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, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: EB-2015-0040 – Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs

As part of its consultation on pensions and other post-employment benefits (OPEBs), the Ontario Energy Board (OEB) convened a stakeholder forum on July 19 and 20, 2016. In its letter of June 23, 2016, the OEB confirmed that following the forum, stakeholders could file written submissions on or before Thursday, September 22, 2016.

By letter dated August 10, 2016, the OEB provided guidance to stakeholders to focus the submissions sought in the June 23, 2016 letter. This submission is consistent with the OEB's guidance in its August 10, 2016 letter. In particular, the submission addresses principles that the OEB should adopt in considering the appropriate rate mechanisms for pension and OPEB cost recovery and discusses specific rate recovery mechanisms.

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").

If you have any questions regarding this submission, please contact me at 416-592-4463.

Yours truly,

Chris Fralick
Vice President, Regulatory Affairs
Ontario Power Generation

cc: Randy Pugh (OPG) via e-mail
Lindsey Arseneau (OPG) via e-mail
Carlton Mathias (OPG) via e-mail
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1 Introduction

The Ontario Energy Board ("OEB") issued a letter on May 14, 2015[1] commencing a consultation on rate-regulated utility pensions and other post-employment benefits ("OPEB") in the electricity and natural gas sectors. In this letter the OEB stated[2] that the objectives of this consultation are to:

- develop standard principles to guide the OEB's review of pension and OPEB costs in the future,
- establish specific information requirements for applications that will be incremental to current filing requirements, and
- establish appropriate regulatory mechanisms for cost recovery which can be applied consistently across the gas and electricity sectors for rate-regulated entities.

This letter also included a list of questions designed to elicit initial views on some of the key issues of interest to the OEB. On July 31, 2015 the OEB received 16 submissions on the key issues, including a submission from Ontario Power Generation Inc. ("OPG").

On May 19, 2016 the OEB issued a letter[3] outlining the next steps in the consultation. The letter was accompanied by a report prepared by KPMG[4] (the "KPMG Report") to assist the OEB in understanding the issues and options that may be available and listed the same key issues of interest to the OEB included in the May 14, 2015 letter. The May 19, 2016 letter indicated the OEB's intention to:

- Use any principles developed through this consultation to guide the assessment of any new information requirements and regulatory mechanisms for recovery of pension and OPEB costs.
- Assess which regulatory mechanisms would facilitate the setting of just and reasonable rates for gas and electricity utilities.

[1] Letter from OEB to All Registered Stakeholders, 14 May 2015, Re: Consultation on Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs. http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2015-0040/letter_Pension_OPEB_20150514.pdf

[2] *Ibid* at 1.

[3] Letter from OEB to All Registered Stakeholders, 19 May 2016, Re: Consultation on Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs. http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2015-0040/OEB_letter_Pension%20OPEB_20160519.pdf

[4] KPMG Report to the Ontario Energy Board, *Report on Pension and Other Post-Employment Benefit Costs*, 2 May 2016, [*KPMG Report*]. http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2015-0040/KPMG_Report_Pension-OPEB_20160415.pdf

- Assess the benefits of developing consistent regulatory mechanisms.
- Hold a Stakeholder Forum commencing July 19, 2016 to present the KPMG report, enable stakeholders to make presentations, and provide an opportunity for participants to ask questions or supplement their initial submissions ("Stakeholder Forum").

By letter dated June 23, 2016[5] the OEB confirmed the issues list included in its May 19, 2016 letter and invited stakeholders to make written submissions on or before September 22, 2016.

The Stakeholder Forum was held on July 19 and 20, 2016. Presentations were provided by KPMG, OPG, Union Gas Limited ("Union"), Hydro One Networks Inc. ("Hydro One"), the Electricity Distributors Association ("EDA"), and the Coalition of Large Distributors ("CLD").

By letter dated August 10, 2016[6] the OEB provided guidance to stakeholders to focus the submissions sought in the June 23, 2016 letter. This submission is consistent with the OEB's guidance in its August 10, 2016 letter. In particular, the submission addresses principles that the OEB should adopt in considering the appropriate rate mechanisms for pension and OPEB ("P&OPEB") cost recovery and discusses specific rate recovery mechanisms.

2 Summary of Submission

The two primary issues in this consultation are the cost recovery approach for P&OPEB costs and the treatment of timing differences resulting from the cost recovery approach (i.e. difference between the utility's funding/payment of obligations and the recovery of costs in rates). OPG submits that the cost recovery approach and the treatment of any resulting material timing differences should be principles based. In particular, the cost recovery approach should reflect the cost of providing the service consumed in the period. The selection of the principled cost recovery approach can produce timing differences between the recovery of costs from customers and the funding/payment of these costs by the utility. OPG submits that the OEB should address such material timing differences through regulatory mechanisms that meet the OEB's ratemaking principle of balancing the effects on both customers and shareholders.

[5] Letter from OEB to All Registered Stakeholders, 23 June 2016, Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs. http://www.ontarioenergyboard.ca/oeb/_Documents/EB-2015-0040/OEBLtr_Consultation_Pensions_OPEB_20160623.pdf

[6] Letter from OEB to All Registered Stakeholders, 10 August 2016, Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs. http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/538477/view/OEB_Letter_Pension%20OPEB_Submissions_20160810.PDF

As a result, OPG submits that:

- **Cost recovery for P&OPEB on an accrual basis is the principled approach**

  With very few exceptions, all aspects of revenue requirement, including other components of compensation costs, are recovered on an accrual basis. For P&OPEB costs, KPMG observed that, with the exception of a few entities, Ontario utilities have been recovering these costs on an accrual basis[7]. The accrual basis of cost recovery is the principled approach to recovery of P&OPEB costs. The accrual basis recognizes that future benefits are earned as a result of the provision of current service, and recognizes the cost in the period the service is provided. Cost recovery on an accrual basis matches the recovery of costs to the period they are incurred, ensures customers that receive the benefit of the services pay the cost of those services, and supports economic decision making as the price of the product reflects its true costs. Cost recovery on an accrual basis promotes consistency and simplicity for most utilities as it avoids transition considerations resulting from a change in methodology, aligns with utilities' existing financial reporting requirements, and avoids the need for the OEB to ensure specific financial accounting criteria for regulatory asset recognition are met on an ongoing basis.

  OPG submits that it is appropriate to continue to allow utilities to recover P&OPEB costs on an accrual basis. OPG supports the consistent application of the ratemaking principles in setting a cost recovery approach; however, in recognizing that a few entities have been recovering their costs through pension funding contributions or OPEB cash payments based on their specific circumstances, OPG believes that these utilities should be provided with the opportunity to justify, in their own individual proceedings, that these circumstances continue to support a cost recovery approach other than accrual[8].

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[7] *KPMG Report,* at 20.

[8] Consistent with ratemaking principle: Universal Requirement--Utility-specific Issues Considered in Individual Applications discussed in Section 3.

- **Material timing differences (positive or negative) should be recorded in a tracking account earning the OEB's generic prescribed rate of interest with exceptions permitted to address utility-specific circumstances**

OPG submits that applying a financing cost to material P&OPEB timing differences directly supports the principle of balancing the effects on both customers and shareholders, and that, of the alternatives identified by both KPMG and Concentric Energy Advisors ("Concentric"), a tracking account is the most efficient, transparent, and practical regulatory mechanism to implement this regulatory treatment As part of the July 19th presentations, Concentric made a presentation supporting the use of a tracking account which is discussed further in Section 6. OPG believes that, once the specific parameters are established, a tracking account would be easily implemented and would provide increased financial certainty to ratepayers and the utilities with respect to the issue of P&OPEB cost recovery. . In combination with an accrual basis of recovery, a tracking account could apply equally to both pension and OPEB costs, providing a consistent ratemaking basis for all post-employment benefit plans.

OPG proposes that P&OPEB timing differences be reported to the OEB quarterly with other Deferral and Variance ("D&V") account balances and, as a default, material balances should earn the applicable prescribed quarterly interest rate as determined by the OEB's Prescribed Interest Rate Policy. The OEB's policy reflects a short-term rate for D&V accounts, and a long-term rate for Construction-Work-In- Progress ("CWIP"). If the OEB were to amend its policy to apply the generic CWIP rate to D&V balances that are longer term in nature, OPG is of the view that it would be reasonable for that rate to apply to the tracking account balance for material P&OPEB timing differences, given the longer term nature of such differences.

