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April 10, 2012

via RESS e-filing – signed original to follow by courier

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th floor
PO Box 2319
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Application for Accounting Order to Establish a Deferral Account
OEB File No. EB-2012-0079

Pursuant to the Board's Procedural Order No. 2 attached is Toronto Hydro-Electric System Limited's ("THESL") Responses to Board Staff Interrogatories. Please note that THESL did not receive any other interrogatories from other parties.

Please direct any questions or comments to my attention.

Yours truly,

[original signed by]

Amanda Klein
Senior Regulatory Counsel

att.

:AK/acc

cc: J. Mark Rodger, Counsel for THESL, by electronic mail only
Intervenors of Record for EB-2010-0142/EB-2012-0079, by electronic mail only

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INTERROGATORY 1:

Reference(s): pp. 1-2

THESL states that the requested deferral account will record the accounting differences resulting from both the transition to and the implementation of US General Accepted Accounting Principles ("USGAAP"). THESL also states that there are specific areas of difference in accounting treatment between Canadian General Accepted Accounting ("CGAAP") and USGAAP, including the treatment of other post-employment benefits ("OPEB"). However, it appears that THESL only explains the differences with respect to OPEB in the application.

Please confirm that the deferral account requested by THESL will be limited to recording the differences with respect to OPEB. Otherwise, please explain the nature and the quantum of the other items that are expected to cause the differences and that will be recorded in the requested deferral account.

RESPONSE:

At this time, THESL confirms that the deferral account requested will be limited to recording the differences with respect to OPEB as described in its application.

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INTERROGATORY 2:

Reference(s): pp. 2-3

THESL cites the Addendum to the Report of the Board – Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment ("Addendum Report") for the creation of a deferral account for IFRS related impacts on Pension & OPEB accounts occurring at the date of transition. Page 14 of the Addendum Report states that:

> "The option remains for these utilities to seek an individual account if they can demonstrate the likelihood of a large cost impact upon transition to IFRS."

Please explain how the large cost impact as was referenced in the Addendum Report applies to THESL upon the transition to and the implementation of USGAAP effective January 1, 2012, given the OPEB difference to be recorded in the deferral account is stated as solely a difference on the balance sheet with no impact in profit and loss.

RESPONSE:

As described in its application, THESL is requesting that the OEB establish a parallel deferral account to record its accounting differences between CGAAP and US GAAP, in reference to Page 14 of the Board's Addendum Report. As at January 1, 2011, approximately $30 million related to the unamortized actuarial gains (losses) and prior service costs, *which were previously unrecognized* under CGAAP, will be recognized on the balance sheet under US GAAP. This has the effect of increasing THESL's OPEB liability, with an offsetting amount in accumulated other comprehensive income

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("AOCI") which is a component of shareholder's equity. Given that rate-regulated accounting applies, upon the establishment of this deferral account, THESL would be able to transfer this balance from AOCI to the said deferral account requested, resulting in the net equity position on the balance sheet being the same under CGAAP and US GAAP. After the establishment of this deferral account, the unamortized balance of OPEB will fluctuate based on changes in actuarial assumptions and changes in benefits that may give rise to prior service costs. The fluctuations in the account would occur independently of the system of accounting in place (CGAAP versus US GAAP).

With respect to the amounts being amortized into the net periodic defined benefit costs on the profit and loss, both CGAAP and US GAAP employ the corridor approach.

If THESL is denied the use of the deferral account requested, the effects of the changes in actuarial assumptions and prior service costs will be recognized as part of other comprehensive income ("OCI") for external reporting purposes. This would have a significant negative impact on the shareholder's equity reported in THESL's general purpose financial statements. For regulatory purposes, if THESL is explicitly not permitted to continue to defer the effects of the changes in actuarial assumptions and prior service costs by way of a deferral account, the costs will be recognized immediately in the profit and loss as an out-of-period cost within operating expenses.

