ONTARIO POWER GENERATION

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VIA RESS AND COURIER

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
2300 Yonge Street, Suite 2700
Toronto, Ontario
M4P 1E4

Dear Ms. Walli:

Re: Initial Written Submissions on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs (EB-2015-0040)

On May 14, 2015, the Ontario Energy Board ("OEB") issued a letter announcing a consultation on utility pensions and other post-employment benefits (OPEBs) in the electricity and natural gas sectors. Included in this letter was a list of questions designed to elicit initial views on issues of interest to the OEB.

Please find attached three (3) paper copies of Ontario Power Generation Inc.'s ("OPG"s") initial written submissions. OPG is also filing these submissions on the Regulatory Electronic Submission System ("RESS").

Please contact me if you have any questions with this submission.

Yours sincerely,

"original signed by:"

Randy Pugh

CC: Andrew Barrett, OPG
Lindsey Arseneau, OPG
Charles Keizer, Torys
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OEB Question #1

Issue: General Principles

What principles should the OEB adopt in addressing pension and OPEB issues? Potential principles 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.

Response

OPG submits that three principles that were adopted by the OEB when considering the transition to IFRS (EB-2008-0408) should be adopted in addressing pension and OPEB[1] issues. The three principles are; (i) alignment with required financial accounting and reporting, (ii) intergenerational equity and (iii) fairness.

In addition, OPG submits that the OEB should consider the principles of efficient consumption/appropriate price signals as well as consistency and simplicity. The five remaining principles cited in the OEB's question have little, if any, relevance and should not be considered.

Alignment with Required Financial Accounting and Reporting

In its report in EB-2008-0408, the OEB said that *"future regulatory accounting and regulatory reporting requirements established by the Board will be aligned with [financial accounting] requirements as long as that alignment is not inconsistent with sound regulatory rate making principles."*[2]

OPG believes that the same approach should be used by the OEB in making determinations on pension and OPEB matters. Since accounting requirements are developed through a transparent and rigorous process, they can be relied upon by the OEB. Using financial accounting requirements also minimizes the financial burden on utilities (keeping two sets of records) and provides a verifiable basis (audited financial information) to establish just and reasonable rates.

Both US GAAP and IFRS require the use of accrual accounting. According to the U.S. Financial Accounting Standards Board ("FASB"):

> *"[Accrual accounting] recognizes that the buying, producing, selling, distributing, and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period…*[3]
>
> *Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays*[4]*…*

[1] Throughout the responses, OPEB refers to post retirement benefit other than pensions
[2] OEB, Report of the Board: Transition to International Financial Reporting Standards, July 28, 2009, p. 7.
[3] FASB, Statement of Financial Accounting Concepts No 6, paragraph 139
[4] FASB, Statement of Financial Accounting Concepts No 6, paragraph 140

[The] recognition of revenues, expenses, gains, and losses and the related increments or decrements in assets and liabilities—including matching of costs and revenues, allocation, and amortization—is the essence of using accrual accounting to measure performance of entities. The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable."[5]

As further discussed in response to questions 5 and 6, US GAAP and IFRS require the use of accrual accounting for pension and OPEB for all entities, including rate regulated entities[6].

Using accrual accounting for rate setting ensures that rates reflect the costs of providing the service during the period to which the rates relate. This matching minimizes intergenerational equity, as discussed below.

Given that accrual accounting is consistent with sound ratemaking principles it is the most appropriate basis for the recovery of pensions and OPEB costs.

<u>Intergenerational Equity</u>

Minimizing intergenerational inequity was another "sound ratemaking principle" cited by the OEB in EB-2008-0408[7].

Intergenerational inequity arises when costs incurred in providing service in one period (for one generation of ratepayers) are paid in a different (typically future) period by a different generation of ratepayers. Sound ratemaking avoids intergenerational inequity so that future ratepayers do not experience an unfair burden to the benefit of customers in the current period.

Under accrual accounting for pension and OPEBs, the amount recovered in rates for a period is aligned with the cost of providing the benefits earned by employees for providing service in that period. The use of accrual accounting for ratemaking purposes is therefore consistent with the principle of minimizing intergenerational inequity.

OPG notes that the pay-as-you-go cash basis of cost recovery for pension or OPEB is contrary to the principle of minimizing intergenerational inequity. This is because the rates charged do not reflect the pension and OPEB costs incurred in that period. Consequently, future generations of ratepayers would carry the burden of compensating utilities for costs incurred in providing services to today's generation of ratepayers.

<u>Fairness</u>

In the context of this proceeding, a cost recovery methodology that does not provide for the recovery of costs as those costs are incurred would be unfair and inconsistent with sound ratemaking principles.

As noted earlier, OPG believes that two other principles should be adopted by the OEB. These are discussed below.

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[5] FASB, Statement of Financial Accounting Concepts No 6, paragraph 145
[6] FASB Accounting Standards Codification Topic 980-715-55-2
[7] OEB, Report of the Board: Transition to International Financial Reporting Standards, July 28, 2009, p. 7.

Efficient Consumption/Appropriate Price Signals

Consumers should make consumption decisions based on the true cost of the product or service. Using cost recovery methods that do not reflect the true period cost for a service sends inappropriate price signals to consumers.

In this context, the accrual method of cost recovery supports efficient consumption through appropriate price signals. Conversely, a pay-as-you-go cash basis would not support efficient consumption of gas or electricity because such an approach does not reflect the pension and OPEB costs incurred to provide the service being purchased in the period thus distorting the price signal.

Consistency and Simplicity

The OEB has previously expressed support for the principles of consistency and simplicity when considering cost recovery for pension and OPEBs:

> "*Consistency in accounting treatment, in order to compare results year to year, is advantageous for purposes of assessing the level of cost reasonableness. A consistent approach over time also ensures a greater level of fairness for ratepayers and the company*"[8].

Changes to a utility's cost recovery methodology are contrary to the principle of consistency. They can also create complicated transition issues in violation of the principle of simplicity. Maintaining a consistent cost recovery methodology over time allows for a comparison of utility results year to year and supports the OEB's assessment of their reasonableness.

The question cites five principles that, for the reasons discussed below, have little, if any, relevance to the appropriate cost recovery methodology for pension and OPEBs. Accordingly, OPG recommends that they be given little or no weight by the OEB in making its determination.

Stable Cost Levels

Stable cost levels is not an appropriate ratemaking principle in OPG's view since costs are an input into the rate-setting process, rather than an output. However, once the regulator determines the overall cost of providing service for a period (i.e., the revenue requirement) on the basis of cost causality and in line with the principle of intergenerational equity, it is reasonable to consider rate impacts when determining the timing and pattern of recovery of the approved revenue requirement in rates.

Pension and OPEB as Measured by Benchmarks

As discussed in response to questions 3 and 4, the proper basis of comparison should be total compensation costs rather than just pension and OPEB costs.

The Most Efficient Level of Costs for Ratepayer

This concept relates more to the incurrence of the cost itself (i.e., whether the utility has demonstrated that the cost is prudently incurred) rather than the recovery methodology.

[8] EB-2010-0008, Decision with Reasons, P. 91

Financial Protection of Future Ratepayers

This is essentially the same point as intergenerational inequity. Consistent use of accrual accounting will protect future ratepayers by ensuring that current ratepayers pay the full cost of the service being provided to them in the current period, including pension and OPEB costs.

Consistency across Gas and Electric Sectors

OPG does not believe that consistency across the gas and electric sectors is necessary or advisable. Instead, as indicated earlier, the OEB should allow a particular utility's regulatory accounting to align with its financial accounting, unless the OEB finds this to be inconsistent with sound rate-making principles.

OEB Question #2

Issue: General Principles

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).

Response

The best analogy is compensation costs (other than pension and OPEBs) which are recovered on an accrual basis.

In OPG's view, the listed examples are unsuitable as analogies for the reasons set out below.

Site Restoration and Asset Retirement Obligations (AROs):

There is no generic OEB-approved approach to recovery for these costs. In the EB-2008-0408 Report of the Board (p. 19), the OEB determined that AROs should be assessed on a utility-specific basis.

OPG's AROs for nuclear assets, which include site restoration costs, are accounted for on an accrual basis as required by US GAAP. The ratemaking treatment for OPG's ARO is also based on accrual accounting values. Given the unique characteristics of OPG's nuclear ARO, OPG is of the view that it is not a useful analogy for the recovery of pension and OPEB costs. Furthermore, in general, ARO costs are typically capitalized at the outset, and then depreciated and collected through rates over the life of the underlying asset. Conversely, pension and OPEB costs are accrued each period in respect of the service rendered by employees during that period.

