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July 31, 2015

via RESS e-filing – signed original to follow by courier

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
PO Box 2319
2300 Yonge Street, 27th floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs
OEB File No. EB-2015-0040

Toronto Hydro-Electric System Limited ("Toronto Hydro") writes to the Ontario Energy Board ("OEB") in respect of the above-noted matter.

In response to the OEB's stakeholder consultation letter dated May 14, 2015, enclosed please find Toronto Hydro's responses to the questions posed by the OEB.

Please contact me if you have any questions.

Yours truly,

[original signed by]

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A. Background and Summary of Position

By letter dated May 14, 2015 ("May 14 Letter"), the Ontario Energy Board (the "Board") invited stakeholders, including Toronto Hydro-Electric System Limited ("Toronto Hydro"), to make submissions in respect of the regulatory treatment of pensions and other post-employment benefit ("OPEB") costs. The stated objectives of the consultation are:

1. To develop standard principles to guide the Board's review of pension and OPEB costs at future applications;

2. To establish specific information filing requirements for applications; and

3. To establish appropriate regulatory mechanisms for cost recovery which can be applied consistently across the gas and electricity sectors.

Toronto Hydro submits that a standard approach to pension and OPEB costs is not necessary. There are substantial differences in pension and OPEB plans across the electricity and gas sectors and utilities use different accounting standards for different reasons. An approach that works well for one utility may have unintended but significant cost consequences for another, resulting in an unnecessary impact on rates. A case-by-case approach is more appropriate because it will allow the Board the flexibility to address specific areas of concern without requiring a heightened level of oversight of utilities that are financially sound and are able to demonstrate the reasonableness of their current and forecasted expenditures. For these reasons and the reasons set out below, Toronto Hydro submits that the recovery of pension and OPEB costs should be determined on a case-by-case basis with regard to the following points:

1. Reasonable costs should be recovered through rates. Reasonableness should be assessed on a case-by-case basis because different utilities have different cost drivers;

2. The accounting method adopted by a utility for financial reporting purposes should be used for the recovery of pension and OPEB costs except where it leads to inconsistencies with sound rate-making principles; and

3. An assessment of whether a utility's financial accounting method leads to inconsistencies with sound rate-making principles should be performed on a case-by-case basis.

Toronto Hydro has had the benefit of reviewing the draft submissions of a number of other utilities including Enbridge Gas Distribution Inc., Union Gas Limited and the Coalition of Large Distributors and notes that there is a high degree of alignment between Toronto Hydro's position and those of these other utilities.

B. THE IMPACT OF A CHANGE IN BOARD POLICY

Toronto Hydro and its eligible employees participate in a pension plan through OMERS. Under the OMERS pension plan, Toronto Hydro and its eligible employees are required to make equal plan contributions based on employees' eligible contributory earnings. Thereafter, OMERS is responsible for making pension payments to retirees. Toronto Hydro also provides OPEBs to eligible employees. In each of its past rate applications, the Board has approved recovery of Toronto Hydro's pension and OPEB costs as reasonable costs.

Toronto Hydro recognizes the expense related to its OMERS pension plan on an accrual basis as contributions are made. Toronto Hydro recognizes OPEB costs on an accrual basis in the period in which employees render services. In each of its past rate applications, pension and OPEB costs have been included in rates on an accrual basis.

The consequences to Toronto Hydro of transitioning OPEBs to the pay-as-you-go method or continuing with the accrual method but with the added requirement that the cash in advance be set aside in a trust are potentially significant. They are discussed in detail below and may be summarized as follows:

- Pay-as-you-go: Changing the recovery of OPEB costs from accrual to pay-as-you-go will likely result in the immediate write-off of an existing regulatory asset, which will be detrimental to Toronto Hydro's debt-to-equity ratio and may result in a higher cost of borrowing.

- Accrual method with the imposition of a trust: If the accrual basis of recovery is maintained for OPEBs, but advanced collections from ratepayers are set aside in a trust, Toronto Hydro will be required to issue additional debt to finance some of its current capital and operating expenditures.

Cost of the additional financing costs associated with the borrowing and administration costs of the trust will outweigh any benefit of investment income on invested funds, and will consequently be more costly to ratepayers.

Toronto Hydro submits that the Board must mitigate these impacts by establishing the deferral and variance accounts described in response to question 7.

