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

November 12, 2012

Attention: Ms. Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: PowerStream Inc.
Application for 2013 Distribution Rates
Board File Number EB-2012-0161

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

The Board had established a filing date for Board staff's submission of November 9, 2012.

Due to an evacuation of the Board's offices and cessation of business based on the notice of a pending power outage on the morning of November 9, 2012, staff was unable to file its submission to meet the filing date established by the Board.

Board staff regrets the late filing of this submission.

Original signed by

Martin Davies
Project Advisor, Applications & Regulatory Audit

Attachment

cc: Parties to EB-2012-0161 proceeding

ONTARIO ENERGY BOARD

BOARD STAFF SUBMISSION

PowerStream Inc.

EB-2012-0161

November 12, 2012

Background

PowerStream Inc. ("PowerStream" or the "Applicant") filed a cost of service application (the "Application") seeking changes to the rates that PowerStream charges for electricity distribution effective January 1, 2013. A Settlement Agreement covering most issues in this proceeding was filed with the Board on October 24, 2012. An oral hearing on the remaining issues was held on October 29, 2012. PowerStream filed its argument-in-chief on Monday November 5, 2012.

This is the submission of Board staff with respect to the four unsettled issues remaining for this application. These issues are the following:

1. The request for a full year of depreciation for capital additions in the 2013 Test year. (Issue 4.2)
2. The accounting method PowerStream used to calculate depreciation for 2010 and 2011, and proposes to continue to use for 2012 and forward. (Issue 4.2)
3. The appropriate interest rate for the promissory notes held by PowerStream's three shareholders (Issue 6.1)
4. The appropriate treatment of property, plant and equipment due to the transition to modified IFRS. (Issue 8.2)

Issue 4.2: The request for a full year of depreciation for capital additions in the 2013 Test year.

Background

PowerStream's application requested a full year of depreciation for capital additions in the 2013 Test year in order to increase its revenue requirement to provide additional funding for capital additions, resulting in an increase in depreciation expense of $1,883,000 and revenue requirement of $2,527,000 as compared to the impacts that would result from use of the half-year rule.

A Board staff interrogatory[1] asked PowerStream to state whether or not it believed that there were any circumstances specific to it that would justify a

[1] Exh. J1, Tab 4, Sch. 4.2, pp. 1-2

departure from the Board's normal practices in this regard and, if so, to explain what those were. In addition, this interrogatory asked PowerStream to explain, in the absence of the referenced specific circumstances, why its proposal would not be more appropriately considered in a more generic proceeding.

PowerStream responded that the inclusion of only a half year of depreciation in the 2013 test year additions in revenue requirement would create a significant funding shortfall during the IRM period as it would mean that in subsequent years until the next rebasing, there would only be a half year of depreciation in rates but a full year of depreciation expense with respect to the capital additions for 2013.

PowerStream stated that this shortfall in depreciation is only partially offset by the amount of depreciation no longer required on assets being fully depreciated during an IRM period. PowerStream noted that the bulk of its assets are distribution assets with long lives and would have much lower costs than assets constructed at current costs and thus the annual depreciation expense would be correspondingly lower.

PowerStream estimated that during the IRM period it would have $91.7 million more in capital additions (average of $104.7 million) than the cost of assets being fully depreciated (average of $13 million) each year. PowerStream concluded that based on the average rate of depreciation for 2013 additions of 4.53%, this would translate into an annual shortfall of approximately $4 million in depreciation expense, between depreciation on new additions less depreciation provided by fully depreciated assets.

PowerStream stated that through its work on the Renewed Regulatory Framework for Electricity Task Force, it had learned that this is an issue for other distributors, but could not comment on whether treatment as a generic issue would be the best course of action. PowerStream stressed that the funding shortfall created by the use of a half year of depreciation was a serious issue and should be addressed in the present application, rather than wait for potential future relief.

Discussion and Submission

Board staff is of the view that this matter is a generic issue that would have an impact on all distributors.

Board staff notes that PowerStream has not provided any circumstances specific to it which would justify a departure from a generic approach and furthermore that PowerStream's response quoted above would appear to support the view that this is a generic issue.

Staff further notes that the assessment of the impacts of PowerStream's request for a full year of depreciation for capital additions in the 2013 Test year is a complex matter and PowerStream has only provided high level calculations of its impacts.

For instance, PowerStream stated that the shortfall in depreciation is only partially offset by the amount of depreciation no longer required on assets being fully depreciated during an IRM period. However, PowerStream did not reference such other offsetting effects that may arise from factors such as those assets that are either not replaced even though they are fully depreciated, or retired early as well as other related impacts.

Staff is also concerned that the granting of PowerStream's request by the Board would result in PowerStream's depreciation being overstated in the Test year, since rates in the Test year would be set on the basis that all assets would go into service January 1, 2013 which staff submits is not a realistic assumption.

