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OEB Consultation Process

Proposed
Principles & Evaluation Framework
For Changes to Regulatory
Accounting Policies

May 4, 2009

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Objective

- Explain basis for proposed guiding principles & evaluation framework presented by eight ratepayer groups (Appendix 1)

Outline

- Underlying issues
- Guiding Principles
- Evaluation Framework
- Appendices
  - Appendix 1 – Eight Ratepayer Groups
  - Appendix 2 – Proposed Guiding Principles
  - Appendix 3 – Proposed Evaluation Framework
  - Appendix 4 – Resume – J T Browne

Underlying Issues

Ongoing Change

- Adoption of IFRS will bring significant change in financial accounting principles
  - Not the end of change
- Requirement for ongoing principles and procedures
  - Efficiency
  - Consistency

Underlying Issues

- **Regulatory vs. Financial accounting**
- Regulatory & financial accounting have different objectives
- Financial Accounting
  - Reports on what happened
    - Financial position, performance, change in financial position
    - Not determine what should happen
  - May be used to support pricing – but not a primary objective

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Underlying Issues

Regulatory Accounting

- Establish just & reasonable rates
- Determine what prices should be

- Not surprising there are differences

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Underlying Issues

Differences

- In most jurisdictions, regulatory accounting is similar to financial accounting – but there are usually differences
  - Some differences in definition of costs
    - - e.g., cost of equity, imprudent costs
  - Most differences are timing differences
    - Same costs are recognized but in different periods

Underlying Issues

Regulatory Assets & Liabilities

- Timing differences give rise to economic benefits & obligations
  - Right to increase future rates from what would otherwise be allowed
  - Obligation to decrease rates from what would other wise be allowed
- Currently recognized as regulatory assets & liabilities
  - Either directly or indirectly

Underlying Issues

- Recognition of regulatory assets & liabilities affects the income statement
- Example – Storm Damage
  - Assume:
    - Income without damage of $10 million per year
    - Storm damage of $5 million
    - Regulator approves deferral and recovery over five years

Underlying Issues

- Utility recognizes regulatory asset of $5 million
  - Recognition results in credit to income of $5 million
  - Amortization of regulatory asset offsets additional revenue over recovery period
  - Income same as if expensed over recovery period

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Underlying Issues

- Reported Income

	Year 1	Years 2 - 6
W/O Damage	10	10
Storm Damage	(5)	
Recovery		1
	5	11
Regulatory Asset	5	(1)
	10	10

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Underlying Issues

- If financial accounting does not recognize regulatory assets & liabilities
  - Economic benefits & obligations are still there, but:
  - Will tend to be confusing
  - May increase cost of capital

Underlying Issues

- Ability to recognize regulatory assets & liabilities may affect choice of regulatory accounting policies
  - i.e., avoid negative consequences
- Not only consideration
  - Should consider other regulatory objectives
  - Recognition of other factors reflected in Board Staff proposals

Underlying Issues

- Question as to whether IFRS will recognize regulatory assets and liabilities
  - For utilities - could be most significant impact of adopting IFRS
  - Currently - recognition looks promising
    - Similar to FAS 71
      - Apply principles same as any enterprise, then
      - Recognize regulatory assets & liabilities as appropriate

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Underlying Issues

- No decision yet - Exposure draft expected this summer
  - Uncertain
  - Could be changes in rules for recognition Likely framework

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Guiding Principles

- Basic principles to guide the development and maintenance of Regulatory Accounting Policies (RAP)
- First two principles - RAP should be set by OEB & reflect regulatory objectives
    - Regulatory & financial accounting have different objectives
    - RAP should reflect application of regulatory principles to circumstances of Ontario utilities

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Guiding Principles

- Third Principle – RAP should stand until changed by OEB
  - Should not change just because IFRS change
  - Follows from RAP should be set by OEB
  - Avoid windfall gains & losses
    - Differences with changes in IFRS deferred

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Guiding Principles

- Fourth Principle – evaluate impact of any change in RAP on all utilities
  - No change should be automatic
  - Must demonstrate policy best meets regulatory objectives

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Guiding Principles

- Fifth Principle – estimates that affect recognition of costs should stand until change approved by OEB
  - e.g., estimates on which depreciation rates are based
  - Avoid windfall gains & losses
    - Differences deferred

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Guiding Principles

- Sixth Principle – consistent application of RAP unless differences justified
  - Improve comparability & consistency

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Evaluation Framework

- Information to be provided for a proposed change in RAP
- Purpose
  - Provide information to evaluate a proposed RAP
  - Focus discussion on criteria that reflect regulatory principles

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Evaluation Framework

- #1 to #5 provide basic information
  - Description of proposed RAP
  - Change from old RAP
  - Comparison of new RAP to IFRS
  - Transition
  - Impact
    - Ongoing & transition

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Evaluation Framework

- # 6 Evaluation against criteria
  - Evaluation should cover both new RAP and transition to RAP
    - Cannot consider a change in RAP without considering the transition
  - Criteria should reflect regulatory principles

Evaluation Framework

- 6.a - Cost Recovery
  - Cost of service standard
- 6.b – Matching Costs to Benefits
  - Does policy best match costs to period in which related services are provided (Intergenerational equity)
  - Financial accounting principles usually produces this result
    - But not always
  - May conflict with other regulatory objectives

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Evaluation Framework

- 6.c – Rate Stability
  - Does policy enhance rate stability & predictability
  - May justify exception to intergenerational equity

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Evaluation Framework

- 6.d - Earnings Stability – Regulatory Accounting
  - Will policy reduce variability in earnings that is largely outside control of utility?
    - Issue with costs, gains and losses that are difficult to estimate
  - May justify exception to intergenerational equity

