Hydro One Networks Inc.
7th Floor, South Tower
483 Bay Street
Toronto, Ontario M5G 2P5
www.HydroOne.com

Tel: (416) 345-5240
Cell: (416) 903-5240
Oded.Hubert@HydroOne.com

Oded Hubert
Vice President
Regulatory Affairs

BY COURIER

July 31, 2015

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

Dear Ms. Walli:

EB-2015-0040 – Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit ("OPEB") Costs in the Electricity and Natural Gas Sectors

Hydro One Networks Inc. ("**Hydro One**") makes this submission in response to the Ontario Energy Board's ("**OEB**" or "**Board**") invitation for submissions on an initial set of questions in the above-noted consultation.

Hydro One's main views in this consultation may be summarized as follows.

- Hydro One encourages the Board to consider both the costs and benefits of any contemplated changes to the regulatory treatment of Pensions and OPEB, with specific consideration of the specific risks that the Board is seeking to mitigate.
- If the Board identifies risks that justify a changed regulatory treatment, increased controls, or additional oversight, the Board can require these measures on a targeted basis to address specific situations, information needs, or entities where there are grounds for concern.
- The introduction of a standardized method of cost recovery for pension and OPEB costs is undesirable, as it ignores the specific considerations that utilities took into account in adopting their current practices. Consistent with outcome-based regulation, the accounting method should be left to management (guided by accounting authorities), as should flexibility in recovery methods, to address the specific circumstances of each utility and its customer base.
- Benchmarking pension and OPEB costs in isolation would not yield meaningful comparisons, as these are only two elements of an integrated total compensation package.
- Pensions are already heavily regulated and, as such, pose no risk to the Board's statutory objectives. The 'pancaking' of further regulation would impose unnecessary costs on the

Board and utilities. The ability to meet OPEB liabilities is not a concern for companies with strong balance sheets.

In addressing the Board's questions below, Hydro One has limited its comments to key principles, recognizing that the Board may later choose to examine these issues more closely, particularly in relation to implementation and other more specific challenges.

GENERAL PRINCIPLES

1. **What principles should the Ontario Energy Board ("OEB") adopt in addressing pension and other post-employment benefit ("OPEB") costs 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.**

Hydro One submits that the OEB should be guided by the following principles when addressing pension and OPEB cost issues:

a. the OEB's statutory objectives[1];
b. general rate-making principles, specifically,
    i. fairness to ratepayers and utilities, and
    ii. fairness within the ratepayer population (intergenerational equity) where responsibility for costs is allocated based on cost causation; and
c. minimize the regulatory burden on utilities and on the Board to the extent possible, absent a compelling reason to do otherwise.

Hydro One submits that the principle of consistency amongst utilities or industries is not an appropriate area of focus given the diversity in compensation strategies and circumstances amongst utilities.

Hydro One submits that benchmarking pension and OPEB costs alone is not useful. Different utilities have different compensation strategies which rely on varying mixes of base salary, incentive payments, equity compensation, education allowances, long-term disability and parental leave payments, vacation and sick pay, employment benefits, pension benefits (defined contribution, defined benefit, varying contribution ratios), and OPEB. If the Board wishes to benchmark these costs, <u>they should be benchmarked as part of total compensation</u>.

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

Hydro One submits that other types of costs which have been specifically considered in a generic proceeding are not suitable analogies to pension and OPEB costs.

[1] Further, the exercise of the Board's power must be a practical necessity to accomplish its legislated objectives, as per *ATCO Gas and Pipelines Limited v. Alberta (Energy and Utilities Board)*, [2006] 1 S.C.R. 140, paragraph 77.

