The Conversion to International Financial Reporting Standards: Ratemaking Impacts

presentation by the

School Energy Coalition

to the

Ontario Energy Board

May 5, 2009

Overriding Principle

Ontario Energy Board has the sole responsibility and mandate to establish "costs" recoverable from ratepayers

Historical Background

- *Financial accounting has different goals from regulatory accounting*
- *Over time:*
  - *Canadian GAAP developed methods to recognize the effects of regulation on the financial statements of regulated entities*
  - *"Industry practice" was used as an indirect way of dealing with regulation when the CICA Handbook was silent or contained flexibility (more recently, FAS 71 being used)*
  - *The OEB and regulated entities developed methods of converting financial statement information into regulatory information*
  - *"Regulatory accounting" became, in reality, financial accounting with adjustments*
- *IFRS "presses the reset button"*
  - *Has not yet evolved a set of accommodations for the impacts of regulation on financial statements*
  - *Although some rules are currently under consideration, there is resistance*
  - *The IASB is not concerned with effective regulation, only effective financial disclosure*

Practical Implications

- *Financial accounting rules will in some respects no longer provide a reliable foundation on which to base revenue requirement and therefore just and reasonable rates*

- *Current shortcuts and other techniques to convert financial information to regulatory information may not work any more*

- *Regulatory accounting does not currently have internal rules for all situations (90%+ based on CGAAP)*

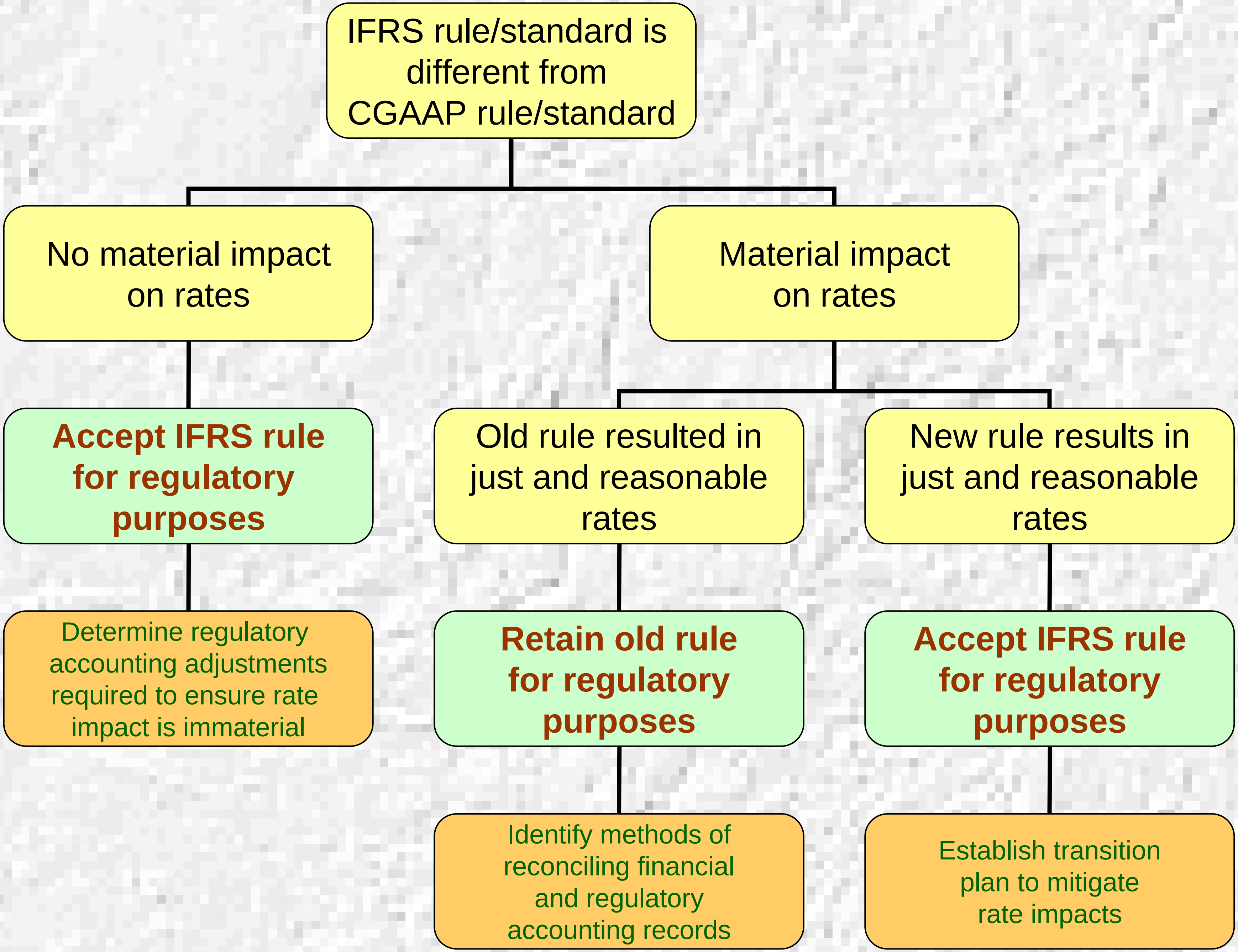
- *There is no external set of rules, other than IFRS, available to form the basis of regulatory accounting*

