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Ontario

BY E-MAIL

March 6, 2012

Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street
27th floor
Toronto ON M4P 1E4

Dear Ms. Walli:

Re: Board Staff Submissions
Hydro One Remote Communities Inc. USGAAP Proposal
Board File No. EB-2011-0427

Please find attached Board staff submissions for this proceeding. Please forward the attached to Hydro One Remote Communities Inc. and to all intervenors in the proceeding.

Sincerely,

Original Signed By

Harold Thiessen
Case Manager – EB-2011-0427
Senior Project Advisor - Applications

Attachment

ONTARIO ENERGY BOARD

STAFF SUBMISSION

Hydro One Remote Communities Inc.

APPLICATION TO ADOPT USGAAP FOR REMOTES RATE SETTING

EB-2011-0427

March 6, 2012

INTRODUCTION

Hydro One Remote Communities Inc. ("Remotes") is a wholly-owned subsidiary of Hydro One Inc. with its head office in Toronto. Remotes is an integrated generation and distribution company licensed to generate and distribute electricity for 21 isolated communities in Northern Ontario. Consistent with the Board's decision in RP-1998-0001, Remotes is 100% debt-financed and is operated as a break-even company with no return on equity.

Most of Remotes' customers are eligible for Rural and Remote Rate Protection ("RRRP") under Section 79 of the *Ontario Energy Board Act, 1998*. O. Reg. 442/01 that requires the Board to calculate Rate Protection for these customers and requires that Remotes charge rates that are not based on the cost of service.

Remotes conducts its operations under a cost recovery model applied to achieve breakeven results of operations after the inclusion of PILs. Any excess or deficiency in remote rate protection revenues necessary to lead to breakeven results of operations is added to, or drawn from, the RRRP variance account, which was established in 2002 for this purpose.

About two-thirds of Remotes' revenues come from RRRP. Remotes does not plan to seek approval to adjust the level of RRRP at this time.[1]

On November 25, 2011, Remotes submitted an application to the Ontario Energy Board to set 2012 distribution rates for Remotes under the Board's 2012 IRM3 framework. The Board assigned EB-2011-0175 to this application. As part of the application, Remotes included a request to utilize United States Generally Accepted Accounting Principles (USGAAP) for regulatory purposes, effective January 1, 2012.

On December 8, 2011 the Board issued a letter acknowledging receipt of this application. In that letter the Board stated: "The Board is of the view that the 2012 IRM3 rate application is not an appropriate forum in which to consider these issues…" and indicated that Remotes should "…not be precluded from requesting, in a stand-alone application, approval to use USGAAP for regulatory purposes and authorization for deferral and variance accounts associated with the use of USGAAP for regulatory purposes".

On December 16, 2011 Remotes made a separate application for approval to utilize USGAAP for rate setting, regulatory accounting and regulatory reporting for

[1] Exhibit A, Tab 3, Schedule 1, EB-2011-0175 2012 IRM3 application

Remotes. The Board assigned file number EB-2011-0427 to the application. The application generally follows the steps outlined by the Board in its EB-2011-0268 Transmission USGAAP Decision.

On February 2, 2012, the Board issued its Notice of Hearing and Procedural Order No. 1 regarding the EB-2011-0427 application (the stand-alone USGAAP application). The Board granted intervenor status to all intervenors in Remotes previous Cost of Service distribution rates proceeding (EB-2008-0232) and indicated that it intended to proceed by way of a written hearing.

Procedural Order No. 1 provided for interrogatories to be submitted by Board staff and intervenors and for Remotes' responses. Interrogatories were submitted by Board staff on February 14, 2012 and Remotes provided responses on February 23, 2012.

