Exhibit ________

Cambridge and North Dumfries Hydro Inc.

Pre-filed Evidence on Removal Costs

Accounting for Removal Costs

As outlined in Exhibit 2, Tab 2, Schedule 2, Page 1 of its 2014 Cost of Service Application, CND revised its capitalization policies under CGAAP effective January 1, 2012 to reflect changes that were required in accordance with regulatory accounting requirements and that align to the capitalization principles if CND were to adopt International Financial Reporting Standards ("IFRS").

The following are two significant elements of CND's capitalization policies of particular relevance to the issue with respect to removal costs:

- Only those costs directly attributable to the acquisition or construction of a capital asset are capitalized. Specific expenditures that are no longer included in the capital burden rates for CND include: (i) building maintenance costs; (ii) health and safety department expenditures; and (iii) municipal property taxes. CND does not, nor has it previously, capitalized any indirect administrative support costs such as Finance, Human Resources, or Corporate Services.
- Costs incurred to remove an existing asset from service are to be expensed and are no longer eligible to be included in the capital cost of the new asset *[emphasis added]*.

As CND explained in its Application:

> *"Prior to January 1, 2012, prior to changing its capitalization policies, such costs incurred to remove an existing asset from service, including labour, vehicles and materials, were included in the capital costs to construct an asset as part of the overall capital project."*[1]

CND, in transitioning its capitalization policies to align to regulatory accounting requirements and ultimately the adoption of IFRS, determined that removal costs would not meet the criteria for capitalization. In particular, CND considered the following considerations under IAS 16.16 and IAS 16.17:

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[1] Exhibit 2, Tab 2, Schedule 3, Page 1.

IAS 16.16 The cost of an item of property, plant and equipment comprises:

(a) its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates.

(b) any costs directly attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management.

IAS 16.17 Examples of directly attributable costs are:

(a) costs of employee benefits (as defined in IAS 19 *Employee Benefits*) arising directly from the construction or acquisition of the item of property, plant and equipment;

(b) costs of site preparation;

(c) initial delivery and handling costs;

(d) installation and assembly costs;

(e) costs of testing whether the asset is functioning properly, after deducting the net proceeds from selling any items produced while bringing the asset to that location and condition (such as samples produced when testing equipment); and

(f) professional fees.

In CND's view, which has been reviewed and confirmed with its external auditors KPMG LLP, the costs associated with removing distribution plant are not considered to be: (i) directly attributable to the construction of the new asset (removing old plant is a separate activity from the installation of the new plant); and (ii) the removal costs do not meet the definition of costs of site preparation, installation costs, nor are these costs incurred to bring the asset to the location or condition necessary for it to be capable of operating. In addition, these costs are not an initial estimate of the costs of dismantling and removing the item and restoring the site as part of an obligation that arises when the asset was acquired. An obligation under IFRS would be a legal or constructive obligation that requires an entity to dismantle or remove the item and restore the site in the future.

In supporting its view, CND would use the following scenario with respect to pole removals to illustrate the point:

Scenario:

As part of a road relocation project, CND is required to relocate a line of poles and wires in a particular area. The Franklin Boulevard road relocation project is a good example of this type of project. As part of the Franklin Boulevard project, there will be significant relocation and installation of overhead triple circuit and double circuit 27.6kV lines, as well as the installation of new poles, as the existing poles date back to the 1970's and have proven too weak to withstand major storms.

CND will install a new line of poles and wires in a different location as a result of the road relocation. The labour, trucking, and third party costs to remove the existing poles and wires are incurred to dismantle the existing assets and remove them from the existing site.

Although the removal and dismantling of the distribution plant in this case may be occurring as a result of the road relocation, the costs of removal are not directly attributable to the construction of the new distribution system plant. The new asset will be constructed in a different location and utilize new labour, new materials, and contractor costs. In addition, the activities undertaken are not "site preparation" costs, as the distribution plant is being removed from a location that is different from the location of the new distribution plant.

In addition to the above, CND would also reference IAS 16.71, which requires that:

> "The gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item".

