EB-2008-0408

International Financial Reporting Standards Consultation

Written Submissions of
The Consumers Council of Canada

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TABLE OF CONTENTS

Introduction ... 3
Background ... 3
A: Scope ... 4
B: Principles ... 4
C: Major Points of Departure between Existing Regulatory Accounting Rate Making and IFRS ... 5
Regulatory Assets and Liabilities ... 5
Property Plant and Equipment ... 6
Opening Rate Base ... 6
Capitalization Requirements ... 6
Borrowing Costs Applied to PP&E ... 7
Customer Contributions received for PP&E ... 8
Asset Reclassifications from PP&E to Intangible Assets ... 8
Asset Retirement Obligations ... 8
Gains and Losses on Disposition of Assets ... 9
Treatment of asset impairment ... 9
4. Depreciation ... 9
5. Other Issues ... 9
Payments in Lieu of Corporate Income Taxes or Income Taxes ... 9
Pensions and Employee Future Benefits ... 10
D. External Uncertainties ... 10
E. Impacts ... 10
Rate Impacts ... 10
Utility and Shareholder Impact ... 10
F. Filing and Reporting Requirements ... 11

Introduction

On December 23, 2008, the Ontario Energy Board (the "Board") initiated a consultation process, to examine issues associated with the transition to International Financial Reporting Standards ("IFRS"), under Board docket number EB 2008-0408 (the "IFRS Consultation").

A series of consultative meetings were held between Board staff and various industry stakeholders in 2009 in order to prepare for the Stakeholder Conference on May 4 and 5, 2009. The Consumers Council of Canada (the "Council") was an active participant in the consultative meetings and the Stakeholder Conference. At the conclusion of the Stakeholder Conference, all participants were invited to make written submissions to the Board by May 25, 2009 on the issues canvassed in the IFRS Consultation.

To guide the consultative process, a List of Issues was established by the participants. For each issue listed, Board staff developed proposals for the Board to consider in a document entitled "List of Issues – Proposal for Discussion" ("Staff's Proposals"). Staff's Proposals evolved over a period of time with the input of the participants to the IFRS Consultation. The objective was to resolve as many issues as possible among the participants prior to the Stakeholder Conference. When issue resolution was not possible, Staff's Proposals provided a benchmark position on which participants could comment.

These are the written submissions of the Council on the issues addressed in the IFRS Consultation. For ease of reference, the submissions follow the order of the List of Issues and of Staff's Proposals.

Background

The Canadian Accounting Standards Board ("AcSB") determined that all publicly accountable enterprises will adopt IFRS as the source of generally accepted accounting principles used in Canada for financial reporting periods commencing on or after January 1, 2011. January 1, 2011, is a transition date; it is the date that Canadian Generally Accepted Accounting Principles ("CGAAP") will cease to underlie financial reporting and IFRS must be used. There are a number of accounting differences between IFRS and CGAAP which could have a material impact on the reported values in financial statements.

It is currently expected that most entities regulated by the Board will be required to adopt IFRS for financial reporting.

To the extent that CGAAP was considered in establishing regulatory accounting policies, the Board initiated the IFRS Consultation process to understand the differences between CGAAP and IFRS, and to identify any potential implications, for established regulatory accounting policies, from the adoption of IFRS.

IFRS is an evolving set of standards for which additions and modifications will be made before and after the Canadian transition date of January 1, 2011. As a result, although the Board established the EB-2008-0408 proceeding to review the current set of IFRS in the context of regulatory accounting principles, it is understood that the Board will need to consider the implications of additions and modifications to the IFRS.

The IFRS Consultation process was unique, in that it provided an opportunity for industry participants to review regulatory accounting principles collectively, in a generic context. The current set of regulatory accounting principles have evolved over time on a case-by-case basis and are not always standard across all utilities. As a result, the Council's submissions include recommendations for the Board to standardize, and in some instances change, current regulatory accounting principles, not just resulting from IFRS, but resulting from the discussion and analysis afforded by this proceeding.