Unlike the examples cited above, pensions are subject to significant regulatory oversight by the Financial Services Commission of Ontario (FSCO), which establishes reporting and minimum annual funding requirements under the *Pension Benefits Act* (Ontario). This regulatory oversight is partially due to the fluctuations in pension valuations. Pensions are funded, in part, by the investment of pension assets. For this reason, they are tied closely to financial markets and are subject to the volatility of financial markets. The complex underlying actuarial assumptions regarding employee turnover rates, remaining years of service, mortality rates, etc. also change over time. All of these factors affect pension valuation and, therefore, pension cost to utilities. In contrast, deferred taxes, asset retirement obligations and site restoration costs are steadier and more predictable in nature, and they are not overseen by a different regulatory body.

Furthermore, pension and OPEBs require significantly more internal governance than the cost examples provided. At Hydro One, a dedicated group of pension and investment professionals, Management Pension Committee, and the Audit Committee of the Board of Directors oversee the management of pension assets and liabilities. Hydro One also periodically reviews and updates, with its actuary, the assumptions underlying its OPEB liability regarding demographics and prescription drug and other medical rates.

Hydro One submits that Pension and OPEB costs should be treated as components of total compensation, subject to the same prudence review as other cost items when establishing just and reasonable rates.

INFORMATION REQUIREMENTS

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

Applicants should be required to compare their pension and OPEB costs to an appropriate peer group only as part of total compensation. Hydro One does not see the benefit of or rationale for isolating pension and OPEB costs for comparison, given the diversity in compensation strategies in the industry as described in our response to Question 1. Also, inherent to any comparison of pension costs will be a comparison of returns on pension plan assets or funded positions. Such a comparison would be unhelpful as there are many reasons why pension plans can have different results, such as different investment objectives, company objectives, plan design, risk tolerances, demographics, etc.

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

The OEB could consider having applicants establish tracking accounts which monitor the variances between accounting costs, recovery in rates and cash outlays of pension and OPEB costs. This could be a means of determining whether a utility's practices are a cause for concern.

Any review of a utility's pension and OPEB costs should entail a consideration of their underlying assumptions, such as discount rates, expected long-term rate of return on assets, salary escalation rates, mortality rates, and medical/dental cost trends; all in the context of the specific circumstances of the utility and its customers.

ACCOUNTING AND RECOVERY IN RATES

5.

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

Hydro One submits that it is not appropriate or necessary for the OEB to establish accounting methods for the electricity and natural gas industries. Utilities have adopted accounting methods that are already governed by their respective accounting authorities (IASB for IFRS, SEC for US GAAP). Furthermore, utilities have adopted specific accounting methods for their specific business reasons. Hydro One selected US GAAP on the basis that it minimized the impact to ratepayers of the mandatory transition away from Canadian GAAP. If the OEB prescribed a method that deviated from conventional accounting principles for a subset of utilities' costs, utilities would be required to maintain two sets of accounting books solely for the purposes of compliance, without regard to whether the approach resulted in an optimal outcome for utilities and their customers. Besides the additional administrative burden, this increases cost, complexity and the possibility for confusion within utilities and externally to their auditors, creditors and other investors.

Hydro One does not see a compelling reason to change the current approach to the recovery of pension and OPEB costs. Presently, the OEB has the flexibility to establish recovery methods based on the facts and circumstances specific to each utility and its customers. This flexibility is desirable when dealing with a varied group of utilities.

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

In addition to the general principles identified in our response to question 1, in determining an approach to accounting and recovery of pension and OPEB costs, Hydro One submits that the OEB consider that the approach:

i. should be consistent and compatible with each utility's chosen accounting framework and other applicable regulatory/legislative requirements;
ii. should be outcome-based, and flexible enough that it can address the specific circumstances of a utility and its customers, in a manner that enables predictability in costs and, therefore, rates and furthers OEB objectives;
iii. does not improperly adversely impact a utility's financial metrics (e.g. capacity, ratios and covenants, credit rating) or its ability to execute its work plans; and
iv. does not add an undue regulatory burden (and associated costs) on utilities and the Board (which requiring utilities to maintain two sets of accounting books would do).