Accordingly, staff submits that PowerStream's request for a full year of depreciation for capital additions in the 2013 Test year should be denied.

Staff further submits that if the Board is inclined to address this matter going forward, it should be dealt with in an appropriate generic proceeding. Furthermore, if the Board is inclined to consider PowerStream's request within the context of this proceeding, staff submits that PowerStream has not submitted sufficiently detailed evidence on this matter to provide the Board with a clear understanding of its impacts in the period until PowerStream's next cost-of-service rate filing.

Issue 4.2: The accounting method PowerStream used to calculate depreciation for 2010 and 2011, and proposes to continue to use for 2012 and forward.

Background

The issue of PowerStream's depreciation methodology has three components:

The first is that for the 2010 and 2011 actual years, PowerStream has calculated depreciation based on an assets-in-service dates approach, which the Settlement Agreement[2] stated was a more accurate approach than the half year depreciation approach. The Settlement Agreement further stated that had PowerStream used the half-year approach in 2010 and 2011, the method used for setting base rates which were subsequently adjusted for those years, depreciation would have been $1,263,000 higher in total for those two years, with a corresponding reduction in net book value of property, plant and equipment ("PP&E") as of January 1, 2013.

The second is that for purposes of forecasting depreciation in the present application, PowerStream applied the half-year rule for all 2012 capital additions. Intervenors proposed that the depreciation expense for 2012 would also be lower than the amount proposed in the application, in an amount of $500,000, reflecting an estimate of the difference between using in-service dates and the half-year rule in 2012, which would increase the $1,263,000 PP&E differential referenced above accordingly.

The third and final component is whether, if the in-service method is to be used in the 2013 Test year and beyond, the forecast of depreciation expense for the Test year should be adjusted to reflect an in-service month approach.

PowerStream submitted that its approach was consistent with Board policy noting that the Board's June 28, 2012 Filing Requirements provide that "…the Board's general policy for electricity rate setting is that capital additions would normally attract six months of depreciation expense. Variances from this "half-

[2] Settlement Agreement, October 24, 2012, p.18

year" rule, such as calculating depreciation based on the month that an asset enters service, must be documented with supporting rationale."

PowerStream submitted that the half-year rule is an assumption for estimating purposes only and noted that the Board has separate guidelines, the *Accounting Procedures Handbook for Electricity Distributors* (the "APH") that deal with accounting for actual transactions. Furthermore, the APH does not mention the half-year rule. PowerStream argued that for the 2010 and 2011 historical years, its calculation of depreciation based on the actual additions and in-service dates is consistent with the APH and good accounting practice, as it would be incorrect to record the forecast additions rather than actual costs.

Discussion and Submission

Board staff notes that the key concern surrounding all three parts of this unresolved issue is whether or not the method used for recording depreciation on an actual basis in PowerStream's financial statements should be the same as that used for forecasting purposes.

Board staff is in agreement with PowerStream's submissions on this issue.

Board staff notes that any requirement by the Board that distributors be required to forecast –in-service dates for assets would increase the complexity of the applications process without any certainty that it would improve the accuracy of the forecasts.

Staff also notes that the introduction of such a requirement by the Board would also significantly increase the complexity of the review process for rate applications based on cost of service, particularly if multi-years of cost forecasting is involved.

Issue 6.1: The appropriate interest rate for the promissory notes held by PowerStream's three shareholders.

Background

PowerStream has outstanding promissory notes with its three shareholders in the total amount of $166.1 million. Of this, $78.2 million is held by the Corporation of the City of Vaughan, $67.9 million by the Corporation of the Town of Markham and $20.0 million by the Corporation of the City of Barrie. The interest rate on each of these debt instruments is 5.58%. This rate was established at the time of issuance of this debt to the City of Vaughan and the Town of Markham on June 1, 2004 and extended to the City of Barrie when it became a shareholder in 2009.

The issuance date for these promissory notes is shown in the application as June 1, 2004 for the Vaughan and Markham notes and January 1, 2009 for the Barrie notes.

The promissory notes have a callability provision and the unsettled issue is whether or not, given this provision, the interest rate on this debt should be the Board’s current deemed rate which is 4.41%, subject to any subsequent updates by the Board before a decision in this proceeding is reached.

In its submission, PowerStream acknowledges that each of the shareholder notes contains an acceleration provision whereby the shareholder may effectively redeem the notes by providing 90 days written notice to PowerStream. However, PowerStream states that the notes have been subordinated to its non-share holder debt in a number of ways outlined in its submission including Postponement Agreements.

PowerStream states that the effect of the Postponement Agreements is that should any of its shareholders call the notes, PowerStream will first be liable for the payment of $200 million to its debenture holders, plus additional millions of dollars in penalties as well as the value of the Promissory Note itself.

PowerStream argued that these provisions make the notes effectively non-callable and further notes that its bank (TD Bank) considers the shareholder notes to be equity in determining PowerStream’s debt-equity ratios.