The Council's Submissions are as follows.

A: Scope

The Council submits that the scope of the IFRS Consultation as stated in the List of Issues is appropriate. The scope of the IFRS Consultation was limited to the effects of IFRS on regulatory accounting and rate making. The scope includes any changes necessary to the Board's filing requirements and rate setting methodologies resulting from IFRS.

At this stage in the regulatory process, the Council agrees that it would be inappropriate to review utility financial risk profiles and the potential implications on those risk profiles from the adoption of IFRS.

B: Principles

The Council agrees with Staff's Proposals for rate making principles, but takes issue with the fourth principle, which is as follows:

> 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.

The Council takes issue with the words "as long as the alignment is not inconsistent" as it implies that IFRS should be the default for regulatory accounting principles. The Council believes that regulatory accounting principles should be established first as the governing standard. A financial reporting standard, such as IFRS, should never be a default for regulatory accounting principles as the objectives of rate making and financial reporting are different. If there needs to be any default, it should be the status quo – the operative set of regulatory principles.

As a caveat, even after regulatory accounting principles are defined, if the rate-making implications of maintaining those principles relative to IFRS are not material, or would impose an undue administrative burden on utilities either logistically or financially, the Council would support the use of IFRS.   Whether starting from regulatory principles or relying upon IFRS as the default, it is possible to end up with the same conclusion.

In addition to the Council's comments regarding the fourth principle, the Council does not consider Staff's Proposals for rate making principles to be complete. Participants in the EB- 2008-0408 proceeding representing various ratepayer groups, commonly referred to as the "Group of 8", submitted a document to the Board entitled "Guiding Principles" for regulatory accounting policies. As a member of the Group of 8, the Council supports the policies contained in the Guiding Principle document.   In particular, a complete list of regulatory accounting policies should include the following:

- Regulatory accounting policies should be approved by the Board, not implicitly set or triggered by accounting bodies such as the AcSB;
- Regulatory accounting policies should be established after consideration is given to the implications on all regulated entities; and
- Regulatory policies should be applicable to all utilities unless justified by differing circumstances.

These additional principles may seem obvious, but the Council submits that they need to be explicitly stated, especially if the Board is to formally document regulatory accounting principles.

C: Major Points of Departure between Existing Regulatory Accounting Rate Making and IFRS

Regulatory Assets and Liabilities

The Council agrees with Staff's Proposals to continue to use deferral and variance accounts for rate making in appropriate circumstances, whether or not these accounts are recognized under IFRS.   The Council submits that deferral and variance accounts are integral to the regulatory process in Ontario as they enable timing differences to be considered in establishing just and reasonable rates. Specifically, they are essential tools used by the Board to minimize rate shock for utility customers.

Ms. Lea of Board staff stated that deferral and variance accounts are very useful in ratemaking when used judiciously. "Indeed, the Ontario Energy Board Act itself contemplates the existence of these accounts. So we are not proposing a change in regulatory practice." **(Tr. Vol. 1, p. 10)**

Although deferral and variance accounts may not be recognized under IFRS, the Council agrees with Staff's Proposal which states that resulting discrepancies between financial and regulatory accounting could be explained in the notes to the audited financial statements and management discussion and analysis.

Property Plant and Equipment

Opening Rate Base

The Council agrees with Staff's Proposals with respect to the value of opening rate base on or after January 1, 2011. The Council submits that opening rate base should be the equal to the regulated net book value based on historic acquisition costs. This proposal is:

- consistent with current regulatory accounting practice;
- cost based; and
- eliminates any transitional differences in the value of rate base.

The Council notes that, during the Stakeholder Conference, all utility presentations indicated a preference to use regulated net book value for both financial reporting of property, plant and equipment ("PP&E") and regulatory accounting of rate base. In addition, many utilities indicated that they had initiated discussions with their auditors in this regard.