BOARD STAFF SUBMISSIONS

In these submissions, as in the previous Hydro One Transmission and Distribution USGAAP cases, 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

Remotes has provided the decision from the securities regulator in Ontario, approving the use of USGAAP by Hydro One Inc. for financial reporting purposes[2]. 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 and Distribution USGAAP cases, Board staff submits that Remotes has demonstrated the required eligibility under relevant securities legislation, and has filed the required copy of the authorization to use this accounting standard from the appropriate securities regulator. Board staff also notes that Ontario Regulation 395/11 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 demonstrated in both the Distribution and Transmission USGAAP cases, that the use of USGAAP for regulatory purposes is in the best interests of stakeholders, including the utility, its shareholder, and ratepayers. At Exhibit C/Tab1/Schedule 1 page 2 and 3 Remotes underlined the efficiencies that will be gained if all Hydro One regulated businesses (transmission, distribution and remotes) are permitted to report to the regulator on a common accounting standard.

As outlined in response to Board staff IR #7, Remotes indicated that significant potential rate increases would result from the adoption of MIFRS but avoided under USGAAP. Remotes estimated that its notional revenue requirement would increase by $2 million under MIFRS. This is similar to the impact outlined in the distribution and transmission USGAAP cases.

Board staff submits that the benefits of a single accounting standard as outlined in the transmission and distribution USGAAP cases would also apply in the case of Remotes. These are:

- the customer benefit of rate stability, as USGAAP is similar to Canadian Generally Accepted Accounting Principles (“CGAAP”),

- the avoidance of regulatory compliance costs 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, and

[2] Exhibit C/Tab 1/Sch 1

- the clearer and more understandable relationship between the accounting basis used to set rates and that used to report financial results.

Finally, in the Board's transmission USGAAP decision (EB-2011-0268), on page 13, the Board indicated that "…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 to regulatory reporting and rate making". Board staff submits that the same conclusion applies to Remotes as well.

Potential Disadvantages

In its application, Remotes did not identify any significant disadvantages to it or to its primary stakeholders in its business, in using USGAAP for rate setting purposes rather than MIFRS.

Remotes is not currently expecting any impact on its rate base or revenue requirement from the adoption of USGAAP. If any differences arise in the future within the existing IRM period, Remotes stated that they would be accounted for consistent with the recommendations of the Board's IFRS Addendum Report and would be recorded in the appropriate regulatory accounts.

Benchmarking

Board staff IR # 8 raised the issue of benchmarking, as this was a significant issue in both the transmission and distribution USGAAP cases.

In its response, Remotes indicated that it had not considered benchmarking issues in the case of its conversion from CGAAP to USGAAP. Remotes stated that it is not comparable to other Ontario utilities as it provides generation and distribution to a small customer base in isolated, off-grid communities scattered over large distances. Remotes pointed to the Comparators and Cohorts Study undertaken for 2006 EDR, where the lack of comparators in Ontario was recognized in the report with the statement: "For regulatory purposes, HORC's (Hydro One Remote Communities) circumstances and operating environment mean that rate-setting is handled differently than that of most utilities."

Remotes also mentioned that there are eight utilities offering off-grid service in Canada: Hydro Quebec, Newfoundland and Labrador Hydro, Manitoba Hydro, BC Hydro, ATCO Electric, North West Territories Power and Quilliq Power (Nunavut). Remotes maintained that benchmarking against these utilities was difficult due to different regulatory and tax regimes, different subsidy structures, different geography and different types of customers.

Board staff accepts this information from Remotes.

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 IR #10 in the current application, Remotes confirmed that it uses the same capitalization policies across all of its regulated businesses. Remotes stated that the conclusions of the capitalization study would be equally applicable to its circumstances.

Board staff submits that as part of Remotes' next cost of service application, it should include the results of this capitalization review as they pertain to Remotes, including information with respect to what other distributors typically capitalize. As Board staff understands Remote's intentions, the evidence in the transmission and distribution cost of service applications should include information regarding the applications of the corporate capitalization policies to Remotes.

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. Hydro One has stated that it chose to request a three-year exemption request based on the term of the Enbridge Income Fund precedent (Exhibit B, Tab 1, Schedule 2, page 6] and advice from advisors that this was the term that was likely to receive regulatory approval.

