ESTABLISHMENT OF NEW AND/OR CONTINUATION OF EXISTING DEFERRAL AND VARIANCE ACCOUNTS

1.0 PURPOSE

This evidence provides a summary of the deferral and variance accounts for which OPG is seeking approval to continue or establish for the test period.

2.0 OVERVIEW

OPG's deferral and variance account proposals are presented under the following two categories:

- The continuation of certain existing deferral and variance accounts
- New accounts

Unless otherwise stated, OPG proposes to record in the approved variance and deferral accounts the difference between the amounts included in the approved payment amounts and the actual costs and revenues. In addition, OPG proposes to record interest on both existing and new deferral and variance accounts. Interest will be applied to the monthly opening balances of these accounts at the interest rate set by the OEB from time to time pursuant to the OEB's interest policy for variance and deferral accounts.

During the portion of the test period before the effective date of new payment amounts (proposed to be March 1, 2011), OPG will record entries to the existing accounts using the same methods used to derive 2010 entries, pursuant to the Accounting Order in EB-2009-0174.

3.0 CONTINUED ACCOUNTS

The company requests approval to continue the following existing deferral and variance accounts:

Accounts Common to Hydroelectric and Nuclear

- Ancillary Service Net Revenue Variance Account – Hydroelectric and Nuclear Sub-Accounts
- Income and Other Taxes Variance Account
- Tax Loss Variance Account

Hydroelectric Variance and Deferral Accounts

- Hydroelectric Water Conditions Variance Account
- Hydroelectric Deferral and Variance Over/Under Recovery Variance Account

Nuclear Variance and Deferral Accounts

- Pickering A Return to Service Deferral Account
- Nuclear Liability Deferral Account
- Nuclear Development Variance Account
- Capacity Refurbishment Variance Account
- Nuclear Fuel Cost Variance Account
- Bruce Lease Net Revenues Variance Account
- Nuclear Deferral and Variance Over/Under Recovery Variance Account

The need for these accounts and their operation is described in further detail in the remainder of this section**.**

3.1 Accounts Common to Hydroelectric and Nuclear

3.1.1 Ancillary Services Net Revenue Variance Account – Hydroelectric and Nuclear Sub Accounts

The Ancillary Services Net Revenue Variance Account was established by O. Reg. 53/05 and approved by the OEB in EB-2007-0905. This account is required because ancillary services revenues are difficult to forecast accurately and the underlying circumstances leading to variances between forecast and actual revenues are beyond OPG's ability to manage or control since they are a function of changing demand and system/grid operating requirements. This account will record the difference between the forecast ancillary revenues included in the payment amounts and the actual ancillary revenues during the test period.

This account needs to continue in order to clear the 2010 year-end balance, and to record additions during the test period as a result of the forecast risks highlighted above.

3.1.2 Income and Other Taxes Variance Account

The OEB approved the establishment of this account in EB-2007-0905. A similar account is also available to electricity distributors. This account will capture the financial impact on revenue requirement due to variations from those assumed in the approved payment amounts during the test period, in municipal property taxes, payments in lieu of capital taxes, property taxes, and income taxes due to changes in tax rates or rules, new assessing or administrative practices of tax authorities, tax re-assessments for past periods, and court decisions for other taxpayers that affect OPG's tax position. OPG continues to be subject to tax audits from prior years dating back to 2000, which could result in changes to tax treatments that may impact similar transactions during the test period. This account needs to continue in order to clear the 2010 year-end balance, and to record additions during the test period as noted above.

3.1.3 Tax Loss Variance Account

The Tax Loss Variance Account was approved by the OEB in May 2009 in EB-2009-0038 as described in Ex. H1-T1-S1. This account needs to continue in order to clear the 2010 year-end balance, and to record additions during the test period before the effective date of new payment amounts (proposed to be March 1, 2011). Following the effective date of new payment amounts, the only entries in this account will be for interest and amortization.

3.2 Hydroelectric Variance and Deferral Accounts

3.2.1 Hydroelectric Water Conditions Variance Account

The Hydroelectric Water Conditions Variance Account was established by O. Reg. 53/05 and approved by the OEB in recognition of the fact that water conditions are subject to a high degree of forecast risk due to factors that are beyond OPG's ability to manage or control, such as weather. This account will record the financial impact of differences between the water conditions underpinning the approved payment amounts and the actual water conditions experienced during the test period. This account needs to continue in order to

clear the 2010 year-end balance, and to record additions during the test period as a result of the risks indicated above.

