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BY E-MAIL

April 10, 2018

Kirsten Walli Board
Secretary Ontario
Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Hydro One Networks Inc.
Request to Establish a New Variance Account
OEB Staff Submission
OEB File No. EB-2017-0338

In accordance with Procedural Order No. 1, please find attached OEB staff's submission in the above noted proceeding. Hydro One Networks Inc. (Hydro One Networks) and all intervenors have been copied on this filing.

Yours truly,

Original Signed By

Mark Rozic
Project Advisor – Rates Major Applications

Encl.

APPLICATION TO ESTABLISH A VARAINCE ACCOUNT

Hydro One Networks Inc.

Transmission

EB-2017-0338

OEB STAFF SUBMISSION

April 10, 2018

Background

In March 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) No. 2017-07 that amends the US GAAP accounting standard for pension and other post-employment benefit (OPEB) costs including, among other changes, how much of these costs a utility is eligible to capitalize in assets. The provisions of this ASU became effective for fiscal years beginning after December 15, 2017. For Hydro One Networks, this means that these changes are applicable to them effective for their fiscal year beginning on January 1, 2018.

Under current US GAAP, the net periodic benefit cost from defined benefit pension and OPEB plans (pension and OPEB expense) is comprised of several components, including current service cost, interest cost, return on plan assets and the amortization of actuarial gains/losses and prior service costs. Prior to the issuance of ASU No. 2017-07, an entity following US GAAP was eligible to capitalize all components of net periodic benefit cost provided that the costs met the specific capitalization criteria under US GAAP. However, ASU No. 2017-07 now only permits the capitalization of the service cost component of net periodic benefit cost. The provisions of this ASU further require that the change in capitalization rules be applied on a prospective basis, meaning that only costs that are capitalized from January 1, 2018 and onward are impacted. Amounts capitalized prior to this period are not affected.

On September 28, 2017, the OEB issued its Decision and Order on Hydro One Networks' 2017 and 2018 transmission rates proceeding.[1] The issuance of ASU 2017-07 is expected to have an impact on the revenue requirement approved in that Decision and Order because the forecast cost used by the OEB to determine the 2018 transmission revenue requirement did not reflect the impact of this accounting standard change. Therefore Hydro One Networks is proposing to establish a variance account that will capture the portion of the 2018 forecast pension and OPEB costs that were classified as capital in the 2018 approved transmission revenue requirement, but for which Hydro One Networks is now (effective January 1, 2018) required to record to OM&A expense as a result of ASU 2017-07. The utility has estimated the related dollar amount for the 2018 rate year to be $11 million[2].

[1] EB-2016-0160

[2] Request for Accounting Order, p. 5.

Hydro One Networks has further clarified its intent with respect to the requested variance account through its response to OEB staff interrogatory #4[3], in which it has indicated the following:.

> The deferral account requested is not intended to capture the 2018 revenue requirement impact only, but it is intended to capture the impact going forward until another mechanism established by the OEB allows for the continued capitalization of the net periodic benefit cost other than the service cost that would have been classified as capital prior to the issuance of ASU 25 2017-07.

Hydro One Networks has further indicated the following in its response to OEB Staff interrogatory #2[4]:

> Subsequent to the filing of the Application, Hydro One's discussion with its Auditors has improved its understanding of the requirements surrounding ASU 2017-07, including the eligibility of utilities to continue capitalizing OPEB costs. Hydro One was advised that it could continue capitalizing OPEB costs, without the requirement of a deferral account, if approved to do so by its respective regulator. FERC has provided such an approval for regulated entities under its jurisdiction. Hydro One would welcome a policy decision from the OEB that allows the continued capitalization of the affected costs, similar to the FERC guidance. Such a decision would achieve the same objective as the requested deferral account without the additional regulatory overhead, going forward.

