Pension & OPEB Stakeholder Forum Presentation

July 19, 2016

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Overview of Presentations

OPG's presentation will focus on:

- Identifying the relevant principles; and
- Applying principles to assess cost recovery methodology alternatives

This presentation will not address information requirements

Concentric Energy Advisors presentation will focus on:

- Assessing regulatory mechanisms available to address timing differences; and
- Establishing a rate associated with a tracking account for timing differences

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Principles

In its letter of May 19, 2016, the OEB stated it would consider the ratemaking principles listed in EB-2008-0408 Report of the Board. OPG believes that the following principles identified in the Report are most relevant to this Consultation:

1) **Alignment with Required Financial Accounting and Reporting:** Sound regulatory principles will be the primary driver, with accounting requirements being an important consideration
   - ➢ The OEB will align with financial reporting requirements unless inconsistent with sound regulatory principles
2) **Intergenerational Equity:** Minimize recovery of costs in a period different than the period in which those costs were incurred
3) **Fairness:** Responsibility for cost is based on "cost causation", with recovery "matched" to the period in which the cost is incurred
4) **Rate Volatility:** Rate impacts should be considered when determining the timing and pattern of recovery of approved revenue requirement
   - ➢ Rate stability is desirable but distinct from achieving stable cost levels in individual cost items, as a particular cost is an input to the rate-setting process

Principles (cont.)

OPG believes that the following principles from the EB-2008-0408 Report of the Board have some applicability:

1) **Universal Requirement with Utility-specific Issues Considered in Individual Applications:**
   - Principles should be universally applied
   - Supports the application of utility-specific circumstances

2) **Balancing Effects on Both Customers and Shareholders:**
   - To be considered as part of overall revenue requirement determination rather than for a single cost item
   - As it applies to this Consultation, this principle is better achieved through treatment of timing differences (i.e. “value for money” options) than cost recovery methodologies

Principles (cont.)

OPG believes the following principles raised in the initial stakeholder submissions from July 31, 2015 should also be considered:

1) **Legal Compliance:**
   - Must enable utility to earn a fair rate of return
   - Must not effectively interfere with collective bargaining processes
   - Defer to relevant legislation (Ontario *Pension Benefits Act*, Income Tax Act, etc.) and accepted accounting or actuarial principles or standards applicable to a particular methodology
   - For OPG, must comply with O. Reg. 53/05

2) **Consistency and Simplicity:**
   - The OEB has long held that maintaining a consistent approach over time has aided in assessing reasonableness and helps ensure fairness to both ratepayers and the company
   - Changes in cost recovery methodology can create complicated transition considerations
   - Incremental complexity typically results in added cost and time to adopt new processes and/or implement new accounting, reporting and record-keeping requirements

3) **Efficient Consumption/ Appropriate Price Signals:**
   - Any costs associated with addressing timing differences should be included in period costs
   - Cost recovery methods that do not reflect the true period cost send inappropriate price signals

OPEB Cost Recovery Methodology – Overview

- Ontario utilities use the accrual approach for financial reporting purposes, regardless of the accounting method (US GAAP, IFRS, PSAB, ASPE)

- Cost recovery methodologies have historically been consistent with the financial reporting approach (i.e. accrual)

- Evidence in support of the accrual costs (e.g., actuarial reports) has been examined and accepted by the OEB as part of rate applications, as appropriate

OPEB Cost Recovery Methodology – Application of Principles

Pay-As-You-Go: Does not align with identified regulatory principles

OPEBs are earned during employment and provided after employment ends

- This makes the approach at odds with Intergenerational equity, Efficient consumption/ Appropriate price signals, and Fairness
- Adds complexity through consideration of transition issues
- Introduces risk of adverse financial consequences: immediate income charge for any historical deferred balances (OPG ~$265M), plus reduced annual income and cash flow (OPG ~$500M for 2017-2021) and added pressure on Debt-to-EBITDA and other credit metrics
- US GAAP restricts establishment of regulatory balances for OPEB specifically
- OPG-specific issues (O. Reg. 53/05 requirements, limited life of nuclear facilities)

Accrual: Best alignment with identified regulatory principles

- Avoids intergenerational equity and related concerns
- Consistent approach over time and across industries
- Uses the financial accounting method all utilities use
- Timing differences best addressed through “value for money” options as required (balances interests of customers and utilities)

OPEB Cost Recovery Methodology – Application of Principles (cont.)

