IFRS Consultation

List of Issues – Proposal for Discussion

A. Scope

This consultation examines the effects of the adoption of International Financial Reporting Standards ("IFRS") on regulatory accounting and rate making, to identify necessary changes to the Board's filing and reporting requirements and rate setting methodologies. It includes changes in Canadian GAAP related to the implementation of IFRS. This consultation will not include a discussion of changes to filing requirements and rate setting methodologies that are not driven by the adoption of IFRS.

This consultation will not include a discussion of the financial risk profile of utilities, and how the adoption of IFRS may affect that risk profile.

B. Principles

1.1 In considering the issues listed below, what principles should the Board use to guide the determination of the preferred alternative? Examples of key questions:

- How much difference between IFRS and regulatory accounting is sustainable in the long term?
- To what degree should avoidance of harm to ratepayers prevail over other considerations?
- To what degree should avoidance of harm to utilities prevail over other considerations?

1. The methodologies used by the Board to establish just and reasonable rates have not always been the same as those used for external financial reporting purposes. The Board has and will retain the authority to establish regulatory accounting and regulatory reporting requirements. IFRS accounting requirements will not be the sole driver of regulatory requirements.

2. Future regulatory accounting and regulatory reporting requirements established by the Board will continue to be based on sound regulatory principles. These principles include fairness, minimizing intergenerational inequity and minimizing rate volatility.

3. Future regulatory accounting and regulatory reporting requirements established by the Board will, in taking into account IFRS requirements, balance the effects on both customers and shareholders.

4. Future regulatory accounting and regulatory reporting requirements established by the Board will be aligned with IFRS requirements as long as that alignment is not inconsistent with sound regulatory rate making principles.

5. Future regulatory accounting and regulatory reporting requirements established by the Board will be universal and standardized for all utilities, while recognizing that utility-specific issues can be addressed through a utility's applications.

C. Major points of departure between existing regulatory accounting and rate making as compared to IFRS

2. Regulatory Assets and Liabilities

2.1 Should the Board continue to use deferral and variance accounts in the event that they are not recognized under IFRS?

The Board will continue to use deferral and variance accounts for rate making in appropriate circumstances, whether or not these accounts are recognized under IFRS.

2.2 Should the Board approve definitions for deferral and variance accounts if the Board retains their use for regulatory purposes?

The Board will retain the use of deferral and variance accounts for regulatory purposes. At this time, the Board will continue to apply the existing approach in the use and establishment of such accounts. The Board may consider the review and adjustment of its existing approach when the rulings from the International Accounting Standards Board are received and the interpretation of IFRS becomes clearer.

Utilities may use appropriate financial reporting methods to increase the understanding of the nature of deferral and variance accounts within the financial community, such as increased disclosure in the notes to audited financial statements, increased management discussion and analysis (MD&A) in annual reports, and the education of financial professionals.

3. Property, Plant and Equipment

3.1 For the purpose of first-time adoption of IFRS, should the Board require historic cost (NBV) or the IFRS adoption requirements (fair value or retrospective restatement) to be used as the basis for setting opening rate base values and reporting to the Board?

The Board will require regulated net book value to be used as the basis for setting opening rate base values and reporting to the Board at the time of the first report to the Board or rate application for periods subsequent to the adoption of IFRS. To establish continuity of historic cost, the statement of opening value for regulated net book value includes providing gross capital cost and accumulated depreciation, subject to additional breakout of amounts as necessary to support regulatory accounting requirements stated in Section 3.4 below.

3.2 After adoption, what should be the basis for reporting PP&E for regulatory purposes (e.g. historical acquisition cost, fair value)?

The Board will require the use of historical acquisition cost as the basis for reporting PP&E for regulatory purposes.

3.3 Should the Board require PP&E to conform to IFRS capitalization requirements (e.g. capitalize less indirect overhead and administration cost)?

The Board will require utilities to adhere to IFRS capitalization accounting requirements for rate making and regulatory reporting purposes after the date of adoption of IFRS. The utility will file a copy of its capitalization policy, identifying any updates to the policy, as part of its first rate filing after IFRS adoption.

3.4 What changes to existing regulatory or rate making treatments should the Board require for other PP&E related items as a result of the adoption of IFRS?

- Borrowing costs applied to PP&E (as opposed to deemed interest or AFUDC)
- Customer contributions received for PP&E
- Asset reclassifications from PPE to intangible assets (e.g., computer software and land rights).
- Asset retirement obligations
- Gains and losses on disposition of assets
- Treatment of asset impairment

The Board will require utilities to adhere to IFRS accounting requirements for items related to PP&E for rate application filings and for reporting to the Board after the date of adoption of IFRS, except where specifically noted below.