Deferred Tax

Financial accounting requires the use of accrual accounting for income taxes, as it does for pension and OPEB costs. While the OEB's practice has been to use the taxes payable method, OPG submits that this is not a suitable analogy when considering the recovery of pension and OPEB costs. There are at least two reasons for this.

First, the accounting for deferred income taxes is different than the accounting for pension and OPEBs. In view of the difficulties in estimating when deferred taxes will reverse and become payable in the future, US GAAP and IFRS do not permit the discounting of deferred tax balances, unlike pension and OPEB obligations which must be measured at fair value by discounting estimated future cash outflows. As such, unlike pension and OPEB costs, the deferred tax expense may not be a good measure of the tax cost that should be recovered from ratepayers for the period.

Second, using a taxes payable method for rates will typically have a much smaller impact on the financial results of a regulated utility (under US GAAP) than would using the pay-as-you go cash basis for pension and OPEB costs. As discussed in response to question 6, US GAAP prohibits recognition of regulatory assets for differences between OPEB accrual costs and cash amounts recovered in rates if the utility is on a pay-as-you-go basis of cost recovery. This means that utilities will report lower income if accrual costs for OPEB are not reflected in rates. This is not the case for income taxes recovered on a taxes payable basis because US GAAP generally allows regulatory assets for deferred taxes that are not reflected in current rates. [9]

OEB Question #3

Issue: Information Requirements

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).

Response

No. Pension and OPEB are just two components of total compensation and therefore it is not useful to benchmark them in isolation from the rest of the components.

Rate-regulated entities use total compensation packages to attract and retain employees. The components of these total compensation packages can vary greatly between entities. For example, an entity may decide to offer more generous pension and OPEBs in lieu of higher salaries.

In unionized environments, compensation packages are typically the result of many years of collective bargaining and reflect different levels of bargaining power. While collective bargaining may result in greater pension and OPEB benefits for unionized employees, non-unionized employees may have other forms of compensation such as pay-at-risk, restricted stock units, or company supported stock based registered retirement savings plans that unionized entities do not have. Comparing or benchmarking pension and OPEB costs in isolation from other aspects of compensation would therefore not produce meaningful results.

Differences in pension and OPEB plan structures would also make it difficult to draw meaningful conclusions from comparisons and benchmarking. For example, in single employer plans, plan members are current and retired utility employees. In multi-employer plans, such as OMERS,

[9] FASB Accounting Standards Codification Topic 980-740-25-2

there are utility and non-utility current and retired employees. As a result, multi-employer plans are reflective of compensation practices in a variety of occupational disciplines, not just utility disciplines.

Since benchmarking of pension and OPEB costs in isolation from other aspects of total compensation is unlikely to produce meaningful results, OPG sees no value developing new information requirements that would apply to all rate-regulated entities. Better information for setting rates can be obtained by benchmarking or comparing total compensation costs.

OEB Question #4

Issue: Information Requirements

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?

Response

Pension and OPEB are just two components of total compensation and should not be evaluated separately from an evaluation of other components such as salaries and wages, employee dental, drug and other health benefits, accident and life insurance, performance bonus, profit sharing, company employee savings plans, and various forms of stock based compensation.

These various components of compensation can vary significantly among entities. For example some entities may have comprehensive OPEBs but no stock based compensation, while others may have generous stock based compensation but limited OPEBs.

In assessing total compensation costs, the OEB should also consider local labour market factors. For example, it may cost more to attract and retain employees in Toronto than in other areas of Ontario. The OEB should also consider the amount of outsourcing by rate regulated entities. Entities that outsource more activities will have lower pension and OPEB costs but may have higher OM&A expenses as the employee benefits for the outsourcing provider will be built into their outsourcing contracts.

OEB Question #5

Issue: Accounting and Recovery in Rates

a) Should the OEB establish accounting and recovery methods for both the electricity and gas sectors?
b) What criteria should be considered to determine the appropriate approach?
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)

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

Response

a) No, the Board should not establish standardized regulatory accounting and recovery methods for the electricity and gas sectors for pension and OPEB costs. The OEB should allow a utility's regulatory accounting (which underpins rate-making) to align with its financial accounting, unless the OEB finds that alignment is inconsistent with sound ratemaking principles, consistent with the Board's findings in EB-2008-0408[10]. As discussed in response to question 1, OPG believes that the use of accrual basis for determining pension and OPEB costs for regulatory purposes is consistent with sound ratemaking principles, particularly if the utility has been previously recovering pension and OPEB costs on that basis.

b) The OEB should consider the principles recommended by OPG in its response to question 1. In summary, the ratemaking principles of alignment with financial accounting, minimizing intergenerational inequity, fairness, encouraging efficient consumption of resources, and consistency and simplicity all support the use of "accounting cost" (accrual) as the rate recovery methodology.

c) and d) If one method is adopted by the Board, OPG submits that it should be the "accounting cost" (accrual) method for both funded and unfunded pension and post-retirement benefit plans. The reasons for adopting this method are discussed above and in response to question 1. In addition, adopting the accrual method avoids the significant adverse financial consequences of going to a cash basis as outlined in OPG's response to question 6. The accrual method is also consistent with the way the OEB determines allowable compensation costs, other than pension and OPEBs. Further support for the accrual method is provided in the attached report (Appendix A) prepared by PricewaterhouseCoopers LLP.

The pay-as-you-go approach should not be adopted by the OEB for any pension or OPEB plan, whether funded or not. In addition to causing significant adverse financial consequences to utilities, as discussed in response to question 6, recovering costs on a pay-as-you-go basis would not be consistent with sound ratemaking principles. For example, minimizing intergenerational inequity requires that ratepayers who are consuming a product or service today should pay the associated cost for the employees providing that service or product. Pension and OPEB costs are incurred when the employee service is

[10] Ontario Energy Board, Report of the Board: Transition to International Financial Reporting Standards, EB-2008-0408, Appendix 2, Page 39

rendered. This is exactly the position adopted by the U.S. Federal Energy Regulatory Commission in relation to post employment benefits other than pensions, for example:[11]

> *"PBOPs [Post-Employment Benefits Other Than Pensions] are a form of deferred compensation to employees for the services that they provide during their working years. Therefore, the costs of providing these benefits are properly included in the cost of service during the period that the benefits are earned."*

The pay-as-you-go method is particularly inappropriate for registered pension plans because neither the accounting cost nor the cash outlay of the utility occurs at the time of the payment to plan beneficiaries. As discussed above, the accounting cost is recognized by a utility when the employee service is rendered and as noted in the question itself, the utility's cash outlay occurs pursuant to funding requirements under the *Pension Benefits Act* (Ontario).

The "accounting cost" or accrual approach is superior to the funding contribution approach, particularly for utilities which, like OPG, have historically been using the accrual method. The funding contribution approach does not align with financial accounting requirements to report costs on an accrual basis, thereby resulting in a mismatch between utility revenues and costs and potential intergenerational inequity. Unlike accrual costs, the funding amounts are not determined with the primary objective of appropriately attributing costs across periods, but rather reflect legislative requirements that focus on protecting the financial health of the pension plans and the security of employee benefits. Further, transitioning to a cash method from an accrual method is contrary to considerations of simplicity and consistency. Additionally, as discussed in OPG's response to question 6, adopting a funding contribution method of recovery for registered pension plan costs is expected to result in adverse financial consequences to OPG. Other utilities may be similarly impacted.

OPG also notes that pension funding amounts pursuant to the *Pension Benefits Act* (Ontario) may be higher or lower than US GAAP costs on an accrual basis. Because of a number of differences between how the funding and accrual amounts are calculated, OPG submits that there is no reliable basis for concluding that either basis consistently produces lower or more stable amounts. In OPG's case, pension funding contributions attributed to the regulated business exceeded accrual amounts in five of the last seven years (2008 to 2014).

<u>OEB Question #6</u>

Issue: Accounting and Recovery in Rates

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

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

[11] See FERC Statement of Policy on Post-Employment Benefits Other Than Pensions (docket no. PL-93-1-000, p. 6)

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.

Response

a) and b) Yes. The OEB should consider the financial reporting and other financial, legal, and tax impacts that would result from changing the cost recovery methodology. As demonstrated below, changing from an accrual basis to a cash-based method would result in a number of significant adverse financial consequences to utilities.

Financial Implications

The significant adverse financial impacts to utilities and their shareholders stem from reductions in income and cash inflow as well as write-offs of regulatory assets. As noted below, the adverse impacts from transitioning to a cash-based method of recovery are expected to be particularly material for OPG and its shareholder.