OPG recognizes that a different rate could apply to the tracking account should utility-specific circumstances warrant. For example, to the extent a utility capitalizes a material portion of its P&OPEB costs, the weighted average cost of capital ("WACC") could apply to the capitalized portion of the P&OPEB timing differences.

For ratemaking purposes, the financial impact resulting from applying a principled approach to cost recovery (i.e., accrual) and applying a financing cost to resulting timing differences are inputs into total revenue requirement.   Once the revenue requirement is determined, the ratemaking principle of minimizing rate volatility would be applied in setting just and reasonable rates.

3 Principles

The OEB's letter of May 14, 2015 initiating the P&OPEB consultation process asked stakeholders to identify the relevant principles to be considered in this consultation. The OEB's letter of May 19, 2016 cited the ratemaking principles the OEB identified in EB-2008-0408, indicating its intention to consider these principles in its assessment process in this consultation.

OPG's Stakeholder Forum presentation of July 19, 2016 provided OPG's view of the relevant regulatory principles, both from the EB-2008-0408 Report of the Board and as raised by stakeholders in their July 31, 2015 submissions in this consultation. OPG received questions to clarify the presentation material, but no participants questioned the principles OPG identified or indicated disagreement with OPG's definition of those principles. No additional principles were identified during the Stakeholder Forum.

The principles OPG identified in its Stakeholder Forum presentation of July 19, 2016 are detailed below.

In their comments at the close of the P&OPEB Stakeholder Forum, Board Staff indicated that where possible, stakeholder submissions should indicate how their proposed ratemaking treatment of P&OPEB costs aligns with the OEB's Renewed Regulatory Framework for Electricity Distributors ("RRFE"). In the discussion on principles that follows, OPG has indicated which RRFE outcome each principle is aligned with. OPG submits that the principles that guide this submission are aligned with the RRFE and as a result, this submission is aligned with the RRFE as well.

1. Alignment with Required Financial Accounting and Reporting:

RRFE Alignment: Financial Performance

This principle from EB-2008-0408 applies to the determination of the cost recovery methodology. It recognizes that there is value in using the financial reporting requirements of a utility to set rates as the information is accounted for pursuant to well-established and widely utilized accounting principles (i.e., for OPG, US GAAP), audited for adherence to those principles, and is intended to fairly represent the financial picture of a utility. The principle also recognizes that the OEB is not bound to accept alignment with financial accounting and reporting if the results are not consistent with sound ratemaking principles[9].

2. Intergenerational Equity:

RRFE Alignment: Customer Focus/Financial Performance

If the costs incurred to produce a service in a specific period are paid for by customers consuming that service in the same period, there is no intergenerational equity. If costs incurred to produce a service in a current period are paid for by customers in a subsequent period, intergenerational inequity is created. The regulatory principle is to minimize intergenerational equity. This principle, cited in EB-2008-0408, should be applicable both to the determination of the cost recovery methodology and the setting of rates. A cost recovery methodology that provides for the recovery of the costs incurred during the period supports intergenerational equity. The accrual basis recognizes that future benefits are earned as a result of the provision of current service, and recognizes the cost in the period the service is provided. Cost recovery on an accrual basis matches the recovery of costs to the period they are incurred rather than the period they are paid, and is therefore consistent with the principle of intergenerational equity.

OPG submits that when all costs are aggregated into a revenue requirement based on the intergenerational equity principle, the regulator will have the appropriate cost information to make an informed decision on the overall level of revenue requirement to be recovered in rates, and the level of revenue requirement (if any) that the regulator determines is acceptable for recovery in a future period. In addition to the principle of intergenerational equity, the principles of fairness, minimizing rate volatility and balancing the effects on both customers and shareholders, discussed below, would be inputs to such a determination.

3. Fairness:

RRFE Alignment: Customer Focus

Fairness is another regulatory principle considered in EB-2008-0408. OPG submits that to ensure fairness the responsibility for costs should be based on cost causation, with recovery matched to the period in which the cost is incurred. In OPG's view, this principle applies to both

[9] EB-2008-0408 Report of the Board, *Transition to International Financial Reporting Standards,* 28 July 2009, Principle 4, at 7.
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/141894/view/BoardReport_IFRS_20090728.PDF

the determination of the cost recovery methodology and the setting of rates as described above under the intergenerational equity principle.

4. Minimizing Rate Volatility:

RRFE Alignment: Public Policy Responsiveness/Customer Focus

Customers prefer stable and predictable rates. OPG submits that this EB-2008-0408 principle applies to overall rate setting, rather than the determination of a specific cost recovery methodology. When all costs are aggregated into revenue requirement based on sound ratemaking principles, the resulting customer impact should be considered in light of the principle of minimizing rate volatility. As many costs are included in revenue requirement, and individual cost item increases may be offset by cost decreases in other areas, the pursuit of stability of costs for an individual component of revenue requirement is not necessary to address overall rate volatility.

5. Universal Requirement with Utility-specific Issues Considered in Individual Applications:

RRFE Alignment: Financial Performance

This EB-2008-0408 principle supports the view that, while ratemaking principles should be universally applied, utility-specific circumstances may support a different ratemaking treatment.

6. Balancing Effects on Both Customers and Shareholders

RRFE Alignment: Customer Focus / Financial Performance

This EB-2008-0408 principle applies to the determination of overall revenue requirement and rate setting, as opposed to the cost recovery methodology for a particular element of the revenue requirement. Once a principled cost recovery methodology is determined, the implications of that methodology should be assessed and additional regulatory mechanisms applied as needed to address any material issues. This principle applies to what the KPMG Report referred to as “the value for money” assessed with respect to OPEB timing differences[10].

[10] *KPMG Report,* at 64.

7. Legal Compliance

RRFE Alignment: Public Policy Responsiveness

This principle was identified in the July 31, 2015 stakeholder submissions and requires that the approach to cost recovery methodology, determination of revenue requirement, and overall rate setting must comply with legal constraints such as the requirement to enable a utility to earn a fair rate of return. In OPG's case, the approach must also respect the requirement of O. Reg. 53/05 that the OEB accept asset and liability values in OPG's audited financial statements at points in time associated with OPG's generation assets entering OEB rate regulation.

This requirement would engage unique transition considerations should the OEB move OPG away from the accrual basis of recovery. While theoretically cash and accrual costs are equal over the life of a company's post-employment benefit plan, O. Reg. 53/05 commenced OEB rate regulation of OPG a number of years after OPG was formed; therefore cash and accrual amounts are not going to be equal over the period subject to rate regulation. This unique position is discussed in further detail under sections 4 and 5.

8. Consistency and Simplicity:

RRFE Alignment: Customer Focus / Financial Performance

The OEB has held that maintaining a consistent approach over time has aided in assessing the level of cost reasonableness and helps ensure fairness to both ratepayers and the company[11]. Changes in cost recovery methodology are counter to consistency and simplicity in that such changes can create complicated transition considerations and typically result in added cost and time to adopt new processes and/or implement new accounting, reporting or record-keeping requirements. Where a cost recovery methodology is not aligned with a utility's financial reporting requirements, additional complexity arises in reconciling the two bases including considerations of net income and balance sheet consequences to the company (e.g., through regulatory asset/liability recognition).

[11] EB-2010-0008 Decision with Reasons, 10 March 2011, at 91. http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/256262/view/dec_reasons_OPG_20110310.PDF

9. Efficient Consumption/ Appropriate Price Signals:

RRFE Alignment: Public Policy Responsiveness

All costs associated with providing a service should be included and recovered in the price of the service in order to enable consumers to make the appropriate choice at time of purchase. This requires intergenerational equity, matching of costs to the period incurred (i.e. fairness through cost causality), and, in the context of this consultation, inclusion in rates of costs (or credits) arising from the treatment of material P&OPEB timing differences in balancing the effects on both customers and shareholders. Cost recovery methods or revenue requirement levels that do not reflect the true period cost would send suboptimal price signals. The regulator would balance this principle against other principles (e.g., minimizing rate volatility) in setting final rates.

