Q. Regarding IFRS and capital expenditures – please provide a list of all changes implemented as a result of P.U.2-2012 and indicate the status of implementation of these changes.

A. The following changes were implemented as a result of Board Order No. P.U. 2(2012):

- Capital Assets – Interest During Construction(IDC): IDC used instead of Allowance for Funds Used During Construction (AFUDC);
- Capital Assets – Overheads and Training Costs: Certain overheads and training costs are no longer being capitalized; and
- Capital Assets – Major Inspections and Overhauls: Major inspections and overhauls are capitalized.

These changes are fully implemented and reflected in Hydro's Application. These changes are described in more detail in Hydro's 2012 Capital Budget Application; refer to an excerpt in IC-NLH-011 Attachment 1.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

<u>Background</u>

The Accounting Standards Board (AcSB) requires publicly-accountable enterprises to adopt IFRS for interim and annual financial statements for fiscal years beginning on or after January 1, 2011. As a result of changes to Part I of the Canadian Institute of Chartered Accountants (CICA) Handbook – Accounting, by the AcSB, certain rate-regulated entities can defer the adoption of IFRS by one year to January 1, 2012. Hydro met the criteria for deferral and as such has chosen to adopt IFRS effective January 1, 2012.

Hydro commenced its IFRS conversion project in 2008 and established a formal project governance structure which includes a steering committee consisting of senior levels of management from various disciplines as appropriate. Regular reporting is provided to the Audit Committee and the Board of Directors. Beginning in March 2010, Hydro has also provided monthly updates to the Public Utilities Board outlining the status of the IFRS transition.

Effective January 1, 2012 Hydro's financial statements will be prepared in accordance with IFRS and, as a result, Hydro has to make recommendations as to whether changes to its accounting methods and policies are warranted. In the case of its capital asset records, which Hydro primarily maintains at an individual asset (e.g. distribution transformer) level, there are several items to be considered in transitioning to IFRS, as discussed below. Calculating separate capital costs, and the resultant depreciation variances, and reconciling the two sets of records for the foreseeable future would require additional investment in both personnel and systems. Additionally, it would impair transparency when parties, including the Board, review external and regulatory records, including financial reports.

Hydro recognizes that the move to IFRS is a significant issue in the regulated utility industry. Hydro intends to engage in a more comprehensive discussion with the Public Utilities Board in the future regarding its overall proposed approach to implementing IFRS. However, in preparing its 2012 Capital Budget Application, Hydro encountered a number of IFRS-related issues that required treatment prior to the full IFRS discourse. The issues and rationale for their treatment are provided herein.

Table- 1 below identifies the five areas of the 2012 Capital Budget Application that are affected by the move to IFRS. The changes that have resulted from the transition to IFRS are consistent with those communicated previously to the Public Utilities Board.

Table - 1 – Treatment of IFRS-Related Issues in the 2012 Capital Budget Application

Description	Description	Amount excluded from capital under IFRS (permitted under GAAP) $ x 000,000	Amount included in capital under IFRS (expensed under GAAP) $ x 000,000	Net Impact on Capital $ x 000,000
Major Overhauls and Inspection	Major Overhauls and Inspections were expensed as operating costs in previous budget applications but capitalized under IFRS	-	6.8	6.8
Training costs	Training costs are operating expenses under IFRS	0.2	-	(0.2)
Capital Labour Overheads (10% and 20%)	Capital Labour overheads are not allowed under IFRS	1.3	-	(1.3)
Corporate Overhead Allocation (2-4%)	Current corporate overheads methodology not allowed under IFRS	2.1	-	(2.1)
AFUDC vs. IDC	AFUDC is excluded and IDC permitted	2.6	2.7	0.1

Major Overhauls and Inspections

International Accounting Standard (IAS) 16 (Appendix A) states that a condition of continuing to operate an item of property, plant and equipment may be performing regular major inspections or overhauls. The cost of these inspections or overhauls should be recognized in the carrying amount of the asset.

Hydro has adopted the following policies and guidelines with respect to capitalizing Major Inspections and Overhauls:

1) The overhaul or inspection will occur at regular intervals throughout the life of the asset, and would occur on a frequency of greater than one year;
2) The total cost of the overhaul or inspection will be greater than $50,000; and
3) Any remaining carrying amount of the previous overhaul or inspection will be derecognized when a new overhaul or inspection occurs.

Hydro believes that it is appropriate to capitalize Major Inspections and Overhauls under these conditions as they represent a benefit that will last over periods of greater than one year and to include the full cost in the year the work was performed would result in volatility in operating costs.

The projects capitalized in the Hydro 2012 Capital Budget Application as Major Inspections and Overhauls under IAS 16 are as follows:

1) Major Overhaul of a turbine at Holyrood generating station $4.2 million
2) Major Overhaul of diesel generators $1.0 million
3) Major Overhaul of Hydro generators $0.4 million
4) Major Inspection of Holyrood plant $1.2 million

These major overhauls or inspections will deliver economic benefit over future years and meet the IFRS capital recognition criteria.

Training Costs

Under Generally Accepted Accounting Principles (GAAP), Hydro included training costs associated with capital projects in the cost of those projects. IFRS no longer allows the capitalization of training costs. This does not represent a material change and therefore Hydro proposed to include training costs in operating rather than capital expenditures for 2012 and beyond.

Allowance for Funds Used During Construction (AFUDC)

Under GAAP, Hydro capitalized borrowing costs using AFUDC which includes both the cost of debt and equity. IAS 23 (Appendix B) only allows the capitalization of borrowing costs based on the cost of debt. Hydro's AFUDC, based on the 2007 approved Test Year Weighted Average Cost of Capital is 7.59%, compared to the forecast[1] interest rate of 8.2% included in this Application. As shown in Table 1, this does not result in a material change and therefore Hydro proposes to include interest at the cost of debt in its capital expenditures, rather than AFUDC.

Capital Overheads

IAS 16 specifically disallows the capitalization of administrative and general overheads. Previously, Hydro included in the cost of property, plant and equipment an allocation of two types of overheads.

The first overhead allocation consisted of Engineering Managers and Supervisors who did not charge directly to capital work orders. An overhead of 10% and 20% was applied to labour charged to capital by individuals working in the corporate office and individuals working in the field respectively. This overhead was intended to capture costs of management which could not be easily identified with a

[1] The actual interest rate will be used for the actual capital expenditures.

specific project. As a result of a re-alignment of the Project Execution and Technical Services group, specifically the establishment of the Project Execution responsibilities, discussed in more detail in the 2012 Capital Plan section of this Application, Hydro is now able to more accurately capture the hours of all engineers that work on capital. Hydro is therefore proposing to replace this overhead allocation by including hours directly charged to capital. This change is also reflected in the estimate for each project.

The second overhead allocation consisted of an allocation of time for support business units that did not charge directly to capital (e.g. Accounts Payable, Inventory and Purchasing services). Under IFRS, Hydro is only able to capitalize an allocation of labour for individuals who would be incremental due to the capital program. Hydro has not identified any of the costs of these support services as incremental costs due solely to the capital programs, as the personnel in these areas provide the same services for capital and operating programs. As a result, has included no allocation of overhead labour to capital in the 2012 estimates.

<u>IFRS Summary</u>

Hydro's 2012 Capital Budget Application has been prepared in accordance with IFRS. Aligning Hydro's regulatory reporting and external reporting will eliminate administrative costs associated with duplicate accounting records and will allow for greater comparability and transparency in Hydro's financial statements. Hydro has assessed each area impacted by IFRS to determine if it was prudent to align regulatory and external financial reporting. This assessment process will be ongoing as changes are made to IFRS.