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BY COURIER, RESS AND COURIER

November 22, 2019

Ms. Christine E. Long
Board Secretary
Ontario Energy Board
Suite 2700, 2300 Yonge Street
P.O. Box 2319
Toronto, ON M4P 1E4

Dear Ms. Long,

EB-2019-0082 – Hydro One Network's 2020-2022 Transmission Rates Application – Undertaking Responses J-6.04, J-6.08 and Megafile of Responses to All Undertakings

In respect of the above-noted proceeding, attached please find:

1. Responses to undertakings J-6.04 and J-6.08; and
2. A megafile of response to all undertakings given at the oral hearing.

This filing concludes Hydro One's responses to undertakings given at the oral hearing.

This filing has been submitted electronically using the Board's Regulatory Electronic Submission System and two (2) hard copies will be sent via courier.

Sincerely,

ORIGINAL SIGNED BY FRANK D'ANDREA

Frank D'Andrea
Encls.
cc.EB-2019-0082 parties (electronic)

UNDERTAKING J6.4

Reference:
F-5-1 Table 3
Oral Hearing Volume 6, Page 48, Line 3 – Page 50, Line 3
Oral Hearing Volume 6, Page 108, Line 21 – Page 109, Line 20

Undertaking:
To provide OPEB figures for distribution similar to the numbers for transmission and any other information required to make a determination for Transmission and Distribution in regards to capitalization of OPEB costs.

Response:
As set out in the Application at Exhibit H, Tab 1, Schedule 2, sections 3.16 and 3.16.2, Hydro One is seeking OEB approval to continue capitalizing the non-service component of Other Post-Employment Benefit costs ("OPEBs") for both its Transmission and its Distribution businesses.

The continued capitalization of the non-service component of OPEBs enables Hydro One to accurately depict the true costs of its capital assets because, under this approach, all relevant labour costs incurred in developing and building capital assets would be allocated to the corresponding assets and be recovered over the useful lives of those assets. If Hydro One's request for continued capitalization is denied, and its alternative proposal of continuing the OPEB Cost Deferral Account and applying a 20-year rolling balance disposition method (as discussed below) is also denied, then the non-service component of OPEBs would instead need to be collected as part of OM&A, which would give rise to revenue requirement increases of $21 million for Transmission in 2020 and $15 million for Distribution in 2020. Similar amounts would impact OM&A for both Transmission and Distribution in future years.

Table 1, below, summarizes the non-service component of OPEBs for Hydro One's Transmission and Distribution businesses. The amounts shown are the amounts for which Hydro One seeks OEB approval to continue capitalizing. The OPEB amounts shown for the Transmission business are derived from Exhibit I, Tab 1, Schedule OEB-221 for 2019 to 2022. The 2018 amount shown for the Transmission business is currently captured under the OPEB Cost Deferral Account and presented in Exhibit H, Tab 1, Schedule 1 Table 2. The OPEB amounts shown for the Distribution business align with the amounts provided by Hydro One in the Distribution Draft Rate Order in EB-2017-0049. These amounts were excluded from the calculation of the Distribution revenue requirement and are currently being tracked in the OPEB Cost Deferral Account.

Table 1 – Non-Service Component of OPEB ($ Millions)

	2018	2019	2020	2021	2022
Distribution	13	15	15	15	16
Transmission	22	19	21	23	23

Background

Hydro One uses the accrual method of accounting for OPEB costs. The OPEB costs included in Transmission rates are presented in Exhibit F, Tab 5, Schedule 1, Table 3 for 2020 Test Year and 2021 and 2022 amounts were provided as part of a response to OEB Staff IR 221. Since 2018, the capital component of OPEBs has been impacted by a change in USGAAP. In particular, and as described further in Exhibit H, Tab 1, Schedule 2, Sections 3.16 and 3.16.2, this change has precluded Hydro One from capitalizing the non-service component of its OPEB costs unless approved to do so by the OEB.[1] The non-service component of OPEB costs refers to all costs other than current service costs.

In response to the change in USGAAP, in EB-2017-0338, Hydro One obtained approval from the OEB to establish the OPEB Cost Deferral Account, effective from January 1, 2018 until the effective date of Hydro One's next transmission revenue requirement application.[2] In the account, Hydro One records the OPEB costs previously capitalized in respect of the Transmission business but no longer allowed to be capitalized as a result of the change to USGAAP, which was issued through Accounting Standards Update (ASU) 2017-07. The OEB, in establishing the OPEB Cost Deferral Account, stated that the panel in Hydro One's next transmission rate application (the current proceeding) could consider whether Hydro One should continue to capitalize OPEBs. The OPEB Cost

[1] Only the service cost component of the net periodic pension cost and net periodic post-retirement benefit cost is eligible for capitalization. Hydro One accounts for pension costs on a cash basis for rate-setting purposes. The cash basis calculates the normal cost using a discount rate which is based on the long term expected return of the plan assets. The normal cost for pensions at this time is solely comprised of current service costs, therefore this amendment to the accounting standards (ASU 2017-07) does not impact capitalization of pension costs. OPEB costs are accounted for on an accrual basis, and therefore are impacted by the amendment.

[2] EB-2017-0338, Decision and Order, Hydro One Networks Inc., Application for an Accounting Order approving the establishment of a deferral account (May 10, 2018).

Deferral Account for the Transmission business was approved for continuance in EB-2018-0130 until the effective date of the revenue requirement in the current application.

In addition, in its decision on Hydro One's most recent Distribution rates application (EB-2017-0049), the OEB approved the establishment of an OPEB Costs Deferral Account for the Distribution business, effective from January 1, 2018. The panel in that proceeding instructed Hydro One to file the necessary evidence regarding the Distribution business's OPEB Costs Deferral Account in the next Transmission rate proceeding, to permit the matter to be determined for both Hydro One's Transmission and Distribution businesses.

Rationale for Continued Capitalization

As noted at the outset of this response, the continued capitalization of the non-service component of OPEBs enables Hydro One to accurately depict the true costs of its capital assets because, under this approach, all relevant labour costs incurred in developing and building capital assets would be allocated to the corresponding assets and be recovered over the useful lives of those assets. If not capitalized, the non-service component of OPEBs would need to be treated as OM&A, instead of as capital, despite the fact that these costs were previously treated as capital. In addition to being inconsistent with the prior treatment of these costs, accounting for these costs as OM&A would give rise to intergenerational inequities by making current transmission and distribution ratepayers pay for assets that future generations of ratepayers will benefit from, and enabling those future generations to benefit from those assets without bearing the costs of those assets.[3]

Hydro One's request for the continued capitalization of the non-service component of OPEB costs is in line with guidance that the Federal Energy Regulatory Commission (FERC) provided in its letter, dated December 28, 2017, which allows FERC-regulated entities, which are subject to USGAAP and the changes in ASU 2017-07, to continue to capitalize both the service and non-service cost components of pensions and OPEBs. A copy of the FERC letter is provided in Attachment 1 of this undertaking response.

Continued capitalization would also prevent material rate impacts to both Transmission and Distribution customers by not increasing OM&A costs as further discussed below.

[3] Oral Hearing Transcript, Volume 6, page 30, lines 9-21.

Another benefit of permitting Hydro One to continue capitalizing the non-service component of its OPEB costs, in respect of its Transmission and Distribution businesses, is that continued capitalization would limit the additional regulatory overhead costs associated with the ongoing tracking and disposition of the balances of the current OPEB Cost Deferral Account.

Potential Outcomes

If the OEB approves Hydro One's request for continued capitalization of the non-service cost component of OPEBs, Hydro One proposes, in respect of the Transmission business, to add the accumulated amounts in the approved OPEB Cost Deferral Account to the Transmission rate base as a single high level adjustment when setting the 2020 revenue requirement. In respect of the Distribution business, as the 2018, 2019, and 2020 Distribution revenue requirement amounts do not include the revenue requirement impact associated with the OPEB component of non-service costs, an adjustment would have to be made to calculate the new revenue requirement during an annual update for 2021 Distribution rates so as to include the OPEB costs captured in the OPEB Cost Deferral Account. Through such adjustment, Hydro One would expect to be able to recover the revenue requirement associated with amounts for 2018, 2019 and 2020, which it did not collect when deriving its 2018, 2019 and 2020 revenue requirement. Moreover, capital expenditures for 2021 and 2022 would have to be adjusted to include the OPEB costs which were previously excluded.[4]

If the OEB denies Hydro One's request for continued capitalization of the non-service cost component of OPEBs, and also denies Hydro One's alternative proposal (described below), this would result in significant rate impacts for Transmission and Distribution ratepayers because Hydro One would need to recover these costs through OM&A each year. As described in Hydro One's response to OEB Staff IR 221, Transmission OM&A for 2020 would increase by approximately $21 million, which would result in a 1.4% increase in the 2020 rates revenue requirement relative to 2019 OEB approved levels. Moreover, as indicated in Table 1, above, Distribution OM&A for 2021 would increase

[4] During the Draft Rate Order process implementing the Distribution Decision (EB-2017-0049), Hydro One reduced the capital expenditures by $13.5 million for 2018, $14.6 million in 2019, $14.8 million in 2020, $14.6 million in 2021 and $16.4 million in 2022. The exact calculation was provided in Table 1 – Proposed Capital Spending Summary ($ millions) in the DRO Reply Submission4 under the OPEB and OPEB Adjustment lines.

by $15 million. Moreover, any amounts accumulated in the OPEB cost deferral account[5] would have to be disposed of which would result in further rate increases.

Alternative Proposal

If the OEB does not approve Hydro One’s request for continued capitalization of the non-service cost component of OPEB for each of the Transmission and Distribution businesses, Hydro One requests as an alternative that it be permitted to continue using the OPEB Cost Deferral Account for each of the Transmission and Distribution businesses and that it be permitted to dispose of the balances of each such account on a twenty-year rolling balance (as opposed to periodic clearance of the accounts in future rate applications). Twenty years is consistent with the US GAAP guidance that allowed recovery of OPEB related amounts not exceed a period of twenty years. Moreover, the twenty-year rolling balance disposition method would be beneficial to ratepayers as it would minimize the impact on rates.[6] As part of the alternative proposal, Hydro One proposes that interest improvement be recorded on the opening monthly balance of the principal amount. While continued capitalization would provide the most effective means of aligning costs with asset lives, and is Hydro One’s preferred approach, the alternative proposal would at least provide better alignment with asset lives as compared to recovery of these costs through OM&A.

[5] For Transmission and Distribution 2018 and 2019 costs are currently accumulated in the OPEB Cost Deferral Account. Pending OEB decision timing, 2020 costs could be captured in the OPEB Cost Deferral Account.
[6] See H-1-2, Attachment 10 in the Transmission Application for disposition example.

FEDERAL ENERGY REGULATORY COMMISSION
Washington, D.C. 20426

In Reply Refer To:
Office of Enforcement
Docket No. AI18-1-000
December 28, 2017

TO ALL JURISDICTIONAL PUBLIC UTILITIES AND LICENSEES, NATURAL GAS COMPANIES, OIL PIPELINE COMPANIES AND CENTRALIZED SERVICE COMPANIES

Subject: Accounting and Financial Reporting for Pensions and Post-retirement Benefits other than Pensions

The Financial Accounting Standards Board (FASB) has issued Accounting Standards Update (ASU) No. 2017-07, *Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost.* ASU No. 2017-07 amends FASB Accounting Standards Codification (ASC), Topic 715, *Compensation – Retirement Benefits*, to specify how the amount of pension costs and costs for post-retirement benefits other than pensions (PBOP) should be presented on the income statement under Generally Accepted Accounting Principles (GAAP), and what components of those costs are eligible for capitalization in assets. The Commission has received a number of inquiries from industry regarding clarification of whether and how to apply this ASU for purposes of regulatory accounting and reporting to the Commission. Accordingly, this accounting issuance is intended to provide clarity and certainty to industry on how they should apply the Commission's accounting and reporting requirements over pension and PBOP costs.

Pension and PBOP costs are made up of several components that reflect different aspects of an employer's financial arrangements as well as the cost of benefits earned by employees. Prior to this ASU, companies typically reported all of these components on an aggregate basis, without separating the various components on the financial statements. The amendments in this ASU require that an employer report the service cost component of pension and PBOP costs with other compensation costs arising from services rendered by employees during the period. Additionally, based on this ASU, these costs generally fall under a subtotal of income from operations for GAAP financial reporting. The other components of pension and PBOP costs are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations. The amendments in this ASU also allow only the service cost component to be eligible for capitalization when all of the other normal criteria for capitalization under GAAP are met.

Based on the Commission's Uniform System of Accounts, Commission jurisdictional public utilities and licensees, natural gas companies, and centralized service companies recognize pension and PBOP costs in Account 926, Employee Pensions and Benefits,[1] while oil pipeline companies recognize pension and PBOP costs in Account 550, Employee Benefits,[2] if the pension and PBOP costs are not eligible for capitalization. The Commission's longstanding policy is to view these expenses as part of a single line item on the income statement in the Form No. 1, Form No. 1-F, Form No. 2, Form No. 2-A, Form No. 3-Q, Form No. 6, and Form No. 60 (collectively as FERC Forms), and that pension and PBOP costs in their entirety are attributable to the calculation of Net Utility Operating Income on the FERC Forms. The pension and PBOP expenses are recorded to the respective jurisdictional account without separation of the various components making up the pension and PBOP costs.

Regarding capitalization of pension and PBOP costs when the costs are incurred as part of a capital project, the Uniform System of Accounts does not specify whether capitalization of pension and PBOP costs should include or exclude the non-service cost components that make up the pension and PBOP costs. The instructions to Account 926 under the Uniform System of Accounts prescribed for public utilities and licensees, natural gas companies, and centralized service companies state that there shall be credited to this account the portion of pensions and benefits expenses which is charged to construction, and that records in support of this account shall be so kept that the amounts of pensions and benefits expenses transferred to construction or other accounts will be readily available. In practice, companies generally have capitalized both the service cost component and non-service cost components of the pension and PBOP costs in the past, as long as the capitalization of those costs were in compliance with Electric Plant Instruction No. 4, Gas Plant Instruction No. 4, or Service Company Property Instruction No. 367.52, of the Uniform System of Accounts. The instructions for Account 550 under the Uniform System of Accounts prescribed for oil pipeline companies similarly do not discuss service or non-service components of pension and PBOP costs to be transferred to construction.

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[1] *See* 18 C.F.R. Part 101, *Uniform System of Accounts Prescribed for Public Utilities and Licensees Subject to the Provisions of the Federal Power Act*; 18 C.F.R. Part 201, *Uniform System of Accounts Prescribed for Natural Gas Companies Subject to the Provisions of the Natural Gas Act*; and 18 C.F.R. Part 367, *Uniform System of Accounts for Centralized Service Companies Subject to the Provisions of the Public Utility Holding Company Act of 2005*.

[2] *See* 18 C.F.R. Part 352, *Uniform System of Accounts Prescribed for the Oil Pipeline Companies Subject to the Provisions of the Interstate Commerce Act*.

The focus of the Commission's accounting regulations is to ensure that the Commission and other stakeholders have available to them financial information about jurisdictional entities that is useful for the development and monitoring of rates. The uniform application of the Commission's accounting regulations is essential in providing comparability and decision-useful information to the Commission and stakeholders to reach informed rate decisions and conclusions. Accordingly, the objective of this guidance is to provide clarification as to how all jurisdictional entities should account for and report pension and PBOP costs, in response to ASU No. 2017-07.

The guidance is being provided to all jurisdictional entities to ensure proper and consistent application of the Commission's accounting requirements over pension and PBOP costs in response to ASU No. 2017-07 for Commission financial reporting purposes. This guidance is for Commission accounting and reporting purposes only and is without prejudice to the ratemaking practice or treatment that should be afforded the items addressed herein.

1. ACCOUNTING FOR PENSION AND PBOP COSTS ON THE INCOME STATEMENT

Question: How should jurisdictional entities account for pension and PBOP costs on the income statement for Commission accounting and reporting purposes?

Response: Jurisdictional public utilities and licensees, natural gas companies, and centralized service companies should record pension and PBOP costs in their entirety in Account 926, while oil pipeline companies should record pension and PBOP costs in their entirety in Account 550, provided the costs are not transferred to construction.

Pension and PBOP costs are made up of several components: service cost, interest cost, actual return on plan assets, gain or loss, amortization of prior service cost or credit, and amortization of any transition asset or obligation existing at the date of initial application of ASC Subtopic 715-30. Though pension and PBOP costs are computed using the aggregate total of these various components, the Commission's longstanding policy is to consider the amount as a singular cost to the employer. This cost is calculated based on Statement of Financial Accounting Standards (SFAS) No. 106[3] and reported as an accrued expense under net income from continuing operations.

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[3] SFAS No. 106 was superseded for GAAP reporting purposes by ASC Topic 715 in 2009 when FASB codified all of the former accounting statements into ASC topics, but the calculations under both SFAS No. 106 and ASC 715 to arrive at the pension and PBOP costs remained the same.

Accordingly, there is one account designated for pension and PBOP costs under each respective Uniform System of Accounts for public utilities and licensees, natural gas companies, centralized service, and oil pipeline companies. This accounting is consistent with the rate treatment of pension and PBOP costs to most jurisdictional entities with cost-of-service rates. While there are some varying rate schemes approved by the Commission and other regulatory bodies to calculate recoverable pension and PBOP costs in cost-of-service rates, the Commission has determined that a uniform requirement for how jurisdictional entities should account for and report pension and PBOP costs are most conducive to promoting comparability and decision-usefulness of the information.[4] As such, we will continue to require all jurisdictional entities to recognize pension and PBOP costs on the income statement, in its entirety without disaggregation of its various components, in the currently existing account designated for pension and PBOP costs under each respective Uniform System of Accounts.

2. CAPITALIZATION OF PENSION AND PBOP COSTS

Question: Is it appropriate for jurisdictional entities to capitalize pension and PBOP costs using the method prescribed under ASU No. 2017-07?

