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September 22, 2016

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

Dear Ms. Walli:

Re: EB-2015-0040 - Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs - Written Submissions of the London Property Management Association

On May 14, 2015, the Ontario Energy Board ("Board") announced its intention to review the regulatory treatment of pensions and other post-employment benefits ("OPEBS) costs in the electricity and natural gas sectors.

For the initial round of submissions, interested parties were invited to provide written comments on a number of issues included in the Board's May 14, 2015 letter. Interested parties were also encouraged to supplement their submissions with views on other issues which they believe warrant the Board's attention at this time.

The OEB convened a stakeholder forum on July 19 and 20, 2016. In its letter of June 23, 2016, the Board confirmed that following the forum, stakeholders were invited to file written submission on or before September 22, 2016.

On August 10, 2016, the Board issued a letter providing guidance with respect to how parties may wish to focus their written submission scheduled for September 22, 2016. The Board indicated that it would benefit from submissions on two objectives: the first is the principles that the Board should adopt for purposes of assessing pension and OPEB costs in rate applications, including any principles the Board should adopt in considering the appropriate rate mechanisms for cost recovery; and the second is options for rate mechanism for cost recovery. The letter indicated that information requirements and any transitional issues would be addressed at a later time.

The Board also indicated in the August 10, 2016 letter that while the Board was inviting parties to provide their views on all of the cost recovery options that KPMG proposed for both pensions and OPEBS, there was no need for submissions on concerns with the first two options provided by KPMG (internally segregated accounts and retirement compensation arrangements). The Board did indicate that it was particularly interested in parties' views on whether a set-aside mechanism was necessary for OPEBS if accrual accounting valued should be used rate setting, and on the latter two options put forward by KPMG, being a reduction to rate base and a tracking account.

The Board also indicated that it would appreciate parties' views on whether either of the two mechanisms noted above could be implemented for pension costs, in the event that the Board favours using accrual accounting values for rate setting. The Board also indicated it was seeking parties' views on KPMG's modified funding contribution method, as well as any method other than a pure accrual accounting method as the basis for cost recovery.

These are the written submissions of the London Property Management Association ("LPMA") with respect to the principles and cost recovery mechanisms as requested in the Board's August 10, 2016 letter.

<u>Principles</u>

LPMA has not changed its view of the principles that should be adopted by the Board for the purposes of assessing pension and OPEB costs in rate applications that were set out in its July 31, 2015 letter that provided the written comments of the LPMA.

LPMA continues to submit that a number of principles should be adopted in addressing pension and OPEB issues. These principles should be applied consistently across all regulated entities in Ontario including gas and electric, distributors, transmitters, IESO and OPG.

A key principle for LPMA is intergenerational equity. Future ratepayers should not subsidize current ratepayers and current ratepayers should not subsidize future ratepayers.

Another principle that is important is stable and sustainable cost levels that reflect an efficient level of costs for ratepayers. This is especially important with respect to the costs associated with pension and OPEB costs which have been rising at significant rates for several years and are, in the view of LPMA, unsustainable.

LPMA continues to emphasize the need to benchmark pension and OPEB costs against not only the industry, but against the private sector. This reflects an important function of the Board - to act as a market proxy. In order for benchmarking to work properly, all regulated entities need to be treated the same. If different accounting methods are used, benchmarking will be suspect.

Another key principle for LPMA is equitable treatment of any difference between the amount collected through rates and the actual cash costs between utilities and ratepayers. The Board must recognize that the funding of these future costs by current customers must be accompanied by a return on that funding commensurate with what a utility would earn on it.

Pay-as-you-go vs. Accrual

LPMA believes that the costs included in rates in any given year should be the forecasted cash costs. This is similar to the treatment of PILS/income taxes that are included in the revenue requirement. In particular, a utility is only able to recover in its rates current PILS/income taxes (i.e. PILS/income taxes payable). The same approach should apply to pension/OPEBS costs. A utility should only recover in its rates the current pension/OPEBS costs based on the payable methodology.

However, LPMA recognizes that there are problems and issues with the use of the "pay-as-you-go" method of recovery when it comes to pension/OPEBS costs based on the type of programs and the various accounting frameworks used by utilities in Ontario (IFRS, USGAAP, ASPE).