PowerStream’s shareholders have also provided statements contained in the application that they will not be calling the debt within the next year.

Staff notes that the Board's current cost of capital policy states as follows regarding the appropriate rate for such debt:[3]

> **The deemed long-term debt rate will act as a proxy or ceiling for what would be considered to be a market-based rate by the Board in certain circumstances**. These circumstances include:
>
> - For affiliate debt (i.e. debt held by an affiliated party as defined by the Ontario *Business Corporations Act, 1990)* with a fixed rate, the deemed long-term debt rate at the time of issuance will be used as a ceiling on the rate allowed for that debt. [Emphasis in original]

The Board's deemed rate on June 1, 2004 for a utility of PowerStream's size was 6.90%[4]. On January 1, 2009 it was 6.10%[5], while on January 1, 2010 it was 7.62%[6]. All of these rates are above the 5.58% rate applicable to PowerStream's promissory notes.

The Board's report goes on to state regarding callability that[7]:

- For debt that is callable on demand (within the test year period), the deemed long-term debt rate will be a ceiling on the rate allowed for that debt. Debt that is callable, but not within the period to the end of the test year, will have its debt cost considered as if it is not callable; that is the debt cost will be treated in accordance with other guidelines pertaining to actual, affiliated or variable-rate debt.
- A Board panel will determine the debt treatment, including the rate allowed based on the record before it and considering the Board's policy (these Guidelines) and practice. The onus will be on the utility to establish the need for and prudence of its actual and forecasted debt, including the cost of such debt.

The Board recently dealt with the callability issue in its 2011 Hydro Ottawa Decision[8]. In this case, the debt in question had been issued in 2005 and 2006,

---

[3] EB-2009-0084, *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities,* December 11, 2009, p.53

[4] RP-2009-0069, *Electricity Distribution Rate Handbook,* November 3, 2000, p. 3-7.

[5] Ontario Energy Board, *Cost of Capital Parameter Updates for 2008 Cost of Service Applications,* March 7, 2008.

[6] EB-2009-0084, *The Cost of Capital in Current Economic and Financial Market Conditions,* March 16, 2009.

[7] EB-2009-0084, *Report of the Board on the Cost of Capital for Ontario's Regulated Utilities,* December 11, 2009, p.54.

[8] EB-2011-0054, *Decision and Order*, Hydro Ottawa, December 28, 2011.

was callable and had rates previously allowed by the Board. Hydro Ottawa had also provided testimony indicating that its parent has no intention of calling the notes before maturity.

The Board's finding was that:

> … as the July 1, 2005 and the December 20, 2008 debt issuances are callable on demand, the applicable LTD rate is 5.01%, the deemed LTD rate issued by way of letter on November 10, 2011. This treatment is consistent with the 2009 Cost of Capital Report at page 53, which states that, "The deemed long-term debt rate will act as a proxy or ceiling for what would be considered to be a market-based rate by the Board in certain circumstances. These circumstances include: …For debt that is callable on demand (within the test year period), the deemed long-term debt rate will be ceiling on the rate allowed for that debt[9].

Discussion and Submission

Board staff accepts PowerStream's conclusion that the shareholder notes are effectively non-callable.

Board staff notes that the Markham/Vaughan debt has been outstanding since 2004 and the original interest rate was accepted in the Board's Decision on PowerStream's 2006 application[10] and in the settlement agreement which the Board approved in PowerStream's 2009 application[11].

Staff further notes in this context that the Board's previous cost of capital report, which came into effect shortly after the 2006 Decision and was still in effect at the time of the 2009 Decision states that:

> The Board has determined that for embedded debt the rate approved in prior Board decisions shall be maintained for the life of each active instrument, unless a new rate is negotiated, in which case it will be treated as new debt[12]

[9] *Ibid, p.18.*
[10] RP-2005-0020/EB-2005-0409 *Decision and Order,* April 28, 2006.
[11] EB-2008-0204 *Decision,* July 27, 2009.
[12] Ontario Energy Board, *Report of the Board on Cost of Capital and 2nd Generation Incentive Regulation for Ontario's Electricity Distributors,* December 20, 2006, p.13.

PowerStream stated in its evidence that while these promissory notes are repayable 90 days following demand by the City or Town, they are subordinate to both its EDFIN debentures and bank loan. PowerStream further stated that the loan agreement specifies the shareholders postponement agreements as “bank security’ and notes that in its financial statements these promissory notes are classified as long-term debt since the shareholders have provided letters confirming their intent to not demand repayment within the next year.

Staff is of the view that given the above factors and also that this debt has been outstanding for a number of years it is appropriate that the rate of 5.58% be maintained in this proceeding.