Response: Provided that the pension and PBOP costs are based on appropriate labor costs and have a definite relation to construction as required under Electric Plant Instruction No. 4, Gas Plant Instruction No. 4, and Service Company Property Instruction No. 367.52, jurisdictional entities may continue to capitalize the service cost component and non-service cost components of pension and PBOP costs as it has traditionally been the widely accepted practice, or they may elect to capitalize only the service cost component of pension and PBOP costs, as prescribed by ASU No. 2017-07. Both methods are appropriate and are not precluded by the Commission's accounting requirements.

The Commission's Uniform System of Accounts prescribed for public utilities and licensees, natural gas companies, and centralized service companies do not require any specific method to determine the components of pension and PBOP costs to be included or excluded from capitalization, as long as the capitalization is based on labor costs and have a definite relation to construction. The instructions to Account 926 only requires that records in support of this account shall be so kept that the amounts of pensions and benefits expenses transferred to construction or other accounts will be readily available. Additionally, Electric Plant Instruction No. 4, Gas Plant Instruction No. 4, and Service

[4] *See* California Independent System Operator Corporation, 126 FERC ¶ 61,263 (2009), *order on reh'g*.

Company Property Instruction No. 367.52 require overhead costs allocated to construction and capitalized to have a definite relation to the construction, either based on direct charges using employee time tracking or special studies. The Uniform System of Accounts prescribed for oil pipeline companies similarly do not discuss the service or non-service components of pension and PBOP costs to be included or excluded from capitalization.

Because there is no definitive requirement under the Uniform Systems of Accounts requiring specific identification of pension and PBOP cost components to be capitalized, outside of the requirement for the capitalization to be based on appropriate labor costs and to have a definite relation to construction, jurisdictional entities may elect to follow the capitalization required under ASU No. 2017-07. It is also acceptable to continue capitalizing all of the pension and PBOP costs, as companies have done so prior to the issuance of the ASU. Either approach will not conflict with the existing requirements under the Uniform System of Accounts, provided that the method of capitalization adheres to Electric Plant Instruction No. 4, Gas Plant Instruction No. 4, and Service Company Property Instruction No. 367.52.

Question: How should jurisdictional entities account for deferred income taxes related to property, plant, and equipment which include capitalized pension and PBOP costs, if those amounts of pension and PBOP costs capitalized for regulatory accounting and reporting to the Commission differ from the amounts capitalized for GAAP reporting purposes?

Response: Jurisdictional entities must account for and report deferred income taxes to the Commission based on the temporary differences between the basis of assets reported to the Internal Revenue Service (IRS) and the basis of assets reported to the Commission. Similarly, the amount of deferred income tax reversals in subsequent periods must be based on the difference between the revenues and expenses used for reporting to the IRS and the revenues and expenses recognized for reporting to the Commission. Balances used in GAAP reporting should not be a factor in determining the deferred income tax balances reported to the Commission. Jurisdictional entities must be able to reconcile deferred income tax balances reported on the financial statements filed with the Commission with the respective asset and liability balances on those same set of financial statements.

3. DISCLOSURES AND FUTURE FILINGS TO THE COMMISSION

Question: What are the required disclosures or filings to the Commission related to changes made to a jurisdictional entity's accounting practice in response to ASU No. 2017-07?

Response: Jurisdictional entities should disclose any changes in accounting practice in response to ASU No. 2017-7 in their respective FERC Forms filed to the Commission quarterly and annually, within the Notes to the Financial Statements. Disclosures should include potential rate impacts resulting from these changes, including the effects on rate base and current period expenses. Jurisdictional entities should also make similar disclosures on future rate filings, as applicable.

Question: What are the required procedures for jurisdictional entities that want to change its capitalization policy over pension and PBOP costs after the 2018 reporting period?

Response: While either approach to capitalization of pension and PBOP costs as discussed herein is acceptable, there is a risk that the approach elected by companies will change from one period to the next in order to influence rate outcomes. Accordingly, jurisdictional entities are required to be consistent in all future periods using the capitalization approach elected after effectuation of ASU No. 2017-07 or during the 2018 reporting period. They must write in to the Commission for approval if there is any change of capitalization policy for pension and PBOP costs in the future.

The Commission delegated authority to act on this matter to the Director of the Office of Enforcement or his designee under 18 C.F.R. § 375.311 (2017). The Director has designated this authority to the Chief Accountant. This letter constitutes final agency action. Your company may file a request for rehearing with the Commission within 30 days of the date of this order under 18 C.F.R. § 385.713 (2017).

Sincerely,

Bryan K. Craig
Chief Accountant and Director
Division of Audits and Accounting
Office of Enforcement

Document Content(s)

UNDERTAKING J6.8

Reference:
Oral Hearing Volume 6, Page 108, Line 21 – Page 110, Line 27

Undertaking:
To provide a list of instances, under either transmission or distribution, where HONI is relying on a regulator's decision that allows it to apply the principles of rate regulation and depart from the US GAAP standard that would not otherwise apply to a non-rate-regulated company.

Response:
Since Hydro One adopted US GAAP in 2012, the OEB has approved a number of instances allowing the company to depart from US GAAP as it applies to non-rate-regulated entities, and as permitted under US GAAP Accounting Standards Codification 980 – Regulated Operations (ASC 980).

These instances have generally arisen where there is a change in law or policy or other external conditions that would result in either (or both):

- A significant rate impact;
- Intergenerational inequity, where the costs incurred in providing service in one period are paid in a different period;

In other words, anytime the OEB has ordered a deferral or variance account to address either of the above-noted issues, there is a departure from US GAAP which is permitted under ASC 980.

Under US GAAP for non-rate-regulated entities, costs are recorded in the period in which they are incurred whereas under regulatory principles, effort is made to match costs to the period in which ratepayers benefit from the costs. The resulting accounting treatments are acceptable under US GAAP.

In this instance, a change to US GAAP standards precipitated by the Financial Accounting Standards Board's new Accounting Standards Update (ASU) No. 2017-07 "Improving the Presentation of Net Periodic Pension Cost and Net Periodic Post-retirement Benefit Cost" (ASU 2017-07) creates both a large rate impact and an inequitable matching of costs.

ASU 2017-07 specifies how pension and OPEB costs should be presented on the income statement under US GAAP and what components of those costs are eligible for capitalization in assets. Consequently, without OEB approval to do otherwise, Hydro One must stop capitalizing the non-service cost component of its OPEBs and must recover this amount through Operations, Maintenance, and Administration expenses (OM&A) instead. This will give rise to revenue requirement increases of $21 million for Transmission and $15 million for Distribution in 2020, and similar amounts in future years.[1]

The OEB may allow Hydro One to continue capitalizing the non-service component of OPEBs and, under ASC 980, Hydro One would be permitted to do so and would remain compliant with US GAAP. This avoids both a large rate impact and an inequitable matching of costs. For the reasons set out in response to undertaking J-6.04, Hydro One submits that this produces the most equitable result for ratepayers (as it effectively retains the cost ratepayers would have otherwise seen absent the accounting change).

In fact, the Federal Energy Regulatory Commission (FERC) took this approach in its guidance dated December 28, 2017, in which it allowed the continued capitalization of both the service and non-service cost components of pensions and OPEBs. A copy of the FERC letter is provided in Attachment 1 of undertaking response J-6.04.

This response to the undertaking details: (i) the parameters of ASC 980; and (ii) prior instances where the OEB has approved a departure from US GAAP principles, as permitted for rate-regulated enterprises such as Hydro One by ASC 980.

Hydro One is asking the OEB to allow the continued capitalization of the non-current component of OPEB costs. Absent OEB approval, these costs would have to be recognized as expenses annually.

ASC 980

Hydro One has been using rate regulated accounting since 1999. Prior to the adoption of US GAAP in 2012, Hydro One used Legacy Canadian GAAP, which contained limited guidance on rate regulation. Where there was no guidance under Legacy Canadian GAAP, companies referred to and securities regulators (such as the Ontario Securities Commission) permitted reliance on US GAAP Accounting Standards Codification 980 – Regulated Operations (ASC 980) (formerly Financial Accounting Standard 71 –

[1] Refer to response to J6.4 for further details

Accounting for the Effects of Certain Types of Regulation). Thus, the transition from Legacy Canadian GAAP to US GAAP has not introduced any new basis of accounting or fundamentally changed the accounting Hydro One uses; rather, it is a continuation of historical practices as the fundamental principles under Legacy Canadian GAAP and US GAAP are the same.

Rate regulated accounting (per ASC 980) applies when all of the following criteria are met:

1. Rates are established by an independent third-party regulator or the entity's own Governing board;
2. Rates are designed to recover costs of service; and
3. Rates designed to recover costs can be charged to and collected from customers.

The purpose of ASC 980 is summarized in PricewaterhouseCooper's "Utilities and Power Companies" accounting guide (partially updated December 2018) ("PWC Guidance") as follows:

> *The purpose of ASC 980 is for financial reporting to reflect the economic effects of certain rate-regulated activities and actions taken by regulators that arise in the normal course of regulated operations. The basic premise of ASC 980 is that the actions of a regulator will impact the financial statements prepared for financial reporting purposes only if the action has an economic effect on the regulated utility and meets the requirements for recognition or deferral under the standard. A regulated utility should comply with U.S. GAAP applicable to entities in general with regard to its accounting and financial reporting. If it is also subject to ASC 980, the applicable provisions within that standard are applied as an adjustment to or in lieu of other U.S. GAAP (when specifically required by ASC 980).*[2]

Rate regulated accounting allows for the recognition of regulatory assets and liabilities. While the timing and recognition of related revenues and expenses may differ from that of non-regulated entities to which ASC 980 is not applicable. In other words, rate regulated accounting (per ASC 980) helps address instances where a change in law or

[2] PWC Guidance, p. 573 excerpt is provided as attachment 3 to this undertaking

policy or other external conditions result in either (or both) a rate shock or intergenerational inequity. The PWC Guidance on ASC 980 is helpful in this regard. It states:

> *One of the primary areas in which accounting by regulated utilities differs from unregulated entities is regulated utilities' ability to defer certain expenditures as regulatory assets that would otherwise be expensed under U.S. GAAP.*[3]

The ability for rate-regulated entities to recognize regulatory assets and liabilities in the form of deferral and variance accounts is inherently covered in the OEB's Accounting Procedures Handbook – the OEB expects utilities to report quarterly on the account balances. Moreover, the OEB expects utilities to bring forward any applicable regulatory accounts for disposition in their rate applications.

Examples of OEB Direction Permitting a Departure from US GAAP Principles

Attachment 1 of this Undertaking Response lists several instances from past Transmission and Distribution proceedings where the OEB approved a departure from standard US GAAP principles under ASC 980 to address large rate impact or intergenerational inequity since 2012 when Hydro One adopted US GAAP. In each of these instances, there is an associated deferral or variance account which allows the company to manage the rate impact or the intergenerational inequity. The corresponding benefit is passed on to ratepayers in the form of current and future rates.

In addition to the items noted in Attachment 1, there are other regulatory asset & liability mechanisms that Hydro One maintains, which a non-rate-regulated company would not otherwise be permitted to maintain under US GAAP. These accounts are detailed in the 2018 financial statements for Hydro One Transmission4 (Note 10) and Hydro One Distribution5 (Note 11). Such current examples include the following accounts, where Hydro One Transmission and Hydro One Distribution recognize a regulatory asset or regulatory liability based on the OEB's approval of the underlying transactions. The treatment of these accounts has been consistent since the inception of each account.

[3] PWC Guidance, p. 581 excerpt is provided as attachment 3 to this undertaking
[4] Exhibit A-6-2 Attachment 3
[5] Provided as Attachment 2 to this undertaking

1. ENVIRONMENTAL REGULATORY ASSET

Background: In 2001, Hydro One Networks revised its accounting policy for environmental costs to move from an incurred approach to one of full recognition. As part of this change, in EB-2001-0016, a request was made for an Accounting Order to establish a deferral account to record environmental costs incremental to those included in Networks' approved revenue requirement. The request recognized the net present value of estimated future cash flows expected to be required to discharge financial obligations associated with PCB management and the remediation of contaminated lands. These past service obligations are intended to be amortized over the term of the remediation program, as expenditures are incurred. The OEB approved the account.

Purpose and description of the account: Hydro One records a liability for the estimated future expenditures required to remediate environmental contamination. The expenditures are included in revenue requirement for the period in which they will be incurred. Based on the OEB's approval of expenditures for recovery in rates in prior periods, a regulatory asset is recognized because Hydro One considers it to be probable that environmental expenditures will continue to be recovered in the future through the rate-setting process.

Since 2001, Hydro One has included environmental contamination remediation costs in its OM&A requests in rate applications and reiterated the existence of the offsetting regulatory asset (See Exhibit A, Tab 12 in EB-2005-0378).

2. SHARE-BASED COMPENSATION REGULATORY ASSET

Background: In 2015, as part of the settlement with the Power Workers' Union ("PWU") and Society of United Professionals ("Society") during the collective bargaining process, eligible PWU and Society employees were awarded shares in exchange for concessions on pension costs. The share-based compensation costs are included for recovery in the year in which the grant is settled, as this is when ratepayers benefit from the work performed by PWU and Society employees.

Purpose and description of the account: Hydro One recognizes costs associated with share grant plans in a regulatory asset, and costs of the share grant plans costs will be sought for recovery in the corresponding rate period. In the absence of rate-regulated accounting, there would be an instant impact on OM&A expenses.

Share based compensation is part of the overall compensation cost of represented employees for each year in which the shares are issued to the eligible employees. These costs were included and discussed in Hydro One's capital and OM&A evidence in its most recent distribution and transmission rate applications (EB-2016-0160 and EB–2017-0049) and Hydro One manages its compensation, including share based compensation, within OEB approved envelopes. As a result, Hydro One recognizes a regulatory asset under ASC 980 to defer the expense (that would otherwise be recognized under ASC 718, Compensation – Stock Compensation) to the period in which it will be incurred and approved for recovery as part of Hydro One's capital and OM&A envelopes.

This approach maintains generational equity in that the pension plan valuations that will be conducted from this point forward which will impact (reduce) the cash pension contributions (which are recovered in rates) commencing 2017 and better matches the ongoing reduction in company pension costs with the temporary increase in compensation costs for the eligible represented employees.

3. DEFERRED INCOME TAX REGULATORY ASSET AND LIABILITY

Background: In August 2007, the Accounting Standards Board decided to remove a temporary exemption in CICA Handbook Section 1100, retain existing references to rate regulated accounting in the CICA Handbook, require the recognition of future income tax liabilities and assets as well as a separate regulatory asset or liability for the amount of future income taxes, and retain existing requirements to disclose the effects of rate regulation.

Purpose and description of the account: Deferred income taxes are recognized on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable income. The Company can recognize regulatory assets and liabilities that correspond to deferred income taxes that flow through the rate-setting process. In the absence of rate-regulated accounting, the Company's income tax expense would have been recognized using the liability method and there would be no regulatory accounts established for taxes to be recovered through future rates. As a result, there would be an impact on income tax expense.

Since 2009, Hydro One has recorded a deferred tax asset due to the existence of temporary differences. Hydro One shares this deferred tax asset with ratepayers, which gives rise to the offsetting regulatory liability. The OEB has approved Hydro One's inclusion of deferred income taxes in its revenue requirement.

4. POST-RETIREMENT AND POST-EMPLOYMENT BENEFITS REGULATORY ASSET

Purpose and description of the account: This account balance is made up of any OPEB actuarial gain/loss that would be recognized within Accumulated Other Comprehensive Income (AOCI) under the provisions of ASC 715 (Compensation – Retirement Benefits) and would be amortized to accrual-basis expense in future periods. Based on the OEB's approval of recovery of OPEB costs on an accrual-basis, Hydro One recognizes a regulatory mechanism (regulatory asset or liability) on the basis that it is probable that accrual-basis OPEB costs including the amortization of any actuarial gain/loss from AOCI would continue to be approved and included in future rates.