List of rate adjustments or prescribed treatments:

- ***Borrowing costs applied to CWIP: IFRS requires utilities to capitalize carrying charges associated with Construction Work in Progress (CWIP) using actual interest cost incurred as opposed to amounts calculated at rates prescribed by the regulator. On or before the date for adoption of IFRS, the Board will discontinue publication of market based rates for applying borrowing costs to CWIP. For regulatory rate making and reporting the Board will use the values calculated in accordance with IFRS to determine capitalized carrying charges on CWIP.***

- ***Customer contributions received for PP&E: IFRS requires customer contributions to be recorded as revenue or deferred revenue (depending on the circumstances) instead of as an offset to capital cost. For regulatory reporting and rate making purposes the amount of customer contributions will be treated as deferred revenue to be included as an offset to rate base and amortized to income over the life of the facility to which it relates. This reclassification is necessary to preserve continuity of the rate base.***

- ***Asset reclassifications from PP&E to intangible assets (e.g., computer software and land rights): IFRS requires certain assets to be recorded as intangible assets (e.g. computer software and land rights) that were previously included in PP&E. Utilities shall include such intangible assets in rate base and the amortization expense in depreciation expense for determining the revenue requirement. This reclassification is also necessary to preserve continuity of the rate base.***

- ***Asset retirement obligations: IFRS requires that asset retirement obligations include estimates of the cost of certain obligations not required under existing accounting requirements, and revaluation of those obligations during the lives of the assets. For rate setting and reporting purposes, utilities shall identify separately the depreciation expense associated with amortizing the asset retirement cost and the accretion expense associated with the amortization of the asset retirement obligation. This will allow the Board to assess these costs independently of other amortization costs to determine the portion, if any, of these costs that should be recovered in revenue requirement.***

- ***Gains and losses on disposition of assets: Where a utility for financial reporting purposes under IFRS has accounted for the amount of gain or loss on the retirement of assets in a pool of like assets as a charge or credit to income, for reporting and rate application filings the utility shall reclassify such gains and losses as depreciation expense and disclose the amount separately. Where a utility for financial reporting purposes under IFRS has reported a gain or loss on disposition of individual assets, such amounts should be identified separately in rate filings for review by the Board (as at present).***

- ***Treatment of asset impairment: Where for financial reporting purposes under IFRS a utility has recorded an asset impairment loss, for rate application filings such losses shall be reclassified to PP&E and identified separately to allow consideration of whether and how such amounts are to be reflected in rates.***

4. Depreciation

4.1 Should the Board set parameters for depreciation accounting for regulatory purposes (e.g. depreciation methods, the level at which sub-componentization should be applied to specified asset classes)?

Utilities should continue to use the straight line method of depreciation*. *As described in issue 4.2 below, the Board anticipates that a joint depreciation study will be conducted which results in depreciation methodologies and rates which are consistent with IFRS requirements.

4.2 Should the Board set the parameters for electricity distributors to establish their own depreciation rates rather than continue to use depreciation rates historically provided by the Board (co-ordination of depreciation studies may be possible)?

The Board will facilitate a joint depreciation study for electrical distribution utilities. The aim of the study will be to determine depreciation methodologies and rates that will be applied to all electrical distribution utilities for the purpose of setting rates and regulatory reporting. The study must give due weight to the IFRS requirements regarding depreciation, including componentization. Until the study is completed and the resulting depreciation rates are modified or adopted by the Board, electrical utilities will continue to use their present depreciation rates.

Any electrical utility retains the option of demonstrating, through a well-founded depreciation study, that the Board should approve specific depreciation methodologies and rates for that utility.

Gas utilities may submit a utility-specific depreciation study, which should include their proposed treatment of items unique to the gas industry (e.g., cushion gas).

5. Other Issues

5.1 What changes to existing regulatory accounting and rate treatments should the Board require for other items?

- Inventory valuation (based on lower of cost and net realizable value)

For gas utilities, the Board will continue the current practice of recording the difference between the actual purchase price of gas inventory and the weighted average cost of gas (forecast purchase price approved by the Board) in a variance account (PGVA) for future collection or refund to customers when approved by the Board.

- Payments in lieu of corporate income taxes

For electrical utilities, the Board will continue with the current practice of using estimated taxes (the tax or PILs proxy) to be included in the revenue requirement for rate-setting purposes.

For gas utilities, the Board will continue with the current practice for the inclusion of an estimated tax recovery in rates.

Tax or PILs related costs as incurred in the future may be recovered in rates when approved in a future rate proceeding.

- Pensions and employee future benefit costs

For gas utilities, the Board will continue to review pensions and employee future benefit costs in the utilities' rate applications.

For electrical utilities, the current practice approved by the Board will continue for pensions and employee future benefit costs. Any changes to current practice may be sought through an application to the Board.