Board's Response

1. *For every change from CGAAP to IFRS, the Board has a statutory obligation to assess whether the change should be accepted for ratemaking purposes*

2. *Each change must be assessed individually and the sole test is just and reasonable rates*

3. *A rigorous and repeatable methodology will ensure more thorough and consistent analysis, and more justifiable results.*


IFRS rule/standard is different from CGAAP rule/standard
No material impact on rates
Material impact on rates
Accept IFRS rule for regulatory purposes
Old rule resulted in just and reasonable rates
New rule results in just and reasonable rates
Determine regulatory accounting adjustments required to ensure rate impact is immaterial
Retain old rule for regulatory purposes
Accept IFRS rule for regulatory purposes
Identify methods of reconciling financial and regulatory accounting records
Establish transition plan to mitigate rate impacts

Step 1:
Identify the Change

- ***OEB only concerned when current regulatory accounting and IFRS are different***
- ***If regulatory accounting and CGAAP are different, and IFRS continues the same difference, existing methods can be retained to deal with it (e.g. PILs)***
- ***If IFRS is different from CGAAP***
  - ***If CGAAP = regulatory, new difference created***
  - ***If existing difference***
    - ***IFRS closer to regulatory accounting (unlikely)***
    - ***IFRS increases the difference***

INFORMATION REQUIRED: Clear understanding of both old and new rules, and regulatory treatment of old rule

Step 2:
Determine Potential Rate Impact

- *If there is no rate impact at all, OEB's jurisdiction is not engaged, and utilities should be free to use IFRS for regulatory purposes*
- *If the rate impact is small (i.e. de minimis), administrative cost of maintaining difference between regulatory and financial accounting rules will outweigh the impact on ratepayers*
- *Keeping rate impact immaterial may require an adjustment to regulatory accounting*

INFORMATION REQUIRED: Detailed rate impact analysis

- *All reasonable scenarios*
- *Different types of utilities and situations*
- *Present and future impacts*

Step 3:
Just and Reasonable Rates

- *Only three possible situations:*
  - *CGAAP resulted in just and reasonable rates*
  - *IFRS would result in just and reasonable rates*
  - *Neither produces proper regulatory result*

- *Change in the right direction vs. change in the wrong direction*

INFORMATION REQUIRED: Standard rate analysis

-Detailed rate impacts (already done), including timing issues and intergenerational impacts

- Application of judgment and experience of Board

Step 4:
No Change: Mitigation

- *If existing regulatory rule is retained, and it is different from IFRS, OEB should consider acting to mitigate impacts on utilities:*
  - *Administrative costs and resources*
  - *Financial reporting (e.g. access to capital impacts)*

- *Regulatory toolkit includes:*
  - *Regulatory assets and liabilities*
  - *Immediate or deferred recovery of all or part of incremental costs*
  - *Joint action by utilities to develop appropriate systems and practices*
  - *Development of specialized financial reporting fixes within IFRS*

INFORMATION REQUIRED: Utility impact data

- Cost data from utilities already working on these issues

- Expert analysis relating to financial disclosure options

- Specialized information on financial markets impacts

Step 5:
Change to IFRS: Mitigation

- ***If IFRS produces better (i.e. more "just and reasonable") rates:***
  - ***OEB <u>must</u> adopt the IFRS rule in place of the existing CGAAP rule***
  - ***Should consider transition and/or mitigation of rate impacts***
  - ***Rate impacts more likely to be increases, but could be decreases in some cases***

- ***Tools include:***
  - ***Regulatory assets and liabilities***
  - ***Phase-in techniques***