HYDRO ONE DISTRIBUTION

Proceeding	Proceeding Description	Request	Request Initiator	Outcome
EB-2011-0399	Distribution 2012 rates and adoption of US GAAP	Discontinue the "Impact for Changes in IFRS Account"	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
		Continue the "IFRS Incremental Transition Costs Account" with modified scope - to change name to "US GAAP – Incremental Transition Costs Account"	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
		Establish the "Impact for US GAAP Account"	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
EB-2012-0136	Distribution 2013 rates	Continue the "Smart Grid Deferral Account"	Hydro One	OEB approved
EB-2013-0416	Distribution 2015-2017 rates	Continue the "Tax Rate Changes Account"	Hydro One	OEB approved
		Continue the "Pension Cost Differential Account"	Hydro One	OEB approved
		Establish a new 2015 "Bill Impact Mitigation Variance Account"	Hydro One, in order to limit the bill impact of those customers that are moving to a rate class classification with higher rates as a result a rate class review. The bill impact is limited to higher of 10% or $3 for residential customers, 10% or $10 for General Service Energy Billed Customers and 10% or $100 for General Service Demand Billed Customers	OEB approved
		Establish a new "Rate Smoothing Deferral Account"	Hydro One, due to large increase in revenue requirement in 2015.	OEB disapproved - revenue requirement and rates approved in this Application were in place for 3 years as opposed to 5
		Discontinuance of the following accounts: 1) Smart Meter – Minimum Functionality 2) Smart Meter – Exceeding Minimum Functionality 3) Distribution Generation – Other Costs – HONI - Variance Account 4) Distribution Generation - Express Feeders – HONI - Variance Account 5) Distribution System Code (DSC) Exemption Deferral Account 6) Deferred Revenue Project Costs Variance Account (2009) 7) Generator Joint Use Revenue Variance Account 8) Special Purpose Charge Variance Account 9) Microfit Connection Charge Variance Account 10) OEB Cost Differential Account 11) Smart Grid Variance Account	Hydro One requested discontinuation of the accounts. Notes below: 1 and 2) Accounts were first directed to be set up by the Minister of Energy and the smart meters initiatives ended by the end of 2014. 3 and 4) Accounts were first directed to be set up by the OEB. Increasing renewable generation was one of the key objectives of the Green Energy and Green Economy Act, 2009 ("GEGEA"). The Hydro One Distribution Green Energy Plan (the "Plan") in EB-2009-0096 presented the Company's response to the GEGEA in alignment with Hydro One's corporate strategy. 10) Account was first directed to be set-up by the OEB on February 6, 2016 and utilities were instructed to discontinue the account when their rates rebased during their next Application. 11) Account was first directed to be set up by the OEB in EB-2009-0096.	OEB approved
EB-2015-0040	Report of the OEB - Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs	The OEB provides for the establishment of the Pension and OPEB Forecast Accrual versus Actual Cash Payment Differential variance account on a generic basis in this Report.	OEB Directive	In EB-2019-0082, Hydro One requests that the OEB approve a modified approach to calculate the reference amount
EB-2017-0049	Distribution 2018-2022 rates	Establish an "Earnings Share Mechanism Account"	Hydro One	OEB approved
		Establish an "OPEB Cost Deferral Account"	Hydro One	OEB approved
		Establish a "Lost Revenue Adjustment Mechanism Variance Account"	Hydro One	OEB disapproved
		Establish a "Capital In-Service Additions Variance Account"	Hydro One	OEB approved
		Establish a "Bill Impact Mitigation Variance Account – Acquired Utilities"	Hydro One	OEB disapproved
		Establish a "Integrated System Operating Center (ISOC) Asymmetric Variance Account"	OEB Directive	
		Discontinuance of the following accounts: 1) Rural or Remote Electricity Rate Protection (RRRP) Variance Account 2) Bill Impact Mitigation Variance Account (2015) 3) Revenue Offset Difference Account – Pole Attachment Charge 4) Revenue Difference Account – Pole Attachment Charge	Hydro One	OEB approved
OEB Accounting Direction - July 25, 2019		Accounting Direction Regarding Bill C-97 and Other Changes in Regulatory or Legislated Tax Rules for Capital Cost Allowance. Establishment of a separate sub-account of Account 1592 - PILs and Tax Variances – CCA Changes specifically for the purposes of tracking the impact of changes in CCA rules.	OEB Directive	

In the most recently OEB approved Distribution Rates Application (EB-2017-0049), Hydro One requested continuance of the following regulatory accounts: Retail Settlement Variance Accounts (RSVAs), Retail Cost Variance Accounts (RCVAs), Pension Cost Differential Account, Tax Rate Changes Account, OEB Cost Differential Account, Smart Meter Entity (SME) Charge Variance Account, and Long Term Load Transfer Rate Impact Mitigation Deferral Account. The OEB approved the continuance of these accounts.

HYDRO ONE TRANSMISSION

Proceeding	Proceeding Description	Request	Request Initiator	Outcome
EB-2011-0268	Transmission 2012 rates and adoption of US GAAP	Discontinue the "Impact for Changes in IFRS Account (2012 only)", the "IFRS – Gains and Losses Account (2012 only)", and the "IFRS Capitalization Policy Variance Account (2012 only)".	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
		Continue the "IFRS Incremental Transition Costs Account" with modified scope - to change name to "US GAAP – Incremental Transition Costs Account"	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
		Establish the "Impact for US GAAP Account (2012 only)"	Hydro One, as a result of requesting to adopt US GAAP for rate setting, regulatory accounting, and regulatory reporting.	OEB approved
EB-2012-0031	Transmission 2013 and 2014 rates	Establishment of the "External Revenue - Partnership Transmission Projects Account"	Hydro One requested the approval to establish the account	OEB approved
		Establishment of the "Long-term Transmission Future Corridor Acquisition and Development Account"	Hydro One requested the approval to establish the account	OEB approved
		Establishment of the "Other External Revenues Variance Account"	As part of the settlement agreement Hydro one agreed to establish a new symmetrical variance account to track differences in Other External Revenue (as this was the only input into External Revenue which was not previously tracked in the other 3 symmetrical variance accounts)	OEB approved
		Discontinuance of the following accounts: 1) Deferred Export Service Credit Revenue Account 2) Long Term Project Development Costs Account 3) Impact for US GAAP Account 4) US GAAP – Incremental Transition Costs Account	Hydro One	OEB approved
		Establishment of the "Conservation and Demand Management (CDM) Variance Account"	Hydro One, resulting from concerns from certain intervenors about the accuracy and reliability of the CDM and Demand Response forecasts prepared by the OPA (now the IESO).	OEB approved
EB-2012-0180	Request to establish the East West Tie Deferral Account (EWTDA)	Establishment of the "EWTDA"	Hydro One requested this account because The Minister of Energy sent a letter to the Board (March 29, 2011) suggesting that the designation process, outlined in the new Board policy "Framework for Transmission Project Development Plans (EB-2010-0059)" be used to select a transmission company for the EWT Line.	OEB approved
EB-2013-0421	Leave to construct a new transmission line and facilities in the Windsor-Essex Region, Ontario.	Establishment of the "Supply to Essex County Transmission Reinforcement Deferral Account"	Hydro One	OEB approved
EB-2014-0140	Transmission 2015-2016 rates	Establishment of a net cumulative asymmetrical variance account for 2014, 2015, and 2016 to track the impact on revenue requirement of any in-service capital additions shortfall compared to Board approved amounts, for disposition in a future rates application.	Hydro One requested this account because Intervenors expressed concern, regarding Hydro One's historic ISA levels compared to Board-approved ISA levels. To address this concern, parties agreed to create a net cumulative asymmetrical variance account for 2014, 2015, and 2016 to track the impact on revenue requirement of any ISA shortfall compared to Board approved amounts, for disposition in a future rates application.	OEB approved
EB-2014-0311	Request for an Accounting Order to Establish a Deferral Account for Preliminary Development work relating to the North West Bulk Transmission Line Project (NWBTL).	Establishment of the "North West Bulk Transmission Line Deferral Account"	Hydro One requested this account because the NWBTL Project was identified as a priority project in the 2013 Long-Term Energy Plan (LTEP) and in December 2013, Hydro One received a directive from the Ministry of Energy (see Attachment A) to begin the development phase of the project and subsequent to that letter, the OEB included this request as a condition to Hydro One Transmission's license in January 2014 (EB-2013-0437).	OEB approved
EB-2015-0040	Report of the OEB - Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs	The OEB provides for the establishment of the Pension and OPEB Forecast Accrual versus Actual Cash Payment Differential variance account on a generic basis in this Report.	OEB Directive	In EB-2019-0082, Hydro One requests that the OEB approve a modified approach to calculate the reference amount
EB-2016-0160	Transmission 2017-2018 rates	In EB-2015-0040, the OEB provides for the establishment of the Pension and OPEB Forecast Accrual versus Actual Cash Payment Differential variance account on a generic basis in this Report.	OEB Directive	Hydro One requests that the OEB approve a modified approach to calculate the reference amount - OEB decision is pending
		Establishment of the "Foregone Transmission Revenue Account"	OEB Directive	
		Closure of the "LDC CDM and DR Variance Account"	Hydro One	OEB disapproved
		Establish an "Incentive Payments Deferral Account"	Energy Probe	OEB disapproved
EB-2018-0269	2018 Transmission Revenue Requirement and Charge Determinants, Reconsideration of Future Tax Savings	The OEB determined in EB-2016-0160 that a portion of the future tax savings resulting from the Government of Ontario's decision to sell its ownership interest in Hydro One Limited by way of an IPO and subsequent sale of shares should be applied to reduce Hydro One's revenue requirement for 2017 and 2018.	Hydro One did not make this request - it was imposed to Hydro One by the OEB.	The OEB found that the Original Decision which resulted in the allocation of the future tax savings (62% to shareholder and 38% to ratepayers) was within the realm of reasonable outcomes. Therefore, this gave rise to the deferred income tax regulatory liability.

EB-2018-0130	Transmission 2019 rates	Establish a "Revenue Cap Index Parameters Differential Account"	Hydro One	OEB disapproved
		Discontinuance of the "OEB Cost Assessment Variance Account"	Account was first directed to be set-up by the OEB on February 6, 2016 and utilities were instructed to discontinue the account when their rates rebased during their next Application.	OEB approved
OEB Accounting Direction - July 25, 2019		Accounting Direction Regarding Bill C-97 and Other Changes in Regulatory or Legislated Tax Rules for Capital Cost Allowance. Establishment of a separate sub-account of Account 1592 - PILs and Tax Variances – CCA Changes specifically for the purposes of tracking the impact of changes in CCA rules.	OEB Directive	
EB-2019-0151	Application for an accounting order approving the establishment of a tracking deferral account	Approval of the Waasigan Transmission Tracking Deferral Account (WTTDA)	Hydro One requested this account because The Minister of Energy issued an Order in Council No. 1701/2013 and Directive to the OEB for Hydro One to commence development work on the North West Bulk Transmission Line (since renamed to Waasigan Transmission Line Project (the Project)) in 2013, and on October 24, 2018, the IESO confirmed the need for the Project. The project has now reached the stage where costs will be capitalized and recorded in CWIP.	OEB approved
In the most recently OEB approved Transmission Rates Application (EB-2018-0130), Hydro One requested continuance of the following regulatory accounts: Excess Export Service Revenue, External Secondary Land Use Revenue, External Station Maintenance, E&CS and Other External Revenue, Tax Rate Changes, Rights Payments, Pension Cost Differential, Long-Term Transmission Future Corridor Acquisition and Development, LDC CDM Variance Account, External Revenue – Partnership Transmission Projects Account, In-Service Capital Additions Variance Account, NWBTL Account, SECTR Account, and EWT Deferral Account. The OEB approved the continuance of these accounts.				

HYDRO ONE NETWORKS INC.

DISTRIBUTION BUSINESS

FINANCIAL STATEMENTS

DECEMBER 31, 2018

To the Directors of Hydro One Networks Inc.

Opinion

We have audited the carve-out financial statements of the Distribution Business (a business of Hydro One Networks Inc.) (the "Entity"), which comprise:

- the carve out balance sheet as at December 31, 2018
- the carve out statement of operations and comprehensive income for the year then ended
- the carve out statement of cash flows for the year then ended
- and notes to the carve out financial statements, including a summary of significant accounting policies (Hereinafter referred to as the "carve-out financial statements").

In our opinion, the accompanying carve-out financial statements as at and for the year ended December 31, 2018 of the Entity are prepared, in all material respects, in accordance with the financial reporting framework described in Note 2 of these carve-out financial statements.

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the "Auditors' Responsibilities for the Audit of the Carve-Out Financial Statements" section of our auditors' report.

We are independent of the Entity in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada and we have fulfilled our other ethical responsibilities in accordance with these requirements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter - Basis of Preparation

We draw attention to Note 2 to the carve-out financial statements which describes the basis of preparation used in these carve-out financial statements.

The purpose of the carve-out financial statements is to meet Hydro One Networks Inc.'s obligation to the Ontario Energy Board. As a result, these carve-out financial statements may not be suitable for another purpose.

Our opinion is not modified in respect of this matter.

Responsibilities of Management and Those Charged with Governance for the Carve-Out Financial Statements

Management is responsible for the preparation of the carve-out financial statements in accordance with the financial reporting framework described in Note 2 in the carve-out financial statements; this includes determining that the applicable financial reporting framework is an acceptable basis for the preparation of the carve-out financial statements in the circumstances, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Those charged with governance are responsible for overseeing the Entity's financial reporting process.

Auditors' Responsibilities for the Audit of the Carve-Out Financial Statements

Our objectives are to obtain reasonable assurance about whether the carve-out financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion.

Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian generally accepted auditing standards will always detect a material misstatement when it exists.

Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the carve-out financial statements.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit.

We also:

- Identify and assess the risks of material misstatement of the carve-out financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion.
- The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Entity's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Entity's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditors' report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditors' report. However, future events or conditions may cause the Entity to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the carve-out financial statements, including the disclosures, and whether the carve-out financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

KPMG LLP

Chartered Professional Accountants, Licensed Public Accountants

Toronto, Canada
April 25, 2019

HYDRO ONE NETWORKS INC.
DISTRIBUTION BUSINESS
STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME
For the years ended December 31, 2018 and 2017

Year ended December 31 *(millions of Canadian dollars)*	2018	2017
Revenues		
Energy sales	4,078	4,005
Rural rate protection *(Note 22)*	239	247
Other	52	63
	4,369	4,315
Costs		
Purchased power *(Note 22)*	2,900	2,875
Operation, maintenance and administration *(Note 22)*	568	567
Depreciation, amortization and asset removal costs *(Note 4)*	396	388
	3,864	3,830
Income before financing charges and income taxes	**505**	**485**
Financing charges *(Notes 5, 22)*	174	165
Income before income taxes	**331**	**320**
Income taxes *(Note 6)*	50	55
Net income	**281**	**265**
Other comprehensive income	—	—
Comprehensive income	**281**	**265**

See accompanying notes to Financial Statements.

HYDRO ONE NETWORKS INC.
DISTRIBUTION BUSINESS
BALANCE SHEETS
At December 31, 2018 and 2017

December 31 *(millions of Canadian dollars)*	2018	2017
Assets		
Current assets:		
Accounts receivable *(Note 7)*	578	588
Due from related parties *(Note 22)*	125	119
Other current assets *(Note 8)*	34	38
	737	745
Property, plant and equipment *(Note 9)*	7,511	7,324
Other long-term assets:		
Regulatory assets *(Note 11)*	204	638
Intangible assets *(Note 10)*	309	289
Goodwill	168	168
Other assets	—	1
	681	1,096
Total assets	**8,929**	**9,165**
Liabilities		
Current liabilities:		
Inter-company demand facility *(Note 22)*	392	213
Long-term debt payable within one year *(Notes 14, 15, 22)*	291	337
Accounts payable and other current liabilities *(Note 12)*	720	679
Due to related parties *(Note 22)*	84	153
	1,487	1,382
Long-term liabilities:		
Long-term debt *(Notes 14, 15, 22)*	3,620	3,498
Deferred income tax liabilities *(Note 6)*	33	499
Regulatory liabilities *(Note 11)*	217	84
Other long-term liabilities *(Note 13)*	856	934
	4,726	5,015
Total liabilities	**6,213**	**6,397**
Contingencies and Commitments (Notes 24, 25)		
Subsequent Events (Note 26)		
Excess of assets over liabilities *(Notes 16, 20)*	2,716	2,768
Total liabilities and excess of assets over liabilities	**8,929**	**9,165**

See accompanying notes to Financial Statements.

On behalf of the Board of Directors:

William Sheffield
Chair, Audit Committee

Russel Robertson
Director

HYDRO ONE NETWORKS INC.
DISTRIBUTION BUSINESS
STATEMENTS OF CASH FLOWS
For the years ended December 31, 2018 and 2017

Year ended December 31 *(millions of Canadian dollars)*	2018	2017
Operating activities		
Net income	281	265
Environmental expenditures	(15)	(15)
Adjustments for non-cash items:		
Depreciation and amortization *(Note 4)*	345	337
Regulatory assets and liabilities	53	172
Deferred income taxes	(15)	(44)
Other	6	5
Changes in non-cash balances related to operations *(Note 23)*	(27)	173
Net cash from operating activities	**628**	**893**
Financing activities		
Long-term debt issued	412	—
Long-term debt repaid	(337)	(195)
Payments to finance dividends and return on stated capital	(333)	(263)
Change in inter-company demand facility	177	138
Other	(2)	—
Net cash used in financing activities	**(83)**	**(320)**
Investing activities		
Capital expenditures *(Note 23)*		
Property, plant and equipment	(483)	(522)
Intangible assets	(75)	(56)
Other	13	(4)
Net cash used in investing activities	**(545)**	**(582)**
Net change in cash and cash equivalents	—	(9)
Cash and cash equivalents, beginning of year	—	9
Cash and cash equivalents, end of year	**—**	**—**

See accompanying notes to Financial Statements.

1. DESCRIPTION OF THE BUSINESS

Hydro One Inc. (Hydro One) was incorporated on December 1, 1998, under the *Business Corporations Act* (Ontario) and is wholly-owned by Hydro One Limited. The principal businesses of Hydro One are the transmission and distribution of electricity to customers within Ontario.

Hydro One Networks Inc. (Hydro One Networks or the Company) was incorporated on March 4, 1999 under the *Business Corporations Act* (Ontario) and is a wholly owned subsidiary of Hydro One. The Company owns and operates regulated transmission and distribution businesses. The regulated distribution business (Distribution Business) operates a low-voltage electrical distribution network that distributes electricity from the transmission system, or directly from generators, to customers within Ontario. The Distribution Business is regulated by the Ontario Energy Board (OEB).

Rate Setting

OEB March 7, 2019 Decisions

Subsequent to year end, on March 7, 2019, the OEB issued a decision on its reconsideration of its decision and order on Hydro One Networks' 2017 and 2018 transmission rates revenue requirements dated September 28, 2017 (Original Decision) with respect to the rate-setting treatment of the benefits of the deferred tax asset resulting from transition from the payments in lieu of tax regime under the *Electricity Act* (Ontario) to tax payments under the federal and provincial tax regime which occurred when Hydro One Limited became a public company listed on the Toronto Stock Exchange.

The March 7, 2019 OEB decision has been determined to be a Type I subsequent event under United States (US) Generally Accepted Accounting Principles (GAAP). As a result, the financial impact of this OEB decision has been reflected in these financial statements, as more fully discussed in Note 11 - Regulatory Assets and Liabilities.

Distribution

In March 2017, Hydro One Networks filed an application with the OEB for 2018-2022 distribution rates. The revenue requirements of \$1,459 million for 2018, \$1,498 million for 2019, \$1,532 million for 2020, \$1,578 million for 2021, and \$1,624 million for 2022 were based on the OEB decision received on March 7, 2019. See Note 26(C) - Subsequent Events - OEB Regulatory Decisions.

On November 17, 2017, Hydro One filed with the OEB a request for 2018 interim rates based on 2017 OEB-approved rates, adjusted for an updated load forecast. On December 1, 2017, the OEB denied this request and set interim 2018 rates based on 2017 OEB-approved rates with no adjustments.

2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting

These Financial Statements are prepared and presented in accordance with the accounting policies summarized below and in Canadian dollars. These policies are consistent with US GAAP, with the exception that business combinations of entities under common control have been accounted for as of the date of the transfer, such that (1) the Financial Statements were not prepared as though the transfer of entities under common control had occurred at the beginning of the year in which the transfer occurred and (2) the comparative year information has not been retrospectively adjusted.