4 Other Post-Employment Benefits Cost Recovery Methodology

OPG submits that the outcome of this consultation should reflect the ratemaking principles outlined above; in particular, that the cost recovery approach for OPEB should reflect the true cost of providing the service consumed in the period. In OPG's view, the accrual basis of cost recovery best aligns with the ratemaking principles identified above. Specifically, the accrual approach is aligned with required financial accounting and reporting, is consistent with intergenerational equity and fairness, is legally compliant (e.g., permits utilities to earn a fair rate of return), provides consistency for the vast majority of utilities, exhibits simplicity (i.e., avoids considerations related to methodology transition as well as related to write-offs[12] against utilities' net income for differences between accrual and cash OPEB amounts being deferred in OEB-authorized D&V accounts and financial reporting implications related to regulatory asset recognition), and provides appropriate price signals to encourage efficient consumption. OPG therefore submits that the accrual basis of cost recovery should be the default approach to OPEB cost recovery used by the OEB to establish rates.

KPMG has noted that a few utilities may be using the cash basis for cost recovery for OPEB[13]. If this is the case, then for these few exceptions, the ratemaking principles of consistency and

[12] Approximately $265M for OPG based on the OPEB portion of the forecast December 31, 2016 balance in the Pension & OPEB Cash to Accrual Differential Deferral Account

[13] *KPMG Report,* at 11.

simplicity of staying on the cash basis of cost recovery should be assessed against the remaining ratemaking principles, and these utilities should be provided the opportunity to provide evidence in their individual proceedings to justify maintaining the cash basis of cost recovery based on their circumstances. This is consistent with the principle of universal application with utility-specific issues addressed in individual applications.

The alternatives to the accrual basis of OPEB cost recovery identified in the consultation include the pay-as-you-go and the adjusted pay-as-you go approaches. Both these approaches appear to OPG to be intended to address timing differences between the collection from ratepayers of OPEB accrual costs as incurred during the service life of employees and the payment of associated cash benefits to employees' upon their retirement in the future. OPG submits that addressing the OPEB timing differences in line with the ratemaking principle of balancing the effects on both customers and shareholders is best achieved through maintaining a principled basis of costs recovery (i.e., accrual) in conjunction with introducing a timing differences tracking account earning a financing rate to provide "value for money" to the benefit of ratepayers. OPG's submission on options to address timing differences is provided in Section 6.

As discussed below, unlike the accrual method of OPEB cost recovery, neither the pay-as-you-go approach nor the adjusted pay-as-you-go approach are aligned with most of the ratemaking principles, and both of these methods would introduce significant transition and financial reporting considerations for most utilities and add complexity to the rate-setting process.

Pay-As-You-Go Approach

As noted by the Federal Energy Regulatory Commission ("FERC"), post-employment benefits other than pensions are "a form of deferred compensation to employees for the services they provide during their working years" and "[t]herefore the costs of providing these benefits are included in the cost of service during the period that the benefits are earned."[14] The benefits are earned during employment. The pay-as-you-go method of cost recovery would result in the recovery of these compensation costs after employment ends, often a number of years after the service has been provided and the benefit earned and accrued. This would result in rates that do not reflect the costs incurred to provide the service to current customers, with future

[14] EB-2013-0321 OPG Reply Argument, 10 September 2014, [OPG EB-2013-0321 Reply Argument], at 173 lines 13 to 17. http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/448909/view/OPG_ReplyARG_20140910.PDF

customers bearing those costs. This mismatch is particularly problematic for regulated utilities with limited life assets such as OPG, as discussed below.

As a result of the above, the pay-as-you-go cost recovery method is inconsistent with the ratemaking principles of intergenerational equity, fairness, and providing appropriate price signals. This method also does not align with required financial accounting and reporting for OPEB costs, is not consistent over time, and adds complexity by creating methodology transition and potential retroactive ratemaking considerations, some of which may need to be assessed on a utility-specific basis.

Switching to a pay-as-you-go basis of recovery for OPEB would result in adverse financial consequences to utilities and their shareholders stemming from write-offs of regulatory balances and ongoing reductions in net income and cash flow going forward. These impacts would be particularly material for OPG. The impacts for OPG include an immediate write-off to net income of approximately $265M, which is the OPEB portion of the Pension & OPEB Cash Versus Accrual Differential Deferral Account (forecast as of December 31, 2016), plus reductions in net income for the foreseeable future (e.g., approximately $500M forecast over the 2017-2021 period based on EB-2016-0152 forecasts[15]). The reductions in net income reflect the US GAAP restriction on establishment of regulatory assets for OPEB (the specific prescribed criteria that must be met in order to record such a regulatory asset are discussed in the Adjusted Pay-As-You-Go Approach section below). The reductions in net income and cash flow would add pressure to OPG's credit metrics such as the debt-to-EBITDA ratio, increase corporate debt levels, result in a reported rate of return that will be systematically short of the OEB-allowed (fair) rate of return, and erode shareholders' equity and investment value. In effect, a pay-as-you-go approach would impose an additional risk on utility shareholders and lenders due to an inherent lack of assurance of recovery of currently incurred costs until a number of years later.

Additional complexities in transitioning OPG away from the accrual methodology are likely to arise because O. Reg. 53/05 commenced OEB rate regulation a number of years after OPG was formed and requires acceptance of OPG's last audited asset and liability values prior to the OEB's setting of initial rates for prescribed assets.

[15] $434M for nuclear in EB-2016-0152 EX. F4-3-2, page 2, line 15 plus approximately $65M for hydro, totaling approximately $500M.

A further complication of a method such as pay-as-you-go that delays recovery of OPEB costs results from the limited life of OPG's nuclear facilities. For instance, as OPG has a fully variable rate, when a plant closes and production ceases, OPEB costs incurred while the plant was operational would need to be paid by customers after the plant is closed, as a cost of future generation. Furthermore, while OPG's nuclear production from existing facilities will shrink with the closure of Pickering and eventually Darlington, the retiree population and associated benefit payments are expected to be increasing. Combined, these factors will create significant and undesirable future rate pressure and intergenerational inequity.

Adjusted Pay-As-You-Go Approach

The adjusted pay-as-you-go method proposed by KPMG[16] appears to attempt to address some of the adverse financial accounting consequences of moving to a pure pay-as-you-go approach, namely those arising from restrictions on recognition of OPEB-related regulatory assets under US GAAP. In OPG's opinion, the specific details of how this approach might work were not made clear in the KPMG Report or during the Stakeholder Forum. OPG understands from KPMG's responses at the Stakeholder Forum that no examples of this method's use were apparent in any of the eight jurisdictions identified as having responded to KPMG's survey used in preparing their report[17]. Concentric, who reviewed portions of the KPMG Report related to the treatment of timing differences and presented their findings at the Stakeholder Forum at OPG's request, informed OPG that the adjusted pay-as-you-go method does not exist in any of the 23 North American utility cases included in their review. OPG infers that the adjusted pay-as-you-go method is more of a concept aimed at addressing the financial accounting implications associated with regulatory asset recognition rather than a defined principle-based option for effective ratemaking. The theoretical concept appears to be that some undefined portion of the timing difference between costs determined on an accrual basis and pay-as-you-go amounts would be recovered in the period those costs are incurred, and the remaining portion of the timing differences would be deferred for future recovery, remaining eligible to be recorded as a regulatory asset by utilities.

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[16] *KPMG Report,* at 60-61.

[17] KPMG Presentation, *KPMG Report on P&OPEB Costs Introduction*, 19 July 2016, [*KPMG Presentation*], at Slide 21.
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/535220/view/KPMG_OPEB_Introduction_20160718.PDF

As it is a theoretical concept, the adjusted pay-as-you-go method is subject to interpretation and perhaps misinterpretation. For example, at the Stakeholder Forum one participant compared the adjusted pay-as-you-go method to the pacing of capital additions as contemplated in the RRFE. The pacing of capital projects in the RRFE contemplates the deferral of projects to delay the incurrence of costs to the future in order to reduce rate impacts. OPG believes that these are not comparable concepts. OPEB costs are a form of compensation incurred to provide service. Unlike pacing of capital additions, the adjusted pay-as-you-go approach does not impact cost incurrence; it simply delays recovery of these costs much like the pay-as-you-go method.