As a result, the use accrual accounting for including the amount in rates may be acceptable, even though this is likely to result in more volatility in these costs. However, under the RRFE and IR plans used by the gas utilities, these costs would be somewhat muted since they would be forecast for the cost of service rebasing year that only occurs every five years. Similarly, under a Custom IR plan, the forecast built into rates would be done at one point in time for the five year period. This would eliminate the volatility that would normally exist if the accrual method was updated every year for the more volatile components of the forecast, such as the discount rate used and market performance.

However, using the accrual method of accounting results in intergenerational inequity. Ratepayers are not paying just current costs in their rates, they are paying future costs in their rates as well. LPMA believes this can be mitigated through the use of a proper cost recovery mechanism, as discussed below, through the use of a set-aside mechanism.

LPMA does not support the use of the KPMG modified funding contribution method. LPMA believes that this method is too complicated and requires a great deal of judgement by the utilities, intervenors and the Board to come up with the addition to the amounts calculated under the pay-as-you-go basis. Not only does it appear complicated, but it is also not a simple approach that can be explained to ratepayers.

LPMA agrees with the statement in the KPMG report (page 8) that "If the OEB were to decide that accrual accounting cost is used to include P&OPEB costs in rates, alternatives for possible set-aside mechanism could also be developed in order to achieve this objective.

Set-Aside Mechanism

If the Board determines that the accrual accounting method is to be used, then LPMA submits that a set-aside mechanism needs to be put in place.

Accrual accounting recognizes the costs when the entitlement to the pension and OPEBs is earned, not when the regulated entity has to pay the costs. The accrual amount can be significantly influenced by the assumptions used in the calculation. This raises the issue of intergenerational equity. Today's ratepayers should not be paying for future benefits. Those future benefits should be paid for by future customers.

In addition, LPMA submits that there is no good reason why ratepayers should pay for entitlements before the regulated entity actually pays them. If they are required to do so, as they would under accrual accounting, then there has to be a benefit provided to ratepayers for providing cash to the utilities before those utilities actually need it.

The Board highlighted this issue in the EB-2013-0321 Decision with Reasons dated November 20, 2014 in which it said (page 88):

> *"The Board is concerned that any money collected from ratepayers today, in excess of the cash requirements, is not being used to fund future pension and OPEB cash requirements. The Board has considered both OPG's needs and those of ratepayers. In the absence of a Board policy, the Board will not allow the collection of funds from ratepayers in 2014 and 2015, of an amount higher than OPG's cash needs, when OPG's use of the excess funds is not understood, and the benefit to ratepayers is uncertain."*

With regards to the OPEB expense, the Board also indicated in the EB-2013-0321 Decision (page 90):

> *"The Board is not confident OPG has undertaken the level of cash flow analysis required to ensure it will have sufficient cash available as a corporation, when its cash needs exceed accrued expenses. It would be inappropriate to collect revenues today in excess of cash requirements and then turn to ratepayers in the future, when cash requirements exceed accrued expenses. The Board must ensure ratepayer interests over time are fully considered."*

LPMA agrees with and shares this concern. How do ratepayers know that any amount built into the revenue requirement (or in the case of OPG, the payment amount) for pension and OPEB costs in excess of the cash need is actually going to go towards those future costs? In the absence of a segregated fund or some other Board mandated mechanism for amounts collected from ratepayers before they are paid out, there is no guarantee that ratepayers will not have to pay for this cost again in the future despite having paid for it in the past already. In addition, ratepayers are not receiving any value for the excess money they have contributed to the utility. In other words, ratepayers are lending money to the utility for future use and getting a 0% return on that money. LPMA submits that this is not appropriate and that ratepayers should not be considered a cash cow with no return for the use of their money.

In summary, a set-aside mechanism is absolutely necessary for ratepayers. This set-aside mechanism should track the difference between the actual cash payments made for pension/OPEBS costs and the amount included in the revenue requirement based on the accrual method. Ratepayers should earn a return on this money that is, in effect, being lent to the utility before it requires the cash. This is the only way that intergenerational inequity can be mitigated from the use of accrual accounting.

Rate Base Reduction vs. Tracking Account

LPMA submits that the difference between treating the difference between the accrual and cash basis as a reduction to rate base or through a variance account raises the issue of whether customers are getting an appropriate return or "value-for-money" on the money that is held by the regulated utility between when it is received and when it is used for the purpose that it was intended for. This issue was identified by KPMG.

LPMA submits that the two options for which the Board requested submissions are similar, yet the impact on ratepayers could be considerably different, depending on the approach taken by the Board.