The purpose of these Financial Statements is to meet Hydro One Networks' obligation to the OEB. As a result, these Financial Statements may not be suitable for another purpose. Consolidated Financial Statements of Hydro One for the year ended December 31, 2018 have been prepared and are publicly available.

Basis of Preparation

These Financial Statements have been prepared on a carve-out basis to provide the financial position, results of operations and cash flows of the Company's regulated Distribution Business. The Financial Statements are considered by management to be a reasonable representation, prepared on a rational, systematic and consistent basis, of the financial results of the Company’s Distribution Business. As a result of this basis of preparation, these Financial Statements may not necessarily be identical to the financial position and results of operations that would have resulted had the Distribution Business historically operated on a stand-alone basis.

The Financial Statements have been constructed primarily through specific identification of assets, liabilities (other than debt), revenues and expenses that relate to the Distribution Business. The Company’s long-term debt is allocated based on the respective borrowing requirements of the Company’s transmission and distribution businesses. A portion of the Company’s shared functions and services costs is allocated to the Distribution Business on a fully allocated-cost basis, consistent with OEB-approved independent studies. Income tax expense has been recorded at effective rates based on income taxes as reported in the Statements of Operations and Comprehensive Income as though the Distribution Business was a separate taxpaying entity. These Financial Statements include deferred taxes and related regulatory balances with respect to the rate-setting treatment of the benefits of the deferred tax asset resulting from transition from the payments in lieu of tax regime under the *Electricity Act* (Ontario) to tax payments under the federal and provincial tax regime which occurred when Hydro One Limited became a public company listed on the Toronto Stock Exchange. Certain other amounts presented in these Financial Statements represent allocations subject to review and approval by the OEB.

Hydro One Networks performed an evaluation of subsequent events through to April 25, 2019, the date these Financial Statements were available to be issued, to determine whether any events or transactions warranted recognition and disclosure in these Financial Statements. See Note 26 - Subsequent Events.

Use of Management Estimates

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues, expenses, gains and losses during the reporting periods. Management evaluates these estimates on an ongoing basis based upon historical experience, current conditions, and assumptions believed to be reasonable at the time the assumptions are made, with any adjustments being recognized in results of operations in the period they arise. Significant estimates relate to regulatory assets and regulatory liabilities, environmental liabilities, post-retirement and post-employment benefits, asset retirement obligations, asset impairments, contingencies, and deferred income tax assets and liabilities. Actual results may differ significantly from these estimates.

Regulatory Accounting

The OEB has the general power to include or exclude revenues, costs, gains or losses in the rates of a specific period, resulting in a change in the timing of accounting recognition from that which would have been applied in an unregulated company. Such change in timing involves the application of rate-regulated accounting, giving rise to the recognition of regulatory assets and liabilities. The Distribution Business' regulatory assets represent amounts receivable from future customers and costs that have been deferred for accounting purposes because it is probable that they will be recovered in future rates. In addition, the Distribution Business has recorded regulatory liabilities that generally represent amounts that are refundable to future customers. The Transmission Business continually assesses the likelihood of recovery of each of its regulatory assets and continues to believe that it is probable that the OEB will include its regulatory assets and liabilities in setting future rates. If, at some future date, the Distribution Business judges that it is no longer probable that the OEB will include a regulatory asset or liability in setting future rates, the appropriate carrying amount would be reflected in results of operations prospectively from the date the Company's assessment is made, unless the change meets the requirements for a Type I subsequent event.

Revenue Recognition

The Company adopted Accounting Standard Codification (ASC) 606 - *Revenue from Contracts with Customers* on January 1, 2018 using the retrospective method, without the election of any practical expedients. There was no material impact to the Company's revenue recognition policy as a result of adopting ASC 606, and no adjustments were made to prior period reported financial statements amounts.

<u>Nature of Revenues</u>

Distribution revenues attributable to the delivery of electricity are based on OEB-approved distribution rates and are recognized on an accrual basis and include billed and unbilled revenues. Billed revenues are based on electricity delivered as measured from customer meters. At the end of each month, electricity delivered to customers since the date of the last billed meter reading is estimated, and the corresponding unbilled revenue is recorded. The unbilled revenue estimate is affected by energy consumption, weather, and changes in the composition of customer classes. Distribution revenue also includes an amount relating to rate protection for rural, residential, and remote customers, which is received from the Independent Electricity System Operator (IESO) based on a standardized customer rate that is approved by the OEB. Revenues are recorded net of indirect taxes.

Accounts Receivable and Allowance for Doubtful Accounts

Billed accounts receivable are recorded at the invoiced amount, net of allowance for doubtful accounts. Unbilled accounts receivable are recorded at their estimated value. Overdue amounts related to regulated billings bear interest at OEB-approved rates. The allowance for doubtful accounts reflects the Distribution Business' best estimate of losses on billed accounts receivable balances. The Distribution Business estimates the allowance for doubtful accounts on billed accounts receivable by applying internally developed loss rates to the outstanding receivable balances by aging category. Loss rates applied to the billed accounts receivable balances are based on historical overdue balances, customer payments and write-offs. Accounts receivable are written-off against the allowance when they are deemed uncollectible. The allowance for doubtful accounts is affected by changes in volume, prices and economic conditions.

Income Taxes

Current and deferred income taxes are computed based on the tax rates and tax laws enacted as at the balance sheet date. Tax benefits associated with income tax positions are recorded only when the more-likely-than-not recognition threshold is satisfied and are measured at the largest amount of benefit that has a greater than 50% likelihood of being realized upon settlement. Management evaluates each position based solely on the technical merits and facts and circumstances of the position, assuming the position will be examined by a taxing authority having full knowledge of all relevant information. Significant management judgment is required to determine recognition thresholds and the related amount of tax benefits to be recognized in the Financial Statements. Management re-evaluates tax positions each period using new information about recognition or measurement as it becomes available.

Deferred Income Taxes

Deferred income taxes are provided for using the liability method. Under this method, deferred income tax assets and liabilities are recognized on all temporary differences between the tax bases and carrying amounts of assets and liabilities, including the carry forward unused tax credits and tax losses to the extent that it is more-likely-than-not that these deductions, credits, and losses can be utilized. Deferred income tax assets and liabilities are measured at the tax rates that are expected to apply in the period when the liability is settled or the asset is realized, based on the tax rates and tax laws that have been enacted as at the balance sheet date. Deferred income taxes that are not included in the rate-setting process are charged or credited to the Statements of Operations and Comprehensive Income.

Management reassesses the deferred income tax assets at each balance sheet date and reduces the amount to the extent that it is more-likely-than-not that the deferred income tax asset will not be realized. Previously unrecognized deferred income tax assets are reassessed at each balance sheet date and are recognized to the extent that it has become more-likely-than-not that the tax benefit will be realized.

The Distribution Business records regulatory assets and liabilities associated with deferred income tax assets and liabilities that will be included in the rate-setting process.

Inter-company Demand Facility

Hydro One maintains pooled bank accounts for its use and for the use of its subsidiaries, and implicitly, by the regulated businesses of its subsidiaries. The balance in the inter-company demand facility represents the cumulative net effect of all deposits and withdrawals made by the Distribution Business to and from the pooled bank accounts. Interest is earned on positive inter-company balances based on the average of the bankers' acceptance rate at the beginning and end of the month, less 0.02%. Interest is charged on overdraft inter-company balances based on the same bankers' acceptance rate, plus 0.15%.

Materials and Supplies

Materials and supplies represent consumables, small spare parts and construction materials held for internal construction and maintenance of property, plant and equipment. These assets are carried at average cost less any impairments recorded.

Property, Plant and Equipment

Property, plant and equipment is recorded at original cost, net of customer contributions, and any accumulated impairment losses. The cost of additions, including betterments and replacement asset components, is included on the Balance Sheets as property, plant and equipment.

The original cost of property, plant and equipment includes direct materials, direct labour (including employee benefits), contracted services, attributable capitalized financing costs, asset retirement costs, and direct and indirect overheads that are related to the capital project or program. Indirect overheads include a portion of corporate costs such as finance, treasury, human resources, information technology and executive costs. Overhead costs, including corporate functions and field services costs, are capitalized on a fully allocated basis, consistent with an OEB-approved methodology.

Property, plant and equipment in service consists of distribution, communication, administration and service assets and land easements. Property, plant and equipment also includes future use assets, such as land, major components and spare parts, and capitalized project development costs associated with deferred capital projects.

Distribution

Distribution assets include assets related to the distribution of low-voltage electricity, including lines, poles, switches, transformers, protective devices and metering systems.

Communication

Communication assets include fibre optic and microwave radio systems, optical ground wire, towers, telephone equipment and associated buildings.

Administration and Service

Administration and service assets include administrative buildings, personal computers, transport and work equipment, tools and other minor assets.

Intangible Assets

Intangible assets separately acquired or internally developed are measured on initial recognition at cost, which comprises purchased software, direct labour (including employee benefits), consulting, engineering, overheads and attributable capitalized financing charges. Following initial recognition, intangible assets are carried at cost, net of any accumulated amortization and accumulated impairment losses. The Distribution Business' intangible assets primarily represent major computer applications.

Capitalized Financing Costs

Capitalized financing costs represent interest costs attributable to the construction of property, plant and equipment or development of intangible assets. The financing cost of attributable borrowed funds is capitalized as part of the acquisition cost of such assets. The capitalized financing costs are a reduction of financing charges recognized in the Statements of Operations and Comprehensive Income. Capitalized financing costs are calculated using the Company's weighted average effective cost of debt.

Construction and Development in Progress

Construction and development in progress consists of the capitalized cost of constructed assets that are not yet complete and which have not yet been placed in service.

Depreciation and Amortization

The cost of property, plant and equipment and intangible assets is depreciated or amortized on a straight-line basis based on the estimated remaining service life of each asset category, except for transport and work equipment, which is depreciated on a declining balance basis.

The Company periodically initiates an external independent review of its property, plant and equipment and intangible asset depreciation and amortization rates, as required by the OEB. Any changes arising from OEB approval of such a review are implemented on a remaining service life basis, consistent with their inclusion in electricity rates. The most recent review resulted in changes to rates effective January 1, 2015 for Hydro One Networks' distribution business. A summary of average service lives and depreciation and amortization rates for the various classes of assets is included below:

	Average	Rate	
	Service Life	Range	Average
Property, plant and equipment:			
Distribution	47 years	1% - 7%	2%
Communication	8 years	1% - 15%	12%
Administration and service	20 years	1% - 20%	5%
Intangible assets	10 years	10%	10%

In accordance with group depreciation practices, the original cost of property, plant and equipment, or major components thereof, and intangible assets that are normally retired, is charged to accumulated depreciation, with no gain or loss being reflected in results of operations. Where a disposition of property, plant and equipment occurs through sale, a gain or loss is calculated based on proceeds and such gain or loss is included in depreciation expense.

Acquisitions and Goodwill

The Company accounts for business acquisitions using the acquisition method of accounting and, accordingly, the assets and liabilities of the acquired entities are primarily measured at their estimated fair value at the date of acquisition. Costs associated with pending acquisitions are expensed as incurred. Goodwill represents the cost of acquired companies that is in excess of the fair value of the net identifiable assets acquired at the acquisition date. Goodwill is not included in rate base.

Goodwill is evaluated for impairment on an annual basis, or more frequently if circumstances require. The Company performs a qualitative assessment to determine whether it is more-likely-than-not that the fair value of the applicable reporting unit is less than its carrying amount. If the Company determines, as a result of its qualitative assessment, that it is not more-likely-than-not that the fair value of the applicable reporting unit is less than its carrying amount, no further testing is required. If the Company determines, as a result of its qualitative assessment, that it is more-likely-than-not that the fair value of the applicable reporting unit is less than its carrying amount, a goodwill impairment assessment is performed using a two-step, fair value-based test. The first step compares the fair value of the applicable reporting unit to its carrying amount, including goodwill. If the carrying amount of the applicable reporting unit exceeds its fair value, a second step is performed. The second step requires an allocation of fair value to the individual assets and liabilities using purchase price allocation in order to determine the implied fair value of goodwill. If the implied fair value of goodwill is less than the carrying amount, an impairment loss is recorded as a reduction to goodwill and as a charge to results of operations.

Based on assessment performed as at September 30, 2018, the Company has concluded that goodwill was not impaired at December 31, 2018.

Long-Lived Asset Impairment

When circumstances indicate the carrying value of long-lived assets may not be recoverable, the Company evaluates whether the carrying value of such assets, excluding goodwill, has been impaired. For such long-lived assets, the Company evaluates whether impairment may exist by estimating future estimated undiscounted cash flows expected to result from the use and eventual disposition of the asset. When alternative courses of action to recover the carrying amount of a long-lived asset are under consideration, a probability-weighted approach is used to develop estimates of future undiscounted cash flows. If the carrying value of the long-lived asset is not recoverable based on the estimated future undiscounted cash flows, an impairment loss is recorded, measured as the excess of the carrying value of the asset over its fair value. As a result, the asset's carrying value is adjusted to its estimated fair value.

The carrying costs of most of the Distribution Business' long-lived assets are included in rate base where they earn an OEB-approved rate of return. Asset carrying values and the related return are recovered through approved rates. As a result, such assets are only tested for impairment in the event that the OEB disallows recovery, in whole or in part, or if such a disallowance is judged to be probable. As at December 31, 2018 and 2017, no asset impairment had been recorded.

Costs of Arranging Debt Financing

For financial liabilities classified as other than held-for-trading, the Company defers its proportionate share of the relevant Hydro One external transaction costs related to obtaining financing and presents such amounts net of related debt on the Balance Sheets. Deferred issuance costs are amortized over the contractual life of the related debt on an effective-interest basis and the amortization is included within financing charges in the Statements of Operations and Comprehensive Income. Transaction costs for items classified as held-for-trading are expensed immediately.

Comprehensive Income

Comprehensive income is comprised of net income and other comprehensive income (OCI). OCI and net income are presented in a single continuous Statement of Operations and Comprehensive Income.

Financial Assets and Liabilities

All financial assets and liabilities are classified into one of the following five categories: held-to-maturity; loans and receivables; held-for-trading; other liabilities; or available-for-sale. Financial assets and liabilities classified as held-for-trading are measured at fair value. All other financial assets and liabilities are measured at amortized cost, except accounts receivable and amounts due from related parties, which are measured at the lower of cost or fair value. Accounts receivable and amounts due from related parties are classified as loans and receivables. The Company considers the carrying amounts of accounts receivable and amounts due from related parties to be reasonable estimates of fair value because of the short time to maturity of these instruments. Provisions for impaired accounts receivable are recognized as adjustments to the allowance for doubtful accounts and are recognized when there is objective evidence that the Company will not be able to collect amounts according to the original terms. All financial instrument transactions are recorded at trade date.

Derivative instruments are measured at fair value. Gains and losses from fair valuation are included within financing charges in the period in which they arise. The Company determines the classification of its financial assets and liabilities at the date of initial recognition. The Company designates certain of its financial assets and liabilities to be held at fair value, when it is consistent with the Company's risk management policy disclosed in Note 15 - Fair Value of Financial Instruments and Risk Management.

Derivative Instruments and Hedge Accounting

Hydro One closely monitors the risks associated with changes in interest rates on its operations and, where appropriate, uses various instruments to hedge these risks. Certain of these derivative instruments qualify for hedge accounting and are designated as accounting hedges, while others either do not qualify as hedges or have not been designated as hedges (hereinafter referred to as undesignated contracts) as they are part of economic hedging relationships. Hydro One's derivative instruments, or portions thereof, are mirrored down to Hydro One Networks, and are allocated between the Company's transmission and distribution businesses. The derivative instruments are classified as fair value hedges or undesignated contracts, consistent with Hydro One's derivative instruments classification.

The accounting guidance for derivative instruments requires the recognition of all derivative instruments not identified as meeting the normal purchase and sale exemption as either assets or liabilities recorded at fair value on the Balance Sheets. For derivative instruments that qualify for hedge accounting, Hydro One may elect to designate such derivative instruments as either cash flow hedges or fair value hedges. Hydro One offsets fair value amounts recognized on its Balance Sheets related to derivative instruments executed with the same counterparty under the same master netting agreement.

For derivative instruments that qualify for hedge accounting and which are designated as cash flow hedges, the effective portion of any gain or loss, net of tax, is reported as a component of accumulated OCI (AOCI) and is reclassified to results of operations in the same period or periods during which the hedged transaction affects results of operations. Any gains or losses on the derivative instrument that represent either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in results of operations. For fair value hedges, changes in fair value of both the derivative instrument and the underlying hedged exposure are recognized in the Statements of Operations and Comprehensive Income in the current period. The gain or loss on the derivative instrument is included in the same line item as the offsetting gain or loss on the hedged item in the Statements of Operations and Comprehensive Income. The changes in fair value of the undesignated derivative instruments are reflected in results of operations.

Embedded derivative instruments are separated from their host contracts and are carried at fair value on the Balance Sheets when: (a) the economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract; (b) the hybrid instrument is not measured at fair value, with changes in fair value recognized in results of operations each period; and (c) the embedded derivative itself meets the definition of a derivative. Hydro One does not engage in derivative trading or speculative activities and had no embedded derivatives that required bifurcation at December 31, 2018 or 2017.

Hydro One periodically develops hedging strategies taking into account risk management objectives. At the inception of a hedging relationship where the Company has elected to apply hedge accounting, Hydro One formally documents the relationship between the hedged item and the hedging instrument, the related risk management objective, the nature of the specific risk exposure being hedged, and the method for assessing the effectiveness of the hedging relationship. Hydro One also assesses, both at the inception of the hedge and on a quarterly basis, whether the hedging instruments are effective in offsetting changes in fair values or cash flows of the hedged items.

Employee Future Benefits

Employee future benefits provided by Hydro One include pension, post-retirement and post-employment benefits. The costs of the Hydro One's pension, post-retirement and post-employment benefit plans are recorded over the periods during which employees render service.