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)**

Hydro One submits that no one method should be adopted for reasons already articulated and given the diversity of pension plan design and funding vehicles. Regardless of the method adopted, ultimately, a utility's pension expense is the same when its pension plan is wound up. The challenge here lies in balancing the objectives of rate stability, inter-generational equity within a ratepayer population, and timely cost recovery for utilities.

While Hydro One has adopted accrual basis of accounting for pension and OPEB obligations, it recovers its pension costs on a cash basis because its pension plan was in a surplus, resulting in a contribution holiday. To pass the benefit of the contribution holiday on to ratepayers, the OEB ordered that pension costs were and continue to be recorded on a cash basis as employer contributions are paid to the pension fund in accordance with the *Pension Benefits Act* (Ontario). A variance account was established to reflect the difference between pension costs paid and OEB-approved amounts. Hydro One recovers OPEB costs on an accrual basis. We believe this approach strikes the appropriate balance between the objectives of rate stability, inter-generational equity, and timely cost recovery for utilities.

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

Hydro One submits that there should not be any difference in cost recovery approach between registered and unregistered plans.

6.

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

Yes, we believe it would be prudent for the OEB to consider the impacts on financial reporting, legal and tax matters, in addition to the impact on rates and ratepayers, as well as utilities' earnings (volatility of earnings), credit rating impacts, and ability/need to raise debt.

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

Any adverse impact on financial reporting or financial metrics should be avoided. Hydro One capitalizes a large portion of its OPEB costs. As a result, recovering this capitalized component of the OPEB costs on a cash basis would require Hydro One to finance its OPEB liability, reducing its free cash flow from operations and affecting other financial metrics. . .

Consistency in financial reporting is critical to the comprehension and credibility of a utility's financial statements, which are used by various stakeholders. The OEB should consider how to best safeguard this consistency (intra- and inter-period financial statements) in any transition to a new approach to recovering pension and OPEB costs.

Ultimately, the OEB should consider whether an approach (a) harms any of its statutory objectives, or (b) imposes a greater regulatory burden than absolutely required to achieve its statutory objectives.

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.**

We understand that IFRS, US GAAP and ASPE differ in when and where financial statement costs are recorded, but that, in the end, they all yield a similar result for pension and OPEB liability.

Under US GAAP, re-measurements are recognized in Other Comprehensive Income (OCI) and amortized as accrual expenses over the average remaining employee service period, which then roll into the Retained Earnings statement. Under IFRS, re-measurements are also recognized in OCI immediately and may subsequently be re-classified as Retained Earnings if the entity elects to do so as an accounting policy choice, but they are not recognized as an accrual expense. Therefore, under IFRS, re-measurements do not impact the Income (Profit-Loss) Statement. Under ASPE, re-measurements are either immediately recognized as expenses or are deferred and amortized, in both cases being recognized eventually in Retained Earnings statement. While each accounting basis presents re-measurements differently in a given period (i.e. income statement vs. OCI recognition), ultimately, they do not impact the costs incurred by the utility, which should be fully recoverable if prudent. The difference in treatment is essentially a difference only of financial statement presentation. We submit that the OEB must take this fact into consideration when assessing comparability.

7.

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

If there is a history of significant over- or under-recovery of costs, it may be appropriate to establish a deferral or variance account, in a given utility's situation, to ensure that both the ratepayer and the utility are treated fairly.

However, for utilities that recover OPEB costs on a pay-as-you-go basis, there is no US GAAP or IFRS standard or regulation that supports the establishment of a regulatory asset to capture the difference between the cash and accrual basis of recovery. Under US GAAP, Financial Accounting Standards Board Accounting Standards Codification 980-715-25-4 expressly disallows it.

b. **How should the account(s) operate?**

The account(s) could operate in a variety of ways. They could capture all of the differences between estimated and actual costs, which the utility could either (i) bring forward at a subsequent application for disposition or (ii) automatically include in a subsequent year's rates for refund/recovery after the balance reached a certain threshold amount (like a rolling variance account where a pre-defined amount can be cleared annually).

