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Susan Frank
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Regulatory Affairs

May 25, 2009

BY COURIER

Ms. Kirsten Walli
Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON.
M4P 1E4

Dear Ms. Walli:

EB-2008-0408 – OEB Consultation on Transition to International Financial Reporting Standards – Hydro One Networks' Comments on IFRS Stakeholder Conference

I have attached two (2) copies of Hydro One Networks' Comments on IFRS Stakeholder Conference.

An electronic copy of Hydro One Networks' Comments on IFRS Stakeholder Conference have been filed using the Board's Regulatory Electronic Submission System (RESS) and the proof of successful submission slip is attached.

Sincerely,

ORIGINAL SIGNED BY SUSAN FRANK

Susan Frank

Attach.

May 25, 2009

OEB IFRS Stakeholder Conference
Hydro One Networks Inc.'s Submissions on Conference and Staff Proposal

Introduction

Hydro One Networks Inc. ("Hydro One") appreciates the opportunity to provide a written submission on the regulatory implications of the transition from Canadian generally accepted accounting principles ("CGAAP") to International Financial Reporting Standards ("IFRS"). It is Hydro One's view that the stakeholder conference and the informal meetings leading up to it were useful in identifying issues and regulatory accounting alternatives associated with the adoption of IFRS in 2011. Hydro One submits that the Board now has all the information it needs to implement IFRS as the basis of regulatory accounting.

Clear direction from the OEB will remove significant uncertainties for all stakeholders and will enable the preparation and finalization of related regulatory accounting instruments. The importance of these instruments should not be underplayed, as the specific regulatory reporting requirements that the Board adopts with respect to IFRS have the potential to significantly affect distributors' reporting systems and business processes. Distributors adopting IFRS effective January 1, 2011, will also have to produce a comparative year of financial statements for 2010. For public securities filers, interim financial statements on an IFRS basis will also be required. These statements will potentially be affected by differences between IFRS as applied by non-rate-regulated enterprises and IFRS as applied by the Board's final regulatory accounting instruments.

A decision on the guiding principles and major topic areas covered by the OEB Staff Proposal is necessary by the end of 2009 in time for the development and finalization of detailed regulatory guidance.

Hydro One Supports the OEB Staff Proposal

As noted in its presentation delivered at the Stakeholder Conference, Hydro One concurs with the Board Staff Proposal as presented. The Staff principles represent a reasonable set of concepts that can be used, with judgement, to ensure that the impact of adopting IFRS for regulatory reporting and accounting is managed in a coherent manner that avoids unnecessary cost, retains reasonable regulatory simplicity and maintains other regulatory principles embodied in the phrase "just and reasonable rates." As Mr. D'Andrea noted in Hydro One's presentation, "It is our view that regulatory principles included in Staff's proposal should be followed when determining the ongoing regulatory accounting and reporting requirements. Specifically, we support the proposal to adopt IFRS as the default regulatory accounting model for all distributors, and the need to balance the effects on both customers and shareholders." [1]

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[1] EB-2008-0408 Transcript, May 4, 2009, page 159

The key principle of balancing of impacts to ensure that neither ratepayer nor distributor is unduly impacted cannot be overemphasized.

Hydro One wishes to reemphasize to stakeholders that IFRS is a non-discretionary change in the overall accounting model that has been thrust upon all stakeholders of the Ontario regulatory process. The content and speed of adoption of the IFRS framework and of new IFRS pronouncements in future are largely outside the control of the participants in the Ontario regulatory arena. The change must be managed with minimal cost and disruption to all stakeholders.

In its presentation, Hydro One put forward a case for the adoption of IFRS without modification for regulatory purposes. Hydro One also noted that it would adopt any measures the Board felt were necessary to maintain regulatory objectives. This differed significantly from some of the other proposals, particularly those put forward by Mr. Browne on behalf of the Group of 8 Participants ("Group of 8") and by Mr. Shepherd on behalf of School Energy Coalition ("SEC"). Mr. Browne's presentation encouraged the Board to analyze every change in accounting from CGAAP to IFRS through the use of a template that would put the burden of proof on the distributor to show that IFRS was a better regulatory accounting treatment in that particular case. The Group of 8's proposed default is the soon-to-be defunct CGAAP.

SEC, on the other hand, noted that it is inevitable that IFRS will be the future on which regulatory accounting will be based. However, Mr. Shepherd also put forward SEC's proposal that would lead to CGAAP being maintained in the event that IFRS did not lead to an improvement in meeting regulatory principles. Mr. Shepherd also proposed to slow down the process and seemed to favour some sort of loosely-defined, issue-specific process to evaluate potential IFRS treatments.[2]

The proposals of both the Group of 8 and SEC would inevitably result in the retention of the defunct CGAAP as the basis of regulatory accounting. While their solutions might allow for the piecemeal adoption of some aspects of IFRS now and in future, the result would be a patchwork quilt of accounting treatments: some based on CGAAP, some on IFRS, and some on OEB modifications. In addition, the review of new treatments through generic processes at the time of rebasing rates, as suggested by SEC, would lead to non-comparative financial information as well as markedly delaying rebasing rate decisions. Hydro One submits that the consequences of these varying frameworks would remove the Board's ability to achieve the comparability needed for regulatory oversight.