Hydro One recognizes the funded status of its defined benefit pension, post-retirement and post-employment plans on its Consolidated Balance Sheets and subsequently recognizes the changes in funded status at the end of each reporting year. Defined benefit pension, post-retirement and post-employment plans are considered to be underfunded when the projected benefit obligation (PBO) exceeds the fair value of the plan assets. Liabilities are recognized on the Consolidated Balance Sheets for any net underfunded PBO. The net underfunded PBO may be disclosed as a current liability, long-term liability, or both. The current portion is the amount by which the actuarial present value of benefits included in the benefit obligation payable in the next 12 months exceeds the fair value of plan assets. If the fair value of plan assets exceeds the PBO of the plan, an asset is recognized equal to the net overfunded PBO. The post-retirement and post-employment benefit plans are unfunded because there are no related plan assets.

Hydro One recognizes its contributions to the defined contribution pension plan (DC Plan) as pension expense, with a portion being capitalized as part of labour costs included in capital expenditures. The expensed amount is included in operation, maintenance and administration (OM&A) costs in the Consolidated Statements of Operations and Comprehensive Income.

Defined Benefit Pension

Hydro One has a contributory defined benefit pension plan covering most regular employees of Hydro One and its subsidiaries, including Hydro One Networks. The Hydro One pension plan does not segregate assets in a separate account for individual subsidiaries, nor is the obligation of the pension plan allocated to, or funded separately by, entities within the consolidated group. Accordingly, for purposes of these Financial Statements, the pension plan is accounted for as a defined contribution plan and no pension benefit asset or liability is recorded.

Post-retirement and Post-employment Benefits

Hydro One has post-retirement and post-employment benefit plans covering all regular employees of Hydro One and its subsidiaries, including Hydro One Networks. The benefit obligations of these post-retirement and post-employment benefit plans are not segregated, or funded separately, for Hydro One Networks. Accordingly, for purposes of these Financial Statements, the post-retirement and post-employment benefit obligations are allocated to the Company based on base pensionable earnings.

The Company records a regulatory asset equal to its allocated share of Hydro One’s incremental net unfunded projected benefit obligation for post-retirement and post-employment plans at each year end based on annual actuarial reports. The regulatory asset for the incremental net unfunded projected benefit obligation for post-retirement and post-employment plans, in absence of regulatory accounting, would be recognized in AOCI. A regulatory asset is recognized because management considers it to be probable that post-retirement and post-employment benefit costs will be recovered in the future through the rate-setting process.

Post-retirement and post-employment benefits are recorded and included in rates on an accrual basis. Costs are determined by independent actuaries using the projected benefit method prorated on service and based on assumptions that reflect management’s best estimates. Past service costs from plan amendments are amortized to results of operations based on the expected average remaining service period.

For post-retirement benefits, all actuarial gains or losses are deferred using the "corridor" approach. The amount calculated above the "corridor" is amortized to results of operations on a straight-line basis over the expected average remaining service life of active Hydro One employees in the plan and over the remaining life expectancy of inactive Hydro One employees in the plan. The post-retirement benefit obligation is remeasured to its fair value at each year end based on an annual actuarial report, with an offset to the associated regulatory asset, to the extent of the remeasurement adjustment.

For post-employment obligations, the associated regulatory liabilities representing actuarial gains on transition to US GAAP are amortized to results of operations based on the "corridor" approach. The actuarial gains and losses on post-employment obligations that are incurred during the year are recognized immediately to results of operations. The post-employment benefit obligation is remeasured to its fair value at each year end based on an annual actuarial report, with an offset to the associated regulatory asset, to the extent of the remeasurement adjustment.

All post-retirement and post-employment benefit costs are attributed to labour costs and are either charged to results of operations (OM&A costs) or capitalized as part of the cost of property, plant and equipment and intangible assets for service cost component and to regulatory assets for all other components of the benefit costs, consistent with their inclusion in OEB-approved rates.

Stock-Based Compensation

Share Grant Plans

The Company measures share grant plans based on fair value of share grants as estimated based on Hydro One Limited grant date common share price. The costs are recognized in the financial statements using the graded-vesting attribution method for share grant plans that have both a performance condition and a service condition. The Company records a regulatory asset equal to the accrued costs of share grant plans recognized in each period. Costs are transferred from the regulatory asset to labour costs at the time the share grants vest and are issued, and are recovered in rates. Forfeitures are recognized as they occur.

Deferred Share Unit (DSU) Plans

The Company records the liabilities associated with the Directors' and Management DSU Plans at fair value at each reporting date until settlement, recognizing compensation expense over the vesting period on a straight-line basis. The fair value of the DSU liability is based on the Hydro One Limited common share closing price at the end of each reporting period.

Long-term Incentive Plan (LTIP)

The Company measures the awards issued under Hydro One Limited's LTIP, at fair value based on Hydro One Limited grant date common share price. The related compensation expense is recognized over the vesting period on a straight-line basis. Forfeitures are recognized as they occur.

Loss Contingencies

Hydro One and its subsidiaries are involved in certain legal and environmental matters that arise in the normal course of business. In the preparation of the Distribution Business' Financial Statements, management makes judgments regarding the future outcome of contingent events and records a loss for a contingency based on its best estimate when it is determined that such loss is probable and the amount of the loss can be reasonably estimated. Where the loss amount is recoverable in future rates, a regulatory asset is also recorded. When a range estimate for the probable loss exists and no amount within the range is a better estimate than any other amount, the Distribution Business records a loss at the minimum amount within the range.

Management regularly reviews current information available to determine whether recorded provisions should be adjusted and whether new provisions are required. Estimating probable losses may require analysis of multiple forecasts and scenarios that often depend on judgments about potential actions by third parties, such as federal, provincial and local courts or regulators. Contingent liabilities are often resolved over long periods of time. Amounts recorded in the Financial Statements may differ from the actual outcome once the contingency is resolved. Such differences could have a material impact on future results of operations, financial position and cash flows of the Distribution Business.

Provisions are based upon current estimates and are subject to greater uncertainty where the projection period is lengthy. A significant upward or downward trend in the number of claims filed, the nature of the alleged injuries, and the average cost of resolving each claim could change the estimated provision, as could any substantial adverse or favourable verdict at trial. A federal or provincial legislative outcome or structured settlement could also change the estimated liability. Legal fees are expensed as incurred.

Environmental Liabilities

Environmental liabilities are recorded in respect of past contamination when it is determined that future environmental remediation expenditures are probable under existing statute or regulation and the amount of the future expenditures can be reasonably estimated. The Distribution Business records a liability for the estimated future expenditures associated with contaminated land assessment and remediation (LAR) and for the phase-out and destruction of polychlorinated biphenyl (PCB)-contaminated mineral oil removed from electrical equipment, based on the present value of these estimated future expenditures. The Company determines the present value with a discount rate that produces an amount at which the environmental liabilities could be settled in an arm's length transaction with a third party. As the Company anticipates that the future expenditures will continue to be recoverable in future rates, an offsetting regulatory asset has been recorded to reflect the future recovery of these environmental expenditures from customers. Hydro One reviews its estimates of future environmental expenditures annually, or more frequently if there are indications that circumstances have changed.

Asset Retirement Obligations

Asset retirement obligations are recorded for legal obligations associated with the future removal and disposal of long-lived assets. Such obligations may result from the acquisition, construction, development and/or normal use of the asset. Conditional asset retirement obligations are recorded when there is a legal obligation to perform a future asset retirement activity but where the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the Company. In such a case, the obligation to perform the asset retirement activity is unconditional even though uncertainty exists about the timing and/or method of settlement. This uncertainty is incorporated in the fair value measurement of the obligation.

When recording an asset retirement obligation, the present value of the estimated future expenditures required to complete the asset retirement activity is recorded in the period in which the obligation is incurred, if a reasonable estimate can be made. In general, the present value of the estimated future expenditures is added to the carrying amount of the associated asset and the resulting asset retirement cost is depreciated over the estimated useful life of the asset. The present value is determined with a discount rate that equates to the Company's credit-adjusted risk-free rate. Where an asset is no longer in service when an asset retirement obligation is recorded, the asset retirement cost is recorded in results of operations.

Some of the Company's distribution assets, particularly those located on unowned easements and rights-of-way, may have asset retirement obligations, conditional or otherwise. The majority of the Company's easements and rights-of-way are either of perpetual duration or are automatically renewed annually. Land rights with finite terms are generally subject to extension or renewal. As the Distribution Business expects to use the majority of its facilities in perpetuity, no asset retirement obligations have been recorded for these assets. If, at some future date, a particular facility is shown not to meet the perpetuity assumption, it will be reviewed to determine whether an estimable asset retirement obligation exists. In such a case, an asset retirement obligation would be recorded at that time.

The Distribution Business' asset retirement obligations recorded to date relate to estimated future expenditures associated with the removal and disposal of asbestos-containing materials installed in some of its facilities.

3. NEW ACCOUNTING PRONOUNCEMENTS

The following tables present Accounting Standards Updates (ASUs) issued by the Financial Accounting Standards Board that are applicable to Hydro One Networks:

Recently Adopted Accounting Guidance

Guidance	Date issued	Description	Effective date	Impact
ASC 606	May 2014 – November 2017	ASC 606 *Revenue from Contracts with Customers* replaced ASC 605 *Revenue Recognition*. ASC 606 provides guidance on revenue recognition relating to the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.	January 1, 2018	On January 1, 2018, the Company adopted ASC 606 using the retrospective method, without the election of any practical expedients. Upon adoption, there was no material impact to the Company's revenue recognition policy and no adjustments were made to prior period reported financial statements amounts. The Company has included the disclosure requirements of ASC 606 for annual and interim periods in the year of adoption.
ASU 2017-07	March 2017	Service cost components of net benefit cost associated with defined benefit plans are required to be reported in the same line as other compensation costs arising from services rendered by the Company's employees. All other components of net benefit cost are to be presented in the income statement separately from the service cost component. Only the service cost component is eligible for capitalization where applicable.	January 1, 2018	The Company applied for a regulatory asset to maintain the capitalization of post-employment benefit related costs and as such, there is no material impact upon adoption. See Note 2 - Significant Accounting Policies and Note 11 - Regulatory Assets and Liabilities.

Recently Issued Accounting Guidance Not Yet Adopted

Guidance	Date issued	Description	Effective date	Anticipated impact
2016-02 2018-01 2018-10 2018-11 2018-20 2019-01	February 2016 – March 2019	Lessees are required to recognize the rights and obligations resulting from operating leases as assets (right to use the underlying asset for the term of the lease) and liabilities (obligation to make future lease payments) on the balance sheet. ASU 2018-01 permits an entity to elect an optional practical expedient to not evaluate under ASC 842 land easements that exist or expired before the entity's adoption of ASC 842 and that were not previously accounted for as leases under ASC 840. ASU 2018-10 amends narrow aspects of ASC 842. ASU 2018-11 provides entities with an additional and option transition method in adopting ASC 842. ASU 2018-11 also permits lessors to elect an optional practical expedient to not separate non-lease components from the associated lease component by underlying asset classes. ASU 2018-20 provides relief to lessors that have lease contracts that either require lessees to pay lessor costs directly to a third party or require lessees to reimburse lessors for costs paid by lessors directly to third parties. ASU 2019-01 provides clarification on three issues: determining the fair value of the underlying assets by lessors that are not manufacturers or dealers, presentation of statement of cash flows for sales-type and direct financing leases and interim transition disclosures relating to Topic 250, Accounting Changes and Error Corrections.	January 1, 2019	The Distribution Business reviewed its existing leases and other contracts that are within the scope of ASC 842. Apart from the existing leases, no other contracts contained lease arrangements. Upon adoption in the first quarter of 2019, the Distribution Business will utilize the modified retrospective transition approach using the effective date of January 1, 2019 as its date of initial application. As a result, comparatives will not be updated. The Distribution Business will elect the package of practical expedients and the land easement practical expedient upon adoption. The impact to the Distribution Business' financial statements will be the recognition of approximately $12 million of Right-of-Use (ROU) assets and corresponding lease obligations on the Balance Sheet. The ROU assets and lease obligations represent the present value of the Distribution Business' remaining minimum lease payments for leases with terms greater than 12 months. Discount rates used in calculating the ROU assets and lease obligations correspond to Hydro One's incremental borrowing rate.
2018-07	June 2018	Expansion in the scope of ASC 718 to include share-based payment transactions for acquiring goods and services from non-employees. Previously, ASC 718 was only applicable to share-based payment transactions for acquiring goods and services from employees.	January 1, 2019	No impact upon adoption
2018-13	August 2018	Disclosure requirements on fair value measurements in ASC 820 are modified to improve the effectiveness of disclosures in financial statement notes.	January 1, 2020	Under assessment
2018-14	August 2018	Disclosure requirements related to single-employer defined benefit pension or other post-retirement benefit plans are added, removed or clarified to improve the effectiveness of disclosures in financial statement notes.	January 1, 2021	Under assessment
2018-15	August 2018	The amendment aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The accounting for the service element of a hosting arrangement is not affected by the amendment.	January 1, 2020	Under assessment

4. DEPRECIATION, AMORTIZATION AND ASSET REMOVAL COSTS

Year ended December 31 *(millions of dollars)*	2018	2017
Depreciation of property, plant and equipment	278	278
Amortization of intangible assets	52	44
Amortization of regulatory assets	15	15
Depreciation and amortization	345	337
Asset removal costs	51	51
	396	388

5. FINANCING CHARGES

Year ended December 31 *(millions of dollars)*	2018	2017
Interest on long-term debt *(Note 22)*	168	170
Interest on inter-company demand facility *(Note 22)*	4	2
Other	10	4
Less: Interest capitalized on construction and development in progress	(8)	(11)
	174	165

6. INCOME TAXES

As a rate regulated utility business, the Distribution Business's effective tax rate excludes temporary differences that are recoverable in future rates charged to customers. Income tax expense differs from the amount that would have been recorded using the combined Canadian federal and Ontario statutory income tax rate. The reconciliation between the statutory and the effective tax rates is provided as follows:

Year ended December 31 *(millions of dollars)*	2018	2017
Income before income taxes	331	320
Income taxes at statutory rate of 26.5% (2017 - 26.5%)	88	85
Increase (decrease) resulting from:		
Net temporary differences recoverable in future rates charged to customers:		
Capital cost allowance in excess of depreciation and amortization	(20)	(15)
Overheads capitalized for accounting but deducted for tax purposes	(7)	(7)
Pension contributions in excess of pension expense	(5)	(6)
Environmental expenditures	(4)	(4)
Interest capitalized for accounting but deducted for tax purposes	(2)	(3)
Other	(1)	4
Net temporary differences	(39)	(31)
Net permanent differences	1	1
Total income taxes	50	55
Effective income tax rate	15.1%	17.2%

The major components of income tax expense are as follows:

Year ended December 31 *(millions of dollars)*	2018	2017
Current income taxes	65	99
Deferred income taxes (recovery)	(15)	(44)
Total income taxes	50	55

Deferred Income Tax Assets and Liabilities

Deferred income tax assets and liabilities expected to be included in the rate-setting process are offset by regulatory assets and liabilities to reflect the anticipated recovery or disposition of these balances within future electricity rates. Deferred income tax assets and liabilities arise from differences between the tax basis and the carrying amounts of the assets and liabilities. At December 31, 2018 and 2017, deferred income tax assets and liabilities consisted of the following:

December 31 *(millions of dollars)*	2018	2017
Deferred income tax assets (liabilities)		
Capital cost allowance in excess of depreciation and amortization	(362)	(808)
Goodwill	(10)	(10)
Post-retirement and post-employment benefits expense in excess of cash payments	291	311
Regulatory amounts that are not recognized for tax purposes	32	(17)
Environmental expenditures	22	30
Non-capital losses	1	1
Other	(7)	(6)
Net deferred income tax liabilities	(33)	(499)

The net deferred income tax liabilities are presented on the Balance Sheets as long-term liabilities.

7. ACCOUNTS RECEIVABLE

December 31 *(millions of dollars)*	2018	2017
Accounts receivable – billed	262	276
Accounts receivable – unbilled	336	341
Accounts receivable, gross	598	617
Allowance for doubtful accounts	(20)	(29)
Accounts receivable, net	578	588

The following table shows the movements in the allowance for doubtful accounts for the years ended December 31, 2018 and 2017:

Year ended December 31 *(millions of dollars)*	2018	2017
Allowance for doubtful accounts – beginning	(29)	(35)
Write-offs	26	25
Additions to allowance for doubtful accounts	(17)	(19)
Allowance for doubtful accounts – ending	(20)	(29)

8. OTHER CURRENT ASSETS

December 31 *(millions of dollars)*	2018	2017
Regulatory assets *(Note 11)*	18	22
Prepaid expenses and other assets	11	12
Materials and supplies	5	4
	34	38

9. PROPERTY, PLANT AND EQUIPMENT

December 31, 2018 *(millions of dollars)*	Property, Plant and Equipment[1]	Accumulated Depreciation	Construction in Progress	Total
Distribution	10,518	3,538	74	7,054
Communication	144	112	—	32
Administration and service	975	583	25	417
Easements	12	4	—	8
	11,649	4,237	99	7,511

[1] Includes future use assets totalling $50 million.

December 31, 2017 *(millions of dollars)*	Property, Plant and Equipment[1]	Accumulated Depreciation	Construction in Progress	Total
Distribution	10,155	3,488	147	6,814
Communication	145	99	2	48
Administration and service	991	561	25	455
Easements	11	4	—	7
	11,302	4,152	174	7,324

[1] Includes future use assets totalling $57 million.

Financing charges capitalized on property, plant and equipment under construction were $5 million in 2018 (2017 - $9 million).

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10. INTANGIBLE ASSETS

December 31, 2018 *(millions of dollars)*	Intangible Assets	Accumulated Amortization	Development in Progress	Total
Computer applications software	492	247	30	275
Other	52	18	—	34
	544	265	30	309

December 31, 2017 *(millions of dollars)*	Intangible Assets	Accumulated Amortization	Development in Progress	Total
Computer applications software	428	201	23	250
Other	49	12	2	39
	477	213	25	289

Financing charges capitalized to intangible assets under development were $1 million in 2018 (2017 - $2 million). The estimated annual amortization expense for intangible assets is as follows: 2019 - $51 million; 2020 - $42 million; 2021 - $41 million; 2022 - $40 million; and 2023 - $31 million.