3.2.2 Hydroelectric Deferral and Variance Over/Under Recovery Variance Account

The Hydroelectric Deferral and Variance Over/Under Recovery Variance Account was approved by the OEB in October 2009 in EB-2009-0174 to record the over collection of hydroelectric variance account balances that were recovered through the hydroelectric payment amount to be effective as of January 1, 2010. The projected over collection as at December 31, 2010 will be cleared by the end of 2012, however, this account needs to continue as OPG recovers variance and deferral account balances through payment riders based on production. Because forecast production is used to determine the rider, and the actual recovery in a particular year is based on actual production, there will be differences that will need to be cleared in a future period.

3.3 **Nuclear Variance and Deferral Accounts**

3.3.1 Pickering A Return to Service ("PARTS") Deferral Account

The PARTS Deferral Account was established pursuant to subsection 5 (4) of O. Reg. 53/05. This account needs to continue until the balance in it is cleared. In EB-2007-0905, the OEB established a 45-month clearance period which ends in December 2011. The only entries in this account during the test period will be for amortization and interest.

3.3.2 Nuclear Liability Deferral Account

The Nuclear Liability Deferral Account (transition) was established pursuant to section 5.1 of the Regulation and was used to record the revenue requirement impact of any change in OPG's nuclear decommissioning liability arising from a reference plan approved between April 1, 2005 and the effective date of the OEB's first payment order, as reflected in the audited financial statements approved by OPG's Board of Directors. The OEB authorized the clearance of the balance in this account as at December 31, 2007 in EB-2007-0905. This account will continue until the balance in it is cleared over the OEB-approved period of April 2008 to December 2010. OPG recorded additions to this account in the first quarter of 2008,

and has only recorded interest and amortization since the second quarter of 2008. The balance in this account will be cleared by December 2010.

Section 5.2 of the Regulation also approved the establishment of a Nuclear Liability Deferral Account. This account will be used to record the revenue requirement impact of any change in OPG's nuclear decommissioning liability arising from an approved reference plan after the OEB's first payment order, which was in December 2008.

The Regulation defines nuclear decommissioning liability as the liability of OPG for decommissioning its nuclear generation facilities and the management of its nuclear waste and used fuel. OPG's current obligations relate to Pickering and Darlington that are operated by OPG, as well as Bruce A and B that are leased by OPG to Bruce Power. This account needs to continue to capture the revenue requirement impacts of future reference plan changes between rate applications.

3.3.3 Nuclear Development Variance Account

The Nuclear Development Deferral Account, Transition was established in accordance with section 5.3 of the Regulation. As provided in the Regulation, this account recorded development costs incurred and firm financial commitments made on or after June 13, 2006 up to the effective date of the OEB's first payment order. The OEB approved recovery of the $11.7M balance in this account as at December 31, 2007 in EB-2007-0905 and ordered that OPG transfer the balance in this account into the Nuclear Development Variance Account effective April 1, 2008. With the transfer of its balance this account ended.

The Nuclear Development Variance Account was established in accordance with section 5.4 of the Regulation and approved by the OEB in EB-2007-0905. This account ensures that OPG recovers the differences between the actual non-capital costs, and firm financial commitments incurred for planning and preparation for the development of proposed new nuclear generation facilities after the effective date of the OEB's December 2008 payment amounts order, and the amount included for these purposes in the payment amounts, along with the April 1, 2008 balance in the Nuclear Development Deferral Account, Transition that

was transferred into this account in accordance with the OEB's order. OPG's nuclear development activities are described in Ex. D2-T2-S1. This account is required to continue during the test period in order to clear the balance as at December 31, 2010 and to record potential additions during the test period related to ongoing nuclear development activities. These potential additions will capture the difference between the nuclear development expenditures included in the approved payment amounts and the actual expenditures during the test period.

3.3.4 Capacity Refurbishment Variance Account

The OEB approved the establishment of the Capacity Refurbishment Variance Account in EB-2007-0905. This account needs to continue in order to clear the balance in it as at December 31, 2010. As discussed in Ex. D2-T2-S1 and Ex. F2-T2-S3, OPG intends to continue nuclear refurbishment activities over the next several years, and proceed with initiatives related to Pickering B continued operations. Potential variances in these projects will be recorded in the Capacity Refurbishment Variance Account.

OPG has proposed to recover financing costs associated with its Darlington Refurbishment project starting in the test period. The financing costs consist of a rate of return on capital applied to the projected capital expenditures. To the extent that actual expenditures differ from the forecast amounts included in approved payment amounts, OPG will record the variance in the Capacity Refurbishment Variance Account.

OPG is not currently planning to commence any refurbishment of its regulated hydroelectric facilities during the test period. Should OPG incur hydroelectric refurbishment costs for its regulated facilities, the costs will be recorded in a separate sub-account.