The Barrie debt is similar in nature to the Markham/Vaughan debt. However, this debt, which was approved by the Board in Barrie Hydro’s last cost of service case,[13] originally had an interest rate of 6.15%. At the time of the merger with PowerStream, the City of Barrie agreed to accept the lower rate of 5.58% in order to conform this debt with that held by the other municipalities holding an ownership position in PowerStream. Staff notes that the Board’s deemed long term debt rate was 6.10% at this point in time so the rate accepted by Barrie was lower than the Board’s deemed rate at the time the 5.58% rate was established.

Staff is of the view that these somewhat different circumstances do not change the basis underlying the conclusion reached for the Markham/Vaughan debt and as such the rate of 5.58% is also appropriate for this debt.

As regards the Board’s Hydro Ottawa Decision referenced above, staff is of the view that the circumstances, while in general terms are similar, the specifics are different. For instance, given the behavior of PowerStream as regards the establishment of the Barrie debt, there is stronger evidence in this case that PowerStream will not call the debt in the test year and, as such, taking a plain reading of the policy in this case may be overly harsh.

[13] EB-2007-0746 *Decision*, March 25, 2008, p. 11.

Issue 8.2: The appropriate treatment of property, plant and equipment due to the transition to modified IFRS.

Background

PowerStream transitioned from CGAAP to IFRS as at January 1, 2011 and adopted IFRS as at January 1, 2012. PowerStream included the difference in overheads capitalized between CGAAP and MIFRS on both rate base and construction work-in-progress (CWIP) as of the end of 2012 in the calculation of the amount to be recorded in Account 1575, IFRS-CGAAP Transitional PP&E Amounts.

The balance calculated by PowerStream for account 1575 was a credit of $2,386,855. The values used in PowerStream's calculation of Account 1575 in Appendix 2-EA, were not consistent with its Fixed Asset Continuity Schedules (Appendix 2-B).

At the Technical Conference, Energy Probe asked PowerStream to recalculate the amount in Account 1575 and provide a new Appendix 2-EA using the values from Appendix 2-B. This information was provided by PowerStream through undertaking JT1.4 filed with the Board on October 12, 2012. As a part of its filing, PowerStream provided further clarification in a filing dated October 12, 2012 as part of a provision of additional information following the settlement conference which included Tables JT1.4-1 and JT1.4-2. These tables showed the calculation of December 31, 2012 transitional PP&E amounts using PP&E in-service and total PP&E (including CWIP not in-service) calculation approaches, respectively. Table JT1.4-2 showed a credit balance of $9,571,000 for the deferral account 1575 if PowerStream would have used a PP&E in-service calculation approach and not included the amount from 2012 CWIP (planned to be in-service in 2013) as a part of 2012 capital additions. These tables show that PowerStream included the December 31, 2012 CWIP and its associated burden/overhead costs of $37,093,000 under CGAAP and $29,909,000 under MIFRS for the calculation of PP&E amounts, respectively.[14]

[14] Undertaking JT1.4, October 12, 2012 – Table JT 1.4-2 Page 55.

PowerStream noted that, under CGAAP, overhead costs are capitalized and recovered in rates through depreciation and that its current rates were set based on the full amount of these costs being capitalized under CGAAP. PowerStream argued that the Board has clearly stated that the change in accounting standards from CGAAP to IFRS should not cause utilities to experience material out of period costs or over-recovery. If PowerStream was continuing on a CGAAP basis, the total amount of CWIP at December 31, 2012 including the higher overhead capitalized would be added to rate base in 2013. PowerStream stated that CWIP is part of PP&E and its addition to rate base is simply an issue of timing. [15]

Discussion and Submission

The accounting treatment and calculation of PP&E components of rate base (hereafter "Rate Base PP&E Account") are outlined in the Board's accounting policy guidance as provided in the June 13, 2011 *Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment* ("Addendum Report").

Regarding the unsettled fourth issue 8.2, Board staff submits that there are two sub-issues that the Board needs to consider:

A. Is PowerStream's accounting treatment of including the December 31, 2012 CWIP under both CGAAP and IFRS in the calculation of the 2012 PP&E a departure from the Addendum Report and if so, should it be disallowed?

B. Notwithstanding the fact that PowerStream may have departed from the Addendum Report, should the Board approve the cost recovery of one of the impacts of PowerStream's transition from CGAAP to IFRS as at January 1, 2011, arising from an accounting change to capitalization of burden and overhead costs which resulted in increases to PowerStream's 2012 OM&A expenses?

[15] Undertaking JT1.4, October 12, 2012 , Page 53.

A. Is PowerStream's accounting treatment of including the December 31, 2012 CWIP under both CGAAP and IFRS in the calculation of the 2012 PP&E a departure from the Addendum Report and if so, should it be disallowed?