It is important to note that for purposes of setting rates, THESL currently defers all unamortized actuarial gains (losses) and prior service costs. The deferred costs that are amortized are accrued as period costs and are included in the calculation of the revenue

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requirement for each fiscal period when the costs are amortized based on accrual accounting rules.

If THESL were transitioning to IFRS, the impact as at January 1, 2011, would be more significant primarily due to the fact that the account would also include the impact for the derecognition of regulatory assets and liabilities.

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INTERROGATORY 3:

Reference(s): pp. 2-3

THESL references USGAAP section ASC 980-715-25-5 and states that ASC 980-715-25-5 specifically allows for the recognition of a regulatory asset for OPEB differences under THESL's circumstances. THESL further states that the facts considered include the assumptions that (1) it is probable for the amount to be recovered in the future and (2) THESL's post retirement benefits liability has been accounted for on an accrual basis.

(a) Please provide a copy of ASC 980-715-25-5.
(b) Please state whether or not THESL will recognize a regulatory asset for OPEB on its balance sheet if the deferral account requested is not approved by the Board.
(c) Please state how the Board's approval of the requested deferral account can help in recognizing a regulatory asset for OPEB on its balance sheet.

RESPONSE:

(a) A copy of ASC 980-715-25-5 is attached as Attachment A.

(b) If the Board does not approve the deferral account requested, THESL will not meet one of the requirements to recognize a regulatory asset related to OPEB on its balance sheet for external reporting purposes as per ASC 980-715-25-5(b)(1), therefore THESL could not recognize these amounts as a regulatory asset.

The Board's approval of the requested deferral account is specifically required by ASC 980-715-25-5(b)(1) in order for THESL to recognize a regulatory asset for

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external reporting purposes. This treatment aligns the existing regulatory and accounting practices with the guidance under US GAAP, which allows THESL to avoid maintaining two sets of ledgers. Please refer to the response in Interrogatory no. 2.

Copy of ASC 980-715-25-5

Source: https://asc.fasb.org

980 Regulated Operations
715 Compensation—Retirement Benefits
25 Recognition

25-5 For a continuing postretirement benefit plan a rate-regulated entity shall recognize a regulatory asset for the difference between Subtopic 715-60 costs and other postretirement benefit costs included in the entity's rates if the entity does both of the following:

- a. Determines that it is probable that future revenue in an amount at least equal to the deferred cost (regulatory asset) will be recovered in rates
- b. Meets all of the following criteria:
  - 1. The rate-regulated entity's regulator has issued a rate order or issued a policy statement or a generic order applicable to entities within the regulator's jurisdiction that allows both for the deferral of Subtopic 715-60 costs and for the subsequent inclusion of those deferred costs in the entity's rates.
  - 2. The annual Subtopic 715-60 costs (including amortization of the transition obligation) will be included in rates within approximately five years from the date of adoption of that Subtopic. The change to full accrual accounting may take place in steps, but the period for deferring additional amounts shall not exceed approximately five years.
  - 3. The combined deferral-recovery period authorized by the regulator for the regulatory asset shall not exceed approximately 20 years from the date of adoption of Subtopic 715-60. To the extent that the regulator imposes a deferral-recovery period for those costs provided for in Subtopic 715-60 greater than approximately 20 years, any proportionate amount of such costs not recoverable within approximately 20 years shall not be recognized as a regulatory asset.
  - 4. The percentage increase in rates scheduled under the regulatory recovery plan for each future year shall be no greater than the percentage increase in rates scheduled under the plan for each immediately preceding year. This criterion is similar to that required for phase-in plans in paragraph 980-340-25-3(d). Recovery of the regulatory asset in rates on a straight-line basis would meet this criterion.

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INTERROGATORY 4:

Reference(s): **p. 3**

THESL states that: "Under US GAAP, recoveries of the amounts in this deferral account happen in the same manner as they do currently under CGAAP, as the amount in AOCI (reclassified to a regulatory asset) is amortized through profit and loss in the current service cost. Accordingly, the establishment of this deferral account will not impact rates for rate payers."