D. External Uncertainties

6. Decisions of Accounting Standard-Setting Bodies

6.1 What are the potential implications on the Board's decisions of the questions now before accounting standard-setting bodies? These uncertainties include:

- Potential exemption from the requirement for retrospective or fair value restatement of PP&E (International Accounting Standards Board)

The Board has determined its policy choice on issue 3.1 in the absence of a decision from the IASB.

- Recognition of regulatory assets and liabilities, e.g., deferral and variance accounts (International Accounting Standards Board)

The Board has determined its policy choice on issue 2.1 in the absence of a decision from the IASB.

- Whether accounting standards will require municipal and provincial government-owned distributors (government business enterprises) to adopt IFRS (Public Sector Accounting Board – Canada)

The Board is proceeding to set policy assuming that the utilities it regulates will be required to adopt IFRS for financial reporting purposes.

- Other developments from accounting standard-setting bodies

The Board is proceeding to set policy in the absence of any other developments from accounting standard-setting bodies.

E. Impacts

There are three kinds of potential impacts related to IFRS. These are:

- ***the one-time administrative cost to switch-over to the IFRS based reporting;***
- ***the ongoing administrative costs for IFRS reporting including any related incremental costs for required regulatory reporting and;***
- ***impact on revenue requirement that may arise from changes in rate base and operating costs determinants, driven by changes in the timing of the recognition of expenses.***

For the purposes of sections 7, 8, 9 and 10 below, "modified IFRS" means financial accounting based on IFRS, with the modifications and exceptions for regulatory accounting identified by the Board in this consultation.

7. Rate Impact

7.1 Compared to rates established under current regulatory accounting, what are the direction and estimated magnitude of rate impacts created by establishing rates on the basis of various IFRS accounting options?

The potential impacts, if any, from the adoption of IFRS, will vary from utility to utility. The Board will require utilities to specifically identify financial differences and any resulting revenue requirement impacts that arise from the adoption of IFRS requirements in the utility's first cost of service rate filing after IFRS adoption.

7.2 Should a mechanism be developed to phase-in or otherwise mitigate the rate impacts, if any, of adopting IFRS?

Rate mitigation or smoothing mechanisms currently used by the Board, such as the use of a deferral account and collection of accumulated amounts from ratepayers over a number of years, can be applied to reduce any rate impacts related to the adoption of IFRS, to the extent the Board permits recovery of IFRS-related costs.

7.3 Should rate increase thresholds be set?

IFRS-related costs will be considered as part of the aggregate rate impact of all the changes included in the utility's rate application. An aggregate threshold of 10% on total bill may trigger mitigation. The applicant shall provide an analysis of the origin of the aggregate impact by individual cost drivers, an analysis of the impact on affected customer consumption, and a demonstration of the need for a rate smoothing mechanism.

8. Utility and Shareholder Impact

8.1 Should the administrative costs (e.g. new systems, special audits, consulting) to transition to IFRS be recovered from ratepayers? On what basis?

Prudently incurred administrative incremental costs directly related to the transition to IFRS will be recovered from ratepayers on the same basis as other costs. This applies to utilities filing for rates on a cost of service basis and to utilities on an incentive rate mechanism. Where the utility incurs incremental costs related to transition to IFRS during a period for

which rates have already been set, and for which the Board did not consider such costs, the utility may record in a Board-approved deferral account such incremental costs incurred after January 1, 2009 for consideration by the Board at the next cost of service proceeding. The Board, in determining the disposition of the account, will consider the criteria of causation, materiality and prudence.

8.2 Should incremental on-going compliance costs be recovered from ratepayers? On what basis (z-factor treatment? threshold amounts?)?

Prudently incurred incremental administrative costs directly related to the compliance with IFRS will be recovered from ratepayers on the same basis as other costs. This applies to utilities filing for rates on a cost of service basis and to utilities on an incentive rate mechanism. Where the utility incurs incremental ongoing costs during a period for which rates have been set, and for which the Board did not consider such costs, the utility may record in a Board-approved deferral account such incremental costs incurred after January 1, 2009 for consideration by the Board at the next cost of service proceeding. The Board, in determining the disposition of the account, will consider the criteria of causation, materiality and prudence.

8.3 How can the Board encourage minimization of IFRS implementation costs?

Some suggestions:

- ***Joint depreciation study (including componentization)***
- ***Minimization of differences between IFRS requirements and regulatory requirements***
- ***A cooperative initiative among electricity distributors regarding accounting practices***
- ***Establish a threshold test similar to that used for Transition Costs (above threshold – more evidence or assurance required)***

8.4 Should any proposed increases in revenue requirement that may arise from changes in accounting for rate base and operating costs prompted by the adoption of modified IFRS be recovered from ratepayers? If yes, on what basis?

F. Filing and Reporting Requirements

9. Filing Guidelines for Rate Applications

9.1 What are the filing requirements for rate applications for entities regulated by the Board during and after the transition to IFRS?
See general description at end of section.