Adjusted Pay-As-You-Go: The approach lacks detail. As written, the specific example (KPMG Report, 74) has several challenges:

- **General:** Unclear if there is a permanent disconnect between cash and accrual, as historical adjustment (Part B) appears to move the entity to a cash basis but future amounts (Part C) are presumably aimed at ensuring recovery of costs on an accrual basis
- **Part B:** Involves a refund of amounts "previously collected from customers" which would be effectively changing the basis on which previous rates were established (i.e. retroactive ratemaking considerations)
- **Part C:** The key objective to ensure there is not a build-up of OPEB costs not being included in rates over a reasonable period of time appears intended to support recording of a regulatory asset for unrecovered timing differences. Very specific US GAAP criteria <u>must</u> be met to set up a regulatory asset (including commencement, duration and pattern of recovery and the regulator's assurance of future recovery)

OPEB Cost Recovery Methodology – Application of Principles (cont.)

Adjusted Pay-As-You-Go: Does not address most of the principled shortcoming of Pay-As-You-Go (e.g., Intergenerational equity, Efficient consumption/ Appropriate price signals not met due to a mismatch between cost incurrence and recovery)

Creates other principled concerns:

- Complicated to implement and administer so as to ensure specific accounting criteria for regulatory asset recognition are met, initially and over time. Also requires additional tracking and reporting.
- Determination of Part C appears arbitrary and not rooted in regulatory or accounting principles
- Impairs comparability across utilities (i.e. method applies to Ontario utilities only, case-by-case recovery in Part C)
- Reduces comparability over time (new approach for all utilities)

Adjusted pay-as-you-go objectives may be more easily achieved by remaining on an accrual basis, with customer impacts considered at the overall revenue requirement level

OPEB Cost Recovery Methodology – Conclusion

Given that:

- Neither Pay-as-you-go nor Adjusted pay-as-you-go methods meet most of the identified regulatory principles;
- There is an inability to establish regulatory accounting with the move to a Pay-as-you-go method;
- The Adjusted pay-as-you-go method is not sufficiently defined, but appears to introduce ambiguity, arbitrary elements and complexity while impairing comparability;
- Recognition of regulatory assets under Adjusted pay-as-you-go would effectively require assurance of accrual recovery as defined by specific accounting criteria; and
- Most utilities already follow the accrual basis of recovery;

OPG believes that the accrual method is the optimal approach for the OEB to retain as a generic cost recovery policy for OPEB costs

To provide balance between customers and shareholders, timing differences are best addressed through "value for money" options

Registered Pension Plan Cost Recovery Methodology – Overview

- Most Ontario utilities have been recovering Registered Pension Plan (RPP) costs using the same basis as financial reporting
  - For utilities with single-employer plans, the defined benefit (DB) plan accrual accounting basis is used
  - The KPMG Report explains that LDCs account for RPP costs based on the amount of their payments into the OMERS plan (i.e. defined contribution basis)
- For certain utilities with single-employer plans, the OEB has adopted a funding contribution method of recovery
- Evidence in support of accrual costs or funding contributions (e.g., actuarial reports) has been examined and accepted by the OEB as part of rate applications

Registered Pension Plan Actuarial Valuations

- Accounting and funding valuations are prepared by independent actuaries
- Funding valuations calculate plan's funded status and required contribution range
  - Pension plan health and benefit security of members are key considerations
  - Funding valuations are not prepared to allocate costs to periods; accounting valuations are prepared for that purpose
- Both types of valuations require assumptions about future events and are subject to third-party review and oversight
  - Funding assumptions and methods are determined in accordance with standards of practice set by the Canadian Institute of Actuaries and legislative/regulatory requirements
    - Must be acceptable to the Financial Services Commission of Ontario
  - Per US GAAP, accounting assumptions must represent management's best estimate
    - OPG is closely guided by independent actuaries in establishing assumptions. Assumptions and results are also reviewed by external auditors
  - Subject to specific US GAAP or legislative/regulatory requirements, OPG's accounting assumptions for funding and accounting are largely aligned. At times, certain funding assumptions may reflect a more "conservative" perspective

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Registered Pension Plan Actuarial Valuations (cont.)