Capitalization Requirements

The Council agrees with Staff's Proposals with respect to capitalization requirements. The proposal is to require utilities to adhere to IFRS capitalization accounting requirements for rate making and regulatory reporting purposes after the date of adoption of IFRS. The Council submits that the Board should not allow indirect costs such as overheads or administrative costs to be capitalized and added to rate base. It is more expensive from a rate recovery perspective to capitalize overheads. In addition to recovering the initial cost of the overhead, capitalized costs accrue carrying charges until depreciated. The overall cost to the ratepayer is higher as recovery is delayed, thereby inflating the initial cost of service.

The overhead capitalization issue is complex as current regulatory accounting principles on the issue are not clearly defined. To date, the Board has allowed some utilities to capitalize indirect overheads for inclusion in rate base, while other Board-regulated utilities capitalize no indirect overheads.

The Council submits that the Board needs to establish clear regulatory accounting principles to provide regulatory certainty. IFRS has forced standardization for financial reporting and the Board should take this opportunity, where appropriate and practical, to standardize regulatory accounting.

To the extent that some utilities currently capitalize indirect overheads, the rate impact of transitioning to zero overhead capitalization is uncertain. The transitional impact will vary by utility, be dependent upon the utility's current Board-approved rates and the degree of capitalized overhead implicit in those rates.

Board staff prepared a questionnaire and encouraged utilities to provide estimates of the financial impact of IFRS, capitalization rules included. Unfortunately, not all utilities responded to the survey and of those that did respond 19% were unable to estimate the impact of transitioning to zero capitalization **(Tr. Vol. 1, pp. 13-14)**.

As with any rate-making decision, the Council submits that the regulatory accounting principle needs to be established first. The objective of the application of regulatory accounting principles should be the establishment of just and reasonable rates. Overheads and administrative costs are often fixed, subject to low volatility or immaterial as a percentage of capital expenditures. Expensing these costs directly should have little or no impact on rate volatility in the long term. However, rate volatility may be relevant if there are transitional impacts of standardizing the regulatory accounting principle for all Board-regulated utilities. The transitional impacts would dissipate as capitalized overheads already imbedded in rate base are expensed through depreciation.

On a utility specific basis, once the rate-making impact of transitioning from the current status quo to the standardized regulatory accounting principles are known, rate mitigation techniques could be considered by the Board.

Borrowing Costs Applied to PP&E

The Council agrees with Staff's Proposals with respect to borrowing costs applied to PP&E. IFRS requires that utilities capitalize carrying charges associated with Construction Work in Progress ("CWIP") using actual interest costs incurred as opposed to amounts calculated at rates prescribed by the regulator.

Current Board practice is to deem an interest cost or provide an allowance for funds used during construction. A deemed interest cost may be preferable to direct interest cost, if the direct cost is unreasonable or imprudently incurred. This situation may arise when a utility enters into lending arrangements with its parent company, or any party that is not at arms length. The Council submits that the Board has the authority to disallow the direct interest costs and deem an interest rate if warranted. As a result, the Board should not discontinue the publication of market based rates for reference purposes.

Current regulatory accounting principles are not clearly defined for capitalized borrowing costs during construction. Not all utilities capitalize direct borrowing costs incurred during CWIP. The Council submits that, with respect to this issue, the Board should clarify the circumstances, for example the necessary project length, and standardize the regulatory policies to establish regulatory certainty.

Customer Contributions received for PP&E

The Council agrees with Staff's proposals with respect to customer contributions received for PP&E. The Council submits that customer contributions should be recorded as revenue or deferred revenue, instead of an offset to capital costs, in accordance with IFRS. The establishment of a revenue or deferred revenue adds clarity and eliminates the allocation otherwise required to the rate base assets.

The Council notes that the current regulatory practice of applying customer contributions as an offset to capital costs results in a lower rate base, carried at a utility's weighted average cost of capital. Deferred revenue is carried at the cost of interest. If customer contributions are material for a particular utility, the Board should address any incremental costs or benefits created due to the change in regulatory accounting treatment.

