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BANK OF CANADA | CELEBRATING 75 YEARS
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# Business Outlook Survey

Conducted by the Bank's Regional Offices

Results of the Autumn 2010 Survey — Vol. 7.3 8 October 2010

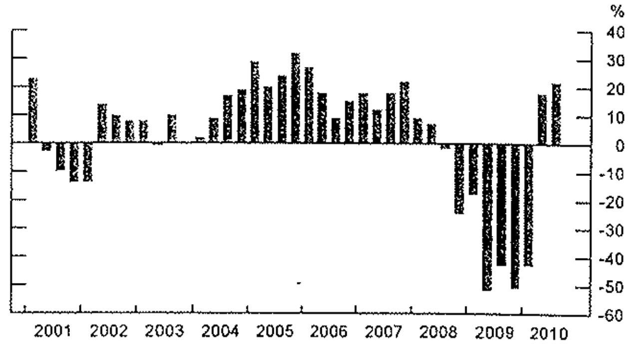
## Overview

- Responses to the autumn survey suggest that the economic recovery is progressing. Firms remain positive about the outlook over the next 12 months, but they generally expect growth to be modest, owing in part to a weaker outlook for the U.S. economy.
- Supported by the recovery to date and recognizing the challenges that lie ahead, firms are increasingly focusing on ways to enhance productivity and create new growth opportunities. The balance of opinion on investment reached a new high, while employment intentions have eased but remain positive.
- Indicators of pressures on production capacity are above the levels recorded during the recession, although they remain below average for the survey. While the balance of opinion on output prices remains elevated, many firms cite plans to keep prices stable or to raise them slightly, following a period during which prices were falling or frozen. Inflation expectations have eased but remain well anchored.
- On balance, firms reported that credit conditions eased over the past three months.

## Business Activity

On balance, firms reported an increase in sales growth over the past 12 months **(Chart 1)** and continue to expect an improvement over the next 12 months **(Chart 2)**. Those expecting a pickup in sales growth are concentrated in the

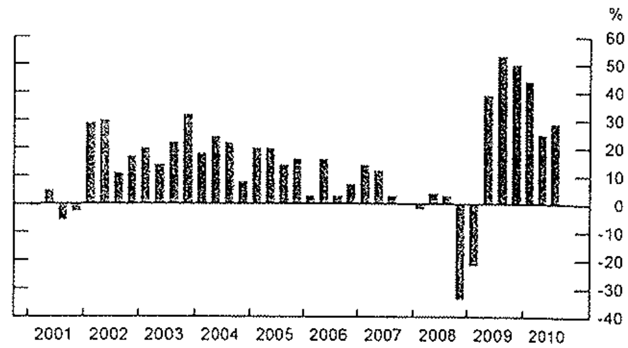
**Chart 1: Firms report a pickup in sales growth over the past year . . .**
Balance of opinion*
Over the past 12 months, did your firm's sales volume increase at a greater, lesser, or the same rate as over the previous 12 months?




Greater: 55% Same: 13% Lesser: 33%

* Percentage of firms reporting faster growth minus percentage reporting slower growth

**Chart 2: . . . and they expect sales volumes to rise at a greater rate over the next 12 months**
Balance of opinion*
Over the next 12 months, is your firm's sales volume expected to increase at a greater, lesser, or the same rate as over the past 12 months?




Greater: 55% Same: 20% Lesser: 26%

* Percentage of firms expecting faster growth minus percentage expecting slower growth

*The Business Outlook Survey summarizes interviews conducted by the Bank's regional offices with the senior management of about 100 firms selected in accordance with the composition of Canada's gross domestic product. The survey's purpose is to gather the perspectives of these businesses on topics of interest to the Bank of Canada (such as demand and capacity pressures) and their forward-looking views on economic activity. Additional information on the survey and its content is available on the Bank of Canada's website at <www.bankofcanada.ca/en/bos/index.html>. The autumn 2010 survey was conducted from 16 August to 16 September 2010. The balance of opinion can vary between +100 and -100. Percentages may not add to 100 because of rounding.*

*The opinions expressed are those of the respondents and do not necessarily reflect the views or policies of the Bank of Canada. The method of sample selection ensures a good cross-section of opinion. Nevertheless, the statistical reliability of the survey is limited, given the small sample size.*