LPMA submits that the simplest approach would be track the accumulated amount of the difference on a year to year basis and use that as an adjustment to rate base.

There are two primary reasons why LPMA submits that this would be the best approach. First, it reflects that the excess cash is either being used to reduce the cash flow requirements of the utility (i.e. the working capital allowance) or it is being used to finance capital additions. In reality, it is probably being used for both purposes.

This could be reflected in the calculation of rate base in a number of ways: a reduction to the working capital allowance, a separate source of funding (separate from equity, short term debt and long term debt) at a cost of 0%, or as a bottom line adjustment to rate base.

LPMA submits that the simplest approach is the bottom line adjustment to rate base. This is the same approach taken by Union Gas ("Union") related to its accumulated deferred tax balance.

The Board has experience with the transition from deferred taxes to taxes payable in the gas industry. As an example, in 1997, Union changed its accounting for income taxes for utility operations from the tax allocation (or accrual) method to flow-through (or cash-basis) tax accounting. The change to flow-through tax accounting was adopted for rate-making purposes on a prospective basis in EBRO 493/494 (Union's 1997 rate case). The tax allocation method of tax accounting used for rate-making purposes prior to EBRO 493/494 resulted in an accumulated deferred tax balance. In EBRO 499 (Union's 1999 rate case) settlement agreement, parties agreed that the accumulated deferred tax balance would be used to reduce Union's cost of service in future years. This reduction in rate base was accomplished by reducing rate base by the average accumulated deferred tax balance in the test year and provided Union's ratepayers a return on their money equivalent to Union's weighted average cost of capital, recognizing the fact that ratepayers have funded a future liability.

If Union had continued to account for income taxes using the tax allocation (or accrual) method, ratepayers would have continue to provide Union more money than was required for the flow-through (or cash basis) taxes payable. This is because as the utility increases the level of its capital expenditures, the capital cost allowance (calculated on a declining balance basis) continues to be higher than the depreciation expense (calculated on a straight line basis) resulting in lower taxes payable in the near term. Over time this will reverse, especially if capital expenditure remain flat or decline.

The same situation would exist if accrual accounting was used for pension and OPEB costs. In both cases, the utility receives cash before it is paid out, thereby improving its cash flow and providing an additional source of funds for capital expenditures (at no cost).

Reducing rate base by the amount accumulated in this account or calculation gives ratepayers the same weighted average cost of capital for their money as that earned by the utility. The reduced rate base would then be funded through the standard debt and equity component shares.

Using a tracking account, rather than a reduction to rate base, could have the same impact on ratepayers, but only if the proper interest rate is applied to the balance in the account and returned to ratepayers on an annual basis.

LPMA submits that clearly, the proper return on the variance account is not the prescribed interest rate for deferral and variance accounts. This is a long term account that is being funded by ratepayers and the use of any short term based rate is not appropriate.

Nor is it appropriate to use a long term debt rate on this account. Again, why should ratepayers expect a return on their money less than what the utility is earning with that money? Specifically the utility is allowed to earn a return on the ratepayer money equal to its weighted after tax cost of capital. This is because there is no cost to the utility for using this money to either finance capital expenditures or reduce their need for working capital.

If the Board were to use the tracking (variance) account approach rather than the adjustment to rate base approach, LPMA submits that, at a minimum, the Board should approve an interest rate on the account equal to the utility's weighted average after tax cost of capital. LPMA notes that this would a minimum return and that the return should actually be the weighted average before tax cost of capital. This is because this is the real cost to ratepayers. Not only does the utility get its after tax cost of capital on this money that costs them nothing, but the government gets to earn PILS/income tax on the equity portion of the return on capital.

The rate base adjustment approach, as described above, has the added simplicity that by reducing rate base, the capital structure gets applied to a smaller rate base amount. This includes the equity component, at 40% (for most utilities) of a smaller rate base. This means less PILS/income taxes. In other words, ratepayers would receive the benefit of a lower cost of capital and the associated lower cost of PILS/income taxes.

LPMA submits that ratepayers should not be expected to provide money free of charge to the utilities for future expenses and receive no return on their money. By applying the adjustment to rate base, ratepayers get the same return as the utility gets. This is fair and equitable. The added bonus is that ratepayers also get the benefit of lower PILS/income taxes in their costs.

If you require any further information or clarification, please contact me.

Sincerely,

Randy Aiken

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Aiken & Associates