Asset Reclassifications from PP&E to Intangible Assets

The Council agrees with Staff's Proposals with respect to intangible assets. The Council submits that intangible assets should continue to be included in rate base and amortized as depreciation expense in accordance with current regulatory practice.

While IFRS requires intangibles to be excluded from PP&E, the reclassification of an asset for financial reporting purposes should have no bearing or impact on rates. Intangible assets, despite the AcSB's definition, should be included in rate base to provide rate base continuity.

Asset Retirement Obligations

The Council does not agree with Staff's Proposals with respect to asset retirement obligations ("ARO"). IFRS requires certain assets to be recorded as intangible assets that were previously included in PP&E. Under Staff's proposal, utilities shall include such intangible assets in rate base and the amortization expense in depreciation expense for determining the revenue requirement. The Council submits that the rate making treatment for asset retirement obligations should be decided on a case-by-case basis.

To date, the Board has yet to establish a regulatory accounting principle for negative salvage, with the notable exception of Ontario Power Generation ("OPG"). The sheer magnitude of OPG's ARO and the complexity of the financial arrangements and government obligations distinguish OPG from other Board-regulated entities with negative salvage or ARO. From the Council's perspective, insufficient information was exchanged during the course of the Stakeholder Consultation to evaluate the rate making principles and opine on a generic rate-making treatment.

Gains and Losses on Disposition of Assets

The Council agrees with Staff's Proposals with respect to gains and losses on the disposition of assets. Such circumstances and situations are rare. As a result, the Board should maintain its current practice regarding gains and losses. Any gains or losses on the disposition of assets should be separately identified and reviewed by the Board on a case-by-case basis.

Treatment of Asset Impairment

The Council agrees with Staff's Proposals with respect to the treatment of asset impairment loses. Circumstances of asset impairment are rare. As a result, the Board should maintain its current practice. The value of any impaired assets should be separately identified and reviewed by the Board on a case-by-case basis.

4. Depreciation

The Council does not agree with Staff's proposals with respect to asset depreciation. The Council submits that while straight-line depreciation should continue to be used, it is premature to recommend a regulatory accounting treatment.

The IFRS rules with respect to depreciation are not well defined and subject to interpretation. While IFRS requires companies to "componentize" assets, the degree of asset dis-aggregation required for utilities currently applying group depreciation methods is unclear. It was apparent during the Stakeholder Conference that accountants, whether employed by the utilities, third-party consulting agencies or audit firms, are still trying to determine the acceptable level of "componentization" for financial reporting and what refinements would be required to adapt their current accounting systems.

The Council submits that the Board should maintain current regulatory accounting treatment until comparative IFRS and CGAAP financial statement are available for each utility and the financial impact can be assessed.

5. Other Issues

Payments in Lieu of Corporate Income Taxes or Income Taxes

The Council agrees with Staff's Proposals with respect to payments in lieu of income taxes ("PILs") for publicly owned utilities, and with respect to income taxes for privately owned utilities.

The Council submits that the Board should continue its current practice of requiring electrical utilities to estimate the PILs proxy for inclusion in their revenue requirement and requiring gas utilities to estimate their tax recovery.

Pensions and Employee Future Benefits

The Council agrees with Staff's Proposals with respect to pensions and employee future benefits. The Council submits that the Board should continue its current regulatory accounting policies for gas and electric utilities.

D. External Uncertainties

The Council agrees with Staff's Proposals with respect to the external uncertainties regarding IFRS. The Council submits that the Board should proceed in the absence of decisions of the IASB. The Council refers the Board to the Council's submissions regarding the value of PP&E, above, the allowance of regulatory assets and liabilities, and applicability of IFRS to government business enterprises involved in the distribution and transmission of electricity.

The Board should provide regulatory clarity in the near term in order to assist all industry participants navigate through the transition to IFRS.