11. REGULATORY ASSETS AND LIABILITIES

Regulatory assets and liabilities arise as a result of the rate-setting process. The Distribution Business has recorded the following regulatory assets and liabilities:

December 31 *(millions of dollars)*	2018	2017
Regulatory assets:		
Deferred income tax regulatory asset	96	513
Environmental	61	83
Stock-based compensation	21	20
Post-retirement and post-employment benefits non-service cost	16	—
Distribution system code exemption	10	10
Post-retirement and post-employment benefits	—	20
Other	18	14
Total regulatory assets	222	660
Less: current portion	(18)	(22)
	204	638
Regulatory liabilities:		
Post-retirement and post-employment benefits	73	—
Green Energy expenditure variance	52	60
Retail settlement variance account	39	—
Pension cost differential	38	13
Deferred income tax regulatory liability	33	—
2015-2017 rate rider	6	6
PST savings deferral	4	4
Other	13	12
Total regulatory liabilities	258	95
Less: current portion	(41)	(11)
	217	84

Deferred Income Tax Regulatory Asset and Liability

Deferred income taxes are recognized on temporary differences between the carrying amount of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable income. The Distribution Business has recognized regulatory assets and liabilities that correspond to deferred income taxes that flow through the rate-setting process. In the absence of rate-regulated accounting, the Distribution Business' income tax expense would have been recognized using the liability method and there would be no regulatory accounts established for taxes to be recovered through future rates. As a result, the 2018 income tax expense would have been lower by approximately $331 million (2017 - higher by $38 million).

On September 28, 2017, the OEB issued its decision and order on Hydro One Networks' 2017 and 2018 transmission rates revenue requirements (Original Decision). In its Original Decision, the OEB concluded that the net deferred tax asset resulting from transition from the payments in lieu of tax regime under the Electricity Act (Ontario) to tax payments under the federal and provincial tax regime should not accrue entirely to Hydro One Limited shareholders and that a portion should be shared with ratepayers. On

November 9, 2017, the OEB issued a decision and order that calculated the portion of the tax savings that should be shared with ratepayers. The OEB's calculation would result in an impairment of a portion of Hydro One Networks' transmission deferred income tax regulatory asset. If the OEB were to apply the same calculation for sharing in Hydro One Networks' 2018-2022 distribution rates, it would also result in an additional impairment of a portion of Hydro One Networks' distribution deferred income tax regulatory asset. In October 2017, the Company filed a Motion to Review and Vary (Motion) the Original Decision and filed an appeal with the Divisional Court of Ontario (Appeal). In both cases, the Company's position is that the OEB made errors of fact and law in its determination of allocation of the tax savings between the shareholders and ratepayers. On December 19, 2017, the OEB granted a hearing of the merits of the Motion which was held on February 12, 2018. On August 31, 2018, the OEB granted the Motion and returned the portion of the Decision relating to the deferred tax asset to an OEB panel for reconsideration.

Subsequent to year end, on March 7, 2019, the OEB issued its reconsideration decision and concluded that their Original Decision was reasonable and should be upheld. Also, on March 7, 2019 the OEB issued its decision for Hydro One Networks’ 2018-2022 distribution rates, in which it directed the Company to apply the Original Decision to Hydro One Networks’ distribution rates.

As a result of these decisions, the Distribution Business has recognized a reduction in Hydro One Networks' distribution deferred income tax regulatory asset of $473 million, an increase in deferred income tax regulatory liability of $33 million, and a decrease in deferred tax liability of $506 million. Notwithstanding the recognition of the effects of the decision in the 2018 financial statements, on April 5, 2019, the Company filed an appeal with the Ontario Divisional Court with respect to the OEB's deferred tax benefit decision.

Environmental

The Distribution Business records a liability for the estimated future expenditures required to remediate environmental contamination. A regulatory asset is recognized because management considers it to be probable environmental expenditures will be recovered in the future through the rate-setting process In 2018, the environmental regulatory asset decreased by $10 million (2017 - $1 million) to reflect related changes in the Company’s PCB and LAR environmental liabilities. The environmental regulatory asset is amortized to results of operations based on the pattern of actual expenditures incurred and charged to environmental liabilities. The OEB has the discretion to examine and assess the prudency and the timing of recovery of all of the Distribution Business' actual environmental expenditures. In the absence of rate-regulated accounting, 2018 OM&A expenses would have been lower by $10 million (2017 - $1 million). In addition, 2018 amortization expense would have been lower by $15 million (2017 - $15 million), and 2018 financing charges would have been higher by $3 million (2017 - $4 million).

Post-Retirement and Post-Employment Benefits - Non-Service Cost

Hydro One Networks applied to the OEB for a regulatory asset to record the components other than service costs relating to its post-retirement and post-employment benefits that would have previously been capitalized to property, plant and equipment and intangible assets prior to adoption of ASU 2017-07. In March 2019, the OEB approved the regulatory asset for Hydro One Networks' Distribution Business. Hydro One Networks has recorded the components other than service costs relating to its post-retirement and post-employment benefits that would have been capitalized to property, plant and equipment and intangible assets, in the Post-Retirement and Post-Employment Benefits Non-Service Cost Regulatory Asset.

Stock-based Compensation

The Distribution Business recognizes costs associated with share grant plans in a regulatory asset as management considers it probable that share grant plans' costs will be recovered in the future through the rate-setting process. In the absence of rate-regulated accounting, 2018 OM&A expenses would have been higher by $1 million (2017 - $4 million). Share grant costs are transferred to labour costs at the time the share grants vest and are issued, and are recovered in rates in accordance with recovery of said labour costs.

Post-Retirement and Post-Employment Benefits

The Distribution Business recognizes the net unfunded status of post-retirement and post-employment obligations on the Balance Sheets with an incremental offset to the associated regulatory assets. A regulatory asset is recognized because management considers it to be probable that post-retirement and post-employment benefit costs will be recovered in the future through the rate-setting process. The post-retirement and post-employment benefit obligation is remeasured to the present value of the actuarially determined benefit obligation at each year end based on an annual actuarial report, with an offset to the associated regulatory liability, to the extent of the remeasurement adjustment. In the absence of rate-regulated accounting, 2018 OCI would have been higher by $93 million (2017 - $116 million).

Pension Cost Differential

A pension cost differential account was established for Hydro One Networks’ Distribution Businesses to track the difference between the actual pension expenses incurred and estimated pension costs approved by the OEB. The Distribution Business balance as at December 31, 2016, including accrued interest, was requested for recovery through the 2018-2022 distribution rate application. In the absence of rate-regulated accounting, 2018 revenue would have been higher by $25 million (2017 - $21 million).

Distribution System Code (DSC) Exemption

In June 2010, Hydro One Networks filed an application with the OEB regarding the OEB's new cost responsibility rules contained in the OEB's October 2009 Notice of Amendment to the DSC, with respect to the connection of certain renewable generators that were already connected or that had received a connection impact assessment prior to October 21, 2009. The application sought approval to record and defer the unanticipated costs incurred by Hydro One Networks that resulted from the connection of certain renewable generation facilities. The OEB ruled that identified specific expenditures can be recorded in a deferral account subject to the OEB's review in subsequent Hydro One Networks distribution applications. In 2015, the OEB also approved Hydro One's request to discontinue this deferral account. There were no additions to this regulatory account in 2018 or 2017. The remaining balance in this account at December 31, 2016, including accrued interest, was requested for recovery through the 2018-2022 distribution rate application.

Green Energy Expenditure Variance

In April 2010, the OEB requested the establishment of deferral accounts which capture the difference between the revenue recorded on the basis of Green Energy Plan expenditures incurred and the actual recoveries received.

Retail Settlement Variance Account (RSVA)

Hydro One has deferred certain retail settlement variance amounts under the provisions of Article 490 of the OEB's Accounting Procedures Handbook. The balance as at December 31, 2014, including accrued interest, was requested for recovery through the 2018-2022 distribution rate application

2015-2017 Rate Rider

In March 2015, as part of its decision on Hydro One Networks' distribution rate application for 2015-2019, the OEB approved the disposition of certain deferral and variance accounts, including RSVAs and accrued interest. The 2015-2017 Rate Rider account included the balances approved for disposition by the OEB and was disposed of in accordance with the OEB decision over a 32-month period ended on December 31, 2017. The balance remaining in the account represents an over-collection to be returned to ratepayers in a future rate application. We have not requested recovery of the remaining balance of this account in the current distribution rate application.

PST Savings Deferral Account

The provincial sales tax (PST) and goods and services tax (GST) were harmonized in July 2010. Unlike the GST, the PST was included in operation, maintenance and administration expenses or capital expenditures for past revenue requirements approved during a full cost-of-service hearing. Under the harmonized sales tax (HST) regime, the HST included in operation, maintenance and administration expenses or capital expenditures is not a cost ultimately borne by the Company and as such, a refund of the prior PST element in the approved revenue requirement is applicable, and calculations for tracking and refund were requested by the OEB. For Hydro One Networks' distribution revenue requirement, PST was included between July 1, 2010 and December 31, 2015 and recorded in a deferral account, as directed by the OEB. In March 2015, the OEB approved the disposition of the PST Savings Deferral account at December 31, 2013, including accrued interest, which was recovered through the 2015-2017 Rate Rider.

12. ACCOUNTS PAYABLE AND OTHER CURRENT LIABILITIES

December 31 *(millions of dollars)*	2018	2017
Accrued liabilities	588	562
Accounts payable	53	66
Accrued interest *(Note 22)*	38	40
Regulatory liabilities *(Note 11)*	41	11
	720	679

13. OTHER LONG-TERM LIABILITIES

December 31 *(millions of dollars)*	2018	2017
Post-retirement and post-employment benefit liability *(Note 17)*	781	838
Environmental liabilities *(Note 18)*	48	66
Long-term inter-company payable *(Note 22)*	17	18
Long-term accounts payable and other liabilities	5	8
Asset retirement obligations *(Note 19)*	5	4
	856	934

14. DEBT

Hydro One issues notes for long-term financing under its Medium-Term Note (MTN) Program. The terms of certain issuances are mirrored down to Hydro One Networks through the issuance of inter-company debt, and are allocated between the Company's transmission and distribution businesses. The following table presents long-term debt allocated to the Distribution Business outstanding at December 31, 2018 and 2017:

December 31 *(millions of dollars)*	2018	2017
Long-term debt	3,921	3,846
Add: Net unamortized debt premiums	7	8
Add: Unrealized mark-to-market gain[1]	(2)	(4)
Less: Deferred debt issuance costs	(15)	(15)
Less: Long-term debt payable within one year	(291)	(337)
Long-term debt	3,620	3,498

[1] The unrealized mark-to-market net gain relates to $30 million of notes due in 2020 and $200 million notes due in 2019. The unrealized mark-to-market net gain is offset by a $2 million (2017 - $4 million) unrealized mark-to-market net loss on the related fixed-to-floating interest-rate swap agreements, which are accounted for as fair value hedges.

In 2018, Hydro One issued $1,400 million (2017 - $nil) of long-term debt under its MTN Program, all of which was mirrored down to Hydro One Networks, and $412 million was allocated to the Company's Distribution Business.

In 2018, Hydro One repaid $750 million (2017 - $600 million) of maturing long-term debt under its MTN Program. On the same date, Hydro One Networks repaid inter-company debt of $750 million (2017 - $600 million) to Hydro One, of which $337 million (2017 - $195 million) was allocated to the Company's Distribution Business.

Principal and Interest Payments

Principal repayments, interest payments, and related weighted-average interest rates are summarized by year in the following table:

Years	Long-term Debt Principal Repayments *(millions of dollars)*	Interest Payments *(millions of dollars)*	Weighted Average Interest Rate *(%)*
2019	291	167	2.0
2020	150	160	3.9
2021	250	154	2.1
2022	261	148	3.2
2023	—	143	—
	952	772	2.7
2024-2028	376	684	3.1
2029 and thereafter	2,593	1,691	5.1
	3,921	3,147	4.3

15. FAIR VALUE OF FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

Fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition focuses on an exit price, which is the price that would be received in the sale of an asset or the amount that would be paid to transfer a liability.

The Company classifies its fair value measurements based on the following hierarchy, as prescribed by the accounting guidance for fair value, which prioritizes the inputs to valuation techniques used to measure fair value into three levels:

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that Hydro One Networks has the ability to access. An active market for the asset or liability is one in which transactions for the asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 inputs are those other than quoted market prices that are observable, either directly or indirectly, for an asset or liability. Level 2 inputs include, but are not limited to, quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active and inputs other than quoted market prices that are observable for the asset or liability, such as interest-rate curves and yield curves observable at commonly quoted intervals, volatilities, credit risk and default rates. A Level 2 measurement cannot have more than an insignificant portion of the valuation based on unobservable inputs.

Level 3 inputs are any fair value measurements that include unobservable inputs for the asset or liability for more than an insignificant portion of the valuation. A Level 3 measurement may be based primarily on Level 2 inputs.

Non-Derivative Financial Assets and Liabilities

At December 31, 2018 and 2017, the carrying amounts of accounts receivable, due from related parties, inter-company demand facility, accounts payable, and due to related parties are representative of fair value due to the short-term nature of these instruments.

Fair Value Measurements of Long-Term Debt

The fair values and carrying values of the Distribution Business' long-term debt at December 31, 2018 and 2017 are as follows:

December 31 *(millions of dollars)*	2018 Carrying Value	2018 Fair Value	2017 Carrying Value	2017 Fair Value
$200 million notes due 2019	198	198	197	197
$30 million notes due 2020	30	30	29	29
Other notes and debentures	3,683	4,028	3,609	4,159
Long-term debt, including current portion	3,911	4,256	3,835	4,385

Fair Value Measurements of Derivative Instruments

Hydro One enters into interest-rate swaps agreements with respect to its long-term debt. The terms of certain of these interest-rate swap agreements are mirrored down to Hydro One Networks, and are allocated between the Company's transmission and distribution businesses.

At December 31, 2018, the Distribution Business' share of the Company's derivative instruments included $230 million (2017 - $230 million) interest-rate swaps that were used to convert fixed-rate debt to floating-rate debt. These swaps are classified as fair value hedges. The Distribution Business' fair value hedge exposure was approximately 6% (2017 - 6%) of its total long-term debt. At December 31, 2018, the Distribution Business' interest-rate swaps designated as fair value hedges were as follows:

- a $200 million fixed-to-floating interest-rate swap agreement to convert $200 million notes maturing on November 18, 2019 into three-month variable rate debt; and
- a $30 million fixed-to-floating interest-rate swap agreement to convert $30 million of the $350 million notes maturing on April 30, 2020 into three-month variable rate debt.

At December 31, 2018 and 2017, the Company had no interest-rate swaps classified as undesignated contracts.

Fair Value Hierarchy

The fair value hierarchy of financial assets and liabilities at December 31, 2018 and 2017 is as follows:

December 31, 2018 *(millions of dollars)*	Carrying Value	Fair Value	Level 1	Level 2	Level 3
Liabilities:					
Inter-company demand facility	392	392	392	—	—
Long-term debt, including current portion	3,911	4,256	—	4,256	—
Derivative instruments					
Fair value hedges – interest-rate swaps	2	2	—	2	—
	4,305	4,650	392	4,258	—

December 31, 2017 *(millions of dollars)*	Carrying Value	Fair Value	Level 1	Level 2	Level 3
Liabilities:					
Inter-company demand facility	213	213	213	—	—
Long-term debt, including current portion	3,835	4,385	—	4,385	—
Derivative instruments					
Fair value hedges – interest-rate swaps	4	4	—	4	—
	4,052	4,602	213	4,389	—

The fair value of the hedged portion of the long-term debt is primarily based on the present value of future cash flows using a swap yield curve to determine the assumption for interest rates. The fair value of the unhedged portion of the long-term debt is based on unadjusted period-end market prices for the same or similar debt of the same remaining maturities.

There were no transfers between any of the fair value levels during the years ended December 31, 2018 or 2017.

Risk Management

Exposure to market risk, credit risk and liquidity risk arises in the normal course of the Company's business.

Market Risk

Market risk refers primarily to the risk of loss which results from changes in costs, foreign exchange rates and interest rates. The Company is exposed to fluctuations in interest rates, as its regulated return on equity is derived using a formulaic approach that takes anticipated interest rates into account. The Company is not currently exposed to material commodity price risk or material foreign exchange risk.

The Company uses a combination of fixed and variable-rate debt to manage the mix of its debt portfolio. The Company also uses derivative financial instruments to manage interest-rate risk. The Company utilizes interest-rate swaps, which are typically designated as fair value hedges, as a means to manage its interest rate exposure to achieve a lower cost of debt. The Company may also utilize interest-rate derivative instruments to lock in interest-rate levels in anticipation of future financing.

A hypothetical 100 basis points increase in interest rates associated with variable-rate debt would not have resulted in a significant decrease in Distribution Business' net income for the years ended December 31, 2018 and 2017.

For derivative instruments that are designated and qualify as fair value hedges, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged item attributable to the hedged risk are recognized in the Statements of Operations and Comprehensive Income. The Distribution Business' net unrealized loss (gain) on the hedged debt and the related interest-rate swaps for the years ended December 31, 2018 and 2017 was not material.

Credit Risk

Financial assets create a risk that a counterparty will fail to discharge an obligation, causing a financial loss. At December 31, 2018 and 2017, there were no significant concentrations of credit risk with respect to any class of financial assets. The Distribution Business' revenue is earned from a broad base of customers. As a result, the Distribution Business did not earn a material amount of revenue from any single customer. At December 31, 2018 and 2017, there was no material accounts receivable balance due from any single customer.

At December 31, 2018, the Company's provision for bad debts was $20 million (2017 - $29 million). Adjustments and write-offs are determined on the basis of a review of overdue accounts, taking into consideration historical experience. At December 31, 2018, approximately 5% (2017 - 5%) of the Distribution Business' net accounts receivable were outstanding for more than 60 days.