Hydro One put forward other important reasons for the adoption of IFRS as the basis for regulatory accounting, namely:

- the avoidance of a transactional two-ledger accounting and planning system with all the cost and confusion that such systems would entail;
- the potential impact on the cost of capital if differences between IFRS as used in the external financial statements and IFRS used for regulatory accounting obscure the

[2] EB-2008-0408 Transcript, May 5, 2009, pages 116-118

predictability of key financial information for external analysts (such as future cash flows); and

- the fact that CGAAP will cease to exist after 2011, making maintenance of the current framework unsustainable.

Hydro One's Proposal

Hydro One submits that the Board should adopt IFRS as the basis for regulatory reporting in place of CGAAP.

Several participants in the conference made a point of indicating that they believed that the Board does not use CGAAP to regulate distributors. Rather, they claimed, the Board has over the years adjusted or modified CGAAP to ensure that regulatory principles are maintained. Hydro One states that the historical modifications to CGAAP are not that pervasive. The Accounting Procedures Handbook ("APH") for electricity distributors makes many references to the CICA Handbook, and there are few treatments in the APH that differ from standard CGAAP. Most differences relate to transactions that are easily handled by deferral or variance accounts, such as the treatment accorded to Retail Settlement Variance Accounts. Other differences between CGAAP and regulatory accounting relate to distributor-specific Board rulings, e.g. those surrounding post-employment benefits.

The point is that CGAAP was not designed to meet regulatory needs but has been able to do so with some overriding regulatory treatments and with some additional interpretation. There is no reason that IFRS cannot also be used as an appropriate basis for regulation despite differences from CGAAP. Hydro One supports the use of IFRS as the basis for regulatory accounting and reporting.

Need for a Decision in 2009

Hydro One submits that there is a pressing need for the Board to pronounce on the issues and principles covered by the Staff Proposal by the end of 2009. Distributors are making strategic decisions now on major information systems, changes in business processes and staff training. Knowledge of the specific rules surrounding the regulatory environment will be key in ensuring that the right decisions are made.

SEC opined that there is no hurry and that the Board should not rush into making decisions on the specific rules to apply to distributors. Hydro One believes that the fairly lengthy process in fact-finding and discussion that lead up to the Stakeholder Conference makes it clear that this has been a well-considered process. No specific time frame was suggested by SEC; and this poses clear problems for distributors who must design complex accounting and reporting processes, and even greater problems for those who are public securities filers and are under an obligation to communicate status and plans with investors and other public market participants.

Furthermore, after multiple stakeholder meetings, significant advisory input from KPMG and a formal Stakeholder Conference, Hydro One submits that sufficient input has been provided and that there would be no gain by waiting for some yet-to-be-determined additional input.

As noted in the conference, Hydro One will file its 2010/2011 distribution rate application in July 2009. The 2010 revenue requirement will be on a CGAAP basis, whereas the 2011 revenue requirement will be requested on an IFRS basis, as developed at the time of filing.

IFRS is Dynamic – but so was CGAAP

Several participants in the Stakeholder Conference noted that IFRS will change over the next few years, given the significant inventory of active projects the International Accounting Standards Board has on its work plan. This is no different from CGAAP. Although CGAAP has recently not undergone much change, as the standard-setter tried to ensure a stable platform for the conversion to IFRS, there have been times in the past when CGAAP underwent significant changes in short time frames. Historically, the Board has succeeded in dealing with CGAAP changes while still meeting its regulatory objectives, and, as discussed several times during the consultation, Hydro One does not expect that will change under an IFRS regime. The Board will still have to determine the impact of new IFRS on its regulatory guidance, and Hydro One expects that the Board will need to continue to issue new updates to its regulatory guidance, including frequently asked questions and APH articles. Hydro One submits that the fact that IFRS is dynamic should not impact the extent to which IFRS as it stands today should be incorporated as the basis for regulatory accounting.

Specific Issues

The Staff Proposal and Hydro One's presentation at the conference both addressed certain specific IFRS issues. In the interests of clarity, some of these issues are addressed again below, taking into account the specific comments and questions that arose at the conference. Hydro One continues to believe that its greatest challenge in the transition to IFRS is in the area of accounting for property, plant and equipment ("PP&E"). This is the area of accounting that results in the greatest risk of having to run two separate ledgers at a transactional level of detail if IFRS is not adopted as the basis for regulatory accounting. The risk of running two sets of ledgers is related primarily to the required change in overhead capitalization methodology, as well as to changes in depreciation methodology and treatment of premature retirement losses. KPMG affirmed this need for two separate transactional ledgers if IFRS is not adopted as the basis for regulatory accounting.