The adjusted pay-as-you-go method relies on the ability of the utility to record regulatory assets. In order to support the recognition of regulatory assets for the deferred portion of OPEB accrual costs, the OEB must ensure that utilities are able to meet very specific, absolute criteria outlined in US GAAP. As confirmed by KPMG at the Stakeholder Forum, in order for utilities to be able to record such a regulatory asset, the OEB must provide sufficient certainty (i.e., effectively a commitment) of the manner and timeframe in which deferred amounts will be recovered in the future, in line with all the following conditions[18]:

- Commencement: collection of deferred amounts must begin within 5 years of the period in which the cost was incurred,
- Duration: the deferred amount must be fully collected within 20 years of the period in which the cost was incurred, and
- Recovery Pattern: the recovery of the deferred amount within the above two constraints must not be "back-end loaded" (e.g., straight-line or front-end loaded recovery is acceptable).

If any one of the three prescribed conditions above is not met or if the regulator's commitment to ensuring that these conditions will continue to be met is found to be uncertain, the utility will be unable to recognize a regulatory asset for the applicable portion of OPEB costs.[19] Based on discussions with its external auditors, OPG suggests that the most practical, definitive and direct means for the OEB to provide the appropriate level of certainty over future recovery of deferred OPEB amounts as required by US GAAP would be to authorize an explicit deferral account

[18] Financial Accounting Standards Board Accounting Standards Codification Topic ("ASC") 980-715-25-5

[19] As noted in the KPMG Report and discussed at the Stakeholder Forum, in addition to the above specific criteria, an OPEB-related regulatory asset must also meet the general US GAAP criteria for recognition of regulatory assets, namely that it is probable that the incurred cost will be recovered in future rates, as per ASC 980-340-25-1.

(such as OPG's Pension & OPEB Cash to Accrual Differential Deferral Account), specifying that the account would accumulate amounts and be cleared in line with the three US GAAP conditions set out above.[20] It is important to note that as a portion of the annual timing differences would be deferred each year under the adjusted pay-as-you-go method, the above conditions must be applied and met for each annual deferred amount, at all times until the amount has been fully recovered. In meeting the above criteria, the substance of the adjusted pay-as-you-go approach would be to allow accrual costs in rates subject to deferring collection of a portion of the costs within a specific period.

As discussed in section 3, OPG believes that individual cost items making up the revenue requirement are best determined using a principles-based approach that best reflects the true cost of providing service in a given period. This enables the regulator to make informed decisions on the overall level of revenue requirement to be recovered in current period rates and the level of revenue requirement (if any) acceptable to be deferred for recovery in a future period in the context of rate mitigation, balancing intergenerational equity considerations and the effects on customers and shareholders. The adjusted pay-as-you-go method, much like the pay-as-you-go approach, would not allow the true cost of current period services to be reflected in the current period revenue requirement and thus is not consistent with the intergenerational equity principle.

Overall, OPG submits the following with respect to the adjusted pay-as-you-go approach:

- It has most of the same principled shortcomings of the pay-as-you-go approach, including intergenerational inequity and the introduction of complex transition considerations;
- It does not address the main concern identified with the use of an accrual approach, as timing differences will continue to exist by virtue of inclusion of a portion of such differences in the current period revenue requirement;
- As proposed by KPMG, it appears to be arbitrary and not rooted in regulatory or accounting principles or conventions, which likely would impair any comparability across

[20] OPG also notes that the recognition of a regulatory asset for the OPEB amounts being recorded in its Pension & OPEB Cash to Accrual Differential Deferral Account since November 2014 is subject to the above three conditions, which means that OPG must begin recovery of amounts within 5 years of the period in which they were incurred. For example, amounts recorded during November 2014 must begin to be recovered no later than November 2019 and must be fully recovered within 20 years of November 2014. Failing this, OPG will be required to write off the regulatory asset for these amounts.

jurisdictions (due to the method's made-in-Ontario nature) and across time periods (due to the method being new for all OEB-regulated utilities). It is also not clear whether the same proportion of amounts allowed immediately in rates versus deferred for future recovery would apply to all utilities, or be consistent across all time periods;

- At the outset, it would be necessary to ensure that the external auditors of each affected utility are in agreement on the operationalization details of the method required to demonstrate compliance with the US GAAP conditions for regulatory asset recognition outlined above;
- As discussed further below, it would be complicated to implement and administer. In order to achieve the primary benefit of this option (i.e., preservation of the net income of the utility), detailed monitoring and tracking would be essential to provide the transparency necessary to demonstrate that the recovery methodology complies with the US GAAP conditions initially, over time and for each affected utility; and
- As discussed below, the adjusted pay-as-you-go approach will be particularly challenging to implement in a multi-year incentive regulation environment where rates are set for a single year and then escalated annually by an index value, given the term of the plan and the time constraints on recovery of deferred portion of accrual and cash OPEB cost differences as required by US GAAP. As such, this approach may not be consistent with the OEB's emphasis on incentive-based regulation.

To illustrate the complexity involved with tracking and monitoring, In Appendix A OPG has provided three examples of the recording/tracking required to determine annual OPEB costs and provide evidence that the above three US GAAP conditions have been applied. OPG has also provided a graph showing the relative impact of the three scenarios in that appendix. All three scenarios adhere to the following parameters:

- 50% of the timing differences in each year is recovered in the year the cost is incurred, with the remaining 50% is deferred for future recovery;
- The amount deferred for recovery is deferred for the maximum period allowed by US GAAP; therefore recovery commences 5 years after the year the cost is incurred; and
- The amount deferred is recovered on a straight line basis over a twelve year period, based on the average remaining service life (EARSL) of OPG's employees. The total deferred amount is therefore recovered over 17 years from the year incurred (5 year

delay to start recovery plus twelve years of recovery). This 17 year recovery period is within the 20 year recovery period limit noted above.

In addition to the complicated record keeping required to demonstrate that the OEB's recovery approach complies with the US GAAP regulatory accounting limitations, the examples show the following:

Scenario A: Timing differences remain constant over the next 20 years. Once one recovery cycle has been completed (i.e., 17 years), the accrual and the adjusted pay-as-you-go approaches result in the same annual recovery of OPEB costs. The difference is that adjusted pay-as-you go results in a future cost pressure, as $630 has been deferred for collection from future ratepayers. Timing differences fall from $2,400 ($3,200 accrual costs less $800 cash) to $1,770 ($2,570 adjusted pay-as-you-go basis less $800 cash).

Scenario B: Timing differences diminish over 12 years (i.e., illustrative EARSL) as discussed in scenario C below, however the timing differences reverse after EARSL (i.e., accrual is less than pay-As-you-go after 12 years). As the Pickering nuclear generating station is approaching its end of life, the corresponding reduction in staffing levels after station shut down would reduce accrual costs; therefore the example is realistic in OPG's circumstances. Not only are costs in the future higher, the utility actually collects more under the adjusted-pay as you go method ($3,288) than it would under accrual ($3,200), which increases the timing differences in this example by $88 (i.e., the accrual method yields $3200 less cash $2,700 = $500 while adjusted pay-as-you-go method yields $3,288 less cash $2,700 = $588). .

Scenario C: Timing differences diminish over 12 years (i.e., illustrative EARSL). As accrual and pay-as-you-go amounts are theoretically equivalent over the life of the benefit plan, if accrual costs remain constant, on average, after the remaining service life of the group earning the benefits in a particular year, the pay-as-you go amounts should equal accrual after EARSL. The adjusted pay-as-you-go method results not only in higher rates than the accrual basis in future years, but the timing differences are only marginally reduced by $50 (i.e., accrual method yields $3,200 less cash $2,420 = $780 while adjusted pay-as-you-go method yields $3,150 less cash $2,420 = $730).

The above three scenarios illustrate the complexity of tracking and monitoring the recovery of amounts recorded as regulatory assets under the adjusted pay-as-you-go approach, and as illustrated by the graph comparing the three scenarios, demonstrate the higher future rates and cost pressures resulting from the deferral of recovery..