9.2 What financial filings should the Board require for use in cost of service rate applications for historical and test years subsequent to 2009?
See general description at end of section.

9.3 Should the Board prescribe any specific rate making measures in its incentive regulation mechanisms to take account of the adoption of IFRS?
No, except the establishment of a deferral account for costs related to implementation subsequent to January 1, 2009.

9.4 Should rate applications under an incentive regulation mechanism be required to include a reconciliation of reported annual performance to the same financial reporting standard as that upon which the incentive framework was approved?
Not until rebasing - see general description below.

Rate application filing requirements prescribe the inclusion of financial data for a test year, bridge year and one or more historical years.
IFRS implementation requirements prescribe that entities report under both the existing CGAAP accounting framework and IFRS for the year 2010.

Proposal

1. For electricity distribution rate application filings:

For distributors making applications for rebasing in the summer of 2009 for 2010 rates:
The rate application filings should be provided under the existing regulatory framework (similar to CGAAP). The distributor may choose to present modified IFRS financial data in addition to filings under the current regulatory framework, with reconciliations between the current framework and the modified IFRS framework.

For distributors making applications for rebasing for 2011 rates:
For years prior to 2011, distributors will file the results under the current regulatory framework. For the 2011 test year, distributors will file forecasts under both the current regulatory framework, and on the basis of modified IFRS. In addition, for 2011, distributors will specifically identify financial differences and any resulting revenue requirement impacts that may arise from the adoption of modified IFRS requirements.

For distributors making applications for rebasing for 2012 rates and subsequent rate years:

For years prior to 2010, distributors will file the results under the current regulatory framework. For 2010 results, distributors will file results under both the current regulatory framework, and on the basis of modified IFRS. In addition, for 2010, distributors will specifically identify financial differences and any resulting revenue requirement impacts that may arise from the adoption of modified IFRS requirements. For the years subsequent to 2010, distributors will file results and forecasts under the modified IFRS framework.

2. For gas distributors making applications for rebasing for rates for years subsequent to 2010, and with an earning sharing mechanism in place: For years prior to 2010, distributors will file the results under the current regulatory framework. For the rebasing test year, distributors will file forecasts under both the current regulatory framework, and on the basis of modified IFRS. Distributors shall continue to present all required IRM application filing materials using the current regulatory framework, while the current IRM is in place. In addition, for the rebasing test year, distributors will specifically identify financial differences and any resulting revenue requirement impacts that arise from the adoption of IFRS requirements.

3. For gas distributors without an earning sharing mechanism in place: Same rules as for electricity distributors.

10. Electricity Distributor and Gas Utility Reporting and Record-Keeping Requirements (RRR)

10.1 What changes are required to financial reporting requirements for entities regulated by the Board during and after the transition to IFRS?

See 10.2 to 10.6 for the changes that will be required.

10.2 Should the Board require all rate-regulated entities to report information to the Board using IFRS beginning January 1, 2011, regardless of whether they are otherwise required to use IFRS?

The Board will require all electricity distributors and gas utilities to report information to the Board using modified IFRS for regulatory accounting values and IFRS for audited financial statements beginning January 1, 2011, regardless of whether they are otherwise required to use IFRS.

10.3 Should the Board require all rate-regulated entities to continue to report information to the OEB using Canadian GAAP until December 31, 2010 (regardless of early adoption by the utility)?

The Board will require all electricity distributors and gas utilities to continue to report information to the OEB using Canadian GAAP until December 31, 2010 (regardless of early adoption by the utility).

10.4 Should the RRR include requirements for reconciliations between financial reporting under IFRS and regulatory accounting information?

The RRR will require reconciliations between financial reporting under IFRS and regulatory accounting information as follows:

For fiscal year 2010, reconciliations between:

- ***IFRS for financial reporting and modified IFRS for regulatory accounting (i.e. financial accounting based on IFRS, with the modifications and exceptions for regulatory accounting identified by the Board in this consultation)***
- ***CGAAP results and modified IFRS***

For fiscal years subsequent to 2010, reconciliations between IFRS for financial reporting and modified IFRS.

10.5 Should the RRR include a requirement for supplementary audit assurance regarding regulatory accounting values where they differ from IFRS reported values and that are not otherwise audited?

The RRR will include a requirement for supplementary audit assurance regarding regulatory accounting values reported on an annual basis where they differ from IFRS reported values in audited financial statements and that are not otherwise audited. The supplementary audit assurance will involve a full audit of regulatory accounting values by a third party auditor in accordance with attest audit requirements. The auditor will be required to express an opinion on the financial information in accordance with a predetermined standard.

10.6 Should the periodic reporting to the Board by utilities under incentive regulation include a reconciliation of reported annual performance to the same basis of accounting as that upon which the incentive framework was approved?

Reporting should be reconciled to the same basis of accounting as that upon which the incentive framework was approved.