The reductions in income and cash flow would in turn increase utility debt levels while weakening credit metrics, increasing the risk of a credit rating downgrade, and putting pressure on debt covenants and other contractually required financial measures. This would raise the cost of capital and/or limit the utility's ability to raise funds. The increased risk profile of the utility would also increase costs to ratepayers through, for example, a higher equity ratio in the deemed capital structure or a higher cost of debt.

Income and Cash Flow

As noted in OPG's response to question 1, regulated companies are required to report pension and OPEB costs using accrual accounting in accordance with their respective financial reporting standards. OPG uses US GAAP as its financial reporting framework, as required by the *Financial Administration Act* (Ontario). US GAAP is also the financial reporting framework of several other large utilities in Ontario including Hydro One, Union Gas, and Enbridge Gas Distribution.

Under the accrual basis of accounting, a utility is required to recognize the cost of service provided by employees in the period the service is rendered. In the context of pension and OPEB, benefit payments will be made well after the services are provided and the costs are incurred. As such, if the OEB decides to provide utilities with revenue determined on a pay-as-you-go basis, the differences between benefit payments and expenses will erode the income and cash flow of utilities and their shareholders. Shareholders' equity and investment value will also be eroded over time as increases in post-retirement benefit obligations over the life of the employees' service will not be matched by corresponding revenues.

These factors will also weaken utilities' credit metrics, putting pressure on the credit ratings and debt covenants and make it more difficult for utilities to raise funds for needed investments.

In effect, under a pay-as-you-go basis the OEB would be imposing a significant additional risk on shareholders and lenders by not compensating the utility for its incurred OPEB costs until years later, without providing assurance of future recovery.

Regulatory Assets

To the extent that it relates to timing, the differences between accrual costs for pension and OPEB under US GAAP and rate recoveries on a cash basis are subject to US GAAP Accounting Standards Codification Topic 980 (ASC 980). Under ASC 980, timing differences may be offset by regulatory assets and liabilities. ASC 980 prescribes when it would be appropriate to record these regulatory assets and liabilities. Discussed below are the financial reporting impacts of a cash basis of recovery in the context of regulatory assets and liabilities.

<u>OPEB</u>

As discussed above, a pay-as-you-go recovery for OPEB will result in an ongoing mismatch between revenues and the costs incurred by a utility, eroding income and shareholder returns. For OPG, income reductions on account of a pay-as-you-go recovery basis for OPEB are currently estimated in the range of approximately $100M-$150M per year for the foreseeable future.

ASC 980 prohibits the recognition of regulatory assets for differences between cash recoveries and accrual costs for non-pension post retirement benefits, if a company is recovering on a pay-as-you-go basis (see ASC-980-715-25-4).[12] As such, regulatory accounting under US GAAP will not mitigate the financial reporting impact of moving to a pay-as-you-go basis for OPEBs, unless, as discussed in response to question 7, the OEB authorizes an appropriately structured accrual-to-cash deferral account that effectively modifies the pay-as-you-go basis.

The balance in this account would need to be recovered over a reasonable period, similar to other deferral and variance accounts. In OPG's case, this would effectively amount to the permanent continuation of the Pension & OPEB Cash Versus Accrual Differential Deferral Account authorized in EB-2013-0321, with an explicit commitment by the OEB to periodically clear the balance through future rates.

In addition to reductions in net income, adopting a pay-as-you-go basis for OPEB would also require OPG and likely other US GAAP reporting utilities to write-off existing regulatory assets for OPEB-related unamortized amounts accumulated in other comprehensive income. For OPG, this would result in a write-off to other comprehensive income (and therefore equity) of approximately $600M (based on year-end 2014 balances).

<u>Pension</u>

In addition to the US GAAP prohibition on regulatory assets for non-pension post retirement benefit plans, there may be circumstances where a utility is unable to recognize regulatory assets for ongoing differences between registered pension plan accrual costs and cash funding-based rate recoveries.

[12] EB-2013-0321 Reply Argument, p. 186 and Tr. Vol. 13, pp. 57-58)

This would be the case for OPG if the OEB were to implement recovery of pension costs on a cash-funding basis going forward. For OPG's registered pension plan, a conversion to a cash-funding basis of recovery will result in OPG writing off approximately $700M (as at December 31, 2014) in regulatory assets for unamortized amounts currently recognized in accumulated other comprehensive income under US GAAP. This amount represents the difference between amounts that remain to be amortized in future years from other comprehensive income and the funded status of the plan. In total, moving OPG to a cash basis of recovery for the registered pension plan and OPEB would result in a charge to other comprehensive income of approximately $1.3B (as at December 31, 2014).

In addition, OPG also would not be able to recognize, in net income, a regulatory asset for the ongoing difference between cash-based recoveries and corresponding registered pension plan costs on an accrual basis until the above mentioned $700M differential is reversed over time. This would significantly impair OPG's net income for a number of years.

In addition, if the OEB does not allow recovery of the registered pension plan portion of the Pension & OPEB Cash Versus Accrual Differential Deferral Account authorized in EB-2013-0321, OPG will be required to write-off approximately $175M (projected to the end of 2015) against net income. Together with the OPEB portion of the account balance, the total net income write-off is projected to be over $300M by the end of 2015 and over $500M by the end of 2016.

Legal Implications

The OEB is legally required to set rates that permit a utility to recover its prudently incurred costs and earn a fair return on invested capital.

The accrual basis of recovery is consistent with this requirement because in a given period a utility is able to recover the costs they incur in the period. Once incurred, these costs become an obligation of the company that, under the accrual basis of recovery, are compensated by corresponding revenue that supports the OEB-approved rate of return on shareholders' capital.

As discussed above, under a cash-basis of recovery, utilities would not recover the costs incurred in the period until a number of years into the future. This would result in a lower reported net income, and returns that will be systematically short of the OEB-allowed (fair) rate of return.

In OPG's submission there are two other legal considerations, as outlined in response to question 7:

- The prohibition, at law, against retroactive making must be respected when considering any change in the methodology; and
- For OPG specifically, the OEB must continue to comply with the provisions of Ontario Regulation 53/05 in setting rates.

Tax Implications

Tax implications are not a factor in determining a cost recovery methodology as, under any cost recovery methodology, regulatory taxable income would reflect deductions for pension and OPEB cash payments as allowed under the *Income Tax Act* (Canada).

However, to the extent that the Board considers use of a set-aside mechanism together with the accrual approach, the tax implications should be considered in evaluating potential alternative approaches to such mechanisms, as discussed in response to question 8.

c) As discussed in response to question 3, comparative analysis of compensation related costs like pension and OPEB should be done on the basis of total compensation. Pension and OPEB costs are one part of total compensation; therefore a separate comparative analysis for pension and OPEBs in isolation would not be meaningful.

With respect to differences related to pension and OPEB liability re-measurements (and a portion of asset returns) under US GAAP and IFRS, OPG observes that these differences over time relate primarily to the classification of costs between other comprehensive income and net income, not the total amount of costs or liabilities recognized.

The difference between IFRS and US GAAP is that IFRS recognizes re-measurements of liabilities and a portion of asset returns in other comprehensive income, but not in net income. US GAAP recognizes these amounts in net income over time. As such, the difference is primarily one of presentation, not the nature of the costs. Under either financial accounting framework, these amounts are a cost to the utility and, if found to be prudent, should be allowed in setting just and reasonable rates.

OEB Question #7

Issue: Accounting and Recovery in Rates

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?

b) How should the account(s) operate?

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

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

- **i.** Should the transition be phased-in, applied retrospectively with catch-up adjustments for prior periods, 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?

Response

a) **b) and c)** A variance account typically tracks the difference between the amounts (revenues or costs) reflected in rates using the methodology adopted by the regulator, and the actual amounts determined using the same regulatory methodology. In that context, regardless of the regulatory methodology for recovery of pension and OPEB costs approved by the OEB, OPG supports the continued use of variance accounts for pension and OPEB cost recovery.

In OPG's submission, these variance accounts would continue to be appropriate because variances between forecast and actual amounts are driven by external factors under any recovery methodology (e.g., discount rates, market performance, actuarial standards, and pension regulatory requirements) that are both difficult to predict and beyond the ability of management to control. In OPG's case, such variances have had, and are expected to continue to have, a material impact on its financial performance. Interest should apply to these accounts as the differences recorded represent cash revenue amounts that have been over or under-collected by a utility.

