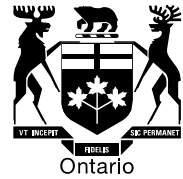


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**BY E-MAIL**

January 31, 2012

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

**Re: Board Staff Submission  
Hydro One Networks Inc. - US GAAP Proposal for Distribution  
Board File No. EB-2011-0399**

Please find attached Board staff submission 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-2011-0399  
Senior Project Advisor - Applications

Attachment



# **ONTARIO ENERGY BOARD**

## **STAFF SUBMISSION**

**Hydro One Networks Inc.  
Distribution**

### **APPLICATION TO ADOPT USGAAP FOR DISTRIBUTION RATE SETTING**

**EB-2011-0399**

**January 31, 2012**

**Board Staff Submissions**  
**Hydro One Networks Inc. Distribution**  
**Adoption of USGAAP, EB-2011-0399**

**INTRODUCTION**

Hydro One Networks Inc. ("Hydro One") is a licensed Ontario electricity distributor.

On November 23, 2011, the Ontario Energy Board (the "Board") issued its EB-2011-0268 Decision with Reasons granting approval for Hydro One Networks Inc. Transmission to utilize United States Generally Accepted Accounting Principles ("USGAAP") as the basis for rate application filings, regulatory accounting and regulatory reporting commencing January 1, 2012.

In its findings in the EB-2011-0268 proceeding, the Board noted that "...its policy states that a cost-of-service application is required for approval to transition to USGAAP. However, given the unique circumstances of Hydro One Transmission and Hydro One Distribution, the Board does not believe this applicant should be precluded from applying to extend the use of the USGAAP accounting standard to the Distribution business on appropriate terms and conditions, as a stand-alone application."

On December 1, 2011, Hydro One filed an application requesting approval to utilize USGAAP for rate setting, regulatory accounting and reporting as of January 1, 2012, for its distribution business. The Board assigned file number EB-2011-0399 to the application.

In the application, Hydro One estimated that the 2012 notional Hydro One Distribution revenue requirement would be \$166 million higher if Modified International Financial Reporting Standards ("MIFRS") were utilized rather than USGAAP. This would result in an approximate rate increase of 14% in 2012 as compared to USGAAP.

In this application, Hydro One also informed the Board that it is not requesting any change to its approved 2011 or 2012 distribution rates. Hydro One expects that its currently approved 2011 distribution rates will continue into 2012 and all appropriate costs will continue to be tracked in Board approved deferral and variance accounts, including its Green Energy related expenditures for Smart Grid, Express Feeders and other renewable generation.

On December 13, 2011, the Board issued its Notice of Hearing and Procedural Order No. 1 regarding this application. The Board granted intervenor status to all intervenors in the previous Hydro One Distribution proceeding (EB-2009-0096) and intervenors in the Hydro One Transmission USGAAP proceeding (EB-2011-0268).

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

Vulnerable Energy Consumers Coalition (VECC), the Canadian Manufacturers and Exporters (CME), the School Energy Coalition (SEC), and Board staff.

Provisions for submissions by Board staff and intervenors, and reply submissions by Hydro One, were also made in this procedural order.

Hydro One provided interrogatory responses on January 16, 2012 and also included Miscellaneous Exhibit K-1-1 which included all interrogatory responses from the EB-2011-0268 (USGAAP for Hydro One Transmission) proceeding.

## **BOARD STAFF SUBMISSIONS**

In these submissions, as in the previous Hydro One transmission USGAAP case, 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 or RRR reporting using USGAAP?" 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 USGAAP by Hydro One Inc. for financial reporting purposes<sup>1</sup>. This exemption, allowing the use of USGAAP, was granted for a period of three years, from January 1, 2012 through to December 31, 2014. As in the Hydro One Transmission US GAAP case, Board staff submits that Hydro One has demonstrated the required

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<sup>1</sup> Exhibit B/Tab 1/Sch 1

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 in the Hydro One Transmission USGAAP case (Exhibit K-1-1) indicates that Hydro One Inc. is required to prepare its financial statements in accordance with USGAAP, beginning at January 1, 2012, with no explicit time limitation.

### **Benefits**

Hydro One's evidence supports the view that the use of USGAAP for their distribution business for regulatory purposes is in the best interests of stakeholders, including the utility, its shareholder, and its ratepayers. In response to Board staff IR#5 in Exhibit K-1-1, and in response to VECC IR#2 in this proceeding, Hydro One underlined the efficiencies that will be gained by the distribution and transmission businesses if they are permitted to report to the regulator on a common accounting standard.