C. Due Process through a Generic Proceeding and Rate Applications

The accounting and recovery of pension and OPEB costs is complex and any changes to Board policy will likely significantly and adversely affect utilities and their customers, as described in this submission. Before implementing any changes, the Board should conduct a careful review the costs, benefits and consequences of a change in policy, with particular regard to the circumstances of individual utilities and their customers.

Toronto Hydro respectfully submits that, given the complexity of the issues and the potentially significant and serious impact of a change in policy, a generic proceeding is the most appropriate procedure to test the issues and assess the consequences of a change in policy.

Moreover, following a generic proceeding and any establishment of a general policy framework, Toronto Hydro further submits that the applying the policy framework to individual utilities must occur on a case-by-case basis during rate applications. The adjudicative panel hearing the rate application must retain the discretion to depart from the policy framework where appropriate in order to ensure that the costs and other adverse effects are outweighed by the benefits to the utility and its customers.

GENERAL PRINCIPLES

1. What principles should the OEB adopt in addressing pension and OPEB issues? Potential issues include: consistency across the gas and electricity sectors; intergenerational equity; financial protection for future ratepayers; ensuring the most efficient level of costs for ratepayers; stable cost levels; pension costs which are comparable as measured by other benchmarks, etc.

Pension and OPEB costs should be recovered if the costs are reasonable. Costs should be assessed on a case-by-case basis which takes into account all relevant factors including those described in response to question 4, below.

The method used to recover pension and OPEB costs should be consistent with accounting for financial reporting except where it would lead to inconsistencies with sound rate-making principles.[1] Sound rate-making principles that should be adopted in addressing pension and OPEB issues include intergenerational equity and stable cost levels. The application of these principles may result in different analysis and outcomes for different Board-regulated entities, depending on the facts and circumstances applicable to the entity under review. Toronto Hydro submits that these principles, which are described below, be applied on a case-by-case basis.

1.1. Intergenerational Equity

The principle of intergenerational equity provides that ratepayers in a given period should pay only the costs necessary to provide them with service in that period. The accrual basis of accounting is consistent with the principle of intergenerational equity because it results in the recovery of pension and OPEB costs in the same period in which employees provide the service.

Generally accepted accounting standards require that pension and OPEB costs be recorded using the accrual method. This reflects the true cost of doing business in the appropriate fiscal year and is, as a consequence, consistent with the principle of intergenerational equity. The accrual method permits

[1] Report of the Board (EB-2008-0408) at p. 7 and Accounting Procedures Handbook, December 2011, Article 315, p. 5. This principle is discussed in greater detail in response to question 5 c)

utilities to match the revenues earned with the cost of delivering electricity in current and future periods. In other words, ratepayers who receive electricity service today pay their fair share of the associated pension and OPEB entitlements earned by the employees providing them with the service.

The application of the pay-as-you-go, or cash recovery method, results in intergenerational inequity because it burdens future ratepayers with employee benefit costs that relate to today's workforce and the cost of today's electricity. The magnitude of the potential inequity to future ratepayers under the pay-as-you-go basis of recovery is impacted by increases or decreases to head count, the age demographic of employees and retirees, changes in level of benefits and the effect of grandfathered benefits, the ratio of retirees to current employees, and changes to Provincial health coverage and the impact on benefits.

1.2. Stable Cost Levels

Rates should remain stable to the extent practicable, such that potential volatility or temporary fluctuations are avoided. Recovering OPEB costs under the accrual method may be less volatile because the accrual method is a proration method that smoothes out cost recognition of future benefits over the working lives of employees. Regular actuarial valuations underlying the accrual method are intended to reflect emerging experience over time.[2]

Year-over-year cash costs for OPEBs are more sensitive to variables such as annual health care and dental care cost increases (benefit cost inflation), survivorship (number of terminations/retirements, life expectancy), and in particular, the health status of retirees in any given year. Any volatility in actual experience will be immediately apparent in the cash cost for the given year.

[2] Under IFRS, actuarial gains or losses are recognized in other comprehensive income – this takes potential volatility due to changes in assumptions out of net income. The actuarial gains or losses are recorded to a regulatory account for future disposition – this is discussed in response 6b) and 7a).

1.3. Efficient Costs for Ratepayers

In this case, neither the pay-as-you-go or accrual basis provide for more efficient costs, relative to the other, over the long term. The cost for one employee will theoretically be the same whether accounted for on a cash or accrual basis.