Part a) refers to questions 5 and 6 which relate to different cost recovery methodologies. As utilities are required to use the accrual basis to determine pension and OPEB costs for financial accounting purposes, the specific issue appears to be whether the OEB should approve a deferral account to record the on-going difference between the accrual costs for the period and amounts recovered using a cash-based methodology.

A deferral account that records ongoing differences between cash benefit payments (for unfunded benefit plans) or cash contributions (for funded benefit plans) and corresponding pension and OPEB accrual costs would be useful if the terms and conditions reflected in the regulatory approval of the account enable the utility to record it as a regulatory asset on its balance sheet and income statement[13]. If these criteria are met, an appropriately structured deferral account may mitigate the adverse financial reporting impacts of adopting a cash-based recovery methodology, as discussed in response to question 6.

In order for the account to mitigate the adverse financial reporting impacts of including cash amounts in rates, the account must provide for disposition of balances consistent with the OEB's normal process for review and approval of balances in other typical deferral and variance accounts. The accumulated balance the account would need to be recovered over a reasonable period.

OPG believes that interest should apply to such an account because the account balance represents an under- or over-collection of a utility's costs incurred in the period, and therefore an under- or over-payment by customers for services received during the period.

d) OPG believes that the accrual basis is the most appropriate cost recovery methodology for pension and OPEBs and accordingly no transition is necessary or advisable.

However, if the OEB decides to switch from the accrual method, then OPG offers the following comments on the four potential transition issues identified by the OEB:

Prospective Application: The OEB sets rates for forward-looking periods. Therefore, while the OEB can change the basis of cost recovery in determining just and reasonable rates, the application of any such change must be prospective only.

Retrospectively with Catch-ups: Any retrospective catch-up adjustment for prior periods would effectively result in changing the basis upon which final rates were set for those periods. This would be retroactive ratemaking, which is not permitted by law.

[13] As discussed in response to question 6, OPG will not be able to recognize a regulatory asset for the differences between future cash recoveries and accrual costs if the OEB adopts a pay-as-you-go basis for OPEB and/or a funding basis for the registered pension plan without an explicit deferral account discussed in this response.

Phase-in: In the event of a change in methodology, any phase-in must reflect utility-specific circumstances and other legal limitations, be applied prospectively and not constitute retroactive ratemaking.

Generic application: The transition to a different recovery methodology should be considered on a case-by-case basis. To the extent that transition issues arise, some implications will likely be utility-specific. This is because utilities may differ with respect to current cost recovery methodologies, underlying financial and regulatory accounting requirements (e.g., IFRS, US GAAP), legal frameworks (e.g., requirements and limitations of O. Reg. 53/05 for OPG), and the magnitude of the impact on utilities and their shareholders, as well as ratepayers, resulting from a change in methodology.

OEB Question #8

Issue: Accounting and Recovery in Rates

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

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

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?

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

Response

a) In OPG's view it would not be appropriate for the OEB to establish a segregated fund or similar set-aside mechanism for amounts collected from ratepayers in respect of unfunded post-retirement benefit plans (OPEB and supplementary employee retirement plans ("SERP")) before such costs are paid out[14].

The financial and regulatory accounting recognition of expenses often occurs prior to their payment; however, funds are not set aside for future payment of the accrued costs unless there is a legal or contractual obligation to do so. Consistent use of accrual accounting inherently protects future ratepayers from having to pay for costs that were incurred in prior periods because it recognizes those costs (and includes them in rates) in the period in which the service is provided.

OPG is not aware of any legal requirement for companies in Ontario, regulated or not, to set aside money to meet OPEB or SERP obligations. Given that there is no evidence that Ontario regulated utilities like OPG will be unable to meet SERP or OPEB obligations in the

[14] As registered pension plans are funded, they are not contemplated in this response

future, there is no need to require the use of a set-aside mechanism. In OPG's submission, the OEB should not take action to address a hypothetical future outcome.

Furthermore, set-aside mechanisms for OPEB or SERP are not a cost effective way to use funds for several reasons. First, as discussed below, set-aside mechanisms have adverse tax implications (including, in some cases, to employees[15]). Second, a set-aside mechanism would reduce a utility's financial capacity and ability to reinvest funds for the benefit of ratepayers and the Ontario economy and/or increase a utility's debt levels and cost of debt, which would increase costs to ratepayers. Third, additional costs to ratepayers and/or rate volatility may arise as a result of the financial accounting implications of some of the mechanisms.

As previously indicated in EB-2013-0321, OPG does not believe that the OEB has the jurisdiction to require utilities to establish a segregated fund or similar set-aside mechanism. However, if the OEB was to find that it has the jurisdiction and that it is necessary to address the timing differences between the collection of accounting costs through rates and the cash payment of benefits for unfunded pension plans and OPEB, OPG submits that the OEB should do so in a manner that minimizes the adverse consequences. For example, some unfunded post-retirement benefit obligations may be secured in a more cost effective manner than through a set-aside mechanism (e.g., letters of credit, surety bonds, shareholder guarantees, or insurance agreements).

b) Below OPG has provided a summary of the available set-aside mechanisms that it has identified. While the mechanisms may differ in their tax, legal, accounting or other implications, all of them have significant limitations and challenges. In OPG's view, these challenges should convince the OEB that it is not advisable to adopt any of these set-aside mechanisms for OPEB or SERP.

Retirement Compensation Arrangement (RCA): Any form of set aside mechanism in which an employer makes contributions to a third party in connection with benefits for employees after their retirement is deemed to be an RCA under the *Income Tax Act* (Canada), as long as contributions have been set apart from the company's assets that are available to general creditors.[16]

Under the RCA rules, the employer's full contribution into the arrangement is deductible against the employer's taxable income (provided the contribution is "reasonable"). This effectively allows deductions for future benefits payable to retirees to be advanced, but at a lower value due to the anticipated growth in the funds over time. However, 50% of the amount contributed must be withheld and remitted as a refundable tax payment to the Canada Revenue Agency ("CRA"), which the CRA holds in a refundable tax account ("RTA"). The 50% refundable tax similarly applies to income realized on amounts set aside in the RCA. The RTA held by the CRA earns no interest.

By way of a numerical example, if $1,000 is the amount available to be contributed to an RCA, $500 will earn investment income and $500 will be remitted to the CRA as a refundable tax. Assuming a 6% return, $500 retained by the RCA will earn $30, of which

[15] Throughout OPG's responses, "employees," "retirees" and "retired employees" are used interchangeably to denote specific qualifying individuals pursuant to the terms of the benefit plan or tax legislation as appropriate in the context. Those individuals may include spouses, dependent family members, survivors, etc.
[16] RCA provisions do not apply to registered plans, employee health and life trusts and other specifically defined arrangements under the *Income Tax Act (Canada).*

$15 will be withheld by the CRA and not earn any income while held in the RTA. This would effectively result in a 1.5% rate of return ($15 for a $1,000 contribution) on the original contribution, until the tax is refunded in the future. As this illustrates, the RCA is a poor investment vehicle and the benefit of obtaining a return from the RCA is significantly diminished.

When funds are distributed from the RCA to provide post employment benefits, an amount equal to 50% of the distribution is refunded to the RCA from the RTA in the following year. For an RCA accumulating differences between accrual cost recoveries and cash benefit payments, the RTA balance for the contributions is not expected to be refunded until these differences begin to reverse. The fact that 50% of the contributions and investment income would earn no return while held by the CRA makes an RCA a poor vehicle for investing capital. The resulting "leakage" of capital out of the Ontario economy would be undesirable. In OPG's case, this would be coupled with a reduction in amounts received by the Province of Ontario through PILs income taxes due to the immediate deductibility of RCA contributions.

A further complication of an RCA is the tax treatment of distributions out of the arrangement. If, as its beneficiaries, retirees receive distributions directly from the RCA (e.g., for health and dental benefits), they would have to pay tax on these distributions at their individual marginal tax rates. As such, the non-taxable attributes of OPEB payments to retirees would be lost. Furthermore, if the employees/retirees are the sole beneficiaries, distribution on RCA wind up would be limited to employees and would be taxable to them at their marginal tax rates.

The adverse tax consequences to current and future retirees would represent a substantial burden on the people working in Ontario's electricity and gas distribution sectors, many of whom are covered by existing collective agreements. The imposition of such a tax burden may result in utilities having to "gross-up" the benefit payments to cover taxes payable by retirees, which would in turn increase the cost to ratepayers.

If the employer is a beneficiary, any distributions it receives (including on wind-up that is a result of a legitimate business decision) would be taxable to the employer. The employer would then be entitled to a tax deduction for benefit payments made out of these distributions. The benefit payments would retain their non-taxable attributes to employees.