The Addendum Report accepted the Board staff proposal [16] on Issue 2 with respect to PP&E in its entirety, including Appendix A detailing the operation of the Rate Base PP&E Account. It stated that the operation of the deferral account is based on the staff proposal, and is set out in detail in Appendix A of the Staff Discussion Paper. Board staff's proposal was based on the principle of the continuation of PP&E in rate base from the date of transition until a distributor files its first cost of service rate application under MIFRS and rebases on a MIFRS basis. The Rate Base PP&E mechanism was designed to specifically address any differences between costs recorded in the balance sheet accounts and costs built into rates.[17] Notwithstanding the name of the account, it is only the PP&E components of rate base that were contemplated for the purpose of calculating the amount in the Rate Base PP&E Account. Board staff submits that the PP&E components of rate base include PP&E in-service (and not the total PP&E which includes CWIP), asset additions (assets which go into the service), and depreciation for the purpose of calculation of the unamortized balance of the Rate Base PP&E Account. The mechanism for recovery or refund of changes in costs for the Rate Base PP&E calculations is outlined in the Addendum Report as a five-step process. [18]

The term CWIP is used to refer to fixed assets of a facility that are deployed for generation, transmission, or distribution services which are under construction or are not yet being used and held in service. Board staff also notes that PowerStream's approach with respect to inclusion of CWIP in the Rate Base PP&E Account was not consistent with respect to the treatment of PowerStream's 2013 rate base that was calculated in its 2013 rate application. While PowerStream has included CWIP and associated overheads in the

[16] EB-2008-0408 *Staff Discussion Paper, Transition to IFRS – Implementation in an IRM Environment* Mar. 31, 2011, p.6.
[17] Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment – EB-2008-0408, June 13, 2011, page 9
[18] Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment – EB-2008-0408, June 13, 2011, pages 9 and 10

calculation of the Rate Base PP&E Account, it correctly excluded CWIP from calculation of its 2013 rate base in its rate application for determining its 2013 rates. Board staff disagrees with PowerStream's approach with respect to the inclusion of CWIP in the Rate Base PP&E Account. The costs associated with CWIP are not part of the balance sheet accounts built into rates. From a regulatory perspective, assets in rate base are only those assets that are used and useful. For example, the costs for assets in inventory are not included in rate base. Similarly, the 2012 CWIP is not in rate base and should not be allowed to be used in the calculation of 2012 PP&E in-service even though CWIP is a component of overall 2012 PP&E. The assets which are part of 2012 CWIP are expected to be in service in 2013 (or beyond) and not in 2012.

PowerStream calculated the return on rate base associated with the PP&E balance including the amount for 2012 CWIP at the weighted average cost of capital in its 2012 rate base.[19] By including CWIP in the calculation of its Rate Base PP&E Account, PowerSteam appears to be deeming the inclusion of the 2012 CWIP to form part of the 2012 in-service assets . Board staff submits that since CWIP is not part of rate base under CGAAP or MIFRS, it needs to be excluded from the impact calculation to be consistent with the Board's policy, with the intended purpose of the Rate Base PPE Account, and with the approach taken by all other distributors that have disposed of this account to date. Essentially PowerStream's approach results in a rate base calculation for 2013 as if all 2012 CWIP would go into service on January 1, 2013, which is not a reasonable assumption.

In a number of cases applicants initially deviated from the Addendum Report regarding the appropriate calculation of the Rate Base PP&E, but they eventually made filings consistent with the Board policy. One such example arose in the current Enersource Hydro Mississauga Inc. ("Enersource") proceeding[20]. Enersource had included CWIP in calculating the Rate Base PP&E arising from the transition to MIFRS. As a result of Board staff interrogatories, Enersource agreed to update its application for the proposed refund amount to exclude CWIP from the Rate Base PP&E Account balance.

[19] Transcript from Oral Hearing October 29, 2012, Volume 1, page 91, Lines 7 to 21.
[20] EB-2012-0033 Enersource Hydro Mississauga Inc. *Application for Distribution Rates*, April 27, 2012.

While Board staff agrees that the Board had stated that the change in accounting standards from CGAAP to IFRS should not cause utilities to experience material out of period costs or over-recovery, Board staff notes that the Board's intent was specific and limited to the only Rate Base PP&E (Issue 2 of the Addendum Report). Board staff further notes that the Addendum Report in addressing Issue 2 arising on transition to IFRS, which was specifically related to the PP&E components of rate base, stated that,

> The Board will approve the proposed PP&E deferral account. The account addresses the unique circumstance of a change in accounting standards and provides for the continuity of rate base. The account allows utilities to avoid the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates. [21]

Furthermore, the Board did not grant a generic variance account to distributors to mitigate volatility in certain expenses that may arise from the application of IFRS standards. In fact, the Addendum Report accepted that,

> Staff does not recommend the creation of a generic deferral account to capture differences arising from the transition to IFRS in any other costs over the IRM period. [22]

Board staff submits that PowerStream's interpretation of the Addendum Report with respect to the Rate Base PP&E calculations is incorrect. Board staff further submits that PowerStream's approach with respect to inclusion of CWIP and its associated overhead costs in Rate Base PP&E is a departure from the Board policy and therefore should be disallowed.