### Ratepayers

As outlined in response to Board staff IR #2 in Exhibit K-1-1, Hydro One indicates that significant potential rate increases that would result from the adoption of MIFRS will be avoided under USGAAP. A 14% increase in the Hydro One Distribution revenue requirement would result in a total bill increase of 5% or \$6.59 per month for a representative R1 class Residential customer.

The response to Association of Major Power Consumers in Ontario ("AMPCO") IR #5 in Exhibit K-1-1 shows the estimated five year impact on revenue requirement for both the transmission and distribution businesses, if USGAAP is used in place of MIFRS. For Hydro One Distribution, this is a reduction in revenue requirement of \$166 million in 2012, \$154 million in 2013, \$140 million in 2014, \$126 million in 2015, and \$112 million in 2016.

Hydro One also added, in response to Board Staff IR #5 in Exhibit K-1-1, that customers can also benefit from rate stability, as USGAAP is similar to Canadian Generally Accepted Accounting Principles ("CGAAP").

### Utility and Shareholder

Also in response to Board staff IR #5 in Exhibit K-1-1, Hydro One submitted that the economy in the Province of Ontario would benefit from lower overall energy costs if USGAAP were used for regulatory purposes. Increased costs of regulatory compliance are avoided through the adoption of USGAAP 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 USGAAP.

#### Financial Community and Investors

In the same response, Hydro One also indicated that 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 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 USGAAP framework.

#### **Potential Disadvantages**

##### Benchmarking

In response to AMPCO IR #2 in Exhibit K-1-1, Hydro One indicated that it has not identified any significant disadvantages to it or to its primary stakeholders in using USGAAP for rate setting purposes rather than MIFRS. However, Hydro One acknowledged in its evidence in the Transmission case that consistency in accounting methodology across local utilities is desirable and that its transition to USGAAP will not facilitate comparison with other local utilities.

While 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 USGAAP. There are however, problems with distribution utility benchmarking which were noted by the Board on page 13 of the EB-2011-0268 decision.

"The Board agrees that on the basis of the record presented in this application, it may be appropriate for Hydro One to adopt USGAAP for distribution rate applications and regulatory reporting. This finding is consistent with the Board's policy in its Addendum Report, which reaffirmed the principle in the original Report of the Board: that to require a utility to file and report in MIFRS when that utility is performing financial reporting under a different accounting standard is generally not desirable. In addition, as the Board has found that Hydro One transmission rates should be set on the basis of USGAAP, it would generally be inefficient to require the distribution utility to use MIFRS for regulatory reporting and rate making.

However, Hydro One must address this issue on the record of its next distribution rate application. The current application has been structured so as only to address the revenue requirement of the transmission business and the consequential Uniform Transmission rates. The Board will require Hydro One Distribution to file the information required on page 19 of the Board's Addendum, and particularly to address the potential disadvantage raised by intervenors and Board staff of the increased difficulty in benchmarking Hydro One Distribution to other Ontario distributors if Hydro One uses the USGAAP accounting standard."

In the past, Hydro One has commissioned benchmarking studies in support of both their transmission and their distribution rate cases. Hydro One's approach in those situations has been to provide data showing how it should be compared in terms of both reliability and cost versus other similar-sized utilities. Because of its unique size, service territory demographics, and system design, Hydro One believed it was necessary to go outside the province of Ontario to find appropriately comparable utilities for comparison.

Board staff notes that the benchmarking studies that Hydro One submitted in its prior cost-of-service applications were of significant benefit to the Board and parties in rates proceedings to test and assess Hydro One's operational costs and practices such as human resources compensation, and tree trimming cycle time. By using benchmarking information, the Board was able to make certain assessments of the reasonableness of information used in setting rates and had a higher level of confidence reviewing and accepting the expert reports (e.g., compensation studies) provided by Hydro One.<sup>2</sup>

In its EB-2007-0681 decision, dated December 18, 2008 for Hydro One distribution rates, the Board emphasized on the importance of the benchmarking evidence in a number of areas and stated, on page 11:

"The Board is concerned however that the Company does not appear to be pursuing efficiency in the delivery of these programs as aggressively as possible. The high level distribution benchmarking study undertaken by the PA consulting group (the "PA Study") suggests, but does not prove, that the Company's per unit costs for delivering this kind of program are higher, perhaps substantially higher, than other utilities.