<u>Internally Segregated Account:</u> Another alternative is an internally segregated account retained by the employer that accumulates funds for future OPEB or SERP payments, which are not otherwise set apart from the company's assets and are available to general creditors. Such an internally segregated account is not likely to be considered an RCA under the *Income Tax Act* (Canada).[17]

The full amount of contributions into an internally segregated account earns investment income, which would be taxed in the same manner as the company's other income at its corporate tax rate. Using the above numerical example, a $1,000 contribution would earn investment income of $60 at 6%, or $45 (4.5%) net of income taxes (assuming a 25% rate). Therefore, a segregated account provides a higher after-tax rate of return on contributions than an RCA, and does not result in a "leakage" of capital out of the Ontario economy. Unlike the RCA contributions however, segregated account contributions would not be tax

[17] One of the key tests applied by the CRA in determining whether an RCA is in place is whether measures have been taken to protect the funds from general creditors.

deductible when made, with the tax benefit realized when benefits are paid to retirees in the future (at a higher value than the equivalent RCA contributions due to the anticipated growth of funds in the RCA).

Benefit payments would retain their non-taxable attributes to retired employees.

Employee Life and Health Trust (ELHT):[18] An ELHT is an *inter vivos* trust that is specifically established to provide health and insurance benefits to employees that meets certain terms and conditions required under the *Income Tax Act* (Canada*).* OPG believes that an ELHT is not a viable option and should not be considered, for several reasons:

- There are limitations on the types of benefits that can be funded using an ELHT. SERP benefits cannot be funded using an ELHT under the *Income Tax Act* (Canada). In addition, some of the OPEB obligations may not qualify for an ELHT.
- Only employees or another ELHT may be a beneficiary to the ELHT. As such, the contributions into the ELHT and related investment income would, at no time up to and including the wind-up, be available to the company and therefore the ratepayers.
- Investment income is taxed in the trust at the top individual marginal rate of approximately 50%, with more than half of the tax payable federally (none of the tax is refundable). The federal portion of the tax would represent a “leakage” of funds from Ontario’s economy and, in OPG’s case, would be a direct and permanent reduction in the monies received by the Province of Ontario.

It may not be possible for utilities to amend benefit plans, employee contracts and collective agreements to implement an ELHT in the short term.

[18] Pursuant to its administrative practice, the CRA also allows an *inter vivos* “health and welfare trust” to fund employee benefits. However, the contributions that the employer may make to the trust in a given year are limited to the amount required to provide the benefits for that year. As such, OPG does not believe that this mechanism could be used to set aside funds collected in rates that are in excess of benefit payments for the year.

Tax-Related and Wind-Up Considerations: The following table summarizes the above discussion of tax-related and wind-up considerations of an RCA (with employer as the beneficiary) and an internally segregated account.

Set-Aside Mechanism	**Tax Deductibility of Contributions (to Employer)**	**Taxation of Contributions and Investment Income**	**Tax Treatment of Distributions (to Employer)**	**Taxation of Benefit Payments (to Employees)**	**Wind Up Implications (to Employer)**
RCA – *Employer as Beneficiary*	Contributions by employer are 100% deductible against employer's taxable income in the year of contribution, provided the contribution is reasonable.	Contributions are subject to a 50% refundable tax payable federally to the Canada Revenue Agency (CRA); therefore, only 50% of contributions earn investment income. Investment income realized in the trust is also subject to the 50% refundable tax payable. The 50% refundable tax is held by the CRA in a Refundable Tax Account (RTA) which earns no return.	When funds are distributed to the employer as the beneficiary, an amount equal to 50% of the distributions is refunded to the RCA from the RTA in the following year. The employer would be taxed on the receipt of distributions, and would receive a tax deduction for the payment of OPEB or SERP benefits to retirees.	Benefit payments are paid to employees by employer from RCA distributions. OPEB payments retain their non-taxable attributes for employees. SERP payments are taxable in the same manner as if they were paid in the absence of an RCA.	Provided a decision to wind up an RCA is a legitimate business decision, remaining assets of the RCA (including the remaining RTA balance) may be distributed to the employer upon wind-up. The distribution is taxable to employer.
Internally Segregated Account	Contributions are not tax deductible	Investment income is taxed at employer's corporate tax rate (e.g., currently 25% for OPG).	Withdrawals are not taxable to the employer. Benefit payments to employees are deductible against the employer's taxable income in the normal course.	OPEB and SERP benefit payments are made by the employer. OPEB payments retain their non-taxable attributes to employees, while SERP payments remain taxable.	There are no tax implications to the employer upon withdrawal of funds on wind-up

Legal Considerations:

In OPG's submission, the OEB would be going beyond its jurisdiction if it were to order a utility to set aside certain funds for the purpose of meeting future SERP and OPEB obligations. The OEB's jurisdiction to set rates does not include the power to manage a utility, such as by ordering it to place, in a set-aside mechanism that the utility would not control, a portion of its revenues for a specific purpose. The OEB has itself stated, in its recent submission to the Supreme Court of Canada, that the "Board's mandate is to determine a reasonable revenue requirement; it is for OPG's management to decide how that revenue is ultimately spent."[19]

In the 2006 Supreme Court of Canada case of *ATCO Gas & Pipeline Ltd. v. Alberta (Energy & Utilities Board)*, [2006] 1 S.C.R. 140 ("ATCO"), the Supreme Court of Canada stated that, through the payment for regulated services, customers do not acquire ownership or control of the utility's assets (at Para. 68). The Court also agreed that, absent any ownership interests, any allocation of the proceeds of a sale, thereby affecting the property interests of the utility, would be confiscatory and would require the clear intention of the legislation (at paras. 69 and 79).

It would be an error of law for the OEB to require a utility to set aside certain funds for the purpose of meeting future pension or OPEB obligations. In respect of the setting of payment amounts for OPG in particular, section 78.1(4) of the OEB Act specifically circumscribes the scope of a payment amounts order under section 78.1. The legislation does not expressly provide the OEB with authority to require OPG to set aside funds for this or any other purpose.

Requiring a utility to establish a segregated fund for the purpose of meeting its future pension or OPEB obligations would be a highly intrusive and confiscatory 'remedy' to a problem that does not exist. For a utility that is using the accrual approach, the difference between the amounts recovered on an accrual basis and the amounts paid out in a given period on account of SERP and OPEB liabilities is simply the outcome of applying the accounting methodology that has previously been approved by the OEB. While in future years it can be expected that the utility will experience periods in which the amounts it recovers will be less than the amounts that it will then be required to pay out, it is the utility's responsibility - not the OEB's - to manage its cash flows and plan and forecast its future cash requirements so as to ensure that it has sufficient funds available to meet those future obligations. If the OEB were to require the utility to establish a segregated fund to protect against the risk that sufficient funds are not be available at some point in the future, this would be an extraordinary measure for purposes of addressing a circumstance, the occurrence of which is uncertain.

In addition to the jurisdiction the OEB derives from the express language of the legislation, the common law doctrine of jurisdiction by necessary implication provides the OEB with "all powers which are practically necessary for the accomplishment of the object intended to be secured by the statutory regime created by the legislature."[20] The test for whether a tribunal has jurisdiction by necessary implication requires that the jurisdiction be necessary to accomplish the objects of the legislative scheme and that the jurisdiction be essential to the

[19] Factum of the OEB in Supreme Court of Canada, File No. 35506, Para. 97)
[20] ATCO at para. 51.

tribunal fulfilling its mandate.[21] Given the OEB's long-standing approach to cost recovery for pension and OPEB without requiring utilities to establish segregated funds, as well as the uncertain and speculative nature of the 'problem' which such a requirement would be intended to address, and the fact that, if the 'problem' does arise, it would arise in a period well after the period in respect of which the OEB is setting rates, it could not reasonably be said that the OEB requires the jurisdiction (to cause utilities to establish segregated funds for pension and OPEB) in order to fulfill its statutory mandate. Accordingly, the OEB does not by implication have this jurisdiction.

<u>Accounting Considerations:</u>

A utility would need to determine if the set-aside mechanism is a benefit plan asset for purposes of determining pension and OPEB costs under its financial accounting framework. Under US GAAP, investments included in a fund which meets the definition of a plan asset are eligible for smoothing mechanisms related to market performance, similar to those applied in accounting for registered pension plans. Smoothing mechanisms allow the impact of certain market volatility in plan assets to be deferred and amortized into income over time.