Hydro One manages its counterparty credit risk through various techniques including: entering into transactions with highly rated counterparties; limiting total exposure levels with individual counterparties; entering into master agreements which enable net settlement and the contractual right of offset; and monitoring the financial condition of counterparties. Hydro One monitors current credit exposure to counterparties both on an individual and an aggregate basis. The Company's counterparty credit risk profile is consistent with Hydro One. The Distribution Business' credit risk for accounts receivable is limited to the carrying amounts on the Balance Sheets.

Derivative financial instruments result in exposure to credit risk since there is a risk of counterparty default. The credit exposure of derivative contracts, before collateral, is represented by the fair value of contracts at the reporting date. At December 31, 2018 and 2017, the counterparty credit risk exposure on the fair value of these interest-rate swap contracts was not material. At December 31, 2018, Hydro One's credit exposure for all derivative instruments, and applicable payables and receivables, had a credit rating of investment grade, with four financial institutions as the counterparties.

Liquidity Risk

Liquidity risk refers to the Company's ability to meet its financial obligations as they come due. Hydro One Networks meets its short-term liquidity requirements through the inter-company demand facility with Hydro One and funds from operations. The short-term liquidity available to the Company is expected to be sufficient to fund normal operating requirements.

16. CAPITAL MANAGEMENT

The Distribution Business' objectives with respect to its capital structure are to maintain effective access to capital on a long-term basis at reasonable rates, and to deliver appropriate financial returns. At December 31, 2018 and 2017, the Distribution Business' capital structure was as follows:

December 31 *(millions of dollars)*	2018	2017
Long-term debt payable within one year	291	337
Inter-company demand facility	392	213
	683	550
Long-term debt	3,620	3,498
Excess of assets over liabilities	2,716	2,768
Total capital	7,019	6,816

The following table shows the movements in the excess of assets over liabilities for the years ended December 31, 2018 and 2017:

Year ended December 31 *(millions of dollars)*	2018	2017
Excess of assets over liabilities - beginning	2,768	2,766
Net income	281	265
Payments to Hydro One to finance dividends and return of stated capital	(333)	(263)
Excess of assets over liabilities - ending	2,716	2,768

17. PENSION AND POST-RETIREMENT AND POST-EMPLOYMENT BENEFITS

Hydro One has a defined benefit pension plan (Pension Plan), a DC Plan, a supplemental pension plan (Supplemental Plan), and post-retirement and post-employment benefit plans.

DC Plan

Hydro One established a DC Plan effective January 1, 2016. The DC Plan covers eligible management employees hired on or after January 1, 2016, as well as management employees hired before January 1, 2016 who were not eligible or had not irrevocably elected to join the Pension Plan as of September 30, 2015. Members of the DC Plan have an option to contribute 4%, 5% or 6% of their pensionable earnings, with matching contributions by Hydro One up to an annual contribution limit. There is also a Supplemental DC Plan that provides members of the DC Plan with employer contributions beyond the limitations imposed by the *Income Tax Act* (Canada) in the form of credits to a notional account. The Distribution Business contributions to the DC Plan for the year ended December 31, 2018 were less than $1 million (2017 - less than $1 million).

Pension Plan and Supplemental Plan

The Pension Plan is a defined benefit contributory plan which covers eligible regular employees of Hydro One and its subsidiaries. The Pension Plan provides benefits based on highest three-year average pensionable earnings. For management employees who commenced employment on or after January 1, 2004, and for the Society of United Professionals (Society)-represented staff hired after November 17, 2005, benefits are based on highest five-year average pensionable earnings. After retirement, pensions are indexed to inflation. Membership in the Pension Plan was closed to management employees who were not eligible or had not irrevocably elected to join the Pension Plan as of September 30, 2015. These employees are eligible to join the DC Plan.

Company and employee contributions to the Pension Plan are based on actuarial reports, including valuations performed at least every three years, and actual or projected levels of pensionable earnings, as applicable. Annual Pension Plan contributions for 2018 were $75 million (2017 - $87 million). Estimated annual Pension Plan contributions for the years 2019, 2020, 2021, 2022, 2023 and 2024 are approximately $78 million, $77 million, $78 million, $79 million, $81 million and $83 million, respectively. The most recent actuarial valuation was performed effective December 31, 2017, and the next actuarial valuation will be performed no later than effective December 31, 2020. Contributions are payable one month in arrears. All of the contributions are expected to be in the form of cash.

The Supplemental Plan provides members of the Pension Plan with benefits that would have been earned and payable under the Pension Plan beyond the limitations imposed by the *Income Tax Act* (Canada). The Supplemental Plan obligation is included with other post-retirement and post-employment benefit obligations on the Consolidated Balance Sheets.

At December 31, 2018, the present value of Hydro One's projected pension benefit obligation was estimated to be $7,752 million (2017 - $8,258 million). The fair value of pension plan assets available for these benefits was $7,205 million (2017 - $7,277 million).

Post-Retirement and Post-Employment Plans

During the year ended December 31, 2018, the Distribution Business charged $33 million (2017 - $35 million) of post-retirement and post-employment benefit costs to operation, and capitalized $31 million (2017 - $35 million) as part of the cost of property, plant and equipment and intangible assets. Benefits paid in 2018 were $27 million (2017 - $24 million). In addition, the associated post-retirement and post-employment benefits regulatory asset was decreased by $93 million (2017 - $116 million).

The Distribution Business presents its post-retirement and post-employment benefit liabilities on its Balance Sheets as follows:

December 31 *(millions of dollars)*	2018	2017
Accrued liabilities	27	26
Post-retirement and post-employment benefit liability	781	838
Net unfunded status	808	864

18. ENVIRONMENTAL LIABILITIES

The following tables show the movements in environmental liabilities for the years ended December 31, 2018 and 2017:

Year ended December 31, 2018 *(millions of dollars)*	PCB	LAR	Total
Environmental liabilities - beginning	61	22	83
Interest accretion	2	1	3
Expenditures	(10)	(5)	(15)
Revaluation adjustment	(8)	(2)	(10)
Environmental liabilities - ending	45	16	61
Less: current portion	(9)	(4)	(13)
	36	12	48

Year ended December 31, 2017 *(millions of dollars)*	PCB	LAR	Total
Environmental liabilities - beginning	66	29	95
Interest accretion	3	1	4
Expenditures	(10)	(5)	(15)
Revaluation adjustment	2	(3)	(1)
Environmental liabilities - ending	61	22	83
Less: current portion	(12)	(5)	(17)
	49	17	66

The following tables show the reconciliation between the undiscounted basis of the environmental liabilities and the amount recognized on the Balance Sheets after factoring in the discount rate:

December 31, 2018 *(millions of dollars)*	PCB	LAR	Total
Undiscounted environmental liabilities	49	16	65
Less: discounting environmental liabilities to present value	(4)	—	(4)
Discounted environmental liabilities	45	16	61

December 31, 2017 *(millions of dollars)*	PCB	LAR	Total
Undiscounted environmental liabilities	64	23	87
Less: discounting environmental liabilities to present value	(3)	(1)	(4)
Discounted environmental liabilities	61	22	83

At December 31, 2018, the estimated future environmental expenditures were as follows:

(millions of dollars)	
2019	14
2020	16
2021	13
2022	11
2023	10
Thereafter	1
	65

The Distribution Business records a liability for the estimated future expenditures for LAR and for the phase-out and destruction of PCB-contaminated mineral oil removed from electrical equipment when it is determined that future environmental remediation expenditures are probable under existing statute or regulation and the amount of the future expenditures can be reasonably estimated.

There are uncertainties in estimating future environmental costs due to potential external events such as changes in legislation or regulations, and advances in remediation technologies. In determining the amounts to be recorded as environmental liabilities, the Company estimates the current cost of completing required work and makes assumptions as to when the future expenditures will actually be incurred, in order to generate future cash flow information. A long-term inflation rate assumption of approximately 2% has been used to express these current cost estimates as estimated future expenditures. Future expenditures have been discounted using factors ranging from approximately 2.0% to 6.3%, depending on the appropriate rate for the period when expenditures are expected to be incurred. All factors used in estimating the Distribution Business' environmental liabilities represent management's best estimates of the present value of costs required to meet existing legislation or regulations. However, it is reasonably possible that numbers or volumes of contaminated assets, cost estimates to perform work, inflation assumptions and the assumed pattern of annual cash flows may differ significantly from the Company's current assumptions. In addition, with respect to the PCB environmental liability, the availability of critical resources such as skilled labour and replacement assets and the ability to take maintenance outages in critical facilities may influence the timing of expenditures.

PCB

The Environment Canada regulations, enacted under the *Canadian Environmental Protection Act, 1999*, govern the management, storage and disposal of PCBs based on certain criteria, including type of equipment, in-use status, and PCB-contamination thresholds. Under current regulations, Hydro One's PCBs have to be disposed of by the end of 2025, with the exception of specifically exempted equipment. Contaminated equipment will generally be replaced, or will be decontaminated by removing PCB-contaminated insulating oil and retro filling with replacement oil that contains PCBs in concentrations of less than 2 ppm.

The Distribution Business' best estimate of the total estimated future expenditures to comply with current PCB regulations is $49 million (2017 - $64 million). These expenditures are expected to be incurred over the period from 2018 to 2025. As a result of its annual review of environmental liabilities, the Distribution Business recorded a revaluation adjustment in 2018 to decrease the PCB environmental liability by $8 million (2017 - increase by $2 million).

LAR

The Distribution Business' best estimate of the total estimated future expenditures to complete its LAR program is $16 million (2017 - $22 million). These expenditures are expected to be incurred over the period from 2018 to 2023. As a result of its annual review of environmental liabilities, the Distribution Business recorded a revaluation adjustment in 2018 to decrease the LAR environmental liability by $2 million (2017 - $3 million).

19. ASSET RETIREMENT OBLIGATIONS

Hydro One Networks records a liability for the estimated future expenditures for the removal and disposal of asbestos-containing materials installed in some of its facilities. Asset retirement obligations, which represent legal obligations associated with the retirement of certain tangible long-lived assets, are computed as the present value of the projected expenditures for the future retirement of specific assets and are recognized in the period in which the liability is incurred, if a reasonable estimate can be made. If the asset remains in service at the recognition date, the present value of the liability is added to the carrying amount of the associated asset in the period the liability is incurred and this additional carrying amount is depreciated over the remaining life of the asset. If an asset retirement obligation is recorded in respect of an out-of-service asset, the asset retirement cost is charged to results of operations. Subsequent to the initial recognition, the liability is adjusted for any revisions to the estimated future cash flows associated with the asset retirement obligation, which can occur due to a number of factors including, but not limited to, cost escalation, changes in technology applicable to the assets to be retired, changes in legislation or regulations, as well as for accretion of the liability due to the passage of time until the obligation is settled. Depreciation expense is adjusted prospectively for any increases or decreases to the carrying amount of the associated asset.

In determining the amounts to be recorded as asset retirement obligations, the Company estimates the current fair value for completing required work and makes assumptions as to when the future expenditures will actually be incurred, in order to generate future cash flow information. A long-term inflation assumption of approximately 2% has been used to express these current cost estimates as estimated future expenditures. Future expenditures have been discounted using factors ranging from approximately 2.0% to 4.0%, depending on the appropriate rate for the period when expenditures are expected to be incurred. All factors used in estimating the Distribution Business' asset retirement obligations represent management's best estimates of the cost required to meet existing legislation or regulations. However, it is reasonably possible that numbers or volumes of contaminated assets, cost estimates to perform work, inflation assumptions and the assumed pattern of annual cash flows may differ significantly from the Company's current assumptions. Asset retirement obligations are reviewed annually or more frequently if significant changes in regulations or other relevant factors occur. Estimate changes are accounted for prospectively. As a result of its annual review of asset retirement obligations, the Company recorded a revaluation adjustment in 2018 to increase the asset retirement liability for the Distribution Business by $1 million (2017 - $nil).

At December 31, 2018, Hydro One Networks had recorded asset retirement obligations of $5 million (2017 - $4 million) related to its Distribution Business, primarily consisting of the estimated future expenditures associated with the removal and disposal of asbestos-containing materials installed in some of its facilities. The amount of interest recorded is nominal.

20. HYDRO ONE NETWORKS' SHARE CAPITAL

Hydro One Networks is authorized to issue an unlimited number of common and preferred shares. At December 31, 2018 and 2017, Hydro One Networks had 207,557,181 common shares issued and outstanding and no preferred shares issued and outstanding.

During 2018, Hydro One Networks declared common share dividends in the amount of $1 million (2017 - $2 million) and made a return of stated capital of $545 million (2017 – $509 million) to Hydro One. The amount allocated to the Distribution Business to finance these dividends and return of stated capital was $333 million (2017 - $263 million).

21. STOCK-BASED COMPENSATION

The following compensation plans were established by Hydro One Limited, however they represent components of compensation costs of Hydro One and its subsidiaries, including Hydro One Networks, in current and future periods.

Share Grant Plans

Hydro One Limited has two share grant plans (Share Grant Plans), one for the benefit of certain members of the Power Workers' Union (PWU) (PWU Share Grant Plan) and one for the benefit of certain members of the Society (formerly the Society of Energy Professionals) (Society Share Grant Plan). Hydro One and Hydro One Limited entered into an inter-company agreement, such that Hydro One will pay Hydro One Limited for the compensation costs associated with these plans. The agreement requires Hydro One Networks to reimburse Hydro One for the value of shares granted to the Company's eligible employees relating to these plans.

The PWU Share Grant Plan provides for the issuance of common shares of Hydro One Limited from treasury to certain eligible members of the PWU annually, commencing on April 1, 2017 and continuing until the earlier of April 1, 2028 or the date an eligible employee no longer meets the eligibility criteria of the PWU Share Grant Plan. To be eligible, an employee must be a member of the Pension Plan on April 1, 2015, be employed on the date annual share issuance occurs and continue to have under 35 years of service. The requisite service period for the PWU Share Grant Plan began on July 3, 2015, which is the date the share grant plan was ratified by the PWU. The number of common shares issued annually to each eligible employee will be equal to 2.7% of such eligible employee's salary as at April 1, 2015, divided by $20.50, being the price of the common shares of Hydro One Limited in the Initial Public Offering (IPO). The aggregate number of Hydro One Limited common shares issuable under the PWU Share Grant Plan shall not exceed 3,981,763 common shares. In 2015, 2,152,519 Hydro One Limited common shares were granted under the PWU Share Grant Plan relevant to the total stock-based compensation recognized by the Distribution Business.

The Society Share Grant Plan provides for the issuance of common shares of Hydro One Limited from treasury to certain eligible members of The Society annually, commencing on April 1, 2018 and continuing until the earlier of April 1, 2029 or the date an eligible employee no longer meets the eligibility criteria of the Society Share Grant Plan. To be eligible, an employee must be a member of the Pension Plan on September 1, 2015, be employed on the date annual share issuance occurs and continue to have under 35 years of service. Therefore the requisite service period for the Society Share Grant Plan began on September 1, 2015. The number of common shares issued annually to each eligible employee will be equal to 2.0% of such eligible employee's salary as at September 1, 2015, divided by $20.50, being the price of the common shares of Hydro One Limited in the IPO. The aggregate number of Hydro One Limited common shares issuable under the Society Share Grant Plan shall not exceed 1,434,686 common shares. In 2015, 743,877 Hydro One Limited common shares were granted under the Society Share Grant Plan relevant to the total stock-based compensation recognized by the Distribution Business.

The fair value of the Hydro One Limited 2015 share grants to employees of Hydro One Networks and allocated to the Distribution Business was $59 million. The fair value was estimated based on the grant date Hydro One Limited share price of $20.50 and is recognized using the graded-vesting attribution method as the share grant plans have both a performance condition and a service condition. In 2018, 248,109 common shares were issued under the Share Grant Plans (2017 - 186,489) to eligible employees of Hydro One Networks and allocated to the Distribution Business. Total stock-based compensation recognized by the Distribution Business during 2018 was $6 million (2017 - $8 million) and was recorded as a regulatory asset.

A summary of the Distribution Business' share grant activity under the Share Grant Plans during years ended December 31, 2018 and 2017 is presented below:

Year ended December 31, 2018	Share Grants *(number of common shares)*	Weighted-Average Price
Share grants outstanding - beginning	2,599,170	$20.50
Vested and issued[1]	(248,109)	—
Forfeited	(55,187)	$20.50
Share grants outstanding - ending	2,295,874	$20.50

[1] In 2018,Hydro One Limited issued from treasury common shares to eligible Hydro One Networks employees in accordance with provisions of the PWU and the Society Share Grant Plans. In accordance with the inter-company agreement between Hydro One and Hydro One Limited, Hydro One Networks made payments to Hydro One for the common shares issued.

Year ended December 31, 2017	Share Grants *(number of common shares)*	Weighted-Average Price
Share grants outstanding - beginning	2,853,079	$20.50
Vested and issued[1]	(186,489)	
Forfeited	(67,420)	$20.50
Share grants outstanding - ending	2,599,170	$20.50

[1] In 2017, Hydro One Limited issued from treasury common shares to eligible Hydro One Networks employees in accordance with provisions of the PWU Share Grant Plan. In accordance with the inter-company agreement between Hydro One and Hydro One Limited, Hydro One Networks made payments to Hydro One for the common shares issued.

Directors' DSU Plan

Under the Directors' DSU Plan, directors can elect to receive credit for their annual cash retainer in a notional account of DSUs in lieu of cash. Hydro One Limited Board of Directors may also determine from time to time that special circumstances exist that would reasonably justify the grant of DSUs to a director as compensation in addition to any regular retainer or fee to which the director is entitled. Each DSU represents a unit with an underlying value equivalent to the value of one common share of Hydro One Limited and is entitled to accrue Hydro One Limited common share dividend equivalents in the form of additional DSUs at the time dividends are paid, subsequent to declaration by Hydro One Limited Board of Directors.