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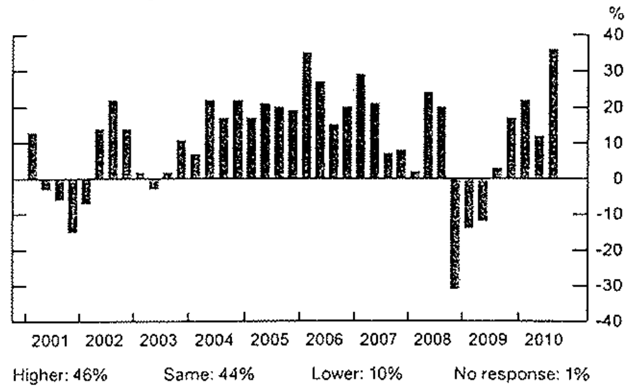
goods sector, and are mainly firms that still await a recovery in sales or that experienced only a modest improvement over the past 12 months. Global uncertainties remain, although concerns have shifted from Europe back to the U.S. economy. A weaker outlook for U.S. economic growth is dampening sales expectations in a number of cases and reinforcing the general view that growth is likely to be moderate. With this context in mind, firms are taking measures to reposition themselves for growth.

The balance of opinion on investment in machinery and equipment rose to a new high in the autumn survey **(Chart 3)**, pointing to an increase in investment over the next 12 months. The increase in this indicator is widespread across all regions and sectors. Following a period of restraint in investment expenditures, many firms reported plans to resume more normal levels of spending, with an increasing focus on enhancing productivity or expanding into new and more profitable business lines.

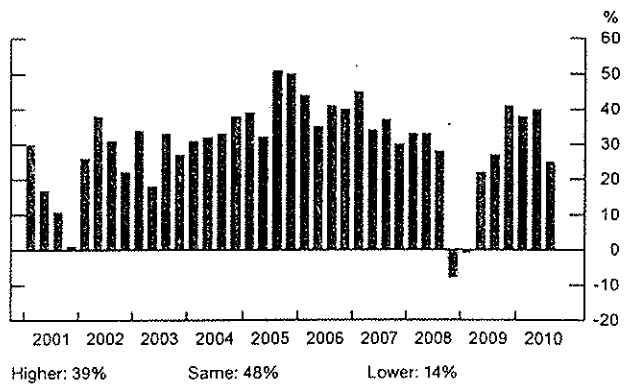
The balance of opinion on employment declined but remains positive, indicating that firms intend to increase employment over the next 12 months **(Chart 4)**. The balance is positive across sectors and regions, supported in part by plans for expansion. However, the balance of opinion has declined from the levels seen earlier in the recovery. Some firms had recently increased employment to a level sufficient to meet expected demand, while others were focusing on achieving productivity gains from new equipment or new processes.

**Chart 3: Firms expect to increase investment in machinery and equipment**
Balance of opinion*
Over the next 12 months, is your firm's investment spending on M&E expected to be higher, lower, or the same as over the past 12 months?




* Percentage of firms expecting greater investment minus the percentage expecting less investment

**Chart 4: Firms expect to increase employment**
Balance of opinion*
Over the next 12 months, is your firm's level of employment expected to be higher, lower, or the same as over the past 12 months?




* Percentage of firms expecting higher levels of employment minus the percentage expecting lower levels

## Pressures on Production Capacity

Responses to the question regarding the ability to meet demand suggest little change in capacity pressures from the summer survey. While the overall number of firms reporting that they would have difficulty meeting an unexpected increase in demand edged down slightly, the number reporting significant difficulty has risen **(Chart 5)**. Reports of capacity constraints are somewhat higher among firms in the goods-producing sector.

**Chart 5: Capacity pressures are little changed . . .**
How would you rate the current ability of your firm to meet an unexpected increase in demand?