IAS 16 does not define "net disposal proceeds". However, KPMG's Insights Into IFRS, 10th Edition, 2013 states:

> **3.2.380.70** In determining the net proceeds received, all directly attributable incremental costs of disposal, such as advertising, legal fees, stamp duty, agency fees and removal costs *[emphasis added]*, are generally deducted. In our view, it is also appropriate to deduct any amounts recognized as liabilities (see chapter 3.12) in relation to the disposal of the asset, such as provisions made for probable claims under warranties in the sales agreement, or for an agreed schedule of repairs to be done at the current owner's expense.

KPMG's Report to the Ontario Energy Board *"Report on the Transition to International Financial Reporting Standards"* dated March 4, 2009 included the following with respect to accounting differences that will exist under IFRS (page 49 and 50):

> "For grouped assets, gains and losses will have to be recognized in the income statement upon the retirement or disposal of items of PP&E and provisions recognized for dismantling and removal costs, where appropriate (see Section 3.4). This may or may not have material impact on actual reported earnings, since such amounts are currently included in an annual depreciation charge".

Section 3.4 (Page 40) provides the following:

> "IFRS requires that gains and losses be recognized at the time that an item of PP&E is disposed. The gains and losses must be recognized in the income statement, and cannot be offset against any remaining PP&E balances, or deferred on the balance sheet."

Thus, in KPMG's view, removal costs would be recorded as an expense when incurred.

CND also provides the following additional reference from the Deloitte iGAAP 2013: A Guide to IFRS Reporting, Global Edition, Page 478-479:

> "The costs that may be included in the carrying amount of an asset are limited to those that arise directly from the construction or acquisition of the

asset. When, for example, costs are incurred to demolish existing structures in order to build on a site, the cost of demolition may be incremental to the construction cost or it may be associated with the derecognition of a previously held asset. It depends on whether the existing structures were previously used in the entity's business, or were acquired as part of the site with the specific intention of demolishing them. In the latter case, the demolition costs are clearly incremental and should be included in the cost of the new asset. In the former case, the cost of the old asset should be written off to profit or loss through accelerated depreciation once the decision to demolish is made; the demolition costs incurred relate to the derecognition of the old asset and should be expensed when incurred."

As summarized in Response to Interrogatory 9.2-Staff-40 (d), CND will incur $806,208 in removal costs for material capital projects in 2014. These removal costs will be incurred due to the removal/dismantling of existing distribution plant as a result of a significant road relocation project, and the removal of distribution assets from service that have reached or are beyond the end of their useful lives, and therefore should be de-recognized.

CND has reviewed the capitalization policies and disclosures of another LDC with respect to removal costs and would reference the following:

1. Kitchener-Wilmot Hydro Inc. (EB-2013-0147):
   (a) Exhibit 2, Tab 2, Schedule 1, Attachment 1 (Capitalization Policy), Page 4
   Disposals and Write-downs
   "Differences between the proceeds, if any and the unamortized asset amount <u>plus removal costs</u> *[emphasis added]* are recorded as a gain or loss in the year of disposal."

   (b) Exhibit 9, Tab1, Schedule 9, Page 5
   Dismantling Costs
   As noted in Exhibit 4, KWHI began expensing dismantling costs (previously capitalized) for IFRS compliance in 2012. These costs were not material in 2012 at value of $12,996.

As KPMG noted in its *"Report on the Transition to International Financial Reporting Standards"* dated March 4, 2009", and as evidenced by Kitchener-Wilmot Hydro Inc., the accounting for removal costs may not be material to all LDC's and therefore it may be possible that such amounts are not being disclosed separately by other LDC's that have been or are before the Board.

Impact on Account 1576

As per the OEB's Frequently Asked Questions ("FAQ"), July 2012, A.2, "Distributors will use Account 1576 to record the financial differences arising as a result of changes to accounting depreciation or capitalization policies permitted by the Board under Canadian GAAP in 2012 or as mandated by the Board in 2013".

In its application, CND has recorded the following financial differences in account 1576:

- difference in depreciation expense arising from the adoption of componentization and useful lives in accordance with the board's direction on regulatory accounting compared to the old basis; and
- difference in costs arising from a change in its capitalization policy, which represents costs that are no longer eligible to be recognized as capital.