During 2018 and 2017, Directors' DSU Plan awards granted by Hydro One Limited that related to Hydro One Networks' Distribution Business were as follows:

Year ended December 31 *(number of DSUs)*	2018	2017
DSUs outstanding - beginning	74,268	53,481
Granted	19,457	20,787
Settled	(52,618)	—
DSUs outstanding - ending	41,107	74,268

For the year ended December 31, 2018, an expense of $nil (2017 - $nil) was recognized in earnings with respect to the Directors' DSU Plan. At December 31, 2018, a liability of $nil (2017 - $1 million) related to Directors' DSUs has been recorded at the December 31, 2018 closing price of Hydro One Limited common shares of $20.25. This liability is included in long-term accounts payable and other liabilities on the Consolidated Balance Sheets.

DSUs related to the Company's former Board of Directors were settled at the June 29, 2018 (last business day in June 2018) closing price of Hydro One Limited common shares of $20.04, with an amount of approximately $1 million paid in 2018.

Management DSU Plan

Under the Management DSU Plan, eligible executive employees can elect to receive a specified proportion of their annual short-term incentive in a notional account of DSUs in lieu of cash. Each DSU represents a unit with an underlying value equivalent to the value of one common share of Hydro One Limited and is entitled to accrue common share dividend equivalents in the form of additional DSUs at the time dividends are paid, subsequent to declaration by Hydro One Limited Board of Directors.

During 2018 and 2017, Management DSU Plan awards granted by Hydro One Limited that related to Hydro One Networks' Distribution Business were as follows:

Year ended December 31 *(number of DSUs)*	2018	2017
DSUs outstanding - beginning	25,162	—
Granted	8,740	25,601
Paid	—	(439)
DSUs outstanding - ending	33,902	25,162

For the year ended December 31, 2018, an expense recognized in earnings by the Distribution Business with respect to the Management DSU Plan was $nil (2017 - $1 million). At December 31, 2018, a liability related to outstanding DSUs recorded at the closing price of Hydro One Limited common shares of $20.25 and included in long-term accounts payable and other liabilities on the Balance Sheets was $nil (2017 - $1 million).

Employee Share Ownership Plan

In 2015, Hydro One Limited established Employee Share Ownership Plans (ESOP) for certain eligible management and non-represented employees (Management ESOP) and for certain eligible Society-represented staff (Society ESOP). Under the Management ESOP, the eligible management and non-represented employees may contribute between 1% and 6% of their base salary towards purchasing common shares of Hydro One Limited. The Company matches 50% of their contributions, up to a maximum Company contribution of $25,000 per calendar year. Under the Society ESOP, the eligible Society-represented staff may contribute between 1% and 4% of their base salary towards purchasing common shares of Hydro One Limited. The Company matches 25% of their contributions, with no maximum Company contribution per calendar year. In 2018, Company contributions made under the ESOP for the Distribution Business were $1 million (2017 - $1 million).

LTIP

Effective August 31, 2015, the Board of Directors of Hydro One Limited adopted an LTIP. Under the LTIP, long-term incentives are granted to certain executive and management employees of Hydro One Limited and its subsidiaries, and all equity-based awards will be settled in newly issued shares of Hydro One Limited from treasury, consistent with the provisions of the plan which also permit the participants to surrender a portion of their awards to satisfy related withholding taxes requirements. The aggregate number of shares issuable under the LTIP shall not exceed 11,900,000 shares of Hydro One Limited.

The LTIP provides flexibility to award a range of vehicles, including Performance Share Units (PSUs), Restricted Share Units (RSUs), stock options, share appreciation rights, restricted shares, DSUs, and other share-based awards. The mix of vehicles is intended to vary by role to recognize the level of executive accountability for overall business performance.

PSUs and RSUs

During 2018 and 2017, LTIP awards granted by Hydro One Limited that related to Hydro One Networks' Distribution Business were as follows:

	PSUs		RSUs	
Year ended December 31 *(number of units)*	2018	2017	2018	2017
Units outstanding – beginning	168,490	74,063	151,490	83,394
Granted	128,364	118,467	97,207	96,697
Vested and issued[1]	(56)	(276)	(45,139)	(7,054)
Forfeited	(13,656)	(23,764)	(13,184)	(21,547)
Settled	(51,010)	—	(34,159)	—
Units outstanding – ending	232,132	168,490	156,215	151,490

[1] In 2018, Hydro One Limited issued from treasury common shares to eligible Hydro One Networks Transmission Business employees in accordance with provisions of the LTIP. In accordance with the inter-company agreement between Hydro One and Hydro One Limited, Hydro One Networks made payments to Hydro One for the common shares issued.

The grant date total fair value of the awards granted in 2018 was $5 million (2017 - $5 million). The compensation expense related to the PSU and RSU awards recognized by the Distribution Business during 2018 was $4 million (2017 - $2 million). The expense recognized in 2018 included less than $1 million related to previously awarded PSUs and RSUs to Hydro One's former President and CEO for which costs had not previously been recognized. These awards were settled in 2018 through a one-time cash settlement arrangement.

At December 31, 2018, $4 million (2017 - $3 million) payable relating to PSU and RSU awards was included in due to related parties on the Balance Sheets.

Stock Options

Hydro One Limited is authorized to grant stock options under its LTIP to certain eligible employees. During 2018, Hydro One Limited granted 1,450,880 stock options (2017 - nil). The stock options granted are exercisable for a period not to exceed seven years from the date of grant and vest evenly over a three-year period on each anniversary of the date of grant.

The fair value based method is used to measure compensation expense related to stock options and the expense is recognized over the vesting period on a straight-line basis. The fair value of the stock option awards granted was estimated on the date of grant using a Black-Scholes valuation model.

Stock options granted and the weighted-average assumptions used in the valuation model for options granted during 2018 are as follows:

Exercise price[1]	$ 20.70
Grant date fair value per option	$ 1.66
Valuation assumptions:	
Expected dividend yield[2]	3.78%
Expected volatility[3]	15.01%
Risk-free interest rate[4]	2.00%
Expected option term[5]	4.5 years

[1] Hydro One Limited common share price on the date of the grant.
[2] Based on dividend and Hydro One Limited common share price on the date of the grant.
[3] Based on average daily volatility of Hydro One Limited's peer entities for a 4.5-year term.
[4] Based on bond yield for an equivalent Canadian government bond.
[5] Determined using the option term and the vesting period.

During 2018 and 2017, the activity of stock options granted by Hydro One Limited that related to Hydro One Networks' Distribution Business were as follows:

Year ended December 31 *(number of stock options)*	2018	2017
Stock options outstanding - beginning	—	—
Granted[1]	391,118	—
Cancelled[2]	(54,604)	—
Stock options outstanding - ending[1]	336,514	—

[1] All stock options granted and outstanding at December 31, 2018 are non-vested.
[2] During 2018, stock options previously awarded to the Company's former President and CEO were cancelled. The Hydro One Networks unrecognized compensation expense related to the cancelled stock options was not significant.

The compensation expense related to stock options recognized by the Company during 2018 was not significant.

22. RELATED PARTY TRANSACTIONS

The Distribution Business is a separately regulated business of Hydro One Networks which is indirectly owned by Hydro One Limited. The Province is a shareholder of Hydro One Limited with approximately 47.4% ownership at December 31, 2018. The IESO, Ontario Power Generation Inc. (OPG), OEFC, and the OEB, are related parties to Hydro One Networks because they are controlled or significantly influenced by the Province.

Year ended December 31 *(millions of dollars)*

Related Party	Transaction	2018	2017
IESO	Power purchased	1,636	1,583
	Amounts related to electricity rebates	475	357
	Distribution revenues related to rural rate protection	239	247
	Funding received related to Conservation and Demand Management programs	62	59
OPG	Power purchased	10	9
	Revenues related to supply of electricity	6	5
OEFC	Power purchased from power contracts administered by the OEFC	2	2
OEB	OEB fees	4	5
Hydro One Limited and its subsidiaries	Revenues for services provided	2	1
	Services received - costs expensed	12	16
	Interest expense on long-term debt	168	170
	Interest expense on inter-company demand facility	4	2
	Payments to finance dividends and return of stated capital	333	263
	Stock-based compensation costs	10	10

The amounts due to and from related parties at December 31, 2018 and 2017 are as follows:

December 31 *(millions of dollars)*	2018	2017
Inter-company demand facility	(392)	(213)
Due from related parties	125	119
Due to related parties	(84)	(153)
Accrued interest	(38)	(40)
Long-term inter-company payable	(17)	(18)
Long-term debt, including current portion	(3,911)	(3,835)

23. STATEMENTS OF CASH FLOWS

The changes in non-cash balances related to operations consist of the following:

Year ended December 31 *(millions of dollars)*	2018	2017
Accounts receivable	10	198
Due from related parties	(6)	(86)
Materials and supplies	(1)	—
Other assets	2	4
Accounts payable	(10)	10
Accrued liabilities	29	32
Due to related parties	(68)	(25)
Accrued interest	(2)	(2)
Long-term accounts payable and other liabilities	(1)	(6)
Post-retirement and post-employment benefit liability	20	48
	(27)	173

Capital Expenditures

The following tables reconcile investments in property, plant and equipment and intangible assets and the amounts presented in the Statements of Cash Flows for the years ended December 31, 2018 and 2017. The reconciling items include change in accruals and capitalized depreciation.

Year ended December 31, 2018 *(millions of dollars)*	Property, Plant and Equipment	Intangible Assets	Total
Capital investments	(497)	(76)	(573)
Reconciling items	14	1	15
Cash outflow for capital expenditures	(483)	(75)	(558)

Year ended December 31, 2017 *(millions of dollars)*	Property, Plant and Equipment	Intangible Assets	Total
Capital investments	(537)	(48)	(585)
Reconciling items	15	(8)	7
Cash outflow for capital expenditures	(522)	(56)	(578)

Supplementary Information

Year ended December 31 *(millions of dollars)*	2018	2017
Net interest paid	170	172
Income taxes paid	70	16

24. CONTINGENCIES

Hydro One Networks is involved in various lawsuits and claims in the normal course of business. In the opinion of management, the outcome of such matters will not have a material adverse effect on the Company's financial position, results of operations or cash flows.

Hydro One and certain of its subsidiaries, including Hydro One Networks, are defendants in a class action suit in which the representative plaintiff is seeking up to $125 million in damages related to allegations of improper billing practices. The action was commenced in the Superior Court of Ontario on September 9, 2015. The plaintiff's motion for certification was dismissed by the court in November 2017. The plaintiff appealed the court's decision to the Divisional Court. The appeal was heard in October 2018; the Divisional Court dismissed the appeal in December 2018; and in January 2019, the plaintiff applied for leave to appeal to the Ontario Court of Appeal. The plaintiff's application for leave to appeal was denied by the Ontario Court of Appeal in March 2019, which means that the lawsuit has effectively ended.

The Company is a wholly owned subsidiary of Hydro One. As such, the assets of the Distribution Business are available to satisfy the debts, contingent liabilities and commitments of both the Company and Hydro One.

25. COMMITMENTS

The Company and Hydro One have numerous commitments. These commitments have not been specifically allocated to the Distribution Business. However, the assets of the Distribution Business are available to satisfy the commitments of both the Company and Hydro One.

26. SUBSEQUENT EVENTS

(A) Payments to Finance Dividends and Return of Stated Capital

On February 20, 2019, Hydro One Networks declared common share dividends of $1 million, and a return of stated capital of $138 million was approved. The amount allocated to the Distribution Business to finance these payments was $93 million.

(B) Stock-based Compensation

Subsequent to December 31, 2018, Hydro One Limited issued from treasury 20,949 and 207,737 common shares to eligible Distribution Business employees in accordance with provisions of the LTIP and Share Grant Plans, respectively.

(C) OEB Regulatory Decisions

Deferred Income Tax Regulatory Asset

Subsequent to year end, on March 7, 2019, the OEB issued a decision on its reconsideration of its Original Decision with respect to the rate-setting treatment of the benefits of the deferred tax asset resulting from transition from the payments in lieu of tax regime under the *Electricity Act* (Ontario) to tax payments under the federal and provincial tax regime. The OEB's Original Decision concluded that these benefits should not accrue entirely to Hydro One shareholders and that a portion should be shared with ratepayers. The OEB has concluded that the Original Decision was reasonable and should be upheld. The March 7, 2019 OEB decision has been determined to be a Type I subsequent event under US GAAP. As a result, the financial impact of this OEB decision has been reflected in these financial statements, as more fully discussed in Note 11 - Regulatory Assets and Liabilities.

Hydro One Networks' 2018-2022 Distribution Rates

Also, on March 7, 2019, the OEB issued its decision for Hydro One Networks' 2018-2022 distribution rates, in which it directed the Company to apply the Original Decision to Hydro One Networks' distribution rates. This aspect of the decision has been reflected in the adjustments discussed in Note 11 - Regulatory Assets and Liabilities. The other impacts from the OEB decision for Hydro One Networks' 2018-2022 distribution rates will be reflected prospectively in 2019.

(D) Long-term Debt

On April 5, 2019, Hydro One issued the following long-term debt under its MTN Program:

- $700 million notes with a maturity date of April 5, 2024 and a coupon rate of 2.54%. This issuance was mirrored down to Hydro One Networks through the issuance of inter-company debt with a coupon rate of 2.79%, of which $287 million was allocated to the Distribution Business;
- $550 million notes with a maturity date of April 5, 2029 and a coupon rate of 3.02%. This issuance was mirrored down to Hydro One Networks through the issuance of inter-company debt with a coupon rate of 3.27%, of which $225 million was allocated to the Distribution Business; and
- $250 million notes with a maturity date of April 5, 2050 and a coupon rate of 3.64%. This issuance was mirrored down to Hydro One Networks through the issuance of inter-company debt with a coupon rate of 3.89%, of which 103 million was allocated to the Distribution Business.

On March 21, 2019, Hydro One repaid $228 million of maturing long-term debt notes under its MTN Program. On the same date, Hydro One Networks repaid inter-company debt of $228 million to Hydro One, of which $91 million was allocated to the Distribution Business.

Chapter 17: Regulated operations

17.1 Chapter overview

Industry-specific accounting guidance for regulated operations is predominantly codified as ASC 980. Regulated utilities that meet certain criteria under ASC 980 are required to apply its guidance.

The purpose of ASC 980 is for financial reporting to reflect the economic effects of certain rate-regulated activities and actions taken by regulators that arise in the normal course of regulated operations. The basic premise of ASC 980 is that the actions of a regulator will impact the financial statements prepared for financial reporting purposes only if the action has an economic effect on the regulated utility and meets the requirements for recognition or deferral under the standard. A regulated utility should comply with U.S. GAAP applicable to entities in general with regard to its accounting and financial reporting. If it is also subject to ASC 980, the applicable provisions within that standard are applied as an adjustment to or in lieu of other U.S. GAAP (when specifically required by ASC 980).

ASC 980 provides guidance for (1) determining whether a reporting entity has regulated operations subject to rate-regulated accounting and (2) accounting for certain assets, liabilities, and transactions arising from regulated operations. This chapter addresses these requirements and the discontinuation of application and reapplication of ASC 980. See UP 18, UP 19, and UP 20 for further information on utility plant, income tax, and business combination issues, respectively, specific to regulated utilities.

17.2 Scope of ASC 980

As outlined in ASC 980-10-15-2, a reporting entity is required to apply ASC 980 if it meets three specified criteria.

- Rates are established by an independent third-party regulator or the entity's own governing board (UP 17.2.1)

- Rates are designed to recover costs of service (UP 17.2.2)

- Rates designed to recover costs can be charged to and collected from customers (UP 17.2.3)

A reporting entity should assess and document whether it continues to meet each of the criteria, setting forth the significant factors considered, at least annually or any time rate structures change or regulatory developments occur. The unit of account for the application of ASC 980 can be a transaction, a group of transactions, a separable operation of the reporting entity or the reporting entity in its entirety. The unit of account is based on the level at which the criteria in ASC 980-10-15-2 are met. The documentation should address the rationale for the determination of the unit of account if there are specific or different factors impacting various parts of the business (e.g., service territories, customer classes, or functional activity such as generation).

The determination of whether a reporting entity's rate structure continues to meet the criteria of ASC 980 should consider the totality of the evidence and all relevant facts.

criteria for application of ASC 980. However, analyzing whether a specific asset or group of costs are subject to regulation and recovery may be complex. Determining whether the asset or group of costs is clearly specified in a rate order or other evidence that would support regulatory accounting, including the means and timing of cost recovery, is key to this analysis.

For example, assuming all of the criteria in ASC 980 are met, a pipeline expansion for which capital and operating expenses will be recovered through rates imposed by a regulator may qualify for regulatory accounting if the related capital and operating costs are segregated such that it is clear which costs are being recovered through a cost-of-service mechanism. Similarly, if a reporting entity does not qualify for application of ASC 980 to its entire business but has cost-of-service regulation for one aspect of its costs (e.g., fuel costs), it may qualify for rate-regulated accounting for those costs, assuming the other criteria of ASC 980 are met.

The application of ASC 980 to a group of costs is highly judgmental and may not be appropriate in many circumstances.

17.3 Regulatory assets

One of the primary areas in which accounting by regulated utilities differs from unregulated entities is regulated utilities' ability to defer certain expenditures as regulatory assets that would otherwise be expensed under U.S. GAAP. Specific criteria exist for the recognition and measurement of regulatory assets as summarized in Figure 17-3.

Figure 17-3
Key areas of accounting consideration for regulatory assets

Area	Considerations
Initial recognition and measurement (UP 17.3.1)	□ Incurred costs may be capitalized as a regulatory asset if the amounts are probable of recovery through rates. □ Regulatory assets are initially measured as the amount of the incurred cost. □ If a cost does not meet the criteria for deferral as a regulatory asset at the date incurred, it should be expensed; a regulatory asset may subsequently be recorded if and when the criteria for recognition are met.
Subsequent measurement (UP 17.3.2)	□ Regulatory assets are typically amortized over future periods consistent with the period of recovery through rates. □ If all or part of an incurred cost recorded as a regulatory asset is no longer probable of being recovered, the amount that will not be recovered should be written off to earnings. □ If a regulator subsequently allows recovery of costs that were previously disallowed, a new asset is recorded; classification of the new asset depends on how the asset would have been classified had it been previously allowed.