Q. **a)** Please confirm whether Hydro is proposing to use AFUDC to calculate the capitalization of borrowing costs for regulatory reporting purposes only or for both regulatory and financial reporting.

b) If Hydro intends to use AFUDC for financial reporting, is approval to deviate from IFRS required? Please explain why approval of a deviation would not be required.

A. **a)** Under International Financial Reporting Standards ("IFRS"), International Accounting Standard ("IAS") 23, *Borrowing Costs*, entities are required to capitalize borrowing costs that are directly attributable to the construction of qualifying assets. Borrowing costs under IAS 23 comprise interest and other costs incurred in connection with the borrowing of funds using debt and do not include the actual or imputed cost of equity. Newfoundland and Labrador Hydro ("Hydro") uses Interest During Construction ("IDC"), which reflects borrowing costs in accordance with IAS 23. Allowance for Funds Used During Construction ("AFUDC") includes both debt and equity financing components.

Hydro is not proposing to replace IDC for IFRS financial reporting purposes. Instead, Hydro is applying to the Board of Commissioners of Public Utilities ("Board") to reflect AFUDC for regulatory reporting purposes, with the difference between AFUDC and IDC captured as a regulatory adjustment in accordance with IFRS 14, *Regulatory Deferral Accounts*.

For regulatory reporting purposes, interest expense will reflect AFUDC, achieved by recording:

- IDC; plus
- An adjustment equal to the difference between AFUDC and IDC.[1]

[1] The adjustment may be positive or negative. Where the AFUDC rate exceeds the IDC rate, the adjustment increases net income. Where AFUDC rate is lower than the IDC rate, the adjustment decreases net income.

For IFRS financial reporting, Hydro will:

- Record IDC in interest expense in accordance with IAS 23;
- Record the difference equal to the difference between AFUDC and IDC as a 'regulatory adjustment' on the income statement; and
- Record the difference between AFUDC and IDC as a regulatory deferral account balance (balance sheet adjustment) under IFRS 14.

Accordingly, the only difference between regulatory reporting and IFRS is the income statement presentation of the adjustment for the difference between AFUDC and IDC. Under regulatory reporting, the adjustment is reflected in interest expense, whereas under IFRS it is recorded as a regulatory adjustment. The resulting impact on net income and the balance sheet is the same under both presentations.

b) The Board approval sought in the application effectively provides the basis for recognition of the regulatory deferral account associated with the difference between AFUDC and IFRS, while Hydro's external financial statements continue to comply with IAS 23 and IFRS 14.