Overhead capitalization

Hydro One noted its expectation that certain overhead costs that are capitalized today will no longer qualify for capitalization under IFRS. If IFRS is not adopted as the basis for regulatory accounting, it is unlikely that a single transactional ledger could be maintained. For example, a construction project would have to be costed for IFRS using one set of labour, fleet, material and interest capitalization rates, rather than the set used for regulatory accounting. Downstream accounting impacts would occur even if the same depreciation method and rates were used for IFRS and regulatory purposes. However, these downstream impacts would be increased if the IFRS and regulatory depreciation method or rates differed. It becomes immediately apparent that reconciliation between the two different bases of accounting is not possible due to these downstream impacts. Again, KPMG affirmed this need at the consultation.

Two transactional ledgers will introduce a plethora of complications into the business, including many which have likely not yet been indentified. It is known that retention of the status quo would result in the requirement to plan, budget, account, control, report and evaluate performance on both an IFRS basis and on a status quo basis. It is also clear that the result would include wastage of resources, distraction and increased cost.

Depreciation

As noted in its Stakeholder Conference presentation, Hydro One currently uses a group depreciation method using rates provided by an independent external consultant. Hydro One noted its desire to continue with its own depreciation study. Under IFRS, the group method will no longer be supportable and Hydro One will be required to depreciate all of its asset components separately.

Hydro One noted that Union Gas is proposing to continue the use of group depreciation for regulatory purposes. Hydro One considered this option for its own assets and determined that there was no compelling reason to introduce this complexity into its proposal, as a component-specific depreciation rate will still allocate costs in a reasonable manner to periods.

Pensions and PILs

Although Hydro One is aware that the Board Staff Proposal indicates a preference for the continued use of a cash basis of accounting for PILs, Hydro One submits that the Board should not modify standard IFRS treatments when providing accounting guidance to distributors in the areas of pensions and PILs. Currently, some distributors are regulated on an accrual basis for pensions, while others are regulated on a cash basis. Use of accrual accounting for pensions and PILs would reduce complexity for distributors and increase the consistency between regulatory financial information and external financial statements. However, if the Board determines to continue to use a cash basis of accounting for PILs, Hydro One would be able to accommodate the preferred model without use of a full two-ledger transactional accounting system.

Modifications to IFRS

In choosing to adopt IFRS as the basis for regulatory accounting, Hydro One submits that the Board must make some modifications. For example, the continued use of deferral and variance accounts could be considered a modification of IFRS if the International Accounting Standards Board chooses not to adopt regulatory accounting rules similar to those found in US Statement of Financial Accounting Standard ("SFAS") 71. This sort of modification can be relatively easily handled with simple tracking on spreadsheets and periodic journal entries. However, a modification that affects the costing of PP&E is another matter entirely. As noted above, such a modification would have serious and possibly yet-to-be-determined consequences for distributors.

Rate Impact Mitigation

If the adoption of IFRS, which may have some puts and takes, results in a net increase in revenue requirement, Hydro One believes that the preferred approach is to implement rate impact mitigation. Mitigation mechanisms such as deferral accounts could be used to smooth impacts that exceed Board-approved thresholds.

Hydro One's Plans for a 2011 IFRS-Based Filing and for Filing Actuals

As noted during the Stakeholder Conference, Hydro One intends to file an application in July 2009 requesting distribution rates for both 2010 and 2011. The 2011 revenue requirement will be filed on an IFRS basis, incorporating the elements of IFRS that have been identified and modeled to date. Hydro One also expects to suggest a variance account to accommodate any differences between IFRS as applied in its filing, as compared to IFRS rules that are set after our submission or as adjusted by specific Board requirements for regulatory purposes.

Since Hydro One will be filing its rate application for 2010 and 2011 revenue requirement in July 2009, Hydro One plans to treat 2011 as its pivot year when actual CGAAP and IFRS results will be filed on a comparative basis.

Conclusion

For all of the foregoing reasons, Hydro One submits that Board Staff's proposal provides a reasonable set of concepts that can be used by both the Board and distributors to adopt IFRS for regulatory reporting and accounting in a manner that observes, and is consistent with, other regulatory principles. Despite reasons given by some of the stakeholders as justification for delay and for retaining either the current form or some other form of legacy CGAAP, Hydro One believes that the concerns of those stakeholders can and will be addressed by means of the steps suggested by Board Staff, by Hydro One, and by other stakeholders who recognize the inevitability of IFRS.