3.3.5 Nuclear Fuel Cost Variance Account

The OEB approved the establishment of this account in EB-2007-0905 in recognition of the fact that the primary driver of nuclear fuel costs is the commodity price of uranium which fluctuates for reasons beyond OPG's control and is difficult to predict. Using the methodology approved in EB-2007-0905, this account will record the difference between the nuclear fuel

costs included in the approved payment amounts and the actual nuclear fuel costs during the test period. This account needs to continue in order to clear the 2010 year-end balance and to record additions during the test period. As described in Ex. F2-T5-S1, uncertainty in factors such as the schedules for new uranium production, liquidation of additional inventories, and the pace of worldwide nuclear expansion are expected to result in price volatility and a range of potential market prices.

3.3.6 Bruce Lease Net Revenues Variance Account

The OEB ordered OPG to establish this account in EB-2007-0905 in order to ensure that OPG recovers its actual costs associated with the Bruce facilities and adjusts the regulated payment amounts by the actual revenues earned from the Bruce Lease. Certain components associated with the Bruce lease, such as earnings on nuclear segregated funds, are market driven and therefore difficult to predict. The earnings or losses on these funds can have a significant financial impact on OPG's operations. During the test period, this account would record the difference between the Bruce costs and revenues included in the approved payment amounts and the actual Bruce costs and Bruce lease revenues realized. This account needs to continue in order to clear the 2010 year-end balance and to record additions during the test period.

3.3.7 Nuclear Deferral and Variance Over/Under Recovery Variance Account

The OEB approved establishment of this account, effective as of April 1, 2008, in EB-2009-0174 to capture any over or under recovery of approved nuclear deferral and variance account balances. Since these balances are recovered through payment riders (i.e., nuclear payment riders A and C) that are calculated on a per MWh basis, differences between forecast and actual production during the test period, including the portion of the test period before the effective date of new payment amounts (proposed to be March 1, 2011)., will create a variance. Because OPG is proposing to recover the balances in its variance and deferral accounts through the use of payment riders, the Over/Under Recovery Variance Account needs to continue as explained above in section 3.2.2.

The OEB approved new payment amounts for OPG in December 2008, which were effective as of April 1, 2008. As a result, OPG had a revenue shortfall for the period April 1, 2008 to November 30, 2008. Rider C was established to allow OPG to recover nuclear payment rider A (for recovery of nuclear variance and deferral accounts) for this period. With the exception of interest and amortization, no additional amounts will be recorded in this account during the test period related to nuclear payment rider C.

4.0 NEW ACCOUNTS

OPG requests approval to establish two new variance accounts:

- the IESO Non-Energy Charges Variance Account; and
- the Pension and Other Post Employment Benefits Cost Variance Account.

4.1 IESO Non-Energy Charges Variance Account

IESO non-energy charges are applied to all load customers in the Ontario wholesale market. They are made up of a number of different components including; Uplift Charges, Debt Retirement Charges, Rural Rate Assistance, Transmission Charges, Global Adjustment, etc. For a detailed description of IESO non-energy charges, please refer to Ex. F4-T4-S1.

These charges are incurred by OPG to operate the regulated facilities and cannot be avoided (while maintaining the ability to operate) nor can the energy to which the charges are attached be supplied cost-effectively by an alternate source. Further, they are beyond management's ability to control.

These charges are difficult to forecast for two reasons. First, the charges fluctuate based on the changes in the wholesale market (Global Adjustment being the largest and most volatile of the components). Second, they are based on consumption which itself can fluctuate hour-to-hour, or month-to-month. As a result of these two factors, the total amount of IESO non-energy charges is very difficult to accurately forecast.

As seen in Ex. F4-T4-S2 Tables 1 and 2, variances associated with both nuclear and regulated hydroelectric facilities have been material and have occurred in both directions in

recent years. For example, in 2008 actual non-energy charges were under budget by 74 per cent or $7.9M for nuclear and 42 per cent or $1.8M for regulated hydroelectric. Conversely, 2009 saw actual charges exceed budget by 95 per cent or $17.6M for nuclear and 108 per cent or $6.6M for regulated hydroelectric**.** Further, the quantum of these charges has increased dramatically since 2007, largely driven by depressed market prices and a corresponding increase in Global Adjustment charges. A variance account for the total of IESO non-energy charges associated with both nuclear and regulated hydroelectric facilities will protect both OPG and ratepayers from over or under collection of these charges. Starting on the effective date of new payment amounts, proposed to be March 1, 2011, this account will record the difference between the IESO non-energy charges underpinning in the approved payment amounts and the actual IESO non-energy charges.

4.2 Pension and Other Post Employment Benefits Cost Variance Account

OPG requests approval to establish a new variance account to be called the Pension and Other Post Employment Benefits Cost Variance Account. This account would record the difference between the pension and other post employment benefits ("OPEB") costs reflected in OPG's approved payment amounts and the actual pension and OPEB costs for the prescribed facilities and associated tax impacts.

