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BY EMAIL and RESS

October 17, 2011
Our File No. 20110268

Ontario Energy Board
2300 Yonge Street
27th Floor
Toronto, Ontario
M4P 1E4

Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2011-0268 – Hydro One Transmission – US GAAP

We are counsel for the School Energy Coalition. Pursuant to Procedural Order #1 in this proceeding, this letter constitutes SEC's submissions with respect to the Application by Hydro One for changes to its 2012 revenue requirement, rate base, and variance accounts resulting from its decision to move to US GAAP effective January 1, 2012.

Our submissions are organized on the same basis as the six requests for approval included by the Applicant in paragraphs 3 through 8 of its Application dated September 6, 2011.

Approval to Use US GAAP

SEC agrees with the Applicant that it is appropriate for Hydro One to use US GAAP commencing January 1. 2012.

Approval to Reduce 2012 Revenue Requirement

In calculating revenue requirement for 2012, the Applicant was ordered by the Board to move $200 million of capitalized overheads from 2012 capital expenditures to 2012 OM&A. This resulted in reductions to depreciation, interest, and ROE, and an increase in PILs, all netting a reduction in revenue requirement of $4.7 million. As a result, revenue requirement was reduced

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overall by $195.3 million. These calculations are set out in Schedule 1.9 of the Draft Rate Order of the Applicant in EB-2010-0002 (the "DRO").

Therefore, subject to our further comment below, we agree with the Applicant that the revenue requirement adjustment now proposed has been calculated correctly.

However, SEC is concerned that the Applicant is proposing to revert to full capitalization of overheads, despite doubts expressed by the Board in the EB-2010-0002 Decision (the "Decision").

In the Decision, the Board dealt with a proposal by the Applicant to have an exemption from the IFRS overhead capitalization rule. The Applicant argued that it would be a substantial rate impact, which it preferred to avoid.

The Board rejected the Applicant's proposal for two reasons.

First, the Board determined that the Board's IFRS capitalization policy should be followed. Since this Application would, if accepted, move the Applicant out of IFRS, this first reason is no longer applicable.

Second, the Board expressed its concern that the Applicant's approach to overhead capitalization was "at the high end of accepted practice under Canadian GAAP".

In the end, the Board stated its denial of the exemption as follows:

> *"The Board is concerned that Hydro One not continue with accounting policies that are at the extreme end of what would otherwise be considered generally accepted under Canadian GAAP, and which are not accepted under IFRS. The Board considers the IFRS capitalization policies to be an appropriate evolution in the treatment of this issue from a regulatory point of view." [Decision p. 64]*

SEC is therefore concerned that the reversal of the entire $195.3 million revenue requirement adjustment, as proposed by the Applicant, deals with only one of the reasons for the Board's adjustment, and not the other.

This puts the Board in a difficult position in this proceeding, though. While the Board has made clear that the Applicant's current overhead capitalization policy is "extreme" and needs to be reviewed, this proceeding is not the appropriate place to do that, and there is certainly insufficient evidence for that purpose. On the other hand, if the Applicant's proposal is accepted, and the Board next year reviews the capitalization policy and requires changes, a high rate increase is possible for 2013 to deal with that.

Based on the limited evidence before the Board, SEC is unable to propose a principled adjustment to the amount to be capitalized that would reflect the Board's concern, and withholding an arbitrary amount would be contrary to the Board's normal approach to ratemaking.

Therefore, SEC proposes that the Board allow the full adjustment proposed by the Applicant, but require the Applicant to implement a full review of their overhead capitalization policies for filing with their next rate case. That review should include not only an analysis of the rationale for the current policy at Hydro One, but also comparisons to other large transmission and distribution utilities in Canada and the United States. While the review should be prepared for the next Transmission rates application, it should, in light of our comments below, be made available to the Board as early as possible in the Applicant's 2012-2013 Distribution rates proceeding.

As with any such study, it should be up to the Applicant to decide how to implement the requirement, but clearly this is one in which external expert assistance may be a good idea.

Approval to Increase 2012 Capital Spending

The impact of $200 million shifted out of capital spending is set out in Schedule 1.3 of the DRO. We agree with the Applicant's adjustment, subject to our comments above on the secondary issue raised by the Board in the Decision.

We do note that, in practice, the Board does not approve capital spending, only rates. The Applicant is free to spend whatever amounts it considers appropriate in 2012, with the responsibility to justify that spending as prudent in its next rate case.