1.4. Consistency across the Gas and Electricity Sectors

There is currently no consistency among utilities in the use of either cash or accrual method for rate recovery of pension and OPEB costs.[3] Toronto Hydro submits that no benefits arise from adopting a standardized approach across the electricity sector, let alone across both the gas and electricity sectors. Toronto Hydro agrees with the position taken by the Board during the transition from generally accepted accounting principles ("GAAP") to IFRS, where the Board declined to adopt a standardized approach, noting instead that issues relating to pension and OPEB were not the same for all distributors.[4] A case-by-case approach will allow the Board to address specific areas of concern without having to heighten its oversight of all pension and OPEB plans or impose unnecessarily conservative limits on regulated entities with sufficiently funded plans.

2. Are there other types of costs previously considered by the OEB that provide suitable analogies for the consideration of pension and OPEB issues? (for example: deferred taxes; asset retirement obligations; site restoration costs)

The pension and OPEB issues being considered by the Board should be resolved by reference to the principles described in response to question 1 above. Analogous situations may be instructive but do not replace the application of those principles. In this instance, asset retirement obligations and capital expenditures provide suitable analogies to the treatment of pensions and OPEBs insofar as the determination of revenue requirement, and thus rate-recovery, follows the accrual basis of accounting.

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[3] EB-2013-0321, Decision with Reasons (November 20, 2014) at p. 85

[4] EB-2008-0408, Report of the Board Transition to International Financial Reporting Standards at pages 23-24, available online at http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2008-0408/IFRS_Board_Report_20090728.pdf

Costs of capital expenditures and asset retirement obligations are recovered in rates through depreciation expense over the service life of the asset even though the actual cash expenditure is incurred at a different date. This reflects the usage of the asset in distributing electricity to earn revenues. Similarly, the accrual method of recovering pension and OPEB costs allocates the true cost of electricity to the ratepayers that consume it and avoids the intergenerational issues that arise when costs are recovered on a pay-as-you-go basis.

Deferred taxes do not provide an appropriate analogy to pension and OPEB costs. Deferred taxes represent future income tax benefits to be recognized over time, whereas pension and OPEB costs are current period employee costs that should be recognized in the period in which services are rendered.

INFORMATION REQUIREMENTS

3. Should the applicants be required to compare their pension and OPEB costs to industry norms and/or other benchmarks? (Note: It is the OEB's expectation that the next phase of the consultation will consider the development of a complete set of new or incremental information that should be filed in applications seeking cost recovery for pensions and OPEBs).

Under previous regulatory frameworks, cost justification was done at a granular level and a review of pension and OPEBs as stand-alone costs would have been appropriate. Under the current regulatory framework, benchmarking tends to occur at a much higher level of spending. A return to a granular level of cost review is not consistent with the direction of the current regulatory framework.

If the Board determines that pension and OPEB costs are significant enough to merit a stand-alone review, Toronto Hydro submits that the review should be performed on a case-by-case basis which considers a utility's specific cost drivers, described in response to question 4. This review may include the use of comparators provided the comparators are relevant. A comparator may provide imprecise results and have limited value if it does not share similar characteristics to the utility under review.[5] If

[5] EB-2013-0416/EB-2014-247, Enbridge Decision (March 12, 2015) at pages 24 to 25

a proposed comparator is distinguishable, it should not form part of the basis for an assessment of reasonable costs.

4. What other relevant information should the Board evaluate in order to effectively assess the pension and OPEB costs that a rate-regulated entity is seeking to be included in the rates charged to customers?

In determining whether pension and OPEB costs are reasonable, Toronto Hydro submits that the Board should consider the following information:

1) The actuarial report that describes the plan

2) Costs of a comparator company, provided it is relevant. A proposed comparator may be relevant if it shares the following characteristics with the company under review:

    - The size of the company and its service area

    - The scope of services provided by the company

    - Composition of the company’s workforce is unionized, non-unionized or outsourced

    - The structure of the pension or OPEB plan

3) The need to attract and retain specialized labour

4) The entire compensation package including salary levels and pension contribution ratios

5) The cost of living and compensation levels in a particular city

6) The sustainability and affordability of the pension or OPEB plans

7) Existing agreements including binding settlements with unionized members of the workforce

8) Other relevant information, including any relevant determinations arising from the Supreme Court of Canada's forthcoming decision in respect of the prudent investment test [6].

ACCOUNTING AND RECOVERY IN RATES

5.

a) Should the OEB establish accounting and recovery methods for both the electricity and gas sectors?