E. Impacts

The Council agrees with Staff's Proposals with respect to potential impacts from IFRS, including one-time administrative costs from the transition and ongoing administrative costs from reconciling the differences between financial and regulatory reporting.

The Council is cognizant of the potential revenue requirement impacts of changing regulatory accounting principles from those of the status quo. The Council reiterates that the principles of regulatory accounting must be established first for all Board-regulated utilities and rate mitigation be considered subsequently, as needed on a case-by-case basis.

Rate Impacts

The Council agrees with Staff's Proposals with respect to rate impacts. The Council submits that utilities should quantify the effect of financial reporting differences and revenue requirement impacts in their first cost of service rate filing after the adoption of IFRS. Any revenue requirement impacts should be included in the utility's aggregate rate impact analysis. The Board should continue to apply a 10% threshold on total bill as a trigger for rate mitigation analysis and recommendations.

Utility and Shareholder Impact

The Council agrees with part of Staff's Proposals with respect to utility and shareholder impact. The Council submits that the Board should approve deferral accounts for incremental administrative costs incurred after January 1, 2009 as a result of IFRS. The Council notes that some utilities applied to the Board prior to January 1, 2009 requesting a deferral account for incremental IFRS-related costs, yet the Board deferred the requests until this proceeding. To the extent that requests were received, the Council submits that those utilities should be permitted to establish deferral accounts to record costs prior to January 1, 2009, yet the costs recorded should not predate the initial Board request.

Assuming deferral accounts are approved to record IFRS-related administrative costs, the Council submits that the Board should establish a standard process to assess the prudence of costs incurred. The Council submits that the Board should compare costs incurred by utility in order to understand the types of legitimate expenditures and the range of total expenditures. The Council believes that it would be difficult for the Board to assess the prudence of costs in the context of an individual rate case without the ability to compare utilities or compare the applicant to a standard benchmark.

The Council agrees with Board staff's suggestions to minimize IFRS implementation costs. The Council submits that the Board needs to encourage a cooperative process for sharing and discussion among the utilities. Utilities could benefit from the advanced thinking of other utilities on accounting practices and audit issues.

F. Filing and Reporting Requirements

The Council will not make any submissions with respect to specific filing and reporting requirements resulting from IFRS. The Council submits that the Board will need to consider the filing and reporting requirements of each utility on a case-by-case basis, depending upon the timing of the utility's next test year. The January 1, 2010, transition date for financial reporting is common to all utilities, but dates for rates cases will cover a spectrum of time. There are utilities with rates cases planned in 2010, utilities that will be in the midst of incentive rate mechanisms ("IRM") on January 1, 2010, and utilities with rates cases planned for 2012. At a minimum, the Council agrees with Staff's proposals that the Board should require one full year of actual results reported under both IFRS and CGAAP in order to assess a utility's financial reporting and revenue requirement impact.

The Council is concerned that, once the Board establishes a set of regulatory accounting principles, utilities will request deferral and variance account to reflect any differences between the existing and any new regulatory accounting principles. Before responding to those requests, and before any deferral and variance accounts are established, the Board should provide instructions to ensure utilities are clear as to how entries should be made to those new accounts. For example, if a utility was in the midst of IRM when the Board established a new regulatory accounting principle for depreciation or capitalization, it would be difficult to determine the starting reference point for reporting "variances" to Board-approved depreciation rates or capital expenditures.

The Council recommends that the Board establish a working group, comprised from a subset of IFRS Consultation participants, to explore the issues related to deferral and variance accounts established as a result of this proceeding and make recommendations to the Board for rate making options. The risk of recording errors and misinterpreting the Board's intentions would be high. In fact, the risk would compound over time, especially if a utility's next rates case was planned for 2012. The Board need not burden each utility's next rates case, post IFRS transition, with issues related to the deferral and variance account assumptions and method for balance accumulation, in the Council's submission. The Board has an obligation to ensure that utilities are provided with clear instructions and guidance, to ensure the utilities understand how they should proceed and maintain their regulatory books through the next few years.

May 25, 2009

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