The Federal Energy Regulatory Commission (FERC) guidance being referenced in the above can be found in undertaking JT 1.16 in Hydro One Networks Inc.'s current distribution rates application[5]. Essentially the guidance provides rate regulated entities under its jurisdiction with the option to elect to follow the cost capitalization provisions of ASU 2017-07, or to continue capitalizing pension and OPEB costs consist with their current pre ASU 2017-07 practices.[6]

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[3] Exhibit I-1-4

[4] Exhibit I-1-2, page 2 of 2.

[5] EB-2017-0049

[6] EB-2017-0049, Exhibit JT 1.16, page 4

OEB Eligibility Criteria to Establish a Deferral or Variance Account

As outlined in section 2.10 of the OEB's Chapter 2 Filing Requirements for Electricity Transmission Applications, if an applicant is seeking an order to establish a new deferral or variance account, the following eligibility criteria must be met:

- Causation – is the forecasted expense clearly outside the base upon which rates were derived.
- Materiality – does the forecasted expense exceed an OEB defined materiality threshold.
- Prudence – does the quantum represent a cost effective option for ratepayers.

OEB staff notes the following with respect to the above eligibility criteria and Hydro One Networks' request for its variance account:

- Causation – this condition is met because the 2018 revenue requirement approved in Hydro One Networks' 2017 and 2018 transmission rates proceeding did not reflect the accounting standard changes provided through ASU 2017-07. This is because the expense that is being captured by the proposed variance account was driven by an external circumstance, mainly a FASB issued change to the accounting standard for pension and OPEB costs.
- Materiality – the established materiality threshold from Hydro One Networks' 2017 and 2018 transmission rates proceeding was $3 million. This threshold was based on the guidance provided in section 2.1.1 of the OEB's Chapter 2 Filing Requirements for Electricity Transmission Applications. As noted previously, the applicant has estimated that the dollar impact of the accounting standard change on its approved 2018 transmission revenue requirement is $11 million. Therefore this condition is met because the estimated dollar impact exceeds the OEB established materiality threshold.
- Prudence –The quantum is ultimately underpinned by an actuarial valuation which was performed by a licensed actuary in accordance with the US GAAP accounting standard. To the extent that the results of the actuarial valuation may be a matter to be examined and challenged at the time of disposition, and to the extent that parties will have an opportunity to assess Hydro One's overall capitalization policy in future proceedings, in OEB staff's view, the applicant has demonstrated that it has a plan in place to track and quantify the subject costs in a prudent fashion.

Based on the above analysis, OEB staff notes that Hydro One Networks' request to establish a variance account meets the eligibility criteria as outlined above. Therefore, OEB staff does not oppose the establishment of this variance account. OEB staff further submits that costs contained within the variance account will be subject to an OEB prudence review in a future rate hearing once disposition of the account balance is requested by the applicant.

What Amounts Should the Proposed Account Track

OEB staff submits that this proposed variance account should capture the revenue requirement impact of the forecast 2018 pension and OPEB costs that were capitalized and embedded in the 2018 transmission rates approved by the OEB in EB-2016-0160, and, effective January 1, 2018, are required to be recognized as OM&A as a result of the issuance of ASU 2017-07. As outlined in the Background section above, Hydro One Networks has estimated an amount of $11 million.

OEB staff notes that the estimated $11 million impact that was quantified by the applicant represents only the capital costs that are now required to be expensed. The figure does not include the complete net revenue requirement impact of capitalizing the subject costs in the first instance. The applicant has not quantified the associated impact that a reduction to the capitalized costs have on the approved return on rate base, depreciation and PILs. As such, OEB staff submits that the impact on these other areas, or the net revenue requirement impact of the accounting standard change, should be captured by the proposed variance account. In response to OEB staff interrogatory #3, the applicant has indicated that it expects the impact on these other areas of the approved 2018 revenue requirement (as described above) to be less than $1 million, which is well below the $3 million materiality threshold that was set in EB-2016-0160[7]. Therefore, based on this response, it is the applicant's intention to not reflect the full net revenue requirement impact of the accounting standard change in the proposed tracking of the variance account.