For a set-aside mechanism to meet the definition of a plan asset under US GAAP, the investments must be segregated and restricted (i.e. cannot be used by the employer for other purposes). Whether a certain set-aside mechanism meets this definition would need to be assessed based on specific facts and circumstances. If the mechanism does not qualify as a plan asset, the investments will be subject to market volatility which would be immediately recognized in income, creating forecast risk and volatility for utilities and ratepayers.

There is another accounting consideration specific to the RCA mechanism. Since the amount in the RTA will not be refunded by the CRA until distributions are made from the RCA a number of years later, the fair value of the funds in the RTA will be materially lower than their face value since they earn no interest. OPG expects that this will lead to lower returns or losses that would flow through its income and therefore rates, increasing the cost to ratepayers.

Using the earlier numerical example, if $1,000 is designated for an RCA contribution, $500 will earn investment income and $500 will be withheld by the CRA in the RTA. Assuming that the fair value of the $500 RTA balance is $100 based on expected timing of future payments out of the RCA, OPG expects that the $400 loss would be reflected in income.

Given the challenges identified above, OPG is of the view that a segregated fund or another set-aside mechanism introduces many adverse tax, legal, accounting, and other consequences for the utility and the ratepayer and should not be considered by the OEB.

c) Setting aside the questions of whether the OEB has the legal authority and whether it is appropriate to do so, any set-aside mechanism should only be implemented prospectively, for the reasons discussed in response to question 7(d).

For the same reasons as discussed in response to question 7(d), transition to a set-aside mechanism should be considered on a case-by-case basis. The magnitude of adopting a

[21] ATCO at para. 73.

set-aside mechanism could be much larger for OPG than for other utilities. This should be one of the factors taken into account.

OEB Question #9

Issue: Accounting and Recovery in Rates

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

Response

Since pension and OPEB costs are an integral part of total compensation, they should be reviewed as part of a review of total compensation (see response to question 3). Therefore, in OPG's submission, utilities should be required to file information on their total compensation program including salaries, wages, cash incentives, stock based compensation, and employee benefits when filing rate applications. Only by examining total compensation costs can the OEB meaningfully and fairly compare costs per employee of the utilities.

The appropriate place for filing this total compensation information is in cost of service and/or re-basing applications and not in annual Reporting and Record Keeping ("RRR") filings.

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Appendix A

PWC Report: Recovery of Pension and Post-retirement Benefits Other than Pension Costs

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Recovery of Pension and Post-retirement Benefits Other than Pension Costs

July 30, 2015

pwc

Contents

Assignment, Scope, and Background

Assignment

1. Ontario Power Generation Inc. ("OPG" or "the Company") is a regulated utility wholly owned by the Province of Ontario. It owns and operates a portfolio of electricity generation assets in Ontario.

2. The prescribed assets of OPG are regulated by the Ontario Energy Board ("OEB") which regulates the province's electricity and natural gas sectors. On May 14, 2014 the OEB announced the commencement of a consultation on rate-regulated utility pensions and Other Post Employment Benefit ("OPEB") costs in the electricity and natural gas sectors and invited submissions on an intial set of questions (Consultation on the Regulatory Treatement of Pensions and Other Post-Employment Benefit Costs - EB-2015-0040).

3. OPG's pension and other post-retirement benefit programs consist of a registered pension plan ("RPP"), a supplementary pension plan ("SPP"), and other post-retirement benefits ("OPRB"), such as group life insurance and health and dental care for pensioners and their dependants. In this report the term "pension" refers only to the RPP, which is funded in accordance with the *Pension Benefits Act (Ontario)*. The terms OPEB and Postretirement Benefits Other than Pensions ("PBOP") are used interchangeably and are comprised of OPRB and the SPP (as SPP is not a funded plan).

4. We understand that OPG is registered as a participant in the consultation process. OPG has engaged me, Eric Clarke CPA, CA; CPA(Illinois) of PricewaterhouseCoopers LLP, to prepare a report to be submitted as part of the consultation process.

5. I have been asked to provide a report stating my opinion on the following question:

    - Should pension and other post-employment benefit costs of a regulated utility be recovered in rates using the cash method (pay-as-you-go or funding contribution) or the accrual method determined in accordance with the applicable financial accounting framework of the utility (i.e. US Generally Accepted Accounting Principles ("US GAAP") for OPG)?

6. This report does not constitute an examination or an audit in accordance with generally accepted auditing standards or attestation standards nor a Report on the Application of Accounting Principles as defined by Canadian Auditing Standards in Section 7600 of the CPA Canada Handbook. I understand this report may be provided to the OEB and that I may be called upon to testify at a generic hearing.

7. This report has been prepared by me to best of my knowledge, acting independently and objectively. My credentials are included in Appendix A.

8. PwC's compensation is not contingent on an action or event resulting from the use of this Report.

Scope

9. In preparing this report, I have held meetings with OPG management and read and discussed the following relevant documents and information:

- EB-2015-0040 Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs – May 14, 2015
- EB-2013-0321 "Ontario Power Generation Inc. Payment Amounts for Prescribed Generation Facilities Commencing for 2014 and 2015" Decision with Reasons - November 20, 2014
- EB-2010-0008 "Payment Amounts for Ontario Power Generation Inc.'s Prescribed Facilities for 2011 and 2012" Decisions with Reasons - March 10, 2011
- EB-2008-0408 "Report of the Board, Transition to International Accounting Standards" – July 28, 2009
- "Accounting for Postretirement Benefits Other Than Pensions" – Accounting guidance issued by the Federal Energy Regulatory Commission - Docket No. AI93-4-000 – June 28, 2010
- "Policy Post-Employment Benefits Other Than Pensions, Statement of Policy." – Federal Energy Regulatory Commission - Docket No. PL93-1-000 – December 17, 1992
- Relevant pronouncements issued by the Financial Accounting Standards Board
- Statement of Financial Accounting Concepts No. 6 "Elements of Financial Statements" –Financial Accounting Standards Board – December 1985
- Statement of Financial Accounting Concepts No. 8 "Conceptual Framework for Financial Reporting" – Financial Accounting Standards Board – September 2010

Background

OEB Consultation on the Regulatory Treatment of Pensions and OPEB

10. The OEB's May 14, 2014 letter (EB-2015-0040) includes a list of questions to obtain views from regulated utilities and other interested parties on the regulatory treatment of OPEB and pension costs. Question 5 in the letter relates to "Accounting and Recovery in Rates" and asks respondents what accounting approach should be adopted to recover pension and PBOP costs in rates. The following options were provided:

- pay-as-you-go (cash);
- funding contribution;
- accounting cost (accrual); or
- another method.

Pay-as-you-go (cash) and Funding Contribution methods

11. The OEB letter defines the pay-as-you-go basis as a method in which the utility recovers costs "*equal to the benefit payment to plan beneficiaries, as determined by the plan.*"

12. The funding contribution method was defined as the "*minimum 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*".

13. Using the funding contribution, I understand that all amounts disbursed by a utility in a period would be recoverable in rates for that period. I understand that for a funded plan this would be when OPG makes a payment to the fund. For an unfunded pension or OPEB plan, this would the same as pay-as-you-go, when OPG makes a payment directly to a beneficiary of the plan or through an intermediary.

Accounting cost (accrual) method

14. The accounting cost (accrual) method is the accrued cost determined by accounting rules (in accordance with a given accounting framework) and recognized and reported in general purpose financial statements. OPG applies US GAAP for its general purpose financial statements, as such, its accounting cost (accrual) method would be determined in accordance with US GAAP. A number of utilities in Ontario use International Financial Reporting Standards ("IFRS") for their general purpose financial statements. Accounting for pension and PBOP costs under IFRS is similar to US GAAP, with some differences primarily related to the classification of certain costs between net income and other comprehensive income and the accounting for actuarial gains and losses. Both follow the accrual method of accounting and the differences between the two standards are well understood by users, preparers, actuaries, and auditors.

15. US GAAP is developed by the Financial Accounting Standards Board ("FASB"). It is a non-profit, private sector organization independent of all other business and professional organizations. The FASB has been delegated the responsibility to develop financial accounting and reporting standards that are in the public interest by the US Securities and Exchange Commission.

General Principles of Ratemaking

16. The regulatory compact allows utilities to recover prudently incurred costs and a reasonable return. This process is overseen by an independent regulator to ensure rates are set on a fair and reasonable basis for both utilities and ratepayers.

17. I understand that in common with other regulatory commissions in North America, the OEB makes decisions, establishes regulatory accounting requirements and rate-making methodologies based on regulatory principles that include fairness, intergenerational equity and minimizing rate volatility (EB-2008-0408—Report of the Board – Transition to International Financial Reporting Standards).