As noted in the Transmission and Distribution USGAAP cases, it appears that 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.

Board staff submits, as it did in the transmission and distribution USGAAP cases, that the Board cannot assess the true potential for a later transition to IFRS by Hydro One at this time. Remotes 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.

Deferral and Variance Accounts

In this application, Remotes seeks approval to establish the Impact for USGAAP Account.

Board staff understands that Remotes is seeking to establish the USGAAP Incremental Transition Costs Account for Remotes in its IRM application (EB-2011-0175) as shown in Remotes' response to Board staff IR #2 i). In addition, as shown in response to Board staff IR #4 iii) Remotes is also seeking the continuance of the RRRP variance account.

In the response to Board staff IR #4, Remotes stated that it does not expect any direct USGAAP impact on the RRRP variance account. As a result, Board staff submits that it would be reasonable to permit Remotes the continuance of the RRRP variance account, with a caveat as discussed below.

Remotes stated in the response to Board staff IR #2 that the variance between incremental IFRS transition costs approved in Remotes 2009 revenue requirement and actual incremental IFRS transition costs incurred was not recorded in the IFRS Transition Costs Variance account approved by the Board[3]. In the response to Board staff IR #2 v) Remotes stated that the after-tax impact of the variance was instead recorded in the RRRP Variance account. Remotes stated that it had incurred a $70,000 variance in 2009 resulting from the difference between $110,000 actual incremental IFRS conversion charges in 2009 and $40,000 included in Remotes' 2009 revenue requirement for incremental IFRS transition

[3] Approved by the Board in the October 2009 Accounting Procedures Handbook Frequently Asked Questions #2

costs. Board staff invites Remotes to explain why this amount was not recorded in the IFRS Transition Costs Variance account.

In the same response, Remotes also stated that a "Corporate Finance cost was also charged by Hydro One Networks through approved service level agreements" but did not disclose the amount charged. Board staff submits that Remotes should disclose the amount charged and explain the rationale for not including this amount in the incremental IFRS Transition Costs Variance account.

Board staff submits that recording costs in either the RRRP Variance account or in the IFRS Transition Costs Variance account does not imply recovery of the balances in the account. These costs will be subject to a prudence review when Remotes seeks clearance of the balance in this account in a future proceeding.

Remotes' evidence advocating for the Impact for USGAAP account indicates that an initial review has been carried out regarding the differences between Canadian and USGAAP to understand how they impact its business.

Remotes indicated that, given that the adoption of USGAAP may result in some differences from Canadian GAAP, it proposed that a symmetrical variance account should be established to record the 2012 impact of such differences in sufficient detail to allow them to be reviewed for future disposition.

In response to Board staff IR #6, Remotes indicated that it had not identified any significant differences that would be recorded in this account and felt that it was premature to anticipate whether it will make any specific entries to this account or the nature of such future entries.

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 Remotes 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 reflecting the incremental IFRS transition cost variance, Board staff submits that recording costs in the Impact for USGAAP account does not provide any guarantee that the balances in the account will be recovered from ratepayers. These costs will be subject to a prudence review when

Remotes 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 Remotes has adequately reviewed all of the impacts of the accounting changes associated with the transition to USGAAP.

Conclusion

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

- Remotes has demonstrated eligibility under relevant securities regulations by seeking and receiving the OSC exemption and through Regulation 395/11.

- Remotes has provided evidence as to the benefits and potential disadvantages of the change to USGAAP as its accounting standard. Remotes has also indicated that there would be immediate rate relief to customers, compared to the use of MIFRS.

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

Board staff submits that it would be costly and inefficient to require Remotes to use MIFRS for regulatory purposes while Hydro One Inc. and Hydro One Transmission (and potentially distribution) use USGAAP.

In addition, Board staff recommends that the Board require Remotes to address how its review of capitalization required in the EB-2011-0268 decision will affect the Remotes business, in its next rates case.

-All of which is respectfully submitted-