Toronto Hydro submits that the Board should not establish a standard accounting and recovery method for all Board-regulated entities. The accounting and recovery of pension and OPEB costs should be determined on a case-by-case basis. A standardized approach will likely have unintended negative consequences for certain Board-regulated entities which will likely impact ratepayers.

b) What criteria should be considered to determine the appropriate approach?

Toronto Hydro submits that the Board should consider the potentially significant costs associated with a transition to a standard accounting and recovery method. If the Board prescribes a standard approach, Toronto Hydro submits that the method used to recover pension and OPEB costs should be consistent with accounting for financial reporting except where it would lead to inconsistencies with sound rate-making principles.[7] Such inconsistencies should be identified and assessed on a case-by-case basis. If the Board decides to standardize the accounting and recovery methods for all Board-regulated entities, the rate-making principles addressed in response to question 1 should be considered in selecting an appropriate method.

[6] SCC Docket No. 35506, *Ontario Energy Board v. Ontario Power Generation Inc., et al.* (heard by the SCC on December 3, 2014). The Supreme Court of Canada (SCC) recently heard argument in respect of the prudent investment test as applied to compensation costs, including pensions. In light of the SCC's forthcoming decision, Toronto Hydro reserves its right to make further submissions if the decision provides guidance relevant to this consultation.

[7] Report of the Board (EB-2008-0408) at p. 7 and Accounting Procedures Handbook, December 2011, Article 315, p. 5.

c) If one method is adopted, what should it be: cash (pay-as-you-go) basis, funding contribution basis, accrual (accounting cost) basis or another method? (please provide details)

- "Pay-as-you-go" cash payment: is equal to the benefit payment to the plan beneficiaries, as specified by the terms of the plan

- Funding contribution: the minimum amount of contribution required to be made by a sponsor of a registered pension plan that is subject to the requirements of pension legislation in Ontario under the Pension Benefits Act, Ontario (PBA), and related rules and regulations

- Accounting cost: this is the accrued cost determined by accounting rules (in accordance with a given accounting framework) and recognized and reported in general purpose financial statements (ultimately split between capital expenditures and operating expenditures)

Toronto Hydro submits that the Board should adopt the accrual (accounting cost) method if it decides to standardize the accounting method for all Board-regulated entities. Board policy is that regulatory accounting should be consistent with accounting for financial reporting by utilities, except where such consistency would prevent the setting of just and reasonable rates.[8] The Report of the Board on the Transition to International Financial Reporting Standards[9] states that the regulatory accounting method should generally be the same as the financial accounting method because:

- large differences between financial and regulatory accounting result in increased administrative costs to utilities and their ratepayers;[10] and

- new regulatory accounting requirements will be "aligned with IFRS requirements as long as that alignment is not inconsistent with sound regulatory rate making principles".[11] This

[8] Accounting Procedures Handbook, December 2011, Article 315, p. 5
[9] EB-2008-0408, Report of the Board, Transition to International Financial Reporting Standards dated July 28, 2009
[10] Report of the Board (EB-2008-0408) at p. 8
[11] Report of the Board (EB-2008-0408) at p. 7

> principle was seen as establishing IFRS as the "default" accounting system for regulatory purposes.[12]

In this instance, an accrual method of recovery is consistent with financial accounting standards and the guiding principles of intergenerational equity and stable costs, and results in administrative simplicity and cost savings.

For these reasons pension and OPEB costs should also be recovered on an accrual basis because this approach best reflects the cost of service that employees have rendered to distribute electricity to ratepayers benefitting from their service.

d) Should the method for recovering costs relating to registered pension plans be different from that used for unregistered pension plans and OPEB plans?

Toronto Hydro submits that there should not be a difference in the method for recovering costs related to registered pension plans on the one hand, and unregistered pension plans and OPEB plans on the other, should the Board decide to standardize the method for recovering pension and OPEB costs.

If the Board approaches pension and OPEB costs on a case-by-case basis, it will have greater flexibility to require different treatment between registered and unregistered plans as necessary.

[12] Report of the Board (EB-2008-0408) at p. 7

6.

a) Should the OEB take into account impacts on financial reporting (US GAAP, ASPE and IFRS) legal, and tax matters.

Toronto Hydro submits that the Board should take into account the impacts of any change in policy on financial reporting, legal and tax matters, as described below, should the Board decide to standardize the method for recovering pension and OPEB costs.

b) If so, what are the issues that should be considered when determining the appropriate approach?