INFORMATION REQUIRED: Impact data

- Rate impacts by rate class and customer category

- Timing information

The “Default” Question

- ***Routes to get to just and reasonable rates:***
  - ***Assume IFRS as default***
    - ***Justify anything different from IFRS***
    - ***Cedes primary responsibility for regulatory accounting to IASB***
    - ***“Tie goes to the runner” risk***
  - ***Assume status quo as default***
    - ***IFRS = CGAAP in many cases***
    - ***when IFRS an CGAAP are different***
      - ***many impacts will be immaterial***
      - ***many impacts will be manageable***
      - ***in some cases, IFRS will produce rates that are <u>more</u> just and reasonable***
    - ***in only a few cases will regulatory accounting be different from IFRS***
- ***Difference: the structure and rigour of the review***

Application to Issues

IFRS Change	Step 2: Rate Impact	Step 3: Just and reasonable rates	Step 4: Utility impact mitigation	Step 5: Rate impact mitigation
3.1 NBV vs. fair value	*Assumed to be material*	*Ratemaking principles require recovery of actual expenditures from ratepayers* ***Old Rule Correct***	***Insufficient information*** *Likely small impact*	*N/A*
3.2 Historical acquisition cost vs. fair value	*Assumed to be material*	*Ratemaking principles require recovery of actual expenditures from ratepayers* ***Old Rule Correct***	***Insufficient information*** *Likely small impact*	*N/A*
3.3 IFRS capitalization restrictions	***Insufficient information*** *New Staff research is a step in the right direction*	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***
3.4 AFUDC vs. actual borrowing costs	***Insufficient information***	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***

Application to Issues (cont.)

IFRS Change	Step 2: Rate Impact	Step 3: Just and reasonable rates	Step 4: Utility impact mitigation	Step 5: Rate impact mitigation
3.4 Customer Contributions	*Not material* *Board Staff proposed treatment results in rate neutrality*	*N/A*	*N/A*	*N/A*
3.4 Asset reclassifications	*Not material* *Board Staff proposed treatment results in rate neutrality* ***Are there scenarios in which the Board Staff proposal will not be neutral?***	*N/A*	*N/A*	*N/A*
3.4 Asset retirement obligations	***Insufficient information*** *Likely material*	***Cannot determine until information available*** *Likely utility specific*	***Cannot determine until information available***	***Cannot determine until information available***
3.4 Gains and Losses	***Insufficient information***	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***

Application to Issues (cont.)

IFRS Change	Step 2: Rate Impact	Step 3: Just and reasonable rates	Step 4: Utility impact mitigation	Step 5: Rate impact mitigation
3.4 Asset impairment	***Insufficient information*** *Likely material*	*Appropriate rule may be different for different categories of assets*	***Cannot determine until information available***	***Cannot determine until information available***
4.1 Depreciation method	***Insufficient information***	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***
4.2 Electricity distribution depreciation rates	***Insufficient information*** *Industry-wide study is the appropriate step*	***Cannot determine until information available*** *Assumption that IFRS will be applied is premature*	***Cannot determine until information available***	***Cannot determine until information available***
4.2 Gas utility depreciation rates	***Insufficient information*** *New utility studies should identify IFRS-driven changes*	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***

Application to Issues (cont.)

IFRS Change	Step 2: Rate Impact	Step 3: Just and reasonable rates	Step 4: Utility impact mitigation	Step 5: Rate impact mitigation
5.1 Inventory Valuation – Gas inventory	*Not material* *Board Staff proposed treatment results in rate neutrality*	*N/A*	*N/A*	*N/A*
5.1 Inventory Valuation – Other Assets	***Insufficient information*** *Likely not material (?)*	***Cannot determine until information available***	***Cannot determine until information available***	***Cannot determine until information available***
5.1 PILs	*Not material (?)* *Board Staff proposed treatment results in rate neutrality*	*N/A*	*N/A*	*N/A*
5.1 Pension and employee future benefits	***Insufficient information*** *Likely material if corridor method disallowed*	***Cannot determine until information available*** *Potentially high volatility could mean IFRS not acceptable for rates*	***Cannot determine until information available***	***Cannot determine until information available***

Further Board Action Recommended

- *Establish a process to gather the missing information necessary to make informed decisions, e.g.*
  - *Many utilities already have extensive impact analyses*
  - *2010 filings at least will have more detailed information*
  - *Data mining of existing Board financial and regulatory data*
  - *Other regulators are gathering information and analysis*
  - *Urgency overstated*
    - *standards changing for 2 ½ years before first IFRS financial statements*
    - *systems being put in place today will have to be flexible in any case*

- *Establish a generic review process for accounting changes as identified*
  - *Separate from individual rate applications*
  - *Application of systematic methodology*

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