions of USGAAP, or is required to adopt ongoing changes emerging in USGAAP, expert knowledge of the rules is required.

One benefit to adopting IFRS was an increase in consistency of utility accounting and business practices. The use of USGAAP by some utilities may compromise consistency among utilities. 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 minimize departure from a common framework.

References:

- Board Report page 5

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

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.

In the Board Report, the Board determined not to require filing under IFRS for utilities that were not otherwise required to adopt IFRS for financial reporting purposes. At that time, the question of whether several large utilities could adopt USGAAP as an alternative to IFRS had not been considered.

Issue 2

> ***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?***

Staff Proposal

Note: The Board may already have dealt with this issue by way of letter to distributors.

Board staff recommends that the Board update paragraph 9.1.2 of the November 8, 2010 Amendment to encourage electricity distributors that are rebasing for test year 2012 to do so using modified IFRS ("MIFRS"). 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.

> **9.1.2 Electricity distributors filing cost of service applications for rates for 2012 should make all reasonable efforts to 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. A distributor for whom the filing of the forecasts for the 2012 test year in modified IFRS is an unreasonable burden and that files under CGAAP must include in its rate application an explanation of the reason for filing under CGAAP and a plan for the transition to modified IFRS accounting as a basis for setting its rates.**

Rationale

As all utilities must transition to IFRS in 2012 for financial reporting, Board staff considers it preferable to have all utilities that are rebasing in 2012 to do so using MIFRS wherever possible. The filing of a cost of service application using the same accounting system as is required to be used in a distributor's financial statements is expected to minimize future complexities.

The Board Report of July 2009 as amended in November 2010, previously required those rebasing for 2012 rates to do so using CGAAP and provided them with the option to use MIFRS. However, if those utilities rebase using CGAAP, it could be a further period of 4 years before they rebase under MIFRS. Working Group participants noted that this long a period of time will present significant challenges. There will be increasing difficulty in maintaining accounting information in two regimes (MIFRS and CGAAP) as each year goes by. In addition, there are potential financial risks associated with using an out of date accounting reference (CGAAP).

At the same time, Board staff and Working Group participants recognize that some utilities that are rebasing for 2012 may currently be well advanced in preparing their applications based on CGAAP, especially any which are proposing to align their rate year with the calendar year in January 2012. For those where preparing an MIFRS-based application may impose an unreasonable burden, Board staff recommends that the Board make provision for a filing under CGAAP, where the utility provides a suitable explanation.

Before seeking to rebase under CGAAP, utilities should assess the burden of maintaining records in both accounting systems, and the need to maintain additional records in both accounting systems for the length of the IRM period before their next cost of service application.

Working Group participants encouraged staff to find a way to make public any decision on this matter at the earliest opportunity.

For those utilities that rebase under CGAAP in 2012, the same policy guidance would apply with respect to the remaining issues 3 to 9 as for those that are on IRM for 2012.

References:

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

Alternative

Status quo – rates set on CGAAP for 2012, with MIFRS as an option.

Issue 3

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

Staff Proposal

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

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

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

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

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[1] Example of where distributor has adopted IFRS for financial reporting, but has not yet made an annual RRR filing under modified IFRS: Distributor rebased in 2010 under CGAAP. In 2012 the distributor adopts IFRS for financial reporting. First modified IFRS RRR filing is due in 2013. However, in fall 2012, the distributor seeks an adjustment under the ICM. Financial information supporting the ICM application must be provided in both CGAAP and modified IFRS, with a reconciliation between the two.

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

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

<u>Rationale</u>

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

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

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

References:

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

<u>Alternative</u>

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

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

Issue 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?

Staff Proposal

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

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

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

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

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

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

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 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 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.

Rationale

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

Need for PP&E Account

The PP&E deferral account is recommended to avoid the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates. The deferral account also allows for monitoring of the extent of potential impact during the IRM period, and the opportunity to identify any unusual circumstances requiring attention before completion of the IRM period.

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

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

The Working Group considered including a requirement for a materiality threshold for the deferral account. However, if utilities are recording these amounts, particularly if there are multiple sources for the entries, work is not reduced by setting a materiality threshold. However, in determining whether and how any difference is to be recovered in rates, staff notes that the Board may choose to consider matters of materiality.

Need for P&OPEB Account

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

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

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

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

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

While carrying charges are added to many deferral accounts granted by the Board, the Board considers the appropriateness of adding carrying charges when approving accounts on an account by account basis. For instance, certain smart meter deferral accounts do not accrue carrying charges (e.g. stranded meters), while the deferral account approved in 2005 for the recording of changes in OMERS pension contributions did accrue interest.

