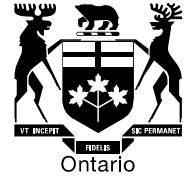


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BY E-MAIL

October 17, 2011

Board Secretary
Ontario Energy Board
2300 Yonge Street, Ste. 2701
P. O. Box 2319
Toronto ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

**Re: Board Staff Submissions
Hydro One Networks Inc. - US GAAP Proposal
2012 Electricity Transmission Revenue Requirement and Rates
Board File No. EB-2011-0268**

In accordance with Procedural Order No. 1, please find attached Board staff submissions for this proceeding. Please forward the attached to Hydro One Networks Inc. and to all intervenors in the proceeding.

Sincerely,

Original Signed By

Harold Thiessen
Case Manager – EB-2011-0268
Senior Project Advisor - Applications

Attachment



ONTARIO ENERGY BOARD

STAFF SUBMISSION

**Hydro One Networks Inc.
Transmission**

**APPLICATION TO ADOPT US GAAP FOR
TRANSMISSION RATE SETTING**

EB-2011-0268

October 17, 2011

INTRODUCTION

Hydro One Networks Inc. (“Hydro One”) is a licensed Ontario electricity transmitter.

On December 23, 2010, the Ontario Energy Board issued its EB-2010-0002 Decision with Reasons (the “Decision”) determining the 2011 and 2012 transmission revenue requirement for Hydro One Networks Inc., and by subsequent rate order dated January 18, 2011, set the Ontario Uniform Transmission Rates, effective January 1, 2011.

The Hydro One transmission revenue requirement for 2012 and the 2012 Uniform Transmission Rates will be established after the Board issues its revised Cost of Capital parameters update in the fall of 2011.

On July 15, 2011, Hydro One filed a letter and a Notice of Motion with the Board seeking to vary the Decision. The Motion sought to vary the Decision to permit Hydro One to use United States Generally Accepted Accounting Principles (“US GAAP”) as the basis for rate application filings, regulatory accounting and regulatory reporting commencing January 1, 2012. The Motion also sought to adjust the 2012 revenue requirement previously approved by the Board and to adjust the variance accounts approved in the Decision, to reflect the adoption of US GAAP rather than Modified International Financial Reporting Standards (“MIFRS”) for regulatory purposes. This would have the effect of reducing the 2012 transmission revenue requirement by \$195 million, from \$1,657.6 million to \$1,462.3 million.

Hydro One had previously informed the Board, by way of letter dated May 31, 2011, that it was evaluating the option of adopting US GAAP in lieu of MIFRS for 2012.

In its evidence filed September 6, 2011, Hydro One stated that it was also seeking “acknowledgement and approval that if US GAAP is adopted to establish the revenue requirement and rates for Hydro One Transmission, it is appropriate for Hydro One Networks to do so for Hydro One Distribution.”

The Motion was copied to all intervenors in the EB-2010-0002 proceeding. In the Motion, and by letter dated August 11, 2011, Hydro One informed the Board that it had sought, and on July 21, 2011 received, approval from the Ontario Securities Commission (“OSC”) to utilize US GAAP as the basis for preparing its financial statements for public securities filings beginning in January 1, 2012 and terminating January 1, 2015.

On August 25, 2011, the Board issued its Decision, Notice of Hearing and Procedural Order No. 1 regarding the Motion. The Board determined under Rule 45 of the Rules of Practice and Procedure that the matter ought not to be considered as a review of the

Decision. However the Board did determine that on its own motion, it would commence a hearing under section 78 of the *Ontario Energy Board Act, 1998* to consider adjustments to Hydro One's 2012 Transmission revenue requirement and other adjustments to variance accounts that may be necessary should Hydro One use US GAAP rather than MIFRS for regulatory purposes.

The Board indicated that it will restrict its consideration of the 2012 Transmission revenue requirement and transmission rates to adjustments consequent on the adoption of US GAAP by Hydro One.

The Board assigned File No. EB-2011-0268 to the proceeding and granted intervenor status to all intervenors in the previous Hydro One transmission proceeding, EB-2010-0002.

Procedural Order No. 1 provided for interrogatories to be submitted by Board staff and intervenors and for Hydro One's responses. Interrogatories were submitted by the London Property Management Association (LPMA), the Association of Major Power Consumers in Ontario (AMPCO), the Vulnerable Energy Consumers Coalition (VECC) and Board staff. Provision for submissions by Board staff and intervenors and reply submissions by Hydro One were also made.