B. Notwithstanding the fact that PowerStream may have departed from the Addendum Report, should the Board approve the cost recovery of one of the impacts of PowerStream's transition from CGAAP to IFRS as at January 1, 2011, arising from an accounting change to the capitalization of burden and overhead costs which resulted in increases to 2012 OM&A expenses?

[21] Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment – EB-2008-0408, June 13, 2011, page 11

[22] Addendum to Report of the Board: Implementing International Financial Reporting Standards in an Incentive Rate Mechanism Environment – EB-2008-0408, June 13, 2011, page 9

In 2007, PowerStream conducted a review of its payroll benefits and overhead costs and corresponding burden rates with respect to the capital and OM&A accounts.[23] The review resulted in higher values for certain burden rates. For example, payroll burden rates for an "Outside A" (e.g. line staff, meter staff) was changed from 2007 rates of 60% to 2008 rates of 80%. Board staff notes that PowerStream, therefore, adopted a policy of capitalizing more under CGAAP at the time.

PowerStream assembled a multidisciplinary team and hired KPMG and commenced its IFRS project in May 2008. The multidisciplinary team consisted of finance, accounting, rates and regulatory, engineering, information systems and internal audit. PowerStream's IFRS project consisted of four phases: initial assessment, detailed assessment, design, and implementation. During the detailed project assessment, it was determined that the area of accounting differences with the highest potential impact to PowerStream would be the accounting for PP&E. During 2010, PowerStream determined the projected impacts of adopting IFRS on its financial statements after considering the exemptions available under First Time Adoption of IFRS ("IFRS 1") [24]. [emphasis added]

Regarding the burdens (Directly attributable costs), PowerStream stated that as a part of its IFRS project, costs that were capitalized under CGAAP were analyzed to determine if they met the IFRS criteria of being directly attributable to the asset. Any costs that were not directly attributable were expensed in both IFRS and MIFRS. Costs that were no longer capitalized include training costs, building costs, engineering and administrative costs that cannot be directly attributed to the asset. [25]

When asked by Board staff whether PowerStream had included CWIP up to the end of 2012 in the subject Rate Base PP&E Account, a PowerStream witness responded that "I think it would be more accurate to say that we have included

[23] Capitalization Policy and Burden Allocation Process – Filed by PowerStream on October 2008, EB-2008-0244, Exhibit B1, Tab 3, Schedule, Pages 1 to 14.
[24] PowerStream Application EB-2012-0161, Exhibit A3, Tab 1, Schedule 5, pages 3 and 4.
[25] PowerStream Application EB-2012-0161, Exhibit A3, Tab 1, Schedule 5, page 13 of 27.

the differential in overhead that would have been capitalized in 2012, that is still remaining in WIP at the end of 2012." [26] [emphasis added]

On February 24, 2010, the Board issued additional guidance on the accounting for overhead costs associated with capital work. In this letter, the Board specifically required full compliance with IFRS requirements on capitalization of overheads which might result in a reduction in capitalized overhead for some electricity distributors that had previously capitalized administration and overhead costs. The Board noted that based on the IFRS consultations (EB-2008-0104/0408) survey results this might mean a reduction in capitalized overhead for some electricity distributors that had previously capitalized administration and other general overhead costs no longer permitted under IFRS.

Staff notes that the specific CWIP issue was not raised by any participant during the consultation as part of the Board's consideration in the Addendum Report. However, the issue of cost-shifting from assets to expenses and vice-versa was clear to all participants of the Board's IFRS Working Group. It was also clear to the participants that utilities had adopted various capitalization policies. While some utilities were capitalizing more under CGAAP as compared to IFRS, some others were capitalizing less. Therefore, the impact of MIFRS on utilities will differ depending on their capitalization policies under CGAAP.

In the oral hearing, PowerStream confirmed that one of the issues that arose for the distributors transitioning from CGAAP to IFRS was related to the way IFRS treats capitalization of PP&E. PowerStream confirmed the fact that under IFRS distributors can capitalize less of the overhead costs and should expense them accordingly.[27] Board staff notes that in 2010 PowerStream stated that it started doing some modelling for the differences between CGAAP and IFRS with respect to capitalization of PP&E and determining of quantum of the burdens that could not be capitalized would need to be expensed as well as the impacts on depreciation, i.e., lower depreciation because of the asset life study in 2010.[28] [emphasis added] However, at the oral hearing PowerStream stated that it did

[26] PowerStream's Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 89, Lines 3 to 6.
[27] PowerStream's Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 97, Lines 12 to 19.
[28] PowerStream's Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 97, Lines 20 to 28 and Page 98, Lines 1 to 3.

not specifically address any issues related to CWIP during its IFRS project and the issue only emerged only during the current rate proceeding.[29]

PowerStream argued that the $7.2 million amount would become an OM&A expense in 2012 and therefore would be regarded as “stranded” or “orphaned” if not addressed in this proceeding. PowerStream stated that there is a significant negative impact on shareholder equity of this out-of-period cost. The write-off of the amount in question is a quarter of PowerStream’s 2012 net income which is significant.[30]

Board staff notes that the impact arising from a change in PowerStream’s capitalization and burden/overhead policy as a result of adopting IFRS led to an increased in OM&A expenses of $7.2 million in 2012. Board staff submits that this impact is not within the scope of the Rate Base PP&E Account for recording or recovery purposes. However, Board staff acknowledges that the amount in question is significant and accepts the fact that this amount was not in PowerStream’s rates in 2012 when PowerStream adopted IFRS as at January 1, 2012.