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<sup>2</sup> For example: In the Hydro One Distribution Decision, EB-2009-0096, the Board found that Hydro One's OM&A budget was excessive. At page 12 the Board stated that, "the benchmarking results also support the conclusion that Hydro One could and should do better in managing its growth in spending. In the EB-2008-0272 transmission case, Hydro One filed a compensation and productivity study, "the Mercer Study". The Board stated at page 30, "The Board concludes that it is appropriate to disallow some compensation costs because these costs are substantially above those of other comparable companies and the company has failed to demonstrate that productivity levels offset this situation. But while the Board does not consider the productivity portion of the Mercer Study to be of determinative value in support of the application it does not draw any negative conclusions from the study either."

The Board is also concerned that the cost structure of the Company, unless it is placed within reasonable boundaries based on appropriate comparisons, will simply continue to rise with successive labour agreements or supply contracts without effective restraint or improvements in efficiency.”

On page 13:

“Accordingly, the Board will require the Company, in consultation with the intervenors and Board staff, to develop a benchmarking approach which will provide the Board at the next rebasing exercise with definitive information respecting the Company’s relative efficiency in this area of operations. In the interim, the Board will expect the Company to give effect to any innovations which improve its productivity and efficiency in this area.”

On page 15:

“Virtually every intervenor expressed some frustration with respect to the nature of the evidence supporting the company’s compensation proposal. This area has been a challenge for the company, intervenors and the Board for some time. It appears as though the company is preparing a more informative benchmarking evidence for the purposes of its transmission application. As noted above with respect to the vegetation management issue, effective benchmarking is absolutely crucial for this Company and the ratepayers’ interest going forward. Without such information, which takes into account the interests of both the ratepayers and the Company, it is difficult to judge the adequacy or inadequacy of the company’s proposal. Accordingly, most parties deferred their concerns on this subject matter for consideration in the context of the transmission case where it is hoped a full and fruitful examination of the Company’s relative compensation costs can be conducted.”

In this application, Hydro One has acknowledged that it will address, in its next rate case, the potential disadvantages of the increased difficulty in benchmarking Hydro One Distribution to other Ontario distributors after it adopts USGAAP.

In its submissions in the EB-2011-0268 proceeding, Board staff invited 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 USGAAP basis, to other Ontario electricity distribution utilities, with rates set on a MIFRS basis.

Board staff also invited Hydro One to demonstrate how the increasing difficulty over time of preparing such reconciliations would be mitigated. In their reply submissions, Hydro One did not provide an example of a reconciliation that could be submitted to the Board, nor did they demonstrate how the increasing difficulty over time of preparing such reconciliations would be mitigated.

In response to Board staff IR #10, Hydro One reported that it did not have any preliminary findings or information on these benchmarking issues but did point out that there were historic difficulties inherent in benchmarking Hydro One’s essentially rural

distribution business with Ontario LDCs that primarily operate urban systems, citing the 2008 Pacific Economics Group Report. Should the Board grant the current application, Board staff submits none-the-less that Hydro One Distribution should propose specific solutions in its next rates application for benchmarking to other distributors in Ontario or comparable distributors in Canada that do not adopt USGAAP. The Board may wish to provide specific direction to Hydro One to provide solutions at the time of its next rebasing application filing to address concerns related to benchmarking.

Board staff notes that benchmarking for Hydro One distribution will become more important if the distributor's rates are set using an incentive rate mechanism. The use of stretch factors in an incentive regime may encourage distributors such as Hydro One to improve their cost performance relative to other distributors. Therefore the importance of accurate benchmarking for Hydro One Distribution is greater if the distributor moves to incentive-based rate setting.

#### Capitalization Policies

In its EB-2011-0268 decision concerning the adoption of USGAAP for Hydro One Transmission, the Board required Hydro One to conduct a critical review of its current and proposed capitalization policies. In the response to Board staff Interrogatory #12 in the current application, Hydro One confirmed that it uses the same capitalization policies for both its distribution and transmission businesses. Hydro One stated that in completing its capitalization study for its transmission business, Hydro One would also consider the implications for its distribution business. Hydro One stated that if Hydro One's review were to result in some immediate change to its existing overhead capitalization methodology, any such change could not be implemented within its distribution business until the Board examined and approved it as part of distribution's next cost of service application.

Board staff submits that as part of Hydro One Distribution's next cost of service application, it should include the results of its capitalization review, including information with respect to what other Ontario distributors or comparable distributors to Hydro One in Canada or US typically capitalize. The evidence in the distribution cost of service application should include information regarding the capitalization policies and methodologies used by other Ontario distributors, and comparable Canadian and US distributors, with a view to comparing these to Hydro One's capitalization policies.