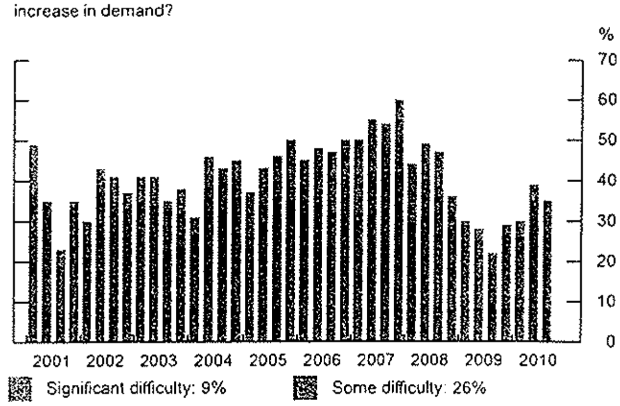
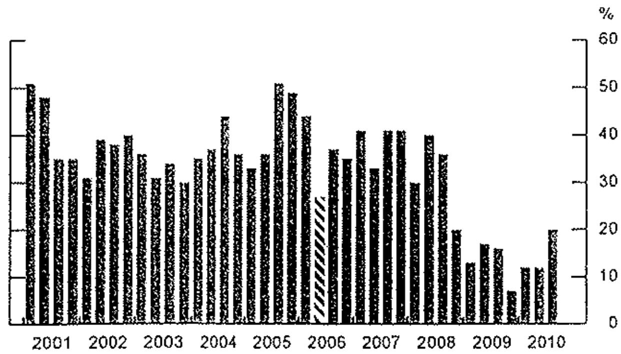


**Chart 6: . . . and reports of labour shortages have moved up but remain relatively low**
Does your firm face any shortages of labour that restrict your ability to meet demand?




Yes: 20%

The summer 2006 results are not strictly comparable with those of the other surveys, owing to a difference in the interview process for that survey.

The number of firms reporting that labour shortages are restricting their ability to meet demand moved up in the autumn survey **(Chart 6)**. Firms reporting labour shortages often cited a lack of workers with highly specialized knowledge or regional pockets where labour is in short supply.

Overall, both indicators of pressures on production capacity have risen above the levels recorded during the recession but remain below their average levels for the survey, notably in the case of labour shortages.

**Chart 7: Firms expect input prices to increase at a greater rate . . .**
Balance of opinion*
Over the next 12 months, are prices of products/services purchased expected to increase at a greater, lesser, or the same rate as over the past 12 months?

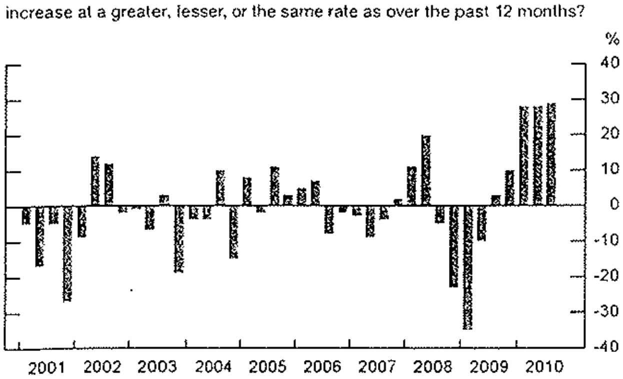

Greater: 43% Same: 34% Lesser: 23% No response: 1%

* Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

## Prices and Inflation

On balance, businesses expect input prices to rise by more than they did over the past 12 months **(Chart 7)**. The balance of opinion has eased from its level in the previous two surveys, however, as some firms that have seen a pickup in input costs now expect price increases to slow over the next 12 months.

**Chart 8: . . . and output prices to increase at a greater rate as well**
Balance of opinion*
Over the next 12 months, are prices of products/services sold expected to increase at a greater, lesser, or the same rate as over the past 12 months?




Greater: 45% Same: 39% Lesser: 16% No response: 1%

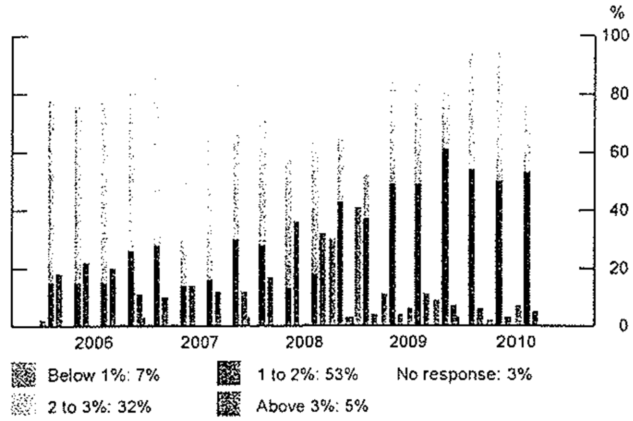
* Percentage of firms expecting greater price increases minus the percentage expecting lesser price increases