The following is the excerpt from the FAQ noted above (<u>emphasis added</u>):

> *"Q.2 What account should be used to record the required accounting changes in relation to depreciation expense and capitalization policies in 2012 or 2013, and what are the accounting requirements?*
>
> A.2 The Board's letter of July 17, 2012 to distributors also indicated that the Board has approved new Account 1576, Accounting Changes Under CGAAP, for distributors to record the financial differences arising as a result of the election to make accounting changes under Canadian GAAP in 2012 or to make these accounting changes in 2013 as mandated by the Board (see Q and A #1 above). The account description for Account 1576 is provided in Appendix A of the APH-FAQs, and is reproduced below:

Account 1576, CGAAP Accounting Changes

A distributor shall use this account to record the financial differences arising as a result of accounting changes to depreciation expense and capitalization policies permitted by the Board under Canadian GAAP in 2012 or as mandated by the Board in 2013, as follows (for purposes of this account, PP&E includes rate base related intangible assets):

A. Distributors shall maintain records before any accounting changes are made to Canadian GAAP of the amounts in the PP&E accounts eligible for inclusion in rate base, commencing in 2011 under their previous accounting policies in Canadian GAAP (or 2012 if mandatory application is applicable), and continuing until their first cost of service application under modified IFRS. This will produce a figure for the PP&E accounts that is consistent with previous accounting policies and their last cost of service application.

B. Distributors shall also calculate "adjusted" values for the PP&E accounts eligible for inclusion in rate base arising from the implementation of accounting changes for depreciation expense and capitalization policies prospectively on January 1, 2012 (or January 1, 2013 if mandatory application is applicable) and as recorded in their accounting system applicable in each year between the previous Canadian GAAP in 2011 (or 2012 if mandatory application is applicable) and their first cost of service application under modified IFRS.

C. Distributors shall record in this variance account the cumulative difference between items A and B above. The offsetting entry will go to Account 4305, Regulatory Debit or Account 4310, Regulatory Credit. A journal entry to record the variance is required at the end of the fiscal year for each year until the distributor's rates are reset under modified IFRS through a cost of service application. The distributor may elect to use monthly journal entries. No interest carrying charges or a rate of return is permitted in this account.

D. The amount of the cumulative variance recorded in this account would be recovered from, or refunded to, ratepayers in the year of the distributor's cost of service application through an adjustment to depreciation expense over the approved amortization period. On approval of the disposition of the balance in this account, the offsetting entry will go to Account 5705, Depreciation Expense.

E. Records should be kept to at a level of detail sufficient

A journal entry to record the variance (i.e., the financial differences) arising from these accounting changes is required at the end of the fiscal year <u>for each year starting with the year of the changes until the year prior to when a distributor rebases its rates through a cost of service application</u>. A distributor may elect to use monthly journal entries.

The amount of the cumulative variance recorded in this account would be recovered from, or refunded to, ratepayers in the year of the distributor's cost of service application through an adjustment to depreciation expense over the approved amortization period.

The reporting of the account balance will be annually under section 2.1.7 of the electricity reporting and record-keeping requirements."

<u>CND's Inclusion of Removal Costs in Account 1576</u>

As CND had previously capitalized removal costs as part of the cost of its new asset, and no longer capitalizes such costs, in CND's view this represented a change in capitalization policy in accordance with regulatory accounting, and therefore, in CND's view, qualifies for Account 1576 treatment.

CND has recorded the amounts of $333,000 and $639,000 in Account 1576 in respect of removal costs for the fiscal years 2012 and 2013, respectively, representing the financial difference in PP&E in each of those years between the amounts that would have been recorded under CGAAP under the old capitalization policy versus nil under the new capitalization policy.

The removal costs are costs incurred by CND. In a prior period, these costs would have been added to property, plant, and equipment. As a result of the change in its capitalization policy, these costs are now expensed and are no longer eligible to be included in the capital cost of the new asset.

APPENDIX A

See Attached

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Ontario

VIA EMAIL AND WEB POSTING

July 17, 2012

TO: Licensed Electricity Distributors
All Other Interested Parties

RE: Regulatory accounting policy direction regarding changes to depreciation expense and capitalization policies in 2012 and 2013

This letter serves to provide the Board's regulatory accounting policy direction to electricity distributors on matters arising from the one-year deferral option for the IFRS changeover in 2012. The Board will permit electricity distributors electing to remain on Canadian GAAP ("CGAAP") in 2012 to implement regulatory accounting changes for depreciation expense and capitalization policies effective on January 1, 2012. The Board however will require that these changes be mandatory in 2013 for all distributors that have not yet made these changes, even if there is a further option to defer IFRS changeover in 2013. A new variance account is created and authorized for distributors to record the financial differences arising from these accounting changes.