BOARD STAFF SUBMISSIONS

In these submissions, Board staff will focus its comments by referring to the Board's *Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment* (EB-2008-0408) (the "Addendum") issued on June 13, 2011.

In the Addendum, Issue #4 "Should the Board permit rate applications of RRR reporting using US GAAP?" is found on page 18. On page 19, the Board states,

"...the Board must consider the general public interest in ensuring efficiency and consistency in utility regulation in Ontario, and will require utilities to explain the use of an accounting standard other than MIFRS for regulatory purposes."

And also, on the same page:

"A utility, in its first cost of service application following the adoption of the new accounting standard, must demonstrate the eligibility of the utility under the relevant securities legislation to report financial

information using that standard, include a copy of the authorization to use the standard from the appropriate Canadian securities regulator (if applicable) showing any conditions or limitations, and set out the benefits and potential disadvantages to the utility and its ratepayers of using the alternate accounting standard for rate regulation.”

Eligibility under Relevant Securities Legislation

Hydro One has provided the decision from the securities regulator in Ontario, approving the use of US GAAP by Hydro One Inc. for financial reporting purposes¹. This exemption, allowing the use of US GAAP, was granted for a period of three years, from January 1, 2012 through to December 31, 2014. Board staff submits that Hydro One has demonstrated the required eligibility under relevant securities legislation, and has filed the required copy of the authorization to use the standard from the appropriate securities regulator. Board staff also notes that Ontario Regulation 395/11, filed in response to Board staff IR #6, indicates that Hydro One Inc. is required to prepare its financial statements in accordance with US GAAP, beginning at January 1, 2012, with no explicit time limitation.

Benefits

Hydro One’s evidence supports the view that the use of US GAAP for regulatory purposes is in the best interests of stakeholders, including the utility and its ratepayers.

Ratepayers:

As outlined in response to Board staff IR #5, Hydro One indicates that significant potential rate increases that would result from the adoption of MIFRS will be avoided under US GAAP. The response to AMPCO IR #5 shows the estimated five year impact on revenue requirement for both the transmission and distribution businesses. For transmission this is a reduction in revenue requirement ranging from \$195 million in 2012 to \$147 million in 2016. The range in distribution is \$166 million in 2012 to \$112 million in 2016.

As for transmission bill impacts, the response to Board Staff IR #2 shows Hydro One estimates of the impact on a typical residential customer’s bill (800 kWh) in 2012 would be an increase of \$2.48 per month if MIFRS is adopted for regulatory purposes and \$1.07 per month if US GAAP is adopted.

Hydro One also adds, in the response to Board Staff IR #5, that customers can also benefit from rate stability as US GAAP is similar to CGAAP, and that deferral and variance accounts with rate adders/riders can be utilized to achieve rate smoothing.

¹ Exhibit B/Tab 1/Sch 1

Utility and Shareholder:

Also in response to Board staff IR #5, Hydro One submitted that the economy in the Province of Ontario would benefit from lower overall energy costs if US GAAP is used for regulatory purposes. Increased costs of regulatory compliance are avoided through the adoption of US GAAP for both regulatory and external financial reporting purposes since Hydro One will not have to duplicate transactional accounting in two sets of books and reconcile between them. Hydro One stated that under IFRS, on consolidation, the Province's retained earnings would be about \$2 billion lower than they would be under US GAAP.

Financial Community and Investors:

As Hydro One also indicated in the same response, from an external investor and supporting financial analyst's perspective, alignment of the accounting frameworks in use for external financial reporting and for rate making provides a clearer and more understandable relationship between the accounting basis used to set rates and that used to report results. Hydro One's evidence argued that this alignment better depicts the link between cash flows stemming from the regulatory process and the underlying accounting. Further, the volatility in annual net income that would result under an IFRS regime (through immediate recognition in net income of changes in pension liability, for example) and the resulting clouding of Hydro One's underlying economic fundamentals, would be avoided under a US GAAP framework.

Potential Disadvantages

In response to AMPCO IR #2 Hydro One indicated that it has not identified any significant disadvantages to it or to its primary stakeholders in using US GAAP for rate setting purposes rather than MIFRS. However, Hydro One acknowledges in its evidence² that consistency in accounting methodology across local utilities is desirable and that its transition to US GAAP will not facilitate comparison with other local utilities. However, the adoption of US GAAP by the transmission utility will improve Hydro One's ability to benchmark with other large North American utilities and other entities which are retaining or adopting US GAAP.