18. Intergenerational inequity arises when a cost incurred to provide a service to ratepayers in one period is paid for by ratepayers in another (usually future) period.

19. As OPG uses US GAAP for its financial reporting, I have looked to how the cost of pension and post-retirement benefits are allowed for recovery by the Federal Energy Regulatory Commission ("FERC"). FERC is a regulator of public utilities in the United States of America. It is my understanding that FERC also recognizes intergenerational equity as a key principle when setting rates. FERC guidance summarized below indicates that it views accrual accounting as the most appropriate basis to determine the cost of employee service in a particular period.

20. In accounting guidance issued by the FERC's Chief Accountant (Docket No. AI93-4-000) updated June 28, 2010, reference is made to FASB Statement of Financial Accounting Standards No. 106 ("SFAS 106") which provides guidance on accounting for PBOPs. Extracts from this guidance follow:

"SFAS 106, essentially finds that PBOP plans are deferred compensation arrangements whereby an employer promises to exchange future benefits for employees' current service. Consistent with that view, SFAS 106 requires that, for fiscal years beginning after December 15, 1992, employers reflect in current expense an accrual for PBOP during the working lives of the covered employees."

"A jurisdictional entity shall adopt the provisions of SFAS 106 for FERC accounting and reporting purposes in the same accounting period an [sic] through use of the same method [...] that was used to adopt SFAS 106 in its general purpose financial statements."

21. In the section on General Principles – Ratemaking, the Statement of Policy on PBOP issued in 1992 stated:

"PBOPs are a form of deferred compensation to employees for the services that they provide during their working years. Therefore, the costs of providing these benefits are properly included in the cost of service during the period that the benefits are earned."

"Measurement of PBOPs for a given rate test period is a process of allocating accrued costs between periods in a rational manner so that each period bears its equitable portion of such costs. SFAS 106 provides a reasonable convention for measurements of accrued costs including the transitional treatment of prior service costs."

Analysis and Conclusions

"Should pension and other post-retirement benefit costs of a regulated utility be recovered in rates using the cash method (pay-as-you-go or funding contribution) or the accrual method determined in accordance with the applicable financial accounting framework of the utility (i.e. US GAAP for OPG)?"

Conclusion

22. In my opinion, the accrual method is the preferable method to use in determining the recoverability of pension and OPEB costs in rates. The principal reasons supporting my conclusion are:

    a. Consistent treatment with other forms of employee compensation

    b. Consistency with the regulatory principle of minimizing intergenerational inequity and better representation in rates of cost incurred to provide services in the period ("cost causation"); and

    c. Alignment with US GAAP financial accounting and certain impacts on general purpose financial statements.

23. I have also considered the verifiability and credibility of costs along with impacts on rate volatility in the context of each alternative in forming my conclusions.

24. I believe that there are two main asserted benefits of using a cash approach to pension and OPEB cost recovery. The first perceived benefit is that pay-as-you-go is less complex as it doesn't reflect the impact of actuarial assumptions. A second asserted benefit is that, for OPEB costs, the pay-as-you-go approach can result in lower costs to ratepayers in periods where OPEB accrual costs exceeds OPEB payments (although there can be circumstances where OPEB accrual costs are less than OPEB payments) and less volatility than the accrual method.

25. In my opinion, none of the above asserted benefits outweigh the benefits of the accrual method. While the determination of pension and OPEB costs on an accrual method is more complex than the cash method, accrual

accounting for these costs is well understood by users of financial statements and has been used for years to set rates. Also the accrual basis of cost recovery represents the costs and obligations incurred to provide the service in a particular period, results in less intergenerational inequity, is consistent with the treatment for other forms of employee compensation, aligns with financial accounting requirements under US GAAP, and avoids potentially significant adverse financial reporting impacts. The way in which certain actuarial gains or losses are amortized to net income under US GAAP also mitigates volatility in cost determined in accordance with the accrual method and can result in the accrual method being less volatile than the cash method.

26. My opinion has been prepared only in connection with a consultation/hearing of the Ontario Energy Board on this issue.

Consistent treatment with other forms of compensation

27. Pension and PBOP costs can be significant elements of the compensation paid to employees. Other compensation elements, in particular salaries and wages and bonuses are included in rates on an accrual basis. I believe that from a consistency and practical perspective, all compensation costs should be reflected in rates using the same method for the reasons noted below.
28. Amounts paid to non-employees such as suppliers reflect the total compensation cost of those suppliers, which usually includes any deferred compensation for pension and PBOP costs of their workforce. If a cash basis were used to recover pension and PBOP costs, there would be an incentive for utilities to increase the use of outside suppliers and outsourced services to ensure that they can recover all of their costs in the period incurred, rather than in the future (as would be particularly the case under the pay-as-you-go method for PBOP). This bias may lead to outsourcing decisions that may not be consistent with improved productivity or lower cost.
29. The recovery of pension and PBOP costs in rates on a cash basis could also create a bias to alter the proportion of pension, PBOP, salary, wage and other elements making up the total compensation to employees. If the economic value of what employees are paid is unchanged, employers and employees should be largely indifferent to a shift to more current compensation, such as salary and wages, and less deferred compensation, such as pension and PBOP entitlements. Consequently, a change in the recovery basis could result in employers changing compensation arrangements to include fewer elements of deferred compensation. Such a shift may not otherwise be in the best interests of employers, employees and others.
30. It could also make it more challenging for a regulator to compare and treat different utilities on a consistent and fair basis. Those utilities using third party suppliers could recover the cost of pension and PBOP in rates earlier than utilities using their own employees for the same service.

31. As indicated above, use of the cash method for some costs and not others could result in a bias in whether to use employees or outside suppliers which may not result in lower costs or improved productivity (and consequently lower rates). That potential bias and differences in individual utility recoveries of total compensation (i.e. deferred vs. current) would make it more complex to set fair rates if a cash method is used for recovery of pension and PBOP. In my opinion having different recovery methods for deferred and current compensation would create an uneven playing field for participants in the utility sector.

Consistent with regulatory principle of minimizing intergenerational inequity

32. Intergenerational inequity arises when costs incurred to provide service in one period (typically for current ratepayers' benefit) are paid in a different period by a different generation of ratepayers. The use of accrual accounting for recovery of cost minimizes intergenerational inequity as the cost of providing service in a specific period is included in rates in the same period.
33. Conversely, the pay-as-you-go method includes pension and PBOP costs in rates in the period in which benefits are paid to retirees, which is likely to be a number years after their services are rendered. This results in future generations of ratepayers paying for services provided to ratepayers in a previous generation.
34. The funding contribution method also results in intergenerational inequity as funding determinations are generally based on legislative requirements and actuarial methods whose primary objective is not measurement and allocation of costs to the period in which the services are rendered, but rather the financial health of the pension plan and the security of benefits to employees. Conversely, as noted by FERC (see para. 21 above), the use of the accrual method is consistent with the objective of attributing an appropriate amount of pension and PBOP cost to each period, which minimizes intergenerational inequity.
35. Under the accrual method, the smoothing of the impact of certain changes in assumptions over a longer period reduces volatility but can result in some intergenerational inequity. However, in my opinion, it is considerably less than would be experienced using the pay-as-you-go cash or the funding contribution method.
36. While the establishment of rates is not identified by the FASB as an objective of financial reporting, the FASB's decision to require the use of accrual accounting in preparing general purpose financial reports is consistent with a regulatory principle of having rates that result in intergenerational equity.

Alignment with US GAAP Financial Accounting and Certain Impacts on General Purpose Financial Statements

37. The FASB has established "Concepts Statements" to guide it in developing standards, including those dealing with pension and PBOP costs. These Concept Statements are intended to set forth the objectives and fundamental concepts that are the basis for the development of financial accounting and reporting guidance.

38. I reference the following specific accounting guidance, which addresses the use of accrual accounting: Statement of Financial Accounting Concepts No. 8 ("Concepts Statement 8").

39. Chapter 1 of Concepts Statement 8 indicates that "*the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity*" (OB2). It also indicates that "*other parties, such as regulators… also may find general purpose financial reports useful*" (OB10). OPG is required to prepare general purpose financial reports.