- OPG believes it is not possible to conclude that either funding contribution or accrual method would produce consistently lower or more stable results for OPG
  - OPG's funding contributions were higher than accrual costs in five of the last eight years, and are projected to be higher than accrual costs in four of the next five years
  - Multiple factors can inherently impact differences between accounting and funding: discount rates, amortization mechanisms for gains/losses, timing of valuations, prescribed solvency assumptions, etc.
- The challenges in comparing funding contributions across utilities are no less great than in comparing accrual amounts
  - Comparability of funding can be hampered by differences in: funding and investment policies, demographic profiles, plan provisions, and perspectives on "conservatism"
  - Wider range of discount rates is typically acceptable for going concern valuations than for accounting purposes

Accrual accounting and funding contribution amounts are established in a similar manner (actuarial involvement, similar assumptions, independent review) and , at least for OPG, neither method is systematically lower or more stable

RPP Cost Recovery Methodology – Application of Principles

Funding Contribution: Weaker alignment with identified principles than accrual basis

- Less aligned with Intergenerational equity, Efficient consumption/ Appropriate price signals, Fairness
  - Not intended to measure a utility's pension cost for a particular period
  - Risk of adverse financial consequences: immediate income charge for any historical deferred balances (OPG's ~$190M), plus reduced income in years when accrual costs exceed funding amounts (OPG will not be able to set up a regulatory asset for such future funding-accrual differences for some time)
- Customer benefits not readily apparent
  - OPG projects a net ratepayer cost of moving to a funding basis for 2017-2021
- Adds complexity through transition issues for most utilities with single-employer DB plans

Accrual /Financial Accounting: Best alignment with identified regulatory principles

- Systematic attribution of DB pension costs over the period employees render service
- Consistent approach over time and across most utilities with single-employer DB plans
- Timing differences would exist for only a few utilities. Effects on customers can be best addressed through "value for money" options, as required
- LDCs already recover pension costs on a financial accounting basis, so they would not be impacted

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RPP Cost Recovery Methodology – Application of Principles (cont.)

Modified Funding Contribution: Same drawbacks as Funding Contribution, plus Fairness concerns and added complexity

- Method arbitrarily defers a portion of legally required payments and is not rooted in regulatory or accounting principles
  - Solvency payments are required as part of funding under the *Pension Benefits Act*
  - Solvency payments are an acceleration of future going concern payments and cannot be considered in isolation
  - OPG must make any required solvency payments; cannot use letters of credit
- LDCs may be unable to identify "solvency" portion of their payments
- Introduces complexity through additional tracking and record-keeping
- A certain degree of volatility is inherent in both accrual and funding amounts; rate stability is better considered at the overall revenue requirement level

Registered Pension Plan Cost Recovery Methodology – Conclusion

Given that:

- Accrual method results in a systematic allocation of costs over the period employees render service, and best meets other identified regulatory principles;
- Neither accrual nor funding contribution methods produce consistently lower or more stable results, at least for OPG;
- Modified Funding Contribution method arbitrarily defers a portion of legally required payments;
- Both accrual and funding amounts are established with actuarial involvement, similar assumptions and independent review; and
- Financial reporting and rate recovery methods are already aligned for most utilities;

OPG believes that alignment with financial reporting (in OPG's case, accrual) is the optimal approach for the OEB to adopt as a default cost recovery policy for pension costs. Individual utility circumstances would be considered when applying this policy

To provide balance between customers and shareholders, timing differences are best addressed through "value for money" options

Regulatory Treatment Of Timing Differences Related To Pension And OPEB Costs

Presented To:
The Ontario Energy Board

July 2016

Agenda

- Scope and Overview
- Precedents
- Summary of Regulatory Mechanisms
- Recommended Approach
- Rate Associated with a Tracking Account