Board staff agrees that for the transmission utility, benchmarking opportunities will not be greatly reduced, and in fact may be enhanced, through the use of US GAAP. However, Hydro One has also asked for the Board's acknowledgement and approval that if US GAAP is adopted to establish the revenue requirement and rates for Hydro One Transmission, it is also appropriate for Hydro One Distribution to use US GAAP for

² Exhibit C/Tab1/Sch1/p4

regulatory purposes. Staff addresses the problems with distribution utility benchmarking below.

Successive Transitions of Accounting Standard

At page 19 of the Addendum, the Board addresses the issue of the use of US GAAP as a short term solution, stating,

“The Board cautions utilities that the adoption of USGAAP as a short term solution may be counter-productive. If a utility is required to transition to IFRS for financial reporting purposes a few years after adopting USGAAP, certain transitional issues may not have been avoided, but delayed, and additional costs may be incurred if the utility changes its accounting standard twice. The Board will carefully scrutinize the costs incurred to accomplish two successive transitions if the utility seeks to recover these costs from ratepayers.”

Board staff notes that the 3 year term of the exemption was not imposed by the OSC but was the time frame applied for by Hydro One Inc. When asked why it had asked for only a 3 year exemption, in the response to Board staff IR #8, Hydro One replied,

“Hydro One chose to request a three-year exemption request based on the term of the Enbridge Income Fund precedent [refer to Exhibit B, Tab 1, Schedule 2, page 1] and advice from advisors that this was the term that was likely to receive regulatory approval.”

It appears that at this time, Hydro One does not intend to adopt IFRS if it can qualify for the continued use of US GAAP. In response to Board Staff IR#9, Hydro One indicates that there is no formal or approved schedule for the United States to adopt IFRS. Hydro One further stated that if the United States does not adopt IFRS, Hydro One Inc. would intend to seek a further exemption from the OSC for reporting subsequent to 2014. In addition, the response to VECC IR #2 states that Hydro One Inc. could become a U.S. Securities and Exchange Commission registrant as it previously had that status.

Hydro One’s response to Board staff IR #20 indicates that the amount of IFRS transition costs embedded in the revenue requirement approved in EB-2010-0002 were \$210,420 and \$0 for 2011 and 2012 respectively. The response further indicates that the balance in the IFRS Incremental Transition Costs Variance Account is a debit balance of \$256,392 as of June 30, 2011.

In response to Board staff IR #13, Hydro One indicates that it does not "...have detailed estimates of the future costs of transitioning to US GAAP available but does not expect that incremental costs will be significant."

In the same response, Hydro One notes that it "...cannot forecast the future costs to transition to IFRS for January 1, 2015 should that occur given uncertainty regarding IFRS and US GAAP developments occurring over the future period. However, Hydro One's IFRS conversion effort was substantially completed in 2011 and the project has been mothballed in an orderly fashion that will allow an orderly future restart. Hydro One would not expect to duplicate any IFRS conversion costs already incurred."

Board staff submits that the Board cannot assess the true potential for a later transition to IFRS by Hydro One, at this time. Hydro One is not seeking to recover any costs of a later transition in this hearing. Staff notes that the Board will have the opportunity to scrutinize the costs of a second transition (should such a transition be necessary) at the time those costs are sought to be recovered from ratepayers.

Using US GAAP in Distribution Rate Setting

Hydro One is also seeking the acknowledgement and approval of the Board that if US GAAP is adopted to establish the revenue requirement and rates for Hydro One Transmission, it is appropriate for Hydro One to do so for Hydro One Distribution.

As noted above, response to AMPCO IR #5 shows the estimated five year impact on the revenue requirement for the distribution business is a reduction in revenue requirement ranging from \$166 million in 2012 to \$112 million in 2016, compared to MIFRS accounting.

The response to Board staff IR #2 shows Hydro One's estimate of the impact on Distribution base rates if US GAAP is utilized rather than MIFRS. Hydro One estimates that 2012 Distribution base rates would increase by 14% if MIFRS were utilized rather than US GAAP. Specifically, if all other items on the current customer bill stay the same, the evidence shows that the utilization of MIFRS rather than US GAAP would result in an increase of \$6.59/month or 5.0% on total bill in the 2012 Total Bill for a typical residential customer (R1) consuming 800 kWh per month.

Board staff submits that if the Board determines that US GAAP is an appropriate regulatory accounting standard for the Transmission business, it would be costly and probably inefficient to require Hydro One Distribution to use MIFRS for regulatory

purposes. However, Board staff is concerned about the ability to benchmark Hydro One Distribution with other Ontario electricity distribution utilities.