OEB staff submits that the applicant is disaggregating the impact of the accounting change to components and then assessing the materiality of each component. If the accounting change is material, which OEB Staff submits that it is, then its impact must be tracked in totality within the proposed variance account.

[7] Exhibit I-1-3

Should the Proposed Variance Account Track Amounts Beyond the Impact to the Approved 2018 Transmission Revenue Requirement

As noted in the Background section of this document, in its response to OEB staff interrogatories, the applicant had further clarified its position with respect to its request for this variance account. Specifically, Hydro One Networks indicated that the intent of the proposed account is to also capture the impact of the accounting change going forward (beyond the impact on the 2018 transmission revenue requirement) until another mechanism is established by the OEB that allows for the continued capitalization of the impacted costs to capital projects, similar to guidance that the FERC issued to regulated utilities under its jurisdiction.

In EB-2011-0188, Hydro One Networks Inc. received OEB approval to use US GAAP as the basis of its rate application filings, regulatory accounting and regulatory reporting requirements, instead of the OEB mandated Modified IFRS (MIFRS) framework that most utilities across Ontario follow. OEB staff notes that US GAAP allows for a more broad interpretation of what types of costs may be capitalized to assets, and therefore Hydro One Networks is already able to capitalize significantly more than they otherwise would be permitted to had they been following the OEB's MIFRS framework. For example, as part of the 2017 and 2018 transmission rates proceeding, the applicant indicated that on a consolidated basis, they would be able to capitalize approximately $310 million less over the test period had they been required to follow MIFRS[8]. On this basis, OEB staff submits that only the net revenue requirement impact of the accounting change on the 2018 approved transmission revenue requirement should be tracked in the proposed variance account. A decision on the regulatory treatment of the impacted costs for 2019 and beyond can be addressed in the applicant's upcoming transmission rates application.

If the applicant is concerned with the adverse impact that the amount accumulated in the proposed variance account for 2018 will have on rates going forward, then OEB staff would support a disposition of the account balance over a period that is consistent with the useful lives of assets to which such costs would have previously been capitalized, but not to exceed 20 years. The applicant has alluded to such a rate mitigation mechanism in

[8] EB-2016-0160, Exhibit I-1-75

its response to OEB staff interrogatories in the current distribution rates proceeding[9]. However the timing and method of disposition of the account balance are outside of the scope of this proceeding.

Have Other OEB Regulated Entities that Follow US GAAP Requested a Similar Account

To date no other OEB regulated utilities that follow US GAAP have come forward to request an account for the purpose of capturing the impacts related to the change in capitalization requirements under ASU 2017-07. Nor has any of those utilities made a request of the OEB to consider providing a policy decision on the continued capitalization of impacted costs.

OEB staff submits that this is likely due to the fact that Hydro One Networks' capitalization policies are far more aggressive than other OEB regulated utilities who follow US GAAP. For example, in response to OEB staff interrogatory 1, the applicant provided a breakdown between capital and OM&A of its pension and OPEB costs that are embedded within the approved 2018 transmission revenue requirement. That breakdown illustrates that Hydro One Networks capitalized approximately 61.4% of its forecast 2018 pension and OPEB costs[10]. In contrast, as part the EB-2017-0307 proceeding (Union/Enbridge MADDs Application), OEB staff asked an interrogatory about the impact that ASU 2017-07 has on the 2019 revenue requirement. In the response, the applicants indicated that ASU 2017-07 is not expected to have a significant impact since Enbridge Gas does not currently capitalize pension and OPEB related costs, while Union Gas estimated its impact to be less than $1 million[11].

It is OEB staff's view that Hydro One Networks' capitalization policies should be brought in-line with the OEB's MIFRS requirements and/or with other less aggressive policies by other US GAAP utilities in order to, among other things, facilitate better benchmarking across OEB regulated utilities. Therefore the provisions of ASU 2017-07 represent a step in the right direction.

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[9] EB-2017-0049, Exhibit I-40-Staff-217

[10] Exhibit I-1-1

[11] EB-2017-0307, Exhibit C, Staff 57

All of which is respectfully submitted