Toronto Hydro submits that the Board should consider the reasonableness of costs, the financial accounting standard adopted by the company and sound rate-making principles when determining the appropriate accounting and recovery methods for pension and OPEB costs.

The contribution ratio under the OMERS plan is 50/50. Toronto Hydro respectfully submits that its pension costs are reasonable and should be recovered through rates on an accrual basis consistent with IFRS and the principle of intergenerational equity. For similar reasons, Toronto Hydro's OPEB costs are reasonable and should be recovered on an accrual basis. For the reasons set out below, if OPEB costs are recovered under a pay-as-you-go recovery scheme instead of on an accrual basis, the result is inconsistent with sound rate-making principles.

6.1. Impact on Financial Reporting

The impact on financial reporting for OPEBs will depend upon the approach selected by the Board for the respective utilities.

6.1.1. Pay-as-you-go – Cash basis

If the Board prescribes a pay-as-you-go recovery scheme, Toronto Hydro and entities similar to it will likely be required to write-off their regulatory OPEB assets or liabilities related to actuarial gains and losses.

IFRS requires that Toronto Hydro follow US GAAP[13] and ASC 980-715-25-4 in respect of the recognition of regulatory OPEB assets or liabilities. ASC 980-715-25-4 specifically provides that OPEB costs "shall not be recorded if the regulator continues to include other postretirement benefit costs in rates on a pay-as-you-go basis".[14] In other words, if the Board prescribes a pay-as-you-go recovery scheme, IFRS will require actuarial gains or losses to be recognized in other comprehensive income with no subsequent reclassification to net income, which will likely result in the regulatory asset being written off. Unless the Board takes steps to mitigate the effects of the write-off, it could have a significant impact on regulated entities, including immediately reducing equity and negatively impacting return on equity and debt-to-equity ratios. A negative change in capital structure can adversely affect an entity's credit profile and consequently reduce an entity's borrowing flexibility, increasing financing costs to the detriment of ratepayers.

Future recognition of actuarial gains and losses will also be affected by a transition to a pay-as-you-go recovery scheme. Regulated entities will no longer be able to defer actuarial gains or losses to a regulatory account. This will create volatility to an entity's equity balance and make it difficult to manage returns on equity and debt-to-equity ratios. If the Board prescribes a pay-as-you-go recovery scheme, it must implement a mechanism to ensure that actuarial gains and losses under IFRS are recovered through rates, as also required under the accrual method. This is further discussed in 7a).

Since a cash-basis of accounting is not permitted under US GAAP or IFRS, the recovery of OPEB costs on a pay-as-you-go basis will require regulated entities to track the difference between what has been recovered on a pay-as-you-go basis versus what has been recognized on an accrual basis for financial reporting. Regulated entities will therefore bear the cost and administrative burden of having to maintain two sets of records (regulatory versus financial reporting) for detailed OPEB tracking. Under an accrual recovery scheme, utilities will not be required to manage two sets of records.

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[13] IFRS 14 *Regulatory deferral accounts* ("IFRS 14") specifically requires that Toronto Hydro "continue to apply its previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral balances…" Toronto Hydro therefore follows US GAAP for the recognition of regulatory assets and liabilities as well as the guidance in ASC 980-715-25-4

[14] ASC 980-715-25-4

6.1.2. Accrual – Accounting cost

Entities applying IFRS and recovering OPEB costs on an accrual basis (which only recovers amounts expensed in net income) are exposed to potential permanent differences between costs and recovery relating to the actuarial gains and losses recorded in other comprehensive income. Toronto Hydro submits that if an accrual recovery scheme is adopted, the Board must authorize a regulatory account to recognize actuarial gains or losses that will be recovered through rates in future periods.

6.2. Tax Impacts

The tax implications of recovering OPEB costs on an accrual versus pay-as-you-go basis are not significant. Under either approach, for tax purposes, OPEB costs will be deductible as payments are made to beneficiaries. Any change in the manner of recovery, however, will directly impact the revenues reported, and thus impact cash taxes payable.

6.3. Legal Issues

If regulated entities have to write off existing regulatory assets as a result of a transition to a pay-as-you-go recovery scheme, Toronto Hydro submits that the Board must address the resulting impacts on financial covenants and debt agreements so that a change in Board policy does not negatively impact regulated entities.

c) For comparative analysis, how should the OEB address differences that arise from (driven by) the basis of accounting that is used by a rate-regulated utility? For example, the treatment of re-measurements under IFRS is different to their treatment under US GAAP and ASPE.