The balance of opinion on output prices is unchanged at a high level **(Chart 8)**, indicating that firms expect output prices to rise at a greater rate over the next 12 months. The balance of opinion continues to reflect, in part, intentions to keep prices stable or to raise them slightly over the next 12 months, following a period of falling or frozen prices. Although some firms cited plans to pass through higher input costs, several mentioned that competitive pressures and modest demand are expected to limit the magnitude of any price increases.

Expectations regarding total CPI inflation over the next two years have eased, although the large majority of firms continue to expect inflation to be within the Bank's inflation-control range of 1 to 3 per cent **(Chart 9)**.

**Chart 9: Inflation expectations remain anchored within the Bank's inflation-control range**

Over the next two years, what do you expect the annual rate of inflation to be, based on the consumer price index?



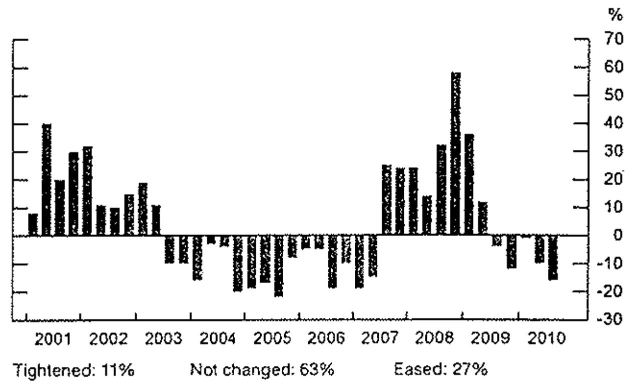

## Credit Conditions

The balance of opinion on credit conditions is negative **(Chart 10)**, suggesting that credit conditions eased over the past three months. While still driven by large firms and those with access to domestic capital markets, the results indicate that improvements in credit conditions are starting to become more broadly based. Nevertheless, small businesses continued to report little change in their access to credit.

**Chart 10: Credit conditions eased over the past three months**

Balance of opinion*

Over the past three months, how have the terms and conditions for obtaining financing changed (compared with the previous three months)?




* Percentage of firms reporting tightened minus percentage reporting eased. For this question, the balance of opinion excludes firms that responded "not applicable."

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MICHAEL MILLAR

THE GLOBE AND MAIL

October 21, 2010

# Pension funds rally in third quarter

By JANET McFARLAND
Globe and Mail Update

*Pull year-to-date returns to 'a respectable' 5.7 per cent, survey finds*

Canadian pension funds rallied in the third quarter this year, making up for losses in the second quarter and pulling year-to-date returns to "a respectable" 5.7 per cent, a new survey has found.

An RBC Dexia Investor Services survey of Canadian pension funds shows a global market rally in September lifted pension fund returns by 7.3 per cent in the third quarter. Canadian stocks were the best-performing asset class, increasing 10.2 per cent in the quarter and 6.7 per cent in the year to date.

"It's been a bumpy ride, but this quarter's gains make up for the last quarter's pull back and bring year-to-date totals to a respectable 5.7 per cent," said Don McDougall, director of advisory services at RBC Dexia.

The gains so far in 2010 come on the heels of a strong increase in pension returns in 2009, when plans posted average returns of 16.2 per cent and made back most of their sharp declines from 2008. Pension funds lost 15.9 per cent in 2008.

RBC Dexia calls its pension survey the most comprehensive in Canada, measuring returns for pension funds with a total of $340-billion of assets under management.

The latest survey found all major asset investment categories posted gains in the third quarter. Foreign stocks rebounded 9.9 per cent in the quarter and Canadian bonds were up 3.4 per cent.

Currency fluctuations did not have a major impact on returns. While currencies have been volatile, RBC Dexia said they have "tended to cancel themselves out" over the third quarter and over the year-to-date, with U.S. dollar weakness offset by the strength of most other major currencies against the loonie.