Background

The Canadian Accounting Standards Board ("AcSB") announced in March 2012 that it would allow rate-regulated entities a one-year deferral option for the IFRS changeover in 2012. In light of the AcSB's announcement, the Board issued a letter to electricity distributors on April 30, 2012 and provided direction regarding this deferral option. The letter indicated, among other things, that,

- The Board will not require regulatory accounting and reporting for 2012 to be in modified IFRS ("MIFRS") if a distributor is not required to adopt IFRS for financial reporting and opts to remain on CGAAP.
- For those distributors that have transitioned to IFRS or whose rates are set based on MIFRS, the Board expects these distributors to conduct regulatory accounting and reporting for 2012 in MIFRS.

The Board has received numerous inquiries for regulatory accounting direction from distributors requesting to make changes to their depreciation rates (for example, using the *Depreciation Study for Use by Electricity Distributors* (EB-2010-0178), (the "Kinectrics Report") or own depreciation study) and capitalization policies while still under CGAAP in 2012. Several distributors indicated that they have already completed sufficient detailed accounting work in these areas in their transition to IFRS, and as such, they are positioned and wish to make these accounting changes while still under CGAAP in 2012. They are seeking accounting direction on whether the Board will allow these accounting changes, and if so, what would be the approval process.

Regulatory accounting policy direction regarding Changes to the Depreciation Expense and Capitalization Policies

A key benefit that was expected to be derived from the Board's established accounting policies under the IFRS accounting framework ("modified IFRS") was that the changes to the depreciation expense and capitalization policies would be applied uniformly and in the same timeframe by all distributors (with a few exceptions, for example, distributors adopting US GAAP).

There were several distributors that have adopted these and other accounting changes for regulatory purposes including ratemaking in their 2012 cost of service applications which were approved by the Board. The same approach is expected from distributors filing 2013 cost of service rate applications, which are required to be filed on an MIFRS basis. The Board encourages and will permit distributors that have deferred the changeover to IFRS in 2012 to also implement regulatory accounting changes for depreciation expense and capitalization policies effective on January 1, 2012. The Board however will require that these changes be mandatory in 2013 (i.e., effective on January 1, 2013) for those distributors that do not elect to make these accounting changes in 2012 regardless of whether the AcSB permits further deferrals beyond 2012 for the changeover to IFRS. These accounting changes should be implemented consistent with the Board's regulatory accounting policies as set out for modified IFRS as contained in the *Report of the Board, Transition to International Financial Reporting Standards,* EB-2008-0408, the Kinectrics Report, and the Revised 2012 *Accounting Procedures Handbook for Electricity Distributors* ("APH").

The Board will not require distributors to seek Board approval in order to make these accounting changes that otherwise would have been required as specified in the "CGAAP-based" APH (dated July 2007), which is applicable and in force for these distributors still under CGAAP. These accounting changes for adherence to Board requirements for MIFRS and their associated rate impacts will be reviewed as part of a distributor's next cost of service application.

Account 1576 and Accounting Requirements

The Board has approved a new variance Account 1576, Accounting Changes Under CGAAP, for distributors to record the financial differences arising as a result of the election to make these accounting changes under CGAAP in 2012 or to make these changes as mandated by the Board in 2013, if applicable.

The account description of Account 1576 and the associated accounting requirements, including an illustrative example, are provided in the July 2012 *Accounting Procedures Handbook – Frequently Asked Questions* (see question and answer #2) posted on the Board's website at www.ontarioenergyboard.ca.

Distributors are expected to reflect these accounting changes in their CGAAP-based financial statements since rate-regulated accounting is recognized in CGAAP.

Any questions regarding the above should be directed to the Market Operations Hotline at 416-440-7604 or by e-mail at market.operations@ontarioenergyboard.ca. The Board's toll free number is 1-888-632-6273.

Yours truly,

Original signed by

Kirsten Walli
Board Secretary