40. Chapter 1 also addresses the use of accrual accounting. OB17 states that "*Accrual accounting depicts the effects of transactions, and other events and circumstances on a reporting entity's economic resources and claims in the periods in which those effects occur, even if the resulting cash receipts and payments occur in a different period. This is important because information about a reporting entity's economic resources and claims and changes in its economic resources and claims during a period provides a better basis for assessing the entity's past and future performances than information solely about cash receipts and payments during that period.*"

41. The FASB Statement of Financial Accounting Concepts No. 6, paragraph 139 states that accrual accounting *"recognizes that the buying, producing, selling, distributing and other operations of an entity during a period, as well as other events that affect entity performance, often do not coincide with the cash receipts and payments of the period…".*

42. Paragraph 140 of the Concept Statement No. 6 states that *"Accrual accounting thus provides information about an entity's assets and liabilities and changes in them that cannot be obtained by accounting for only cash receipts and outlays…"*. Paragraph 145 continues by stating *"The goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances, to the extent that those financial effects are recognizable and measurable."*

43. The OEB and other regulators in North America generally seek to align regulatory reporting and accounting with general purpose accounting principles. These regulators provide for the recovery of most expenses on an accrual basis with a few exceptions. The OEB stated this in the EB-2008-0408 Report of the Board when it established as a principle that regulatory accounting should be aligned with financial accounting unless sound ratemaking principles dictate otherwise. "*Future regulatory accounting and regulatory reporting requirements established by the Board will continue to be based on sound regulatory principles. These principles include fairness, minimizing intergenerational inequity and minimizing rate volatility.*" (EB-2008-0408 Guiding Principles - Principle 2).

44. One of the more common exceptions is accounting for deferred income taxes. In some jurisdictions (including Ontario) the regulator includes income taxes in the revenue requirement in the year the taxes become currently payable. Although this can create some intergenerational inequity, the accounting for deferred income taxes is different than the accounting for PBOP and pension arrangements. US GAAP and IFRS accounting rules do not allow deferred tax balances to be discounted and there are inherent difficulties in estimating when deferred taxes will reverse and become payable in the future. Consequently, the deferred tax expense of a particular period does not often represent the real current cost of such taxes in the current period. Furthermore, in my opinion, for capital intensive businesses like electric utilities, there is generally a long time frame for crystallization of deferred tax (and continuous origination of new timing differences), which may extend the time period when taxes become payable. Accordingly, because deferred income taxes are not discounted and the potential timeframe of reversal is long, the impact of the intergenerational inequity of not including deferred income taxes in rates is generally mitigated by these factors.

45. Requiring use of a cash method will also result in financial reporting issues which may result in negative financial and other implications. US GAAP guidance (ASC 980-715-25 Recognition), summarized below, severely restricts an entity from recognizing regulatory assets for PBOP costs when a cash (pay-as-you-go) method is the basis on which such costs are recovered in rates:

> ***Criteria for Recognizing Regulatory Assets for Postretirement Benefit Differences***
>
> *25-3 For purposes of this Subtopic, other postretirement benefits refer to all forms of benefits, other than pensions, provided by an employer to retirees.*
>
> *25-4 For continuing postretirement benefit plans, a regulatory asset related to Subtopic 715-60 costs shall not be recorded if the regulator continues to include other postretirement benefit costs in rates on a pay-as-you-go basis.*

46. As PBOP costs are significant components of total compensation for many utilities, the inability to record a regulatory offset for PBOP costs incurred would impact net income and shareholder returns, as well as key balance sheet and performance ratios derived from a utility's general purpose financial statements and credit metrics. This could also impact the utility's cost of capital or access to capital, which in turn would increase rates to consumers.
47. Similarly, use of a cash method for recovery of pension costs would raise questions about the ability to record a regulatory asset for differences between cash and accrual costs as the criterion in ASC 980-10-15-2(b) which requires a cause-and-effect relationship between a reporting entity's costs and its rate base recoveries and timely recovery of cost incurred. It may be difficult to meet this criterion if recovery of pensions on a cash basis significantly lags the period in which such costs were incurred.
48. Further to the ongoing financial reporting impacts, utilities transitioning from an accrual to a cash basis could be required to write-off any previously recognized regulatory assets for unamortized pension and OPEB amounts.
49. In addition to the impact on general purpose financial statements and credit metrics, the above would also require a utility to maintain two sets of financial records which would increase its financial burden.

Verifiability and credibility of costs

50. Both the cash method and the accrual method provide assurances that the amounts paid or accrued are verifiable and credible. Cash amounts paid are easily understood. From an accrual perspective, the use of actuaries (both internal and external to an entity) and independent auditors provide comfort that the amounts accrued and key assumptions are verified.
51. Use of the accrual method by an entity results in a high level of transparency regarding pension and PBOP costs. There are generally various reports by internal and/or external actuaries, and extensive disclosures in an entity's financial statements. This information included within audited financial statements and actuarial reports facilitates a rigorous analysis and assessment of the determination of pension and OPEB costs and comparability across entities.
52. Considering the above, both methods are verifiable and credible.

Volatility

53. I have also considered the impact that different recovery mechanisms could have on rate volatility. Each method can result in volatility in certain circumstances. Volatility in cost may be undesirable but it is real. Notwithstanding the volatility, rates based on the accrual method better reflects the cost of a service in a particular period as it includes the cost and obligations necessarily incurred by the utility (subject to prudency) to deliver a service in a particular period.
54. I also note that, as some of a utility's limited-life assets (such as the case with OPG's nuclear facilities) reach the end of their service lives, the use of cash basis for pension and PBOP costs could result in more volatile rates as one-time events (e.g., staff restructuring, modifications to plans) lead to a significant rate impact as large sums relating to deferred compensation pension and PBOP plans may be paid over short periods. Also, a utility with a large portion of its workforce retiring early or in large numbers could experience a significant impact in rates as PBOP benefits are paid out relating to services rendered by previous generations.

55. The funding contribution method can also result in volatility as contributions are based on actuarial assumptions. Changes in actuarial assumptions and discount rates can have significant impacts on funding requirements in a particular period and can vary depending on the funded status of the plan.
56. The use of accrual accounting for pension and PBOP costs can also result in some volatility in amounts reported from period to period because the accounting expense is impacted by changes in actuarial assumptions. However, under US GAAP, changes in actuarial assumptions are generally charged to net income systematically over time (e.g. over the estimated average remaining service lives of employees) and only to the extent that the unamortized gains or losses exceed a certain threshold ("Corridor Method"). "*This is intended to reduce pension cost volatility resulting from short-term market swings by providing a reasonable opportunity for gains and losses to offset over time without affecting pension cost.*" (PricewaterhouseCoopers LLP 2014 Accounting and Reporting Manual). This reduces volatility arising from changing actuarial assumptions in a particular period. Consequently, the accrual basis can result in less volatility than the funding contribution basis in the longer term.
57. IFRS does not permit the use of the Corridor Method to smooth actuarial gains and losses through net income over the remaining service lives of employees. Instead it requires immediate recognition of such gains or losses in either net income or Other Comprehensive Income. IFRS differs from US GAAP in the way in which certain costs are charged to income mean the OEB may need to consider recovery methods for these costs on an entity-specific basis to address the differences in accounting between entities.

Respectfully submitted,

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Appendix A

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Eric is a power & utilities specialist partner in our assurance practice. He joined PricewaterhouseCoopers in Edmonton, Alberta in 1993 after graduating from the University of Saskatchewan with a Bachelor of Commerce degree. On obtaining his Chartered Accountant qualification in 1996, he transferred to PricewaterhouseCoopers in London, England where he worked in the Firm's Energy & Utilities assurance practice from 1996 to 2003. During this period, Eric also spent one year working in Paris to transition the audit of one of the Firm's Global audit clients to PricewaterhouseCoopers Paris. He returned to Canada in 2003 to join the PricewaterhouseCoopers Assurance practice in Toronto.

In addition to leading PwC Canada's Power & Utility Assurance Services practice, Eric provides a full range of assurance and business advisory services to a number of our clients in the sector. His audit clients include regulated utilities, energy retailers, traders and independent power producers reporting in accordance with both IFRS and US GAAP. In addition to his responsibilities as audit partner on a number of listed and private clients, he is an advisor on accounting and reporting matters to several Canadian utilities. In this role, he works with his clients to research, document and develop solutions on complex technical matters. He has a wide range of international experience in leading large and complex internal and external audit assignments, regulatory matters, IFRS and US GAAP conversion projects, due diligence and transaction services, stock exchange listings and other risk management and advisory services.

In addition to his client commitments, Eric also presents at external seminars and workshops on accounting, governance and regulatory developments. He is regular presenter at the Directors Education Program of the Institute of Corporate Directors and Rotman School of Business and also the Canadian Electricity Association Finance & Accounting Committee. Eric is a member of the global working group which developed the PwC response to the IASB's Exposure Draft, *Rate-Regulated Activities* and is continuing to represent PwC Canada on that global working group and on other activities.