# OPG

## Selection of Discount Rates for Pensions and OPEBs

## Excerpts from CICA Handbook Section 3461

**Measurement date of plan assets and accrued benefit obligation**

.057 ♦ *The plan assets and the accrued benefit obligation shall be measured as of the date of the annual financial statements, except that they may be measured as of a date not more than three months prior to that date provided the entity adopts this practice consistently from year to year.*

**Measurement of cost for employee future benefits**

.058 ♦ *The measurement of cost in both interim and annual financial statements shall be based on the assumptions used in measuring the plan assets and the accrued benefit obligation at the preceding year end, unless a more recent measurement of both the plan assets and the accrued benefit obligation is available. When available, more recent information shall be used.*

.059 A remeasurement is usually called for when a significant event such as a plan amendment, settlement or curtailment occurs. The assumptions adopted for a remeasurement are used in determining the cost for employee future benefits from the date of the significant event to the year-end measurement date. The measurement of the cost for the period from the beginning of the year to the date of the significant event is based on the assumptions at the beginning of the year.

**Actuarial assumptions**

.060 ♦ *Each actuarial assumption shall be management's best estimate solely with respect to that individual assumption, determined on the basis that the plan will continue to be in effect in the absence of evidence to the contrary. The set of actuarial assumptions for each plan shall be internally consistent.*

.061 Actuarial assumptions include:

(a) demographic assumptions about the future characteristics of employees and their beneficiaries who are eligible for benefits, including:

- (i) mortality, both during and after employment;
- (ii) rates of employee turnover, disability and early retirement;
- (iii) the proportion of employees with their beneficiaries eligible for benefits; and
- (iv) per capita claims cost by age and by type of benefit;

and

(b) financial assumptions, including:

- (i) the **discount rate** for future cash flows;
- (ii) future salary and benefit levels;
- (iii) future medical costs, in the case of medical benefits; and
- (iv) the **rate** of return on plan assets.

.062 In making actuarial assumptions, management takes into account the relationships between the factors for which assumptions are required, and keeps the assumptions internally consistent. For example, the level of inflation underlying the assumption about future rates of return on plan assets is the same as the level of inflation underlying the assumption about future salary levels. All assumptions are based on the presumption that the plan will continue in effect in the absence of evidence that it will not continue.

The actuarial assumptions used for funding purposes may differ from those used for accounting purposes using the deferral and amortization approach because funding is a financing procedure that considers cash requirements and other matters such as pension legislation.

Discount rate

.063 ♦ *The* ***discount rate*** *used to determine the accrued benefit obligation shall be an interest* ***rate*** *determined by reference to:*

(a) *market interest rates at the measurement date on high-quality debt instruments with cash flows that match the timing and amount of expected benefit payments; or*

(b) *the interest* ***rate*** *inherent in the amount at which the accrued benefit obligation could be settled.*

.064 The objective of selecting a **discount rate** is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary pre-tax cash flows to pay the accrued benefits when due. For example, the current market value of a portfolio of high-quality zero coupon bonds acquired to pay the cost of benefits, when due, equals the amount of the actuarial present value of the benefits because cash inflows equal cash outflows in timing and amount. There is no reinvestment risk in the yields to maturity of the portfolio. However, in other than a zero coupon portfolio, such as a portfolio of long-term debt instruments that pay interest semi-annually or have maturities that do not extend far enough into the future to meet expected benefit payments, the **discount rate** (the yield to maturity) needs to incorporate reinvestment rates expected to be available in the future. Those reinvestment rates are extrapolated from the existing yield curve at the measurement date.

.065 When rates on high-quality corporate bonds are available, they are used to determine the **discount rate**. When the maturities of corporate bonds do not extend far enough into the future to match the cash flows inherent in the accrued benefit obligation, the rates on government bonds are used to determine the **discount rate** for the expected benefit payments that are farther into the future than the corporate bond maturities.

.066 The **discount rate** reflects the estimated timing of benefit payments. When some benefits are payable after the maturity of all available corporate or government bonds, the present value of that portion of the benefits is unlikely to vary significantly as a result of the selected **discount rate**. For that portion of the benefits, an entity may use a **discount rate** based on the yield of the last maturing corporate or government bond available.

.067 The **discount rate** is re-evaluated at each measurement date. When long-term interest rates rise or decline, the **discount rate** changes in a similar manner.