PowerStream confirmed that had it been continuing its accounting on a CGAAP basis, the total amount of CWIP at December 31, 2012 including the higher overhead capitalized would have been added to its rate base in 2013.[31] Board staff notes that the closing balance of net book value of PowerStream’s PP&E in-service as at December 31, 2012 is higher by an amount of approximately $10 million under IFRS as compared to that of CGAAP ($698,664 - $689,093).[32] Board staff acknowledges that PowerStream’s transition from CGAAP to IFRS has caused a reduction of $7.2 million in capitalized costs from its net book value of 2012 PP&E in-service. However, Board staff notes that PowerStream gained an increase of $10 million in its net book value of its 2012 PP&E in-service when it adopted IFRS in 2012. This is mostly due to the fact that the offsetting effect of PowerStream’s asset additions and depreciation expenses on PP&E in-service was lower under IFRS as compared to CGAAP (see Tables JT1.4-1 and JT1.4-

[29] PowerStream’s Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 99, Lines 7 to 27.
[30] PowerStream’s Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 101, Lines 26 to 28 and Page 102, Lines 1 to 12.
[31] Undertaking JT1.4, October 12, 2012 - Page 33 Lines 1 to 7.
[32] Undertaking JT1.4, October 12, 2012 – Table JT 1.4-2 Page 55.

2). In a request by SEC for an undertaking with respect to the difference between revenue requirement on a MIFRS and CGAAP basis for 2013, PowerStream stated that the resulting 2013 CGAAP revenue requirement would be $167.8 million, which is $5.6 million higher than the revenue requirement determined under MIFRS.[33] PowerStream did not show how it derived the amount of $5.6 million and did not provide an explanation on its assumptions that it used for calculation of this figure. PowerStream is invited to provide comments on this matter.

Board staff notes that in the recent Toronto Hydro-Electric System Limited (EB-2012-0079) and Ontario Power Generation (EB-2011-0432) cases, the Board received applications for the establishment of deferral accounts for OPEB for transitioning from CGAAP to USGAAP. These utilities that if no deferral account was granted by the Board, the financial impact of the OPEB amount may be characterized as an out-of-period cost and the recovery of such a cost may be denied due to retroactive rate-making considerations. . The Board approved the establishment of a deferral accounts in these cases. PowerStream stated that it did not file a similar application and that it was of the view that it did the accounting for the Rate Base PP&E properly. [34]

Board staff submits that PowerStream's transitional costs related to the changes in its capitalization and burden/overhead allocation due to the adoption of IFRS as at January 1, 2012 may be regarded as out-of-period costs and that the principle of retroactive rate making needs to be considered given the fact that PowerStream filed its 2013 CoS rate application in May 2012.

Board staff identifies the following options for the Board's consideration with respect to this issue:

Option 1 – Deny PowerStream's request for cost recovery of the costs related to the changes in PowerStream's capitalization and burden/overhead allocation.

The Board did not grant several generic deferral and variance accounts to distributors in the Addendum Report to capture the impacts of changes to IFRS

[33] Undertaking No. J1.1, November 2, 2012, page 2 of 6.
[34] PowerStream's Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 102, Lines 10 to 15.

standards and to mitigate volatility in certain expenses that may arise from the application of IFRS. For example, the Board did not approve the creation of a generic account for IFRS related impacts on Pension and Other Post-Employment Benefits ("P&OPEB") costs. The Board also articulated that utilities that faced large impacts from a change in standards could bring their cases before the Board.

The Board in approving the Rate Base PP&E Account only addressed the single issue associated with the change in the rate base and specifically considered the differences between costs recorded in the balance sheet accounts and costs built into rates. With respect to avoiding the potential for material out of period costs (or over-recovery) that might not be eligible for inclusion in the current period determination of rates, this consideration was made by the Board only with respect to the rate base impacts as a result of the transition to IFRS.
Board staff disagrees with PowerStream's approach of using the Rate Base PP&E Account to include and address the impacts of PowerStream's transition from CGAAP to IFRS as at January 1, 2011, arising from an accounting change to capitalization of burden and overhead costs which resulted in increases to PowerStream's 2012 OM&A expenses (income statements impacts).