The complexity of the tracking and monitoring illustrated through the three scenarios above is increased in a multi-year incentive regulation environment where rates are set for a single test year and then escalated annually by the index value. For example, to meet the US GAAP condition of commencing recovery within five years, amounts deferred in the base year would need to be either factored into the base rate in the next rate-setting period (assuming the period is not greater than five years), or be reflected as a rider during the current rate-setting period. Amounts deferred in years two to four of a five-year incentive rate-setting period would need to be reflected as a rider during either that period or the next one. The five deferred amounts arising in a single rate-setting period therefore could result in up to five separate riders in the current or next rate-setting period and, depending on the length of recovery, up to ten different riders in the subsequent rate-setting period. Given that many utilities have variance accounts to track the difference between forecast and actual costs, further complication would also result from tracking the portion of such account additions that would need to be recoverable in a given period in line with the US GAAP requirements.

Conclusion on OPEB Cost Recovery Methodology

Neither the pay-as-you-go method nor the adjusted pay-as-you-go methods meet most of the regulatory principles identified in Section 3. In general, both of these options reduce cash flow and therefore result in additional pressure on credit metrics. The pay-as-you-go method significantly reduces net income and cash flow, and results in immediate write-offs of previously deferred cash-to-accrual differences and puts additional pressure on credit metrics. While the adjusted pay-as-you-go method may mitigate the net income consequences of the pay-as-you-go method if it is appropriately operationalized, this method is not sufficiently defined and appears to introduce ambiguity, arbitrary elements, and complexity while impairing comparability.

OPG believes that the accrual method is the optimal approach for the OEB to retain as a generic cost recovery policy for OPEB costs. Cost recovery on an accrual basis is strongly aligned with relevant ratemaking principles, is currently used by most utilities, allows the OEB to leverage a well-established financial reporting framework, and avoids complicated methodology transition considerations, negative financial implications to shareholders, and the need to design and operationalize a ratemaking mechanism to meet specific regulatory asset criteria. OPG submits that to provide balance between customers and shareholders, timing differences between the recovery of accrual costs and the payment of OPEB benefits are best addressed through "value for money" options discussed in Section 6 of this submission.

5 Registered Pension Plan Cost Recovery Methodology

OPG submits that the generic review of registered pension plan (RPP) cost recovery methodology should be considered in the context of the vast majority of Ontario utilities participating in a multi-employer pension plan (i.e., OMERS), as there appear to be no practical alternatives to the current recovery methodology for these utilities. The current methodology for these utilities reflects their funding contributions to OMERS, which are also their accounting costs. Therefore, as noted by KPMG[21], a funding contribution approach and an accrual accounting approach would lead to the same result for these utilities and there are no timing differences between cost recovery amounts and funding contributions. No alternatives to the current recovery methodology for these utilities were identified by KPMG.[22] Furthermore, the modified funding contribution alternative described by KPMG, which contemplates deferral of recovery of voluntary funding amounts and solvency special payments, is not applicable for utilities participating in OMERS because their funding contributions are determined by OMERS and because OMERS is currently exempt from solvency funding requirements.

As noted by KPMG during the Stakeholder Forum, in the above circumstances, the scope of any generic industry approach to recovery of RPP costs established in this consultation is essentially limited to the following five regulated entities with single-employer defined benefit pension plans – OPG, Hydro One (distribution and transmission), Union, Enbridge Gas Distribution ("Enbridge") and the Independent Electricity System Operator ("IESO").[23] With the exception of Hydro One, these entities have been recovering their registered pension plan costs on an accrual basis.[24] Hydro One recovers its registered pension plan costs using the funding contribution method.

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[21] *KPMG Report*, at 25.

[22] *Ibid.*

[23] *Ibid* at 21.
KPMG presentation, at slide 3.

[24] Although OPG's RPP costs allowed in the revenue requirement in EB-2013-0321 were limited to funding contribution amounts, the OEB indicated that it was not "necessarily moving from an accrual basis to a cash basis for setting OPG's payment amounts" and that "transition to a different accounting treatment of pensions and OPEBs for

OPG submits that any generic cost recovery approach for the utilities with single-employer defined benefit registered pension plans should align with the ratemaking principles identified in Section 3. As discussed below, OPG believes that the accrual basis of cost recovery for registered pension plans best aligns with these principles. As with OPEB, OPG therefore submits that the accrual basis of cost recovery should be the default approach to RPP cost recovery used by the OEB to establish rates.

As with OPEB, the accrual basis achieves a systematic attribution of the defined benefit registered pension plan compensation costs incurred by a utility over the period employees render service, and it enables the utility to earn a fair rate of return. In contrast, neither the funding contribution approach nor the modified funding contribution approach identified in this consultation as alternatives to the accrual approach is intended to measure a utility's pension cost for a particular period. Rather, funding valuations calculate the plan's funded status and required contribution range in line with requirements set out by legislation and oversight bodies, with pension plan health and benefit security of members generally being the key considerations. In OPG's submission, cost recovery methods such as funding contribution and modified funding contribution that do not have cost incurrence and cost allocation to time periods as the primarily objective are not well aligned with the relevant ratemaking principles, including intergenerational equity, fairness, and providing appropriate price signals. In addition, for the four entities identified above as historically using the accrual basis of cost recovery, adopting an alternative method would be contrary to the principle of consistency, would introduce methodology transition considerations and, at least for OPG, result in write-offs against net income and risk of future net income reductions, as discussed below.

OPG submits that the benefits of retaining the funding contribution basis for Hydro One with respect to the ratemaking principle of consistency and simplicity should be assessed against the remaining ratemaking principles, and Hydro One should be provided the opportunity to provide utility-specific evidence in its own proceedings to justify maintaining the funding contribution basis of cost recovery. This is consistent with the principle of universal application with utility-specific issues addressed in utility applications.

OPG, if required, would be addressed by Board in OPG's next cost of service proceeding, having been informed by the outcomes of the generic proceeding."
EB-2013-0321 Decision with Reasons, 20 November 2014, at 88.
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/456585/view/dec_reasons_OPG_20141120.PDF

In their report, KPMG suggests that funding contribution amounts may represent a more reliable basis for ratemaking than accrual costs[25]. As explained by OPG and a senior actuary from Willis Towers Watson (on behalf of Union) at the Stakeholder Forum, this view does not fully reflect the realities of how accrual accounting and funding valuations are performed and overseen. As discussed in further detail below, accrual accounting costs and funding contributions for registered pension plans are established in a similar manner, and both accounting and funding valuations are prepared by independent actuaries using similar assumptions and are subject to independent review/oversight. Subject to specific US GAAP requirements for accounting valuations and prescribed legislative/regulatory requirements for funding valuations, OPG's actuarial assumptions and underlying data are largely aligned between funding and accounting valuations. Consistent with KPMG's observations[26], where there are instances of divergence in certain non-prescribed assumptions between the two valuations for OPG, funding assumptions typically reflect a more conservative perspective, which increases funding contributions.

OPG also notes that, as previously noted in its EB-2013-0321 Reply Argument and July 31, 2015 submission in this consultation, neither accrual costs nor funding contributions for OPG can be said to be systematically lower or more stable compared to one another. Empirically, OPG's funding contributions attributed to the regulated business were higher than corresponding accrual costs in five of the last eight years (2008 to 2015)[27] and are projected to be higher than the accrual costs in four of the next five years (2017 to 2021) based on EB-2016-0152 forecasts[28]. These forecasts show that total funding contributions for the nuclear business are projected to be approximately $30M higher than accrual costs (i.e., a net ratepayer cost of adopting a funding contribution approach over the accrual basis) over the five year period. Overall, OPG considers the likelihood of material timing differences between pension accrual cost recovery and funding of pension obligations persisting over extended periods of time to be low.

Both accrual accounting and funding calculations are inherently complex and involve multiple interrelated variables, some of which are different across the two valuations. These differences

[25] *KPMG Report,* at 21.

[26] *KPMG Report,* at 28.

[27] Some of the accrual costs in those years are recorded in variance accounts and have not been recovered as highlighted in EB 2013-0321 OPG's Reply Argument.
OPG EB-2013-0321 Reply Argument, at 176.