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Evaluation Framework

- 6.e - Earnings Stability – Financial Accounting
  - Variability due to not recognizing regulatory assets & liabilities
  - May not be significant?
- 6.f - Administrative Burden
- 6.g - Other

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Evaluation Framework

- #7 Conclusion
  - Summary of why OEB should accept proposed RAP

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Questions

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Appendix 1

Ratepayer Groups
Presenting
Guiding Principles & Evaluation Framework

- Association of Major Power Consumers in Ontario
- Building Owners and Managers Association of the Greater Toronto Area
- Canadian Manufacturers & Exporters
- Consumers Council of Canada
- Energy Probe Research Foundation
- London Property Management Association
- School Energy Coalition
- Vulnerable Energy Consumers Coalition

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Appendix 2

GUIDING PRINCIPLES
REGULATORY ACCOUNTING POLICIES
KEY POINTS
(Proposed)

- The OEB should develop guiding principles for the development and maintenance of regulatory accounting policies and not just changes arising from the adoption of IFRS. These principles should include the following points

1. Regulatory accounting policies should be set / approved by the OEB.

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Appendix 2

2. Regulatory accounting policies should be designed to meet regulatory objectives, and therefore, should not be the same as financial accounting principles (e.g., IFRS) unless use of those financial accounting principles achieves regulatory objectives.
3. Regulatory accounting policies should not be changed until the change has been approved by the OEB, even where there is a change in financial accounting principles.
4. Changes in regulatory accounting policies should be undertaken only after the OEB has considered the implications of the changes on all regulated entities, using a rigorous framework.

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Appendix 2

5. Estimates that affect the recognition of costs (e.g., estimates that affect depreciation rates) should not be changed for regulatory purposes until the change has been approved by the OEB.

6. Unless justified by differing circumstances, the same regulatory accounting policies should apply to all utilities.

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Appendix 3

PROPOSED REGULATORY ACCOUNTING CHANGES SUPPORTING INFORMATION (Proposed)

The following sets out the information that should be presented in support of any proposed change in regulatory accounting policies.

1. Description of the Proposed New Regulatory Accounting Policy
2. Changes from Existing Regulatory Accounting Policy
3. Comparison of Proposed New Regulatory Accounting Policy to IFRS
   - (Will the new regulatory accounting policy ("RAP") result in differences with IFRS? What are these differences? Will it reduce any differences that exist with the current RAP?)

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Appendix 3

4. Transition

- ➢ (How would a utility deal with any unrecovered or over-recovered costs that arise on transition?)

5. Impact

4.a Ongoing

- ➢ (What is the likely impact of the proposed new RAP on revenue requirements and unrecovered costs that must be financed – i.e., $% of total?)

4.b Transition

- ➢ (What is the amount of any unrecovered or over-recovered costs that will arise on transition to the proposed RAP?)

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Appendix 3

6. Evaluation
   - The proposed new RAP, along with any transition to the new RAP, should be evaluated against the following criteria:

   6.a Cost Recovery
   - (Does the proposed RAP provide a utility with an opportunity to recover its costs of providing service, including a fair return on its investment devoted to regulated operations – no more, no less?)

   6.b Matching Costs to Benefits
   - (Does the proposed RAP match costs to the period in which the related services are provided? Does it provide a better matching than the current RAP?)

   6.c Rate Stability
   - (What is the impact of the proposed RAP on rate stability? Will it result in more stable rates than the existing RAP?)

Appendix 3

6.d Earnings Stability – Regulatory Accounting

- (This refers to variability in the earnings from a regulatory perspective – i.e., using RAP. This variability may differ from the variability reported in a utility's financial statements in accordance with IFRS)
- (Will the proposed RAP materially impact the variability in earnings due to factors that are largely outside the control of the utility? Compared to the existing RAP, will it reduce this variability?)

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Appendix 3

6.e Earnings Stability – Financial Accounting

- (Will the proposed RAP materially impact the variability in earnings reported in the utility's financial statements - i.e., due to differences between RAP and IFRS? Will it materially impact the equity reported in a utility's financial statements – i.e., due to the cumulative differences between RAP and IFRS?)

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Appendix 3

6.f Administrative Burden

- (For example, will the proposed RAP have a material impact on the complexity or cost of a utility's accounting system?)

6.g Other

- (The proposed RAP should be evaluated against any other criteria that may be relevant.)

7. Conclusion

- (Summary of why the proposed RAP should replaced the existing RAP)

Appendix 4

RESUME – JOHN T BROWNE

- John T Browne is a Chartered Accountant and an economist (MA economics).
- Over the last 25 years, he has directed and worked on a wide range of assignments dealing with accounting, costing and financial issues with a focus on rate-regulated entities.
  - Many of his assignments have dealt with the relationship between regulatory and financial accounting.

Appendix 4

- Of particular note for the current issue before the Board, Mr. Browne:
  - Chaired the Canadian Institute of Chartered Accountants ("CICA") Study Group that produced the research report "Financial Reporting by Rate-Regulated Enterprises".
  - Co-authored the Deloitte & Touche publication "Basics of Canadian Rate Regulation" and subsequently updated the monograph with the new title "Fundamentals of Rate Regulation".
  - Co-authored the CA Magazine articles "A Matter of Principles - Part I" and "A Matter Of Principles - Part II" (these articles dealt with reporting by rate-regulated enterprises).

Appendix 4

- Authored the CA Magazine article "Transition to IFRS – Regulatory Assets".
- Authored a number of comment papers including the following that deal with accounting in a regulatory context:
  - Financial Reporting by Rate-Regulated Enterprises - Response to Potential Concerns
  - Comments on Deferral Accounts to Deal with Uncertainty.
  - Comments on Recognizing Regulatory Assets & Liabilities Under IFRS
  - Comments on Accounting for Rate Regulation