Scope and Overview

- **Concentric was asked to review and respond to the "KPMG Report to the Ontario Energy Board. Report on Pension and Other Post-Employment Benefit Costs" (the "KPMG Report", published May 2, 2016)**
  - Specifically, Concentric was asked to review and respond to section 3.4.2 of the KPMG Report (pp 65-69)
- **KPMG identified four alternatives for possible set-aside mechanisms (p. 65):**

(1) internally segregated accounts;

(2) retirement compensation arrangements ("RCAs"), *i.e.*, externally segregated accounts;

(3) excess recoveries reduce rate base; and

(4) record excess recoveries in a tracking account that is monitored by the OEB

Precedents

- **Similar to KPMG, Concentric was asked to review treatment of "cash-versus-accrual" timing differences in North American regulatory jurisdictions. Our findings were as follows:**
    - There is a wide diversity of practice across Canada and the U.S. in terms of treatment (if any) of "cash-versus-accrual" timing differences
    - In many jurisdictions, there is no ratemaking allowance for "cash-versus-accrual" timing differences
    - Different jurisdictions have allowed different carrying costs on such timing differences

- **Where this issue has been addressed from a ratemaking perspective, there is general agreement that it is appropriate to apply a rate to timing differences (positive or negative) between P&OPEB costs recovered in rates and cash payments by utilities.**

Summary of Regulatory Mechanisms

- **Concentric considered potential alternatives for possible set-aside mechanisms**
- **Concentric identified the same range of alternatives that were identified by KPMG**
- **Concentric interprets the KPMG Report to state that alternatives 1 and 2 are sub-optimal, and we agree:**
  - Internally segregated funds do not optimize utility funds and may result in the need to raise additional debt to replace the funds that are set aside (p. 65)
  - Retirement Compensation Arrangements are tax inefficient and could have a negative implication on rates (pp. 66-67)

Recommended Approach

The OEB should consider the fourth alternative identified by KPMG (*i.e.*, record excess recoveries in a tracking account that is monitored by the OEB)

- Such an approach would:
  - Be administratively efficient;
  - Provide customers with a specified and predictable return on any funding provided for costs that will be paid in the future (KPMG report p. 67); and
  - Take into account the nature of the underlying costs that are under consideration

- **The use of a separate tracking account would still allow the OEB to establish the rate to be applied to the account based on utility-specific considerations**
- **Concentric generally agrees with KPMG's conclusion that either approach 3 (*i.e.*, excess recoveries reduce rate base) or 4 (*i.e.*, record excess recoveries in a tracking account that is monitored by the OEB) could "represent no change with regards to cash funding requirements" (p. 67)**
- **We caution, however, that (as KPMG further notes) such approaches could "[c]hange the utility's investment and credit risk profile" (p. 67), and could "potentially reduce the utility's credit rating and/or borrowing capacity (or increase its borrowing rates)" (p. 67)**

Rate Associated with a Tracking Account

Precedent research:

- **Concentric found a variety of approaches used in applying a rate to any cash vs. accrual timing differences. Those approaches included:**
  - **0% carrying costs (*i.e.*, no reflection of P&OPEB assets or obligations in rate base or deferral accounts);**
  - **Carrying costs at the cost of long-term debt; and**
  - **Inclusion of timing differences in rate base at the utility's weighted average cost of capital ("WACC")**

Options:

- **The interest rate currently authorized for Ontario deferral and variance accounts;**
- **Utility-specific long-term debt rate (used in British Columbia and the U.S.); or**
- **WACC (used by jurisdictions that apply the "rate base treatment" for prepaid pension assets)**

Rate Associated with a Tracking Account

Recommendation: it is reasonable for the OEB to follow the current practice of applying its prescribed deferral and variance account rate

- **The effect of the decisions made in this consultation on the overall financial health, financing needs and risk profile of the utilities should be considered**
- **The use of deferral accounts over longer-term periods would not be unique from an OEB ratemaking perspective. Current accounts already in use reflect longer-term resolution of accumulated balances; these accounts attract the OEB's prescribed rate of interest, if any**
- **Based on the above, it is reasonable for the OEB to apply its prescribed interest rate authorized for D&V accounts to a P&OPEB cash-accrual timing difference tracking account unless utility-specific evidence indicates a different rate is appropriate**