[28] EB-2016-0152 – 2017-2021 Payment Amounts Application, 27 May 2016, Ex F4-3-2, at 7 chart 3.
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/529942/view/OPG_Ex%20F4_Operating%20Costs_Other%20Operating%20Costs_20160527.PDF

relate to the derivation of discount rates, amortization mechanism for gains and losses, and timing of valuations, to name a few. These examples are discussed in greater detail below. Also discussed below are the multiple factors that impact the comparability of funding contribution levels across utilities, which OPG submits point to funding contributions being no more comparable than accrual accounting amounts, contrary to KPMG's views.[29]

Notwithstanding the above, OPG acknowledges that if the OEB maintains the accrual basis of cost recovery for utilities with single-employer defined benefit plans, there could be instances of RPP timing differences in a given year or over a period of several years. In line with the principle of balancing the effects on customers and shareholders, OPG recommends these differences be addressed through the same tracking account approach as for OPEB. This would allow for a consistent approach for all post-employment benefit plans while introducing little incremental complexity. OPG's submission on options to address timing differences is provided in Section 6.

Funding Contribution Approach

The valuations of accounting costs and funding amounts are prepared for different purposes. Accounting actuarial valuations are prepared by independent actuaries to measure benefit plan obligations and period costs in accordance with applicable accounting standards. Accounting standards set out the required actuarial valuation methodology and parameters for determining actuarial assumptions. The objective of the accounting valuation is to attribute the pension costs to each period that employees render services and accrue the pension benefits earned to be paid in the future, in accordance with the accounting standards.

The *Pension Benefits Act* (Ontario) ("PBA") requires funding valuations to be prepared by independent actuaries on a going concern basis and a solvency basis at least once every three years in order to determine the funded status of a registered pension plan (i.e., the difference between the value of pension fund assets and the actuarial present value of the accrued liability as of the valuation date) and the minimum required future contributions. The going concern valuation measures the financial position of the pension plan assuming that the plan continues indefinitely into the future. The solvency valuation measures the financial position of the pension plan, as defined pursuant to the PBA, assuming that the plan is wound-up on the valuation date and all benefits are settled by either lump sum payments or annuity purchases. Pension plan

[29] *KPMG Report*, at 28.

health and benefit security of members are the key considerations underlying these valuations as the PBA aims to ensure that a registered pension plan has sufficient assets to deliver the pension benefits promised to plan members on an ongoing basis or in the event that the employer becomes insolvent. Funding valuations also set out the maximum tax deductible plan contribution pursuant to the *Income Tax Act* (Canada), therefore; in OPG's submission, funding valuations are not primarily prepared with the objective of allocating pension costs to the appropriate period. As such, the funding contribution approach is not nearly as well aligned with the relevant ratemaking principles as the accrual approach.

In addition to not aligning with the financial accounting and reporting for pension plan costs and potentially engaging retroactive ratemaking issues as part of methodology transition considerations, adopting a funding contribution method for the above noted four affected utilities that have historically been on the accrual basis of cost recovery, complexity increases in the form of transition considerations which can result in adverse financial consequences to shareholders. While the specific financial circumstances of the three other affected utilities (IESO, Enbridge and Union) were not discussed during the Stakeholder Forum, two issues impacting OPG were identified.

The first financial issue raised by OPG at the consultation was an immediate write-off to net income of approximately $190M, which is the value of the regulatory asset on OPG's balance sheet for the RPP portion of the Pension & OPEB Cash Versus Accrual Differential Deferral Account (forecast as of December 31, 2016).[30] The write-off would take place to the extent the OEB does not allow recovery of this balance in transitioning OPG to a contribution funding method of recovery. For example, if the OEB were to prospectively transition OPG to a contribution funding method as of January 1, 2017, the proposed effective date for new payment amounts in OPG's EB-2016-0152 rate application, and therefore allow recovery of the December 31, 2016 account balance, the write-off would be avoided.

The second financial issue relates to an economic loss and reductions in net income that OPG would experience going forward if the funding contribution method is adopted. The economic loss arises from the fact that, while the other three affected utilities have been regulated since

[30] The risk of the write-off was also raised at page 11 lines 16-19 in OPG's July 31, 2015 submission to the consultation
OPG, EB-2015-0040 Initial Written Submissions on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs, 31 July 2015, [*OPG Initial Submission*].
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/489086/view/OPG_Sub_20150731.PDF

their inception, OEB regulation of OPG began almost a decade after OPG's inception. The theory that accrual costs and cash amounts for post employment benefit plans are the same over time only holds if the starting point for both is at the inception of the benefit plan. As funding contributions attributed to the regulated business were in the order of $600M higher than corresponding accrual costs in the period prior to regulation by the OEB, total accrual costs during the regulation period must exceed total future funding amounts by the same amount.[31] This means that converting to a funding contribution basis of cost recovery in the period of regulation would result in lower future revenues and therefore a future economic loss in the above amount[32]. In order to reflect this economic loss in accordance with US GAAP, OPG would experience reductions in net income by not being able to set up a regulatory asset for the excess of incurred accrual costs over funding amounts recovered in rates until the net income reductions accumulate to the full amount of the loss. For example, based on EB-2016-0152 forecasts, RPP accrual costs attributed to OPG's regulated business will exceed contribution amounts by over $50M in 2017, which would directly reduce OPG's 2017 net income under the funding contribution basis of recovery relative to the accrual basis. Such negative net income consequences could be avoided if the OEB were to authorize additional recovery amounts to "top up" the funding contribution amounts to cover the amount of the loss. However, this effectively would be equivalent to retaining the accrual basis of recovery for those years. The above economic loss outcomes are reinforced by sections 6(2).5 and 6(2)11(ii) of O. Reg. 53/05

[31] Amount cited represents the estimated pre-regulation excess of accumulated contributions over accrual costs attributed to the assets regulated by the OEB as of April 1, 2008, based on the following: accrued RPP asset of $626M as at Dec. 31, 2008 plus 3/4 x RPP cost recognized of $147M for the year then ended (both per 2009/2008 audited financial of OPG's Prescribed Facilities found at EB-2010-0008 Ex. A2-1-1 Att. 3, p. 38) less 3/4 x RPP contributions of $199M for the year ended.
EB-2013-0321 OPG Argument in Chief, 28 July 2014, at 105, Chart 4.
http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/444637/view/OPG_ARGChief_20140728.PDF

[32] The estimated total future economic loss would be equal to the pre-regulation excess of accumulated contributions over accrual costs attributed to the assets regulated by the OEB as of April 1, 2008 of approximately $600M (see footnote 31) assuming a hypothetical transition to a funding contribution basis as of April 1, 2008 and assuming no retroactive ratemaking considerations. The estimated total future economic loss attributed to these assets would be in the order of $700M assuming a transition date of November 1, 2014 based on the following: unamortized RPP gains and losses recognized in accumulated other comprehensive income of $2,831M as at Dec. 31, 2013 less accrued RPP liability of $2,023M as at Dec. 31, 2013 (both per 2014/2013 audited financial statements of OPG's Prescribed Facilities found at EB-2016-0152 Ex. A2-1-1 Att. 6, pp. 49-50) less RPP cost recognized of $360M for Jan-Oct 2014 plus RPP contributions of $246M for Jan-Oct 2014 (both from EB-2014-0370 Ex. H1-1-2 Table 8a). The estimated total future economic loss is projected to be in the order of $500M if the transition were to take place as of January 1, 2017 (i.e. the projected excess of accrual costs over contribution amounts for the period from November 1, 2014 to December 31, 2016 of approximately $190M recorded in the Pension & OPEB Cash to Accrual Differential Deferral Account would be allowed for recovery).

that effectively puts a bright line between the period prior to OPG's regulated facilities becoming prescribed for OEB regulation and the period of OEB regulation[33].

OPG further notes that many of the perceived benefits of the funding contribution method that appear to relate to governance and oversight, the nature of the valuation assumptions used, and the stability, magnitude and comparability of the resulting costs are not clear. These three areas are discussed below.