(a) Please explain in detail why the deferral account is needed by THESL given that it is stated that its establishment will not impact rates for ratepayers.

(b) Please state whether or not the deferral account requested is intended to be used as a tracking account to hold the differences with respect to OPEB's unamortized actuarial gains/losses and unamortized past service costs upon the transition to and implementation of USGAAP. If yes:

  (i) please state whether or not the establishment of an internal tracking account, rather than a deferral account would be more appropriate to THESL's needs, and

  (ii) if yes, please discuss why the Board should approve such an internal tracking account for THESL given that it is stated there will not be any rate impact on ratepayers.

(c) If an internal tracking account would not be appropriate, please explain why not.

RESPONSE:

(a) As THESL has stated in its application, the establishment of this deferral account will not impact rates for ratepayers. The existence of the deferral account simply enables

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the transfer of the location of the account balances from shareholder's equity to regulatory assets. These amounts are categorically excluded from revenue requirement. THESL is seeking approval of the deferral account in order to meet a specific requirement of ASC 980-715-25-5(b)(1). The initial establishment of the deferral account as requested will not give rise to rate impacts to ratepayers. However, the future recovery of the regulatory asset will occur when the actuarial gains (losses) and prior service costs are amortized into profit or loss as part of the current service costs of that period. This amortization into profit and loss will be consistent with Part V of Canadian GAAP. It is worth noting that, like Part V of Canadian GAAP and current regulatory practice, US GAAP applies a deferral methodology since OCI itself achieves a deferral mechanism as the balance is amortized into profit and loss on a straight line basis. Without the deferral account requested, one of the criteria for deferring the cost as a regulatory asset under US GAAP would not be met. This would have a significant negative impact on the shareholder's equity reported in THESL's general purpose financial statements.

THESL notes that other utilities have received approval for similar deferral accounts. Should THESL be denied of the deferral account requested, benchmarking against industry peers may be impacted.

Finally, the accounting order gives THESL's external auditors a simpler, more transparent method of obtaining confirmation of the regulatory asset and provides THESL a more transparent method of tracking this balance.

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(b) The deferral account requested is intended to record the differences with respect to the transition and implementation of US GAAP, i.e. the impacts on the opening balance sheet as a result of the recognition of OPEB's unamortized actuarial gains (losses) and unamortized prior service costs under US GAAP.

The establishment of an internal tracking account would not be appropriate as ASC 980-715-25-5(b)(1) requires a regulator to have issued a rate order or a policy statement.

On March 30, 2012, the Accounting Standards Board issued an extension on the use of CGAAP for entities with qualifying rate-regulated activities until January 1, 2013[1]. However, conversion to CGAAP at this time would materially jeopardize THESL's ability to meet its March 31, 2012 Ontario Securities Commission external reporting timelines, given that THESL already implemented US GAAP for financial reporting as at January 1, 2012. Utilizing the extension of CGAAP would not be a cost effective option as this would require THESL to incur additional costs to unwind the implementation of US GAAP and extend the accounting transition project to another year. Further, the implementation of US GAAP is preferable for THESL compared to IFRS since US GAAP is more comparable to CGAAP and IFRS results in a significantly higher financial impact, when considering rate impact, the cost of implementation, and the number of measurement differences. In addition, THESL has publicly disclosed in its external reporting documents and to its bond holders and credit rating agencies that it would be converting to US GAAP. Finally, there can be no certainty that a final rate-regulated standard will be issued under IFRS by January

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[1] Refer to http://www.frascanada.ca/accounting-standards-board/meetings/decision-summaries/2012/item63796.aspx

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1, 2013. THESL intends to apply to the Board for approval for the use of US GAAP in its next cost of service application.

(c) An internal tracking account would not be appropriate as a deferral account is a specific requirement of ASC 980-715-25-5(b)(1). Under US GAAP, if THESL does not receive the regulator's approval to recognize the difference as a regulatory asset, THESL must recognize the balance in OCI for external reporting purposes. This would have a significant negative impact on the shareholder's equity reported in THESL's general purpose financial statements.