We would therefore propose that the Board not make a formal order approving any specific capital spending amount for 2012, but acknowledge that the new revenue requirement is based on this $200 million capital expenditure and OM&A adjustment.

Approval to Increase 2012 Rate Base

The DRO adjusted rate base downward by a net of $48.3 million as a result of this change to IFRS capitalization, as detailed in Schedule 1.2 and 1.9. Subject to our comments earlier, we agree that this is the appropriate amount to increase 2012 approved rate base.

Approval to Change Deferral and Variance Accounts

The Applicant proposes that the Board:

1. Discontinue the Impact of Changes in IFRS Account.

2. Discontinue the IFRS – Gains and Losses Account.

3. Discontinue the IFRS Capitalization Policy Variance Account.

4. Revise the scope of the IFRS Incremental Transition Costs Account.

5. Establish an Impact for US GAAP Account.

Since the balances in the first three accounts are zero [Ex. I/1/19], and cannot be increased under US GAAP, SEC agrees with Hydro One that they are no longer required.

With respect to the IFRS Incremental Transition Costs Account, Hydro One is electing late in the process to go with US GAAP instead of IFRS. As a result, there will likely b duplication of expenditures, and in our submission these additional costs should not be for the account of the ratepayers. We note that the Board's Report dated June 13, 2011 entitled "Addendum to Report of the Board' (the "IFRS Addendum") deals with this indirectly at p. 19-20, and makes clear that costs of two transitions may not be recoverable from ratepayers.

In our submission, the IFRS Incremental Transition Costs Account should be changed to "US GAAP Incremental Transition Costs Account", and only US GAAP transition costs should be eligible for the account. Where there are costs that were incurred for IFRS transition, but are also applicable for US GAAP, those costs should also be eligible. The rest of the costs for the "mothballed" [Ex. I/1/13] IFRS transition, including those already included in 2011 and 2012 rates, should not be recoverable.

With respect to the proposed Impact for US GAAP Account, we agree with the Applicant that it should be established, but it should be recharacterized as "Impact of Changes in US GAAP Account". This is consistent with the Decision, where the Board said:

> *"The Impact for Changes in IFRS Account is approved to record the impact on revenue requirement of changes in IFRS arising between those IFRS standards in force at the date of the company's application and those in force at the time of their next application, i.e. IFRS to IFRS changes. The Board considers it reasonable that Hydro One be allowed to record the effects from changes that might arise under IFRS after the date of their application for consideration in a future proceeding. This account is not for use in recording differences between Canadian generally accepted accounting principles and IFRS." [Decision, p. 58]*

In our submission, the same reasoning applies to US GAAP. The Applicant is proposing a change to that accounting standard, and must be presumed to have reviewed all of the impacts of that change. All such impacts should be included in the Application, and the Applicant should be at risk if they are not. Under the Board's rules, the Applicant is allowed to make accounting changes approved by the Board, which in this case would be limited to the change in capitalization policy requested in the Application. In the event that the Applicant discovers further differences between CGAAP and US GAAP, it must, we believe, either make a separate application to reflect those differences, or wait until its next rate case to implement them.

Approval of US GAAP for Distribution

The Applicant seeks an order from this Board panel approving the use of US GAAP for its distribution business effective January 1, 2012.

SEC agrees that, if the Board accepts the use by Hydro One of US GAAP in its transmission business, it should also accept that accounting standard for distribution as well.

We note that the Board, on page 3 of its decision dated August 25, 2011, expressly limited the scope of this proceeding to transmission only. However, on page 4 of the same decision the Board expressly included consideration of the Applicant's July 15, 2011 letter relating to its distribution business.

In light of the ambiguity in the August 25th decision, we propose that the Board indicate that US GAAP is appropriate, but make clear that only the Board panel hearing the Applicant's 2012 distribution rate application can make a binding order relating to the accounting rules to be used for distribution ratemaking purposes.

<u>Conclusion</u>

Subject to the caveats noted above, SEC supports the Application of Hydro One, as amended to be a section 78 proceeding.

SEC has sought to be as efficient as possible in its participation in this proceeding, with a view to maximizing its assistance to the Board, and requests that the Board order payment of SEC's reasonably incurred costs.

All of which is respectfully submitted.

Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC (email)
Donald Rogers, QC, Hydro One (email)
Susan Frank, Hydro One (email)
Harold Thiessen, Board Staff (email)
Interested Parties