Governance and Oversight

The inputs to an actuarial valuation include the provisions of the pension plan, plan membership data, an actuarial cost method and a set of assumptions, certain of which may vary depending on the type of the valuation being performed. OPG submits that both funding and accounting actuarial valuations would represent a reliable basis for rate-setting, as there are various regulatory and professional bodies that provide review/oversight over the funding and accounting actuarial valuations of registered pension plans.

As noted by KPMG[34], funding valuations for pension plans are subject to review by the Financial Services Commission of Ontario ("FSCO") and the Canada Revenue Agency ("CRA"). FSCO enforces the PBA and releases policies to assist actuaries in completing their work in compliance with the PBA. The PBA sets out the requirements when it comes to pension benefits and pension funding. All actuarial funding reports are filed with FSCO, which reviews and could ultimately reject an actuarial valuation if it deems it to not be in compliance with the pension regulations. CRA enforces the *Income Tax Act* ("ITA") as it pertains to registered pension plans and also reviews the actuarial funding reports.

For accounting valuations, independent review is provided by financial statement auditors whose objective is to ensure that pension related amounts reflected in an entity's financial statements are in accordance with the stated accounting framework in all material respects. Utilizing specialized accountants and actuaries as part of their assurance team, OPG's independent auditor critically reviews the accounting valuations of OPG's pension (and OPEB)

[33] EB-2013-0321 Argument in Chief, p. 102 states: "OPG's interpretation is that s. 6(2)11(ii) of O.Reg 53.05 means exactly what it says, that in setting payment amounts for the newly regulated hydroelectric assets the OEB is required to accept the asset and liability values associated with those assets, which includes the ongoing liabilities with respect to pension and other post- retirement benefit ("OPRB") obligations that are allocated to those assets. It cannot take action that would effectively change those values." Although this submission related to the hydroelectric facilities prescribed for OEB regulation effective July 1, 2014, the same position would apply to the facilities prescribed for OEB regulation effective April 1, 2008 which fall under s. 6(2)5 of O. Reg. 53/05.

[34] *KPMG Report*, at 121-122.

plans prepared by the independent actuary, including assumptions and other inputs, and evaluates the appropriateness and consistency of accounting policies and approaches. The independent auditor also tests the calculations performed by OPG's independent actuary by reproducing and validating the valuation results on a sample basis.

In addition, as noted by KPMG[35], the Canadian Institute of Actuaries ("CIA") sets actuarial standards that govern actuaries in the performance of their work and issues of guidance to assist the actuary in applying those standards. All valuations (including for funding and financial accounting purposes) must be performed in accordance with the actuarial standards of practice as detailed in the CIA Standards of Practice.

Actuarial Assumptions

Actuarial valuations of a pension plan require economic and demographic assumptions to determine the pension plan's accrued liability as of the valuation date (annually for accounting) and to calculate current service cost for future years (annually for accounting). Examples of economic assumptions include discount rates, inflation rate, and salary escalation rate. Examples of demographic assumptions include mortality rates and improvement scale, termination rates, and retirement rates. At page 28, the KPMG Report suggests that assumptions for funding valuations are determined more independently than for accounting valuations because they are determined by actuaries rather than management. As discussed below, OPG does not believe it is possible to draw such a categorical conclusion. KPMG further observes at p. 99 of their report that "in some instances, a utility's management may be able to impact the accounting costs that are recognized by the utility as a result of selecting specific actuarial assumptions within [the] acceptable ranges." As discussed below, while an element of judgement is inherently present in both accounting and funding valuations, given the long-term, complex nature of these forward looking estimates, OPG management's ability to apply such judgement to impact accounting costs and funding contributions is similarly limited and subject to a number of constraints, including acceptance by external auditors and independent actuaries.

It is true that most going concern funding valuation assumptions are ultimately the responsibility of the actuary preparing the valuation and must be determined in accordance with accepted actuarial practice and taking into account regulatory and legislative constraints and guidance

[35] *Ibid* at 123.

issued by the CIA. However, the actuary also applies his or her judgement and takes into account input from plan sponsors. In addition, given the focus of the funding valuation on pension plan health and benefit security of members, plan sponsors may direct actuaries on the use of margins for adverse deviations that result in relatively more conservative assumptions and therefore higher contributions, as well as on the use of asset valuation averaging methods which also affect contribution levels.

With respect to actuarial assumptions used for accounting purposes, with the exception of discount rates discussed below, US GAAP requires that these represent management's best estimate[36] and does not allow for adjustments for margins for adverse deviations or "conservatism". For both P&OPEB, OPG relies extensively on its independent actuaries in developing the accounting assumptions, which, for pension, are largely aligned with the funding assumptions. For many of the assumptions (such as demographic assumptions), management must rely on the actuaries' recommendations because management simply does not have the expertise to develop these assumptions independently. For the remaining assumptions, OPG is very closely guided by the actuaries' recommendations and ensures that the actuaries are in agreement with the assumptions adopted. P&OPEB plans represent a significant item on OPG's balance sheet, and OPG does not adopt assumptions that its independent actuaries do not find reasonable in the circumstances.

Specifically, with respect to the discount rate, OPG notes that there is much more likely to be a wider range of acceptable values for going concern funding valuations than for accounting valuations. The discount rate is considered to be the single most impactful assumption. The going concern valuation typically reflects a discount rate based on the expected long-term rate of return on pension plan assets, modified to take into account a margin for adverse deviation to reflect a degree of uncertainty of the best estimate assumption, including the potential barriers to achieving this return. This determination requires judgement from both actuaries (for the discount rate before the application of the margin for adverse deviations) and from management (in directing the actuaries on the margin for adverse deviations). Actuarial standards do not prescribe a single approach to determining either component of the rate. In contrast, US GAAP requires that the discount rates used in determining benefit obligations and accrual costs must be based on AA corporate bond yields in Canada for the appropriate duration of the benefit

[36] ASC 715-30-55-27

obligation[37]. For financial reporting purposes, OPG uses the discount rates derived by independent actuaries from their actuarial model without adjustment.

In addition, as discussed above, the actuaries' work for accounting purposes is subject to review by external auditors of financial statements. To that end, a senior actuary from Willis Towers Watson noted at the Stakeholder Forum that, over the last decade, external auditors have significantly increased their professional scepticism in the P&OPEB area and are actively testing key assumptions, which has resulted in a significant narrowing of what is considered to be the acceptable range for key assumptions. The external auditors are also focused on ensuring consistency in methods for determining assumptions and estimates. Particularly given the material impact of P&OPEB plans on OPG's financial statements, this provides assurance that management could not adopt a key assumption that was outside of the norm or implement arbitrary changes to how these assumptions are determined. In effect, the external auditor provides a second set of "checks and balances" for accounting valuations in addition to the independent actuaries which, in OPG's submission, ensures that the accounting valuation is just as rigorous and objective as the funding valuation.

Stability, Magnitude and Comparability of Costs

As noted previously, OPG does not believe it is possible to conclude that either the funding contribution method or accrual method would produce consistently lower or more stable results for OPG. Multiple factors can inherently impact differences between accounting and funding valuations. To illustrate the point, three examples of differences are discussed below: derivation of discount rates, amortization mechanisms for gains and losses, and timing of valuations.

Going concern funding valuations use a discount rate based on the expected long-term rate of return on pension plan assets, which typically include both fixed income and equity assets, subject to a margin for adverse deviations and an allowance for passive investment management fees. The solvency discount rates are typically lower than the going concern discount rates, as they reflect current government bond yields and annuity purchase rates determined using information provided by insurance companies. On the other hand, accounting

[37] Refer to EB-2013-0321 Ex F4-3-1 section 6.3.3 for a discussion of USGAAP requirements in this area. EB-2013-0321 – 2017-2021 Payment Amounts Application, 27 September 2013, Ex F4-3-1, at section 6.3.3 http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/411331/view/OPG_Ex%20F4_Operating%20Costs%20-%20Other%20Operating%20Costs_20130927.PDF.

discount rates are set with reference to AA corporate bond yields in Canada, and do not reflect a margin for adverse deviations or an allowance for passive investment management fees.