As discussed in EB-2007-0905, OPG's pension and OPEB costs are difficult to forecast and often result in variances that are material[1]. As indicated in the Impact Statement filed by OPG on September 30, 2010 (Ex. N-T1-S1, pages 2 to 4), the difference between the forecast included in this application for pension and OPEB costs and the updated projection of pension and OPEB costs is material (i.e., greater than $250M). This updated projection of pension and OPEB costs for the prescribed facilities is based on a projected actuarial accounting assessment of OPG-wide costs for the test period provided by OPG's external actuaries, Mercer, using data as of August 2010. The letter from Mercer setting out its updated OPG-wide projection is presented in Attachment 1 to this exhibit. This OPG-wide projection is then assigned to the prescribed facilities using the same methodology as was

[1] EB-2007-0905, Ex. J1-T3-S1, Page 13. Forecast variances of between $11M under-forecast and $130M over-forecast on a company-wide basis.

used in EB-2007-0905 and in this application. This methodology is described in Ex. F4-T3-S1, page 24, lines 4 through 27.

The main drivers of variance for pension and OPEB costs are discount rates and pension fund performance. These factors are both difficult to forecast and beyond OPG management's ability to control. As noted in pre-filed evidence at Ex. F4-T3-S1, pages 23 and 24, significant variability can occur between forecast and actual pension and OPEB costs due to changes in economic conditions, demographics and other actuarial assumptions used in determining these costs, as well as differences in actual experience, such as the return on pension fund assets.

In EB-2007-0905, OPG proposed a variance account to capture the financial impact of differences between forecast and actual discount rates used to determine pension and OPEB costs. The primary arguments against OPG's proposal in EB-2007-0905 were that "the Board should take the same approach for variances in OPG's pension and OPEB costs as it does for other entities regulated by the Board," and that OPG's focus on a single driver of pension and OPEB cost changes (i.e., the discount rate) without considering potential offsetting factors "amount[s] to single issue ratemaking.[2]" Although it rejected OPG's proposal in EB-2007-0905, the OEB noted that, "In the event that OPG's actual pension and OPEB costs during the test period are materially in excess of the amounts included in the revenue requirement, OPG would have the ability to apply to the Board.[3]" The currently forecast variance in these costs is in excess of $250M, as presented in Ex. N-T1-S1; an amount which is material.

In addition, on April 9, 2010 the OEB issued its Decision with Reasons in EB-2009-0096 which included approval of a Pension Cost Differential Account for Hydro One Networks Inc. "to track the difference between the actual pension costs booked using the actuarial assessment provided by Mercer, and the estimated pension costs used in this filing.[4]"

[2] EB-2007-0905 Decision with Reasons, November 3, 2008, page 125.
[3] Ibid. page 127.
[4] EB-2009-0096 Decision with Reasons, April 9, 2010, page 56.

In light of the OEB's findings in EB-2007-0905 and EB-2009-0096, OPG is proposing to establish an account to track, for its prescribed facilities, the difference between the actual pension and OPEB costs booked using the actuarial accounting assessments provided by OPG's external actuaries, and the forecast of pension and OPEB costs included in the OEB-approved payment amounts.

In addition to the differences between forecast and actual pension and OPEB costs, there is expected to be a difference between forecast and actual regulatory tax deductions for pension plan contributions and OPEB benefit payments. As OPG expects its pension plan contributions to be higher than those included in the application, capturing this difference in regulatory tax deductions in this account will partly offset the expected increase in pension and OPEB costs. (The portion of the forecast contributions and benefit payments attributable to the prescribed facilities per the May 26, 2010 filing is shown in response to interrogatory L-01-085.) Accordingly, OPG proposes that the proposed Pension and Other Post Employment Benefits Cost Variance Account also record the difference in the regulatory tax expense resulting from the difference in pension plan contributions and OPEB benefit payments included in determining the tax expense for the prescribed facilities in the OEB-approved payment amounts and the portion of actual pension plan contributions and OPEB benefit payments attributable to the prescribed facilities made by OPG.

OPG proposes to apply interest to the monthly opening balances of the account at the interest rates set by the OEB from time to time pursuant to the OEB's interest rate policy for variance and deferral accounts.

The proposed variance account is symmetrical and would apply equally to positive and negative variances and will result in payment amounts that are more accurate and fair to both OPG and ratepayers.

LIST OF ATTACHMENTS

Attachment 1: Letter from Mercer dated October 8, 2010 re: Projected Pension and Non-Pension Benefit Expense for Fiscal Years 2011 and 2012.