Ontario Energy Board
P.O. Box 2319
27th. Floor
2300 Yonge Street
Toronto ON M4P 1E4
Telephone: 416- 481-1967
Facsimile: 416- 440-7656
Toll free: 1-888-632-6273

Commission de l'Énergie de l'Ontario
C.P. 2319
27e étage
2300, rue Yonge
Toronto ON M4P 1E4
Téléphone; 416- 481-1967
Télécopieur: 416- 440-7656
Numéro sans frais: 1-888-632-6273

Ontario

BY E-MAIL

May 1, 2012

Ontario Energy Board
P.O. Box 2319
27th Floor
2300 Yonge Street
Toronto ON M4P 1E4

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: Board Staff Submission
Toronto Hydro-Electric System Limited
Application for Accounting Order
Board File Number EB-2012-0079

Please find the attached Board staff submission in the above proceeding.

Sincerely,

Original Signed By

Martin Davies
Project Advisor, Applications & Regulatory Audit

Attachment

cc: Parties to EB-2012-0079 proceeding

ONTARIO ENERGY BOARD

BOARD STAFF SUBMISSION

Toronto Hydro-Electric System Limited

Application for Accounting Order

EB-2012-0079

May 1, 2012

Background

Toronto Hydro-Electric System Limited ("THESL") requested that the Board approve the establishment of a deferral account to record certain accounting differences between Canadian Generally Accepted Accounting Principles ("CGAAP") and United States Generally Accepted Accounting Principles ("USGAAP").

THESL stated that it formally received its decision from the Ontario Securities Commission, allowing it to utilize USGAAP for external financial reporting and securities filing purposes, effective January 1, 2012[1]. THESL stated that it already implemented USGAAP for financial reporting as at January 1, 2012.[2] THESL has indicated it intends to apply for Board approval to use USGAAP in its next cost of service application.[3]

THESL identified a $30M difference resulting from the transition and implementation from CGAAP to USGAAP pertaining to unamortized net actuarial gains or losses and past service costs of its Other Post Employment Benefits ("OPEB"). THESL confirmed that the deferral account requested will be limited to recording the differences with respect to OPEB at this time[4]. THESL stated that as at January 1, 2011, the $30M unamortized actuarial gains or losses and prior service costs of OPEB were previously unrecognized under CGAAP, but will be recognized on the opening balance sheet under USGAAP. As a result, the OPEB liability will be increased with the offsetting amount to be recognized in the shareholder's equity.

THESL explained that the Board's approval of the requested deferral account is specifically required by USGAAP in order for THESL to recognize a regulatory asset for external financial reporting purposes[5]. As such, THESL is requesting the approval of a deferral account so that THESL can recognize the $30M as a regulatory asset instead of as Accumulated Other Comprehensive Income ("AOCI"), a component of shareholder's equity for external reporting purposes[6].

[1] THESL, EB-2012-0079 Application, p.1.
[2] THESL, EB-2012-0079 Response to Board Staff Interrogatories, Tab 1, Schedule 4, p.3.
[3] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p.4 .
[4] THESL, EB-2012-0079 Response to Board Staff Interrogatories, Tab 1, Schedule 1, p.1.
[5] THESL, EB-2012-0079 Response to Board Staff Interrogatories, Tab 1, Schedule 3, p.1.
[6] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 2, p.1.

THESL indicated that the establishment of the deferral account enables the transfer of the $30M from shareholder's equity to regulatory assets on the balance sheet; with the net equity position remaining the same. THESL stated in its application that there was no rate impact expected from the initial establishment of the deferral account.[7] However, in response to a Board staff interrogatory, THESL provided a clarification that the future recovery of the regulatory asset would occur when the actuarial gains/ (losses) and prior service costs are amortized into profit and loss as part of the current service costs of that period.[8]

THESL is of the view that if it is denied the use of the deferral account, there would be a significant negative impact on the shareholder's equity reported in THESL's general purpose financial statements as for regulatory purposes the costs would be recognized immediately in the profit and loss as out-of-period cost[9].

THESL noted that other utilities have received approval for similar deferral accounts and, as such, benchmarking may be impaired if THESL's request is denied[10]. Lastly, THESL stated that the creation of the deferral account would provide THESL a more transparent method of tracking the balance[11].

Submission

Board staff submits that the deferral account requested by THESL is required to appropriately track the effects of the change in accounting standard upon THESL's transition and implementation to USGAAP as at January 1, 2012 for a number of reasons which are outlined in the following:

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[7] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p.1.
[8] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p.2.
[9] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 2, p.2.
[10] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p.2.
[11] THESL, EB-2012-0079 Responses to Board Staff Interrogatories, Tab 1, Schedule 4, p.2.

1. *There is a potential future impact on rates*

It is clear to staff that the $30 million difference represents a one time adjustment of the OPEB liability upon the transition to USGAAP and the amount of the adjustment was not recognized under CGAAP.

Staff notes that THESL has stated that there is no rate impact from the initial establishment of the deferral account. However, staff further notes that THESL has acknowledged that there may be rate impacts when the $30 million unamortized gains (losses) and prior service costs on the transitional date are amortized through the income statement over the period of the average employee remaining service life. Staff also observes that THESL indicated that without the deferral account requested, the costs will be recognized immediately in the profit and loss as out-of-period cost for regulatory purposes.

Staff further notes that THESL's last cost of service test year was 2011 and THESL's rates are expected to be set under the Incentive Rate Mechanism ("IRM") regime for 2012.