.068 Immediate settlement of an accrued benefit obligation may be possible through, for example, the purchase of an **insurance contract**, such as an annuity contract, that transfers the significant risks associated with the accrued benefit obligation to a third-party insurer. In such circumstances, the interest **rate** inherent in the amount at which the accrued benefit obligation could be settled may be used in determining the **discount rate**.

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**Susan Frank**
Vice President and Chief Regulatory Officer
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BY COURIER

May 21, 2010

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
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Dear Ms. Walli:

**EB-2010-0178 – "Depreciation Study for Electricity Distributors – Transition to International Financial Reporting Standards (IFRS)"**

Attached are three (3) paper copies of Hydro One Networks' comments on the Kinectrics Inc. draft Depreciation Study for Electricity Distributors that was issued for comment on April 30, 2010.

I have also attached proof of successful submission of these comments through the Board's Regulatory Electronic Submission System.

Sincerely,

ORIGINAL SIGNED BY SUSAN FRANK

Susan Frank

# HYDRO ONE COMMENTS ON DRAFT REPORT: DEPRECIATION STUDY FOR ELECTRICITY DISTRIBUTORS - TRANSITION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Hydro One Inc. ("Hydro One") is pleased to provide comments on the draft industry depreciation/amortization study performed by Kinectrics Inc. ("Kinectrics") and issued for comment by the Board on April 30, 2010.

Background and General Comment

In its EB-2008-0408 report on the adoption of IFRS, the Board undertook to sponsor a common industry depreciation study to provide some guidance to Distributors that are setting initial IFRS-compliant asset service lives. The study was meant to be used by Distributors that do not use the services of an external depreciation expert to recommend service lives. Provision of this industry guidance was expected to result in more consistency and cost efficiencies as it would avoid the necessity of each Distributor to engage its own external depreciation consultant.

Kinetrics' draft study provides useful information that we expect will provide relevant assistance to those Distributors that do not opt to sponsor their own external depreciation studies. The report's proposed typical useful lives ("TULs") and related minimum and maximum service life ranges will be useful tools, particularly for smaller Distributors with no experience of conducting their own depreciation reviews. The proposed lives are primarily based on a professional engineering assessment of physical service life expectations, as one would expect given the absence of detailed historical retirement data. Distributors should assess local factors to determine any deviations from the TULs. We expect that the actual service lives that emerge from the application of this guidance will represent an improvement over the service life assumptions that are currently mandated by the Distribution Accounting Procedures Handbook.

Application to Hydro One Inc

Hydro One will not apply the Kinectrics recommendations for our property, plant and equipment or intangible assets. The regulated businesses owned and operated by Hydro One Networks Inc. ("Networks") and by Hydro One Remote Communities Inc., have historically sponsored and filed depreciation studies performed by an independent external expert. Hydro One's other regulated distribution business, Hydro One Brampton Networks Inc., has also sponsored an initial depreciation review to develop IFRS-compliant service life assumptions to be used following its January 1, 2011 adoption of IFRS.

Hydro One carries out external depreciation reviews because external review provides for high quality and independent regulatory support for an expense category that is very material to our revenue requirement. The use of an external consultant was initially ordered by the Board in Networks' Distribution and Transmission transitional rate orders for 2000 and 2001.

The fact that depreciation service life recommendations are made by an expert external consultant provides additional assurance to our external auditors and, indirectly, to other financial statement users that the depreciation expense and related asset carrying values included in our external financial reports are appropriate. As we are a public securities filer, it is critical that all management estimates that impact the balance sheet or income statement are credible. External expert review supports the assertion that the service life estimates we apply in arriving at reported depreciation expense appropriately reflect expected asset useful lives. Our service life estimates have historically incorporated physical life assumptions as well as other expected forces of retirement such as: technical, economic, social or environmental obsolescence; the impact of government policy decisions; upgrades for changes in service quality or increased load; storms, catastrophes and accidents; and miscellaneous external factors. In addition, in some cases, asset component service lives applied should be limited by related agreement or contract terms or by the service lives of the facilities in which the components are installed. It is our experience that many of these non-physical external factors have a significant impact on the accounting life of asset components.