OPEB plan costs will remain the same irrespective of the accounting framework selected. Although measurement differences may arise under the different accounting frameworks, the Board should ensure that total OPEB costs are recovered by utilities in the manner described in 6b) and 7a).

7.

a) Would it be appropriate to establish a deferral or variance account(s) in association with the approaches discussed above in numbers 5) and 6) respectively?

Toronto Hydro respectfully submits that the Board must establish deferral or variance accounts in association with each of the approaches described in numbers 5) and 6) to ensure that Toronto Hydro is not harmed by any changes in Board policy. Specifically, the regulatory accounts described below will be required to address the Board's treatment of OPEB costs.

7.1. Pay-as-you-go – Cash basis

If the Board prescribes a pay-as-you-go recovery scheme, three regulatory accounts will be required to address the impacts of the change in Board policy on regulated entities. These are:

1) OPEB Accrual versus Cash Recovery Deferral Account;

2) OPEB Variance Account; and

3) Transition & Administration Costs Deferral Account.

7.1.1. OPEB Accrual versus Cash Recovery Deferral Account

If the Board prescribes a pay-as-you-go recovery scheme, Toronto Hydro will likely be required to write-off its OPEB regulatory asset. To address the consequences that follow from the write-off, Toronto Hydro submits that the Board must:

- authorize a deferral account to capture differences between amounts expensed for accounting purposes and cash recovered from ratepayers;
- allow for the subsequent disposition of the deferral account; and
- allow the balance of the deferral account to be periodically cleared through future rates so that regulated entities are able to recover the accrual-to-cash differences.

This account is similar to the account proposed and implemented in EB-2013-0321, and must go beyond a mere tracking account so that the regulatory asset can be recognized for financial accounting purposes.

7.1.2. OPEB Variance Account

If the Board prescribes a pay-as-you-go recovery scheme, Toronto Hydro submits that a variance account must be established to record the difference between actual cash benefit payments to beneficiaries and the forecasted benefit payments used in calculating rates. Cash benefit payments to beneficiaries can vary significantly based on the health status of beneficiaries, survivorship, etc. A variance account will ensure that any significant differences between forecast and actual expenditures are recovered. This account is not necessary if the Board prescribes an accrual basis of recovery because it generally results in stable current service costs being recognized in net income.[15]

7.1.3. Transition & Administration Costs Deferral Account

If the Board prescribes a pay-as-you-go recovery scheme, Toronto Hydro submits that the Board must establish a deferral account to capture costs associated with the change in policy including the costs of external experts engaged to address the change in policy.

The timing and manner of disposition of each of these regulatory accounts should be determined on a case-by-case basis taking into account the nature and the materiality of the balance. Formal disposition of the recommended regulatory accounts will be required.

7.2. Accrual – Accounting cost

If the Board retains the accrual basis of recovery of OPEB costs, two regulatory accounts will be required.

[15] Volatility in OPEB costs typically arises when the OPEB liability is re-measured, which results in an actuarial gain or loss being recognized to other comprehensive income. Under the accrual basis of recovery, actuarial gains or losses are deferred to a regulatory account for disposition over a reasonable period.

7.2.1. OPEB IFRS Accounting Deferral Account

A regulatory account will be required to record actuarial gains and losses recognized in other comprehensive income for entities that report in accordance with IFRS and US GAAP. The regulatory account will ensure that regulated entities are able to recoup the same amount of OPEB costs had they reported under previous GAAPs. Because the actuarial gains or losses relate to the re-measurement of the OPEB liability, Toronto Hydro submits that the disposition of this account should be made on a case-by-case basis in relation to the magnitude of the balance. While expected average remaining service lifetime[16] ("EARSL") may be a reasonable time period in certain instances, the Board must account for the guidance in ASC 980-715-25-5 that amounts with a recovery period greater than 20 years may be ineligible for recognition as a regulatory asset.

7.2.2. Transition & Administration Costs Deferral Account

If the Board prescribes an accrual recovery scheme and in addition, requires that cash collected in advance of payment be set aside, Toronto Hydro submits that the Board must establish a Transition and Administration Costs Deferral Account similar to the account described in the preceding section titled "Pay-as-you-go – Cash method", so that Toronto Hydro may recover its costs associated with the new policy.

b) How should the account(s) operate?

Please refer to response 7 a).

c) Should interest be applied to the accounts(s), and if so, why?

Interest should only be applied to a deferral or variance account if the balance represents a timing difference between when cash is recovered from ratepayers and when the utility expends cash on the underlying cost.