PowerStream had ample time and resources, including expert access, to address the issues related to its transition from CGAAP to IFRS. As of December 31, 2011, PowerStream had spent $1,917,398 on IFRS transition costs and is projecting to spend approximately another $600,000 in 2012. PowerStream was aware that less capitalization is permitted under IFRS than under CGAAP. PowerStream was aware in 2010 of the impact of the accounting change with respect to the capitalization of PP&E and the quantum of the burdens that could not be capitalized and would need to be expensed under IFRS.[35]

PowerStream was able, in the context of its IFRS conversion project, to fully assess the impacts of transition from CGAAP to IFRS on its operations and financial affairs as well as having the chance to review and assess the impacts of the change from its previous capitalization policy under CGAAP. It had an opportunity to plan for and take mitigation steps to minimize the impacts of the

[35] PowerStream's Oral Hearing Transcripts, EB-2002-0161, October 29, 2012, Volume 1, Page 97, Lines 20 to 28 and Page 98, Lines 1 to 3.

transitional issues on its shareholders as well as on its rate payers with respect to the accounting change in its capitalization and the allocation of burden/overhead costs under IFRS, including those specifically related to the treatment of CWIP.

However, PowerStream did not seek relief from the Board for the transitional costs by asking for establishment of a deferral account or by filing a Z factor application as part of its 2012 IRM application to avoid the potential for material out-of-period costs. Board staff submits that such an approach would have provided the appropriate and timely opportunity for PowerStream to seek the recovery of the impact for any transitional costs arising from the move from CGAAP to IFRS. In this way, PowerStream's ratepayers would have been afforded the opportunity to provide comments that would have been informed by PowerStream's transitional issues at that time. PowerStream had the responsibility to ensure the risks associated with its transition from CGAAP to IFRS are mitigated. Board staff notes that in situations where a utility does not undertake the necessary actions to mitigate potential risks impacting its financial affairs, the Board has not traditionally been driven by a need for the symmetrical treatment of ratepayers and utilities. Furthermore, Board staff notes that it is not a Board practice to approve any distributor's out-of-period cost recovery because approval of such recovery may violate the rate retroactivity principle. For these reasons, the Board could find in favour of the ratepayers and not find in favour of the utility and deny the cost recovery of the amount in question.

Option 2 – Approve PowerStream's request for one-time costs recovery either in part or in full

Despite Board staff's view that inclusion of the difference in overheads capitalized between CGAAP and MIFRS on both rate base and CWIP as of the end of 2012 in the calculation of the amount to be recorded in Rate Base PP&E Account is inconsistent with Board policy, the Board may consider the impact arising from the accounting change from CGAAP to IFRS on PowerStream's financial statements to be material and significant enough that some or all of the PowerStream proposed costs recovery could be allowed.

One way of dealing with such a determination would be for the Board to split the impact between both the ratepayers and the utility for the reasons provided below. The first reason that the Board may wish to consider is that, the Board sets just and reasonable rates to protect the interests of both ratepayers and the utility alike. The second justification for such an approach is that the Board could consider PowerStream's argument that the OM&A expense for the accounting change was not in PowerStream's rates in 2012 when PowerStream adopted IFRS as at January 1, 2012. The amount in question with respect to the accounting change from CGAAP to IFRS for the capitalization and allocation of burden and overhead costs needs to be recorded by PowerStream as an expense in its 2012 financial statements, which would impact 2012 net income significantly. The Board may wish to accept PowerStream's argument that the change in accounting standards from CGAAP to IFRS should not cause utilities to experience material out of period costs or over-recovery.

The third justification for a partial recovery approach is that the PowerStream's calculation for the Rate Base PP&E Account balance assumes that the whole $7.2 difference in CWIP becomes in-service assets on January 1, 2013, i.e., the calculation does not consider at a minimum the application of the half-year rule.

The fourth reason for a partial recovery of the amount in question is that PowerStream will be using a higher value of net book value for the PP&E in-service as at January 1, 2013 by approximately $9.571 million for its 2013 rate base. This will lead to a higher rate of return under MIFRS than otherwise would have been achieved under CGAAP.

Finally, as a justification for only partial recovery, the Board could consider the fact that PowerStream management had control over this matter and was in a position to take action to mitigate the impact on the utility as well as the rate payers, as has been discussed. Given that PowerStream did not do that, the rate payers should not be left to absorb the full impact of the shortfall.

For the above reasons, the Board may therefore wish to split the recovery of the amount in question equally (or in some other proportion) between PowerStream's shareholders and its ratepayers.

Finally, Board Staff submits that should the Board approve the recovery by PowerStream of all or part of its costs stemming from its transition from CGAAP to IFRS and relating specifically to the accounting change for the treatment of capitalization, burden and overhead, that Account 1575 is not the appropriate account in which to book these costs. The Board may wish to consider a one-time limited deferral account permitting PowerStream to record the amount and amortize it over a four year period, consistent with the amortization period of Account 1575.

- All of which is respectfully submitted-