Accuracy of service life assumptions becomes even more important under IFRS as group depreciation can no longer be applied. Actual depreciation methods and service lives will now have a direct impact on asset component net book values. Under IFRS, a gain or loss will be reported in the income statement whenever a depreciable component with remaining net book value is derecognized from the balance sheet. Once IFRS is adopted, asset service lives will directly impact the income statement in two ways; through depreciation expense levels and through the measurement of component gains and losses on sale or retirement. Given the importance of depreciation estimates, we expect to continue to engage the services of an independent depreciation consultant for all of our regulated businesses, including those that are technically out of scope for the Kinectrics study (e.g. transmission and remote diesel generation assets).

It is useful to note that our existing and historic asset componentization is significantly more detailed than that assumed in the draft report. We maintain defined plant retirement units that are used as criteria for determining when asset sub-components should be retired and recapitalized when assets are removed and replaced. Our granular asset componentization and our use of defined retirement units has a direct impact on ensuring that we are as accurate as possible in estimating the accounting life of our assets.

Finally, we have not needed to make significant changes to our asset componentization or plant retirement unit definitions in moving from Canadian generally accepted accounting principles ("CGAAP") to IFRS. As such, we generally have strong continuity between our asset records and underlying asset service life assumptions previously used for CGAAP and those that will be used as we transition from CGAAP to IFRS.

Going Forward

We expect that the Board will need to periodically refresh the guidance provided in the draft report to ensure that relevant guidance is available for future application by smaller Distributors. This could result from new service life intelligence gathered through actual retirement experience. In addition, future external events may have the effect of changing service life assumptions for the industry as a whole. Examples in past years would include the Province's smart meter initiative, which had a service life impact on conventional meters, and recent federal PCB mitigation requirements, which could have had impacts on the service lives of distribution transformers and other electrical equipment.

Timing of Implementation of Depreciation Changes

Management has an obligation under IFRS to actively annually review and attest to the continued adequacy of depreciation methods and service life assumptions. In the past, under CGAAP-based regulatory accounting, the implementation date for any service life changes resulting from external events, such as major government decisions or newly completed external depreciation reviews, could be deferred until the impact of those changes was effective in rates. This is no longer the case. Under IFRS, such service life changes will now need to be implemented for external reporting purposes as soon as they are known.

Since the Board will be basing its regulatory service lives on the IFRS service lives used for external reporting purposes, it should consider how it will handle this timing issue. We suggest that a variance account be established for the impact on approved revenue requirement of any changes in depreciation rates so the same rates are applied both for external reporting and regulatory purposes. To minimize differences between the external financial statements and regulatory reporting, the variance account could hold the revenue requirement impact of depreciation changes between the date of implementation for financial reporting purposes and the date that the change is effective in rates. The impact of service life changes, such as those attributable to a new external depreciation study or a major external event like those described above for smart meters, would be held in this variance account until disposed of through a future rate application. This treatment would be analogous to the existing regulatory treatment accorded to Hydro One Networks' distribution and transmission businesses for changes in statutory tax rates.

DAVIES
WARD
PHILLIPS &
VINEBERG LLP

**Canada: Federal Government Reintroduces Proposed Changes to Nuclear Liability Legislation**
21 April 2010
**Article by Sarah V. Powell , Alexandria J. Pike and Michel Pelletier**

On April 16, 2010, the federal government reintroduced Bill C-15 – *Nuclear Liability and Compensation Act* to amend and replace Canada's existing nuclear liability regime with respect to nuclear incidents. Bill C-15 is in substance identical to numerous other bills that have been introduced by the federal government over the past three years to amend and replace the existing *Nuclear Liability Act*, each of which has died on the Order Paper with the prorogation of Parliament. The most significant change proposed by these bills is the increase in the maximum liability for operators of nuclear installations for damage resulting from a nuclear incident from $75 million to $650 million (per nuclear installation). This amount would be publicly reviewed at least every five years by the federal government and, if appropriate, could be increased by regulation. Bill C-15 would require the first public review of the maximum liability for operators to be completed within 15 months of Bill C-15 coming into force. The federal government has been attempting to modernize Canada's nuclear liability regime for decades, but earlier attempts have either met with constitutional challenge or died on the Order Paper. Bill C-15 would bring Canada's nuclear liability regime more in line with international standards and is consistent with the Harper government's commitment to modernize Canada's nuclear regulatory framework.



http://www.mondaq.com/canada/article.asp?articleid=98676&print=1