[16] The EARSL reflects the average remaining service period of active employees expected to receive OPEBs and therefore would allow recognition of the over/under collected amount over the service period of the employees to which it relates.

Interest should not be applied to deferral and variance accounts that capture the differences between how pension and OPEB costs are recovered from ratepayers and how they are expensed for financial reporting purposes because the balance in the account does not represent a difference in the timing of cash recovery and cash expenditure.

d) How should the transition from the current practice to the new method of recovery be addressed?

(i) Should the transition by phased-in, applied retrospectively with catch-up adjustments for prior period, prospectively with no adjustments for prior periods or a combination of any of these methods?

(ii) Should a generic approach be used or should the transition be addressed on a case-by-case basis?

If the Board prescribes a particular recovery method, the change from the current practice to the new method of recovery should be phased-in to coincide with rebasing. The transition to a new recovery method should be addressed on a case-by-case basis, taking materiality into consideration.

If the Board prescribes a pay-as-you-go approach but does not establish the requested OPEB Accrual versus Cash Recovery Deferral Account, a phased-in historic reconciliation with catch-up adjustments would be required despite the principle against retroactive rate-making, because a prospective transition with no adjustments for prior periods may result in a permanent over or under-recovery of pension and OPEB costs from ratepayers. In other words, the OPEB Accrual versus Cash Recovery Deferral Account is required to ensure that OPEB costs previously recovered under the accrual method are not recovered again under the pay-as-you-go method.

8.

a) Would it be appropriate to establish some form of segregated fund of similar set-aside mechanism for amounts which are collected from ratepayers before they are paid out?

Toronto Hydro respectfully submits that a segregated fund to set-aside amounts collected from ratepayers before they are paid to beneficiaries is not necessary where a regulated entity demonstrates that its current and forecasted expenditures are reasonable and it is financially sound. A segregated fund represents an unnecessarily conservative measure that does not provide a corresponding benefit to ratepayers and may in fact impose additional and unnecessary cost on ratepayers.

When funds are collected in advance, to the extent that they are not used for benefit payments, they are prudently re-directed to other capital and operational expenditures. If Toronto Hydro was required to set-aside or restrict cash collected in advance related to its OPEB plan, it would be required to fund this cash shortfall by issuing debt. The finance costs of issuing debt at Toronto Hydro's weighted average cost of debt of 4.31%,[17] are far in excess of any return that would be earned on segregated funds at a risk-free rate (approximately 1%). In this situation, setting aside these funds would not benefit ratepayers because it would drive up the cost of distributing electricity.

If the Board implements a set-aside mechanism, Toronto Hydro submits that this should be prescribed on a case-by-case basis.

b) What tax, legal, accounting or other issues arise?

The discussion below focuses on the tax, accounting and administrative issues that arise related to the imposition of a trust to set aside cash collected from ratepayers.

8.1. Tax Issues Associated with the Imposition of a Set-Aside Mechanism

The tax implications associated with a set-aside mechanism depend on the type and structure of the mechanism. To Toronto Hydro's knowledge, there are three types of trust that could be established for the purposes of delivering health and group life insurance benefits. These are: (1) Health and Welfare Trust ("HWT"); (2) Employee Life and Health Trust ("ELHT"); and (3) Retirement Compensation Arrangement ("RCA"). While there are limited tax benefits associated with HWTs, ELHTs and RCAs, these are modest and may not be offset by the costs described in the Accounting and Administration of the Trust section below.

[17] As of April 20, 2015, as filed in Reply Argument for Toronto Hydro's CIR Application 2015-2019, EB-2014-0116.

8.1.1. Accounting and Administration of the Set-Aside Mechanisms

Investment income earned from any of the potential structures may be entirely offset by significant administrative costs, opportunity costs and tax costs. Accounting and administrative consequences associated with the set-up and administration of an HWT, ELHT or RCA are described below.

8.1.2. Governance and Investment Management Risk

Setting up a trust, whether an HWT, ELHT or RCA, requires thorough compliance with complex rules set out in the *Income Tax Act (“Canada”)* and its associated regulations. Failure to comply with these rules can result in significant negative tax consequences. Expenses incurred in setting up the trust, including the cost of engaging external experts, could be in the hundreds of thousands of dollars for each Board-regulated entity. These costs will be passed on to ratepayers.