At page 19 of the Addendum, the Board recognized the general public interest in maintaining consistency in utility regulation in Ontario. Board staff notes that Hydro One Networks lacks a suitable Ontario comparison group needed to perform benchmarking using the unit cost indexing method, however it can be included in the econometric benchmarking because of the ability of this approach to accommodate dissimilar utilities within the analysis.

In response to Board staff IR #17, Hydro One submits that benchmarking between its Distribution business and other Ontario LDCs can still take place once normalization occurs, and that any required adjustments could reasonably be made on a top-down basis. Board staff is unclear on how these top-down adjustments could be made, especially as the financial data under each accounting system will increasingly diverge as time elapses.

On page 20 of the Addendum, the Board stated:

“...the Board emphasizes to utilities that it retains the authority to require specific accounting standards and practices for regulatory purposes in any case where the Board finds that the public interest requires uniformity in those standards and practices among utilities.”

Board staff invites Hydro One to address, in its reply submission, whether there are any specific accounting standards and practices that must be uniform among all Ontario distribution utilities to allow robust benchmarking to occur.

Board staff further invites Hydro One to give an example of a reconciliation that could be provided to the Board to effectively compare Hydro One Distribution, with rates set on a US GAAP basis, to other Ontario electricity distribution utilities, with rates set on a MIFRS basis. Board staff invites Hydro One to demonstrate how the increasing difficulty over time of preparing such reconciliations would be mitigated.

Deferral and Variance Accounts

In this application, Hydro One also seeks approval to:

- discontinue the Impact for Changes in IFRS Account, the IFRS – Gains and Losses Account, and the IFRS Capitalisation Policy Variance Account;

- continue with the IFRS Incremental Transition Costs Account (with revised scope); and
- establish the Impact for US GAAP Account.

Hydro One indicates, in response to Board staff IR #19, that it has not entered any amounts into the accounts that it wishes to discontinue. As noted above, response to Board staff IR#20 shows that the balance recorded in the IFRS Incremental Transition Costs Variance Account is a debit amount of \$256,392 as of June 30, 2011.

With respect to the establishment of the Impact for US GAAP account, Hydro One proposes to recover or refund any amounts in the account in the next Transmission rates case. Board staff questions the need for this account. Unlike the Impact for Changes in IFRS account, this account is not proposed to record the impacts of changes in US GAAP standards, but rather to record the impact of differences between CGAAP and US GAAP that affect the 2012 revenue requirement. Hydro One indicates in response to Board staff IR #21 that it has not yet identified any significant differences, but such differences could be identified at a later date.

Staff submits that Hydro One has provided insufficient evidence to support the creation of this “just in case” account. The main justification for the adoption of US GAAP by Hydro One is the elimination or reduction of differences between CGAAP and IFRS that would have large impacts on the utility and its revenue requirement. If the Board is to agree to adjust rates to reflect the adoption of US GAAP in preference to MIFRS, it should be able to rely on Hydro One’s evidence that the impacts of a transition to US GAAP will be minimal. Board staff invites Hydro One to provide further justification of the need for this account in its reply submission.

Conclusion

Board staff submits that Hydro One has largely satisfied the requirements outlined in the Addendum.

- Hydro One has demonstrated eligibility under relevant securities regulations by seeking and receiving the OSC exemption and by filing Regulation 395/11.
- Hydro One has provided evidence as to the benefits and potential disadvantages of the change to US GAAP as its accounting standard. Hydro One has shown that there would be immediate rate relief to customers, compared to the use of MIFRS.

- Hydro One has addressed the Board's concerns regarding the costs that could be incurred by two successive transitions of accounting standard. A future panel of the Board may have to address this issue in a future rates case.

However, Board staff has raised concerns in two areas: benchmarking for the Distribution business, and the need for the Impact for US GAAP account.

Board staff agrees that benchmarking with comparable US transmission companies may be enhanced with common US GAAP accounting. Board staff also submits that it is appropriate for Hydro One's distribution business to have similar accounting standards as its transmission business. However, it is not clear to staff how Hydro One will be able to appropriately normalize its financial reporting to allow benchmarking with other Ontario distribution utilities. Board staff notes the Board's emphasis at page 20 of the Addendum regarding its authority to require specific accounting standards and practices for regulatory purposes where uniformity is in the public interest. Board staff urges Hydro One to specifically address these issues in its reply submission, as well as in its next distribution rate application.

In addition, Board staff invites Hydro One to provide further clarification of the need to establish the Impact for US GAAP account.

-All of which is respectfully submitted-