In the case of the deferral account proposed for PP&E differences on adoption of IFRS, Board staff recommends that carrying charges not be added to the balance accruing in the deferral account for the following reasons:

- The amounts in the deferral account reflect a policy change (adoption of different accounting principles) that has effect <u>for accounting purposes</u> at January 1, 2012, but has no effect for rate-setting purposes until the utility's rates are rebased under MIFRS. In Board staff's view, until that MIFRS rebasing occurs, it is not appropriate to conclude that the utility has over or under collected in rates. Unless a real over or under collection has occurred, it is not appropriate to compensate the utility or the ratepayers by permitting the accrual of carrying charges on the deferral account. The existence of the deferral account is not an acceptance of MIFRS as the basis for setting rates. It is a means of keeping track of the differences during the period of an IRM otherwise based on CGAAP so that the

- The amounts in the deferral account are derived from PP&E accounts that represent assets already in service. Carrying charges accrue on such amounts only during the period when assets are under construction. Carrying charges are not added to the underlying PP&E accounts thereafter. It would be conceptually inconsistent with the underlying source of the difference recorded in the deferral account for this amount to attract carrying charges when the underlying accounts do not.

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

References:

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

Alternatives

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

Rationale for this alternative:

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

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

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

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

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

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

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

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

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

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

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

Issue 5

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

Staff Proposal

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

Issues Arising after Adoption of Modified IFRS

Issue 6

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

Staff Proposal

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

Rationale

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

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

Alternative

The Board grants a generic deferral account.

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

Issue 7

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

Staff Proposal

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

Rationale

Board staff recognizes that the introduction of IFRS leads to increased volatility in earnings as compared to CGAAP. However, staff submits that many utilities will not experience sufficient volatility to warrant maintaining a variance account after the transition to IFRS is complete.

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. Utilities under an IFRS regime should still be able to manage the adoption of changes to service lives to coincide with cost of service proceedings. The impacts on cost patterns of changes in service lives are not generally large for most utilities.

Another issue considered was whether there should be a variance account to capture losses arising on early retirement of in-service assets required for recognition under IFRS and accounted for under CGAAP using group depreciation methods. That account was suggested as a generic account on the basis that utilities have no experience in forecasting the extent of such losses and, as such, rebasing in the short term would be inaccurate. The deferral account proposed in issue 4 captures only the effects of transition to IFRS that relate to PP&E components of rate base. A variance account would likely be a temporary measure that reduces the risk to utilities and ratepayers until the forecasting of the gains or losses improves with experience. However, staff recommends that no such generic account be considered, as many utilities are not expected to encounter material difficulties in forecasting these amounts.

Staff notes that for pension and other post-employment benefits relatively small adjustments in underlying assumptions can cause major swings in cost for utilities with certain types of employee benefit plans. However, such volatility would generally a problem only for larger employers with their own defined benefit pension plans and significant other post-employment benefit plans. In Board staff's view, this type of variability is not sufficiently pervasive across the utility community to justify the Board creating an ongoing generic variance account. In addition, as noted in issue 4, it may be problematic to isolate variability caused by IFRS rules from other sources of variability.

References:

- Board Report pages 20 - 22

Alternative

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

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

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

Issue 8

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

Staff Proposal

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

Staff recommends that:

- **A one-time reconciliation between the 2011 CGAAP audited financial statements figures and the 2011 IFRS audited financial statements comparative figures that were reported as part of the 2012 IFRS audited financial statements must be performed and submitted with the RRR annual performance reporting for 2012.**
- **A one-time mapping and reconciliation between the 2011 uniform system of account balances and the 2011 IFRS audited financial statements comparative figures that were reported as part of the 2012 IFRS audited financial statements must be submitted with the RRR annual performance reporting for 2012.**
- **Where an electricity distributor has not rebased under modified IFRS, a reconciliation be provided each year during an IRM period for Group 1 deferral and variance accounts between amounts recorded under CGAAP and modified IFRS. This reconciliation must be submitted with the RRR annual performance reporting for each year beginning with the year of adoption of IFRS.**

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

Rationale

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

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

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

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

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

References:

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

Alternative

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

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

Issue 9

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

Staff Proposal

Board staff recommends that the Board consider potential adjustments to the IRM methodology related to the transition to IFRS in the upcoming work of the Board.

Rationale

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

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

Alternative

None identified**.**