An HWT, ELHT or an RCA must be managed by an independent board (the “Trust Board”). Trust Board members must accept responsibility for managing the trust and will require a certain requisite level of investment training and knowledge as well as legal expertise. While the Trust Board will provide general direction for the administration of the investments within the Trust, it will be necessary to engage staff or external consultants to administer the fund. Utilities do not typically have this type of in-house knowledge and most if not all Board-regulated entities will need to engage an investment manager. The Trust Board will also have to engage tax advisors and actuaries to assist with the administration of the Trust, auditors to opine on the Trust’s financial statements, and a financial institution to act as custodian of the Trust. Expenses incurred in administering the trust will be significant and these costs will be passed on to ratepayers.

The set-up and administration of a trust for estimated OPEB amounts “collected from ratepayers before they are paid out” will likely be quite complicated from a legal and practical perspective. Toronto Hydro submits that the form and operation of any potential set-aside mechanism be explored at the generic hearing of this matter.

8.1.3. Consequences of Additional Financing

As previously noted, amounts collected in advance from ratepayers are used to finance an entity's development of capital infrastructure and current operations. If entities are required to set these funds aside, capital infrastructure and operations may have to be financed through the issuance (or incurrence) of debt. This more expensive financing (as noted in 8 a) may outweigh any benefits of investing the funds in the trust. Additional debt on the financial statements will have a negative impact to debt-to-equity ratios and may negatively impact credit ratings.

8.1.4. Separate Trust Financial Reporting and Audit Requirements

Entities would be required to maintain separate financial records for the trust, which will likely require a stand-alone audit resulting in additional costs and an increase in rates.

As illustrated above, the tax, accounting and administrative costs associated with setting up and administering an HWT, ELHT or RCA are significant. The cost associated with these trust structures offset the perceived intended benefit of the trust and to the detriment of ratepayers.

c) How should the transition to the new practice be addressed?

(i) Should the transition be phased-in, applied retrospectively with catch-up adjustments for amounts collected from ratepayers to date but not yet paid out, prospectively with no adjustments for prior periods or a combination of any of these methods?

Toronto Hydro believes that prospective application will be more appropriate as utilities will have to adjust their cash management policies to address this new fund requirement.

(ii) Should a generic approach be used or should the transition be addressed on a case-by-case basis?

The transition should be addressed on a case-by-case basis, considering the magnitude of the balance and the specific environment in which every utility operates.

9. What information should the utilities report and how frequently should it be reported?

Under either the cash or accrual approach, the information listed in response to question 4 may be reported as part of future rate applications.

Forward-Looking Information

This document contains forward-looking information within the meaning of applicable securities laws in Canada. The purpose of the forward-looking information is to provide the Board with management's expectations relating to the Board's decision regarding the regulatory treatment of pensions and OPEB costs and may not be appropriate for other purposes. All forward-looking information is given pursuant to the "safe harbour" provisions of applicable Canadian securities legislation. The words "aims", "believes", "can", "committed", "could", "estimates", "expected", "focus", "forecast", "may", "plans", "seek", "should", "strives", "will", "would" and similar expressions are often intended to identify forward-looking information, although not all forward-looking information contains these identifying words. The forward-looking information reflects management's current beliefs and is based on information currently available to Toronto Hydro's management.

The forward-looking information herein includes, but is not limited to, statements regarding the expectation that the Board will continue to approve pension and OPEB costs as reasonable costs, the anticipated consequences, direct and indirect, of the Board's policy decision regarding the permitted recovery basis of pension and OPEB costs, the anticipated costs of complying, and accounting-related and other administrative changes required to comply, with the permitted recovery basis of pension and OPEB costs, and the expectation that pension and OPEB costs will theoretically be the same whether accounted for on a cash or accrual basis. The statements that make up the forward-looking information are based on assumptions that include, but are not limited to, the accounting and recovery methods for pension and OPEB costs.

The forward-looking information is subject to risks, uncertainties and other factors that could cause actual results to differ materially from historical results or results anticipated by the forward-looking information. The factors which could cause results or events to differ from current expectations include, but are not limited to, the timing and extent of changes in the permitted recovery basis of pension and OPEB costs, any material changes to the Board's plans, market condition that impact cost of borrowing and accounting and tax-related developments that could affect the treatment of pension and OPEB costs.

All forward-looking information herein is qualified in its entirety by the above cautionary statements and, except as required by law, Toronto Hydro undertakes no obligation to revise or update any forward-looking information as a result of new information, future events or otherwise after the date hereof.