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

Interest should be applied to the account(s) provided these are cash costs, so that in the event that the utility over-collects, rate payers are fairly compensated and earn a return on this over-collection. Conversely, if a utility is required to fund costs prior to recovering them in rates, there would be an interest cost payable to the utility for this cash outlay.

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?

As noted above, Hydro One submits that it would not be appropriate to establish accounting and recovery methods for pension and OPEB costs. In the event that the OEB elected to adopt a single approach, Hydro One supports the prospective application of such approach.

There may be a risk of double-recovering costs in a move from accrual-based recovery to cash-based recovery and of under-recovering costs in the opposite scenario. Mitigating this risk would involve significant effort. The transition may create transitional assets or liabilities, depending on how each utility recovers pension and OPEB costs in rates. The phase-in period for each utility would vary and depend on such factors as impact on the utility's rates and financial metrics. We would also advocate for some form of variance account to capture the cost of complying with the new approach.

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

Hydro One submits that a transition to any new approach should be addressed on a case-by-case basis, where justified.

8.

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?

Hydro One submits that it is not appropriate to require utilities to establish a segregated fund or similar set-aside mechanism for amounts collected from ratepayers before they are paid out. Hydro One submits that this proposed measure is not practically necessary to achieve any OEB statutory objective. For Hydro One, the connection between this proposed measure and the OEB's statutory objectives or established principles of rate-making is unclear.

Registered pension plans are already subject to this requirement by other regulatory authorities. For OPEB's, the set-up and ongoing administrative costs for a set-aside mechanism would nearly offset the benefit of having a set-aside mechanism and cannot really be justified when utilities can manage the liability using more cost efficient business practices. The absence of a segregated fund for OPEB obligations is really only a risk for utilities with weak balance sheets or poor credit ratings. Given the financial strength of Hydro One as evidenced by its strong and stable credit ratings, this is not a risk. Therefore, the costs of setting up a segregated OPEB fund are not warranted.

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

Currently, there are no vehicles in Canada that would allow the establishment of a segregated fund that is efficient from a tax and business/economic perspective.

Tax legislation permits the use of trusts to fund OPEB liabilities. Depending on the vehicle used, tax laws allow for varying levels of tax deductible contributions and causes temporary or permanent tax leakages that would put pressure on the income earning capacity of such funds and, therefore, on the utility's cash flows. In view of the strict tax requirements, the establishment of such a segregated fund involves significant expenses to address legal, tax and accounting requirements for its initial set-up and ongoing administration in compliance with laws and regulatory instruments.

In view of the tax leakage associated with the use of a segregated fund, the funding of OPEB would generally shift the immediate tax burden associated with OPEB accruals from rate payers to a non-regulated entity. Therefore, consideration should be given to the treatment of such tax leakage in the segregated fund, be it permanent or temporary, on the determination of rates for any given year. In addition, the use of a segregated OPEB fund imposes a new cash commitment on the utility that erodes the utility's autonomy in determining the best use of available funds. It also puts additional stress on the utility's borrowing capacity by limiting the operational cash available to the business.

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?

Hydro One does not support the establishment of a segregated fund for the reasons discussed earlier. Should the OEB mandate the establishment of a segregated fund, consideration of the impact on individual utilities and their rates needs to be considered on a case-by-case basis.

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

Utilities currently file quarterly Reporting and Record keeping Requirements reports with the OEB and provide copies of actuarial valuation reports as part of rate filings. Hydro One submits that this is sufficient information and any additional information requirements should be imposed on a case-by-case basis.

Hydro One appreciates the opportunity to provide its views on the questions put forward by the Board and would be pleased to offer further comments if the Board chooses to examine these issues further.

Sincerely,

ORIGINAL SIGNED BY ODED HUBERT

Oded Hubert