As a result, Board staff is of the view that if the deferral account is not established during the IRM period, the costs may become out of period for regulatory purposes. Therefore, Board staff submits that in order to ensure that balances arising from the transition and implementation of USGAAP are eligible for recovery, the Board may consider approving the establishment of the deferral account at this time, even though there is no immediate rate impact. In addition, Board staff agrees with THESL that an internal tracking account, which Board staff had asked THESL to opine on as a possible alternative is not appropriate because of the potential rate impacts going forward.

Staff has some concerns about the conditions under which recovery of any amounts that may accumulate in the proposed deferral account may be appropriate.

Staff notes that in its application THESL states:

> Under US GAAP, recoveries of the amounts in the 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[12].

Staff submits that given the above statement, it would be helpful if THESL would clarify in its reply submission, why if these amounts are being recovered in the current service cost, there would be any need for additional recovery of any amounts which would accumulate in the proposed deferral account.

More specifically, staff is concerned that if THESL is already recovering these costs through its currently approved rates, there would be an issue of double recovery of any such amounts in the deferral account, unless there is an increase in these costs relative to the level on which THESL's currently approved rates are based.

Under such circumstances, staff would be of the view that an increase in a cost of this nature which is not specifically related to the transition to USGAAP, would be a normal cost increase that would not be appropriate for inclusion in a deferral account and THESL should not be able to incorporate such a cost increase into its rate recovery until the time of its next cost of service filing.

Accordingly, staff submits that THESL should demonstrate before being allowed to recover any costs that may accumulate in the proposed deferral account: (1) that these costs are incremental to what is already being recovered in THESL's approved rates and (2) that the incremental increase is specifically related to the transition from CGAAP to USGAAP and would not have occurred in the absence of this transition.

2. *Similar deferral accounts have been approved for other utilities*

Staff notes that the Board has approved similar deferral accounts to track costs associated with the transition to USGAAP for Ontario Power Generation Inc., Hydro One Networks Inc., Hydro One Remote Communities Inc. and Union Gas Limited.[13]

[12] THESL, EB-2012-0079 Application, p.3.
[13] EB-2011-0432 Ontario Power Generation Inc.Decision, EB-2011-0268 Hydro One Transmission Decision, EB-2011-0299 Hydro One Distribution Decision, EB-2011-0427 Hydro One Remote Connections Decision, EB-2011-0025 Union Gas Limited Decision.

3. THESL's request is consistent with Board policy

On page 14 of the EB-2008-0408 *Addendum to the Report of the Board* regarding the implementation of International Financial Reporting Standards ("Addendum") dated June 13, 2011 for the creation of a deferral account for Pension &OPEB at the date of the transition, the Board 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.

Staff notes that THESL has already implemented USGAAP for financial reporting as at January 1, 2012. Board staff also notes that the deferral account requested represents a one time transitional adjustment related to an OPEB liability of approximately $30 million upon THESL's transition to and implementation of USGAAP. Therefore, THESL's request for the establishment of the deferral account with respect to the large cost impact upon transition is consistent with the guidance provided in the Addendum.

4. THESL's request conforms with USGAAP requirements

Board staff agrees with THESL that the need for a deferral account conforms with the specific requirement of USGAAP regulatory accounting for OPEB (ASC 980-715-25-5 Regulated Operations- Compensation – Retirement Benefits – Recognition).

Conclusion

Board staff notes that while the approval of a deferral account will allow THESL to establish a regulatory asset for its external financial reporting, this should not be the main reason for requesting a deferral account. The Board does not regulate THESL's external financial reporting. It is up to the individual utility's management to decide how it tracks the amounts that arise due to a transition in accounting standards.

Board staff notes that should the Board decide to grant THESL's request, the establishment of the deferral account does not guarantee THESL that any amounts will necessarily be recovered. In its Decision issued for Union Gas Distribution related to the request for a deferral account upon the transition to USGAAP, the Board stated,

> Moreover, approving the establishment of the USGAAP Transition Deferral Account does not guarantee that the amount in the deferral account will be disposed of, consistent with the principles underlying all Board-approved deferral accounts.[1]

Board staff is of the view that the same principle applies to THESL's request for a deferral account in this application. Board staff submits that the costs recorded in the deferral account will be subject to a prudence review when THESL seeks clearance of the balance in this account in a future proceeding.

Board staff notes that THESL intends to use USGAAP for rate-setting purposes in its next cost of service application. Board staff reminds THESL that in doing so, it is necessary that THESL provide the relevant documents and explanations in detail to satisfy the criteria[14] listed in the Addendum for the use of USGAAP as an alternative for MIFRS for ratemaking purposes.

Staff submits that THESL's request for the deferral account is appropriate and should be approved by the Board. Board staff is of the view that the Board may wish to consider incorporating in its findings, the following caveats regarding the establishment of the deferral account:

- The establishment of the deferral account does not guarantee that the amount in the deferral account will be disposed of, consistently with the principles underlying all Board-approved deferral accounts
- The establishment of the deferral account would not be predictive of the Board's ultimate decision on USGAAP for regulatory purposes for THESL and that in the event the Board did not approve the use of USGAAP for regulatory purposes, the requested deferral account would not be required and the balance recorded in the account would not be recognized.

- All of which is respectfully submitted-

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[14] Appendix A of the EB-2008-0408 Addendum to the Report of the Board regarding the implementation of International Financial Reporting Standards.