#### Cost of Successive Transitions of Accounting Standard

At page 19 of the Addendum, the Board addresses the issue of the use of USGAAP 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 in Exhibit K-1-1, 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 USGAAP. In the transmission USGAAP case, Hydro One indicated 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, Hydro One also noted 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 #2 indicates that:

“The incremental USGAAP transition costs incurred in 2011 and to be reflected in the ‘USGAAP Incremental Transition Cost Account’ total \$75 K. These amounts were incurred for audit-related services in support of Hydro One’s successful application to the OSC for approval to adopt USGAAP. Hydro One does not currently expect to incur significant incremental USGAAP transition costs during 2012. Due to the similarities between USGAAP and legacy CGAAP, the transition work can be managed by internal staff.”

When asked by Board staff about the IFRS –Incremental Transition Costs Account in Board staff IR#5, Hydro One reported that,

“The balance in the ‘IFRS – Incremental Transition Costs Account’ as of December 31, 2011 is about \$309 K, representing the cumulative differential between IFRS transition amounts in approved revenue requirements and actual expenditures. IFRS Transition Project costs

included in the revenue requirements approved in EB-2009-0096 were approximately \$770 K in 2010 and \$255 K for 2011.”

Hydro One also indicated that it would seek recovery of these amounts at its next cost of service rates application.

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. As in the transmission case, 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.

### **Deferral and Variance Accounts**

In this application, Hydro One Distribution also seeks approval to:

- discontinue the Impact for Changes in IFRS Account;
- continue with the IFRS Incremental Transition Costs Account (with revised scope); and
- establish the Impact for USGAAP Account.

Hydro One indicates, in response to Board staff IR #3 that it has not entered any amounts into the Impact for Changes to IFRS Account (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 Account is a debit amount of \$309,000 as of December 31, 2011. Board staff submits that recording costs in this variance account does not provide indication of recovery of the balances in the account. These costs will be subject to a prudence review when Hydro One seeks clearance of the balance in this account in a future proceeding.

With respect to the establishment of the Impact for USGAAP account, Hydro One proposes that a symmetrical variance account be established to record the 2012 impact of differences between Canadian and USGAAP in sufficient detail to allow them to be reviewed for disposition in a future proceeding.

Board staff notes that the Board approved the establishment of an Impact for USGAAP account in the recent Hydro One Transmission proceeding, EB-2011-0268. Board staff submits that it is reasonable to extend this regulatory treatment to Hydro One’s distribution business as the amounts that would be recorded in the account would likely relate to costs in the same corporate structure. Board staff submits that the account

should be limited to potential impacts on the 2012 revenue requirement, and not relate solely to balances incorporated into the audited financial statements.

Similar to balances recorded in the IFRS Incremental Transition Costs Account, Board staff submits that recording costs in the Impact for USGAAP account does not provide any indication that the balances in the account will be recovered from ratepayers. These costs will be subject to a prudence review when Hydro One seeks clearance of the balance in this account in a future proceeding. As the Board noted in the transmission proceeding, upon request for disposition of this variance account, the Board should take into account whether Hydro One adequately reviewed all of the impacts of the accounting changes associated with the transition to USGAAP.

### **Conclusion**

Board staff submits that Hydro One Distribution 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 USGAAP 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.

Board staff submits that it would be costly and probably inefficient to require Hydro One Distribution to use MIFRS for regulatory purposes while Hydro One Inc. and Hydro One Transmission use USGAAP. However, it is still not clear to staff how Hydro One will be able to appropriately normalize its financial reporting to allow benchmarking with other Ontario distribution utilities or comparable distributors in Canada which do not adopt USGAAP. 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 recommends that Hydro One Distribution be required, in its next rates application, to propose specific solutions for benchmarking Hydro One Distribution to other distributors in Ontario or comparable distributors in Canada that do not adopt USGAAP. Staff submits that this

evidence should include examples of reconciliations that facilitate comparisons between Hydro One Distribution and other distributors whose rates are set on a MIFRS basis.

In addition, Board staff recommends that the Board require Hydro One to bring forward as evidence in its next distribution rates case the capitalization review required in the EB-2011-0268 decision, accompanied by evidence of the capitalization policies and methodologies used by other Ontario distributors, and Canadian and US distributors comparable to Hydro One Distribution.

-All of which is respectfully submitted-