With respect to amortization mechanisms for gains and losses, special payments for going concern funding deficits are made over a 15-year period, and to the extent these special payments will not eliminate the solvency deficit over a 5-year period, additional payments towards the solvency deficit (i.e., solvency special payments) are currently required over the 5-year period. For the purpose of these calculations, pension fund asset values may be subject to certain averaging mechanisms. For accrual costs, in accordance with US GAAP, OPG amortizes the net cumulative unamortized gain or loss for the registered pension plan in excess of 10 per cent of the greater of the benefit obligation and the market-related value of the plan assets over the expected average remaining service life of the employees (i.e., the “corridor approach”). In using the market-related value, OPG consistently recognizes gains and losses on equity assets relative to a six per cent assumed real return over a five-year period; this approach may differ from the asset value averaging mechanisms used for funding purposes.

With respect to the timing of valuations, in accordance with the PBA, if a certain prescribed funding level is met, funding valuations must be performed at least once every three years and set contributions for a three year period. On the other hand, US GAAP requires re-measurement of benefit plan obligations and costs every year using best estimate assumptions reflecting the market conditions as at the measurement date.

At page 28, the KPMG Report asserts that a funding contribution basis would result in “greater comparability among utilities since costs in rates do not depend on the accounting standards that are used by a utility.” OPG disagrees and submits that the challenges in comparing funding contributions across utilities are no less great than in comparing accrual amounts. Comparability of funding contributions can be hampered by a number of differences across plans including factors such as:

- Different funding and investment policies between plans that could lead to differences in fund performance, timing of valuations, and economic actuarial assumptions including discount rates;
- Different demographic profiles and plan provisions that would lead to differences in demographic actuarial assumptions, benefit obligations, and funding and investment policies;

- Based on their respective accountabilities, different actuaries and administrators' perspectives on the use of margins for adverse deviations, asset valuation methods and appropriate actuarial assumptions are likely to differ across pension plans. As discussed above, a wider range of discount rates is typically acceptable for going concern valuations than for accounting purposes.

With respect to challenges with the comparability of different accounting standards raised by KPMG[38], OPG observes that four of the five major OEB-regulated entities with single employer defined benefit contribution pension plans (i.e. OPG, Hydro One, Union, and Enbridge) report their financial results in accordance with US GAAP. As acknowledged by KPMG during the Stakeholder Forum, this means that accrual cost comparability considerations related to the ultimate financial statement classification of defined benefit liability re-measurement for registered pension plans (i.e., net income under US GAAP versus other comprehensive income under IFRS) are effectively not a factor the OEB needs to consider. Furthermore, as accounting standards are set by standard setters through a transparent process and are widely articulated, and as assurance over their application is provided by independent auditors, OPG is of the view that differences in accrual costs arising from the use of different accounting standards are generally better defined, better understood, more transparent and more consistent across entities than differences in funding valuations.

Modified Funding Contribution Approach

The modified funding contribution method identified by KPMG has all of the principled shortcomings of the funding contribution approach without the main benefit of the funding contribution approach (i.e., elimination of timing differences). The modified funding contribution approach introduces a new form of timing difference between the time a utility makes a pension contribution and the time the contribution is recovered from ratepayers, increases the number of utilities affected by methodology transition considerations relative to the funding contribution method (i.e., from 4 to 5 as Hydro One would also have to transition), and adds complexity through additional tracking and record keeping for portions of funding contributions (i.e., solvency special payments and voluntary payments) deferred for future recovery.

In OPG's opinion, the modified contribution approach represents an arbitrary deferral of recovery of a portion of legally required contribution payments and is not rooted in regulatory or

[38] *KPMG Report*, at. 28

accounting principles. Once determined by a funding valuation, OPG has no discretion over solvency payments or their timing. Solvency payments are required under the PBA as part of the current pension funding mechanism in Ontario, and, as a public sector entity, OPG is not permitted to use letters of credit to meet this obligation. Furthermore, solvency payments are essentially an acceleration of future going concern payments and therefore should not be considered in isolation from the other components of the contribution amount. As it is not aligned with the legal requirements for solvency payments, OPG finds the modified contribution method of recovery lacking in fairness.

A primary benefit of the modified contribution method raised by KPMG[39] is that deferral of recovery of a portion of contributions could be used to provide greater stability in cost levels included for recovery. OPG suggests that this claim has limited usefulness. First, by its nature, the claim appears to apply to the relative volatility of the modified funding contribution method to the funding contribution method, <u>not</u> to the accrual method. Second, there are only five utilities with single-employer pension plans and the extent to which they have made or are forecast to make "modifiable" payments[40] is not known; therefore it is not clear the extent to which this approach will have substantial practical application. Third, the Ontario Ministry of Finance has launched a consultation to review the current solvency funding framework with the objective of developing a set of solvency funding reforms and, in July 2016, released a consultation paper on this topic.[41] Finally, it is unclear whether the modifications actually would provide greater stability for a particular plan (e.g., deferring recovery will result in additional cost recovery requirements in future years and, given that the future contribution funding profile is unknown, may compound future spikes in recovery requirements if non-solvency components of future contributions increase).

Overall, as discussed in the Funding Contribution Approach section above, a certain degree of volatility is inherent in both accrual and funding valuations and resulting cost levels. As discussed in Section 3, OPG's view is that the achievement of the ratemaking principle of rate stability is best effected at the overall revenue requirement level, not at the level of an individual cost item through a specific cost recovery methodology.

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[39] *Ibid* at 5.

[40] OPG and Hydro One indicated during the Stakeholder Forum that only going-concern special payments had been made during at least the last five years, while Union discussed prior solvency payments only.

[41] See http://www.fin.gov.on.ca/en/pension/solvency/review-solvency-funding.html

Conclusion on RPP Cost Recovery Methodology

OPG submits that accrual is the most principled and optimal approach for the OEB to adopt as a default cost recovery policy for registered pension plan costs, with individual utility circumstances considered when applying this policy. The accrual method results in a systematic allocation of costs over the period employees render service, best meets other identified regulatory principles, is currently used by most of the utilities with single-employer defined benefit pension plans, and avoids negative financial consequence for most utilities.

The funding contribution approach raises complex methodology transition considerations involving significant financial consequences, and its perceived benefits over the accrual basis of pension cost recovery in terms of governance and oversight, the nature of actuarial valuation assumptions, and the stability, comparability and magnitude of the resulting costs are not clear. Overall, in OPG's submission, the funding contribution approach is not intended to measure a utility's pension cost for a particular period, and, as such, is inferior to the accrual approach in terms of alignment with the relevant ratemaking principles.

The modified funding contribution approach has all of the same principled shortcomings as the funding contribution approach, introduces additional complexity and new timing differences and appears to have limited practical application.

OPG expects that the use of an accrual cost recovery approach for pension costs may result in timing differences for a few utilities. OPG believes it would be reasonable to apply a consistent approach to balancing the effects on customers and shareholders for both pensions and OPEB timing differences and that there would be little incremental complexity to extending the tracking account proposed for OPEB timing differences to include pension differences.

6 Proposed Treatment of Regulatory Timing Differences

To achieve the principle of balancing the effects on both customers and shareholders, OPG believes it is reasonable to associate a "value for money" component with material timing differences between P&OPEB accrual costs recovered in rates and P&OPEB cash payment or funding amounts. As explained below, OPG submits that material timing differences should be recorded in a tracking account, and that an OEB's prescribed interest rate should apply to the tracking account balance. Exceptions to the quarterly prescribed rate could apply if a material portion of the timing differences is capitalized or if utility-specific circumstances support the application of a different rate of return.

6.1 Approach

Approach:

KPMG identified four possible mechanisms in order to provide "value for money" on timing differences: internally segregated accounts, Retirement Compensation Arrangements (RCAs), rate base reduction, and a tracking account that would attract interest as specified by the OEB[42].

In its report and Stakeholder Forum presentation, KPMG assessed the four identified options using ten criteria, considering whether each criterion was a pro or a con for each of the four alternatives. Ranking the alternatives in terms of the number of criteria considered pros for each option, the tracking account (8 pros) and rate base reduction (7 pros) were considered superior to either the internally segregated funds (3 pros) or the RCA (2 pros)[43].

During its presentation, KPMG indicated that of the eight jurisdictions responding to their survey, only one jurisdiction (FERC) required utilities to set money aside (e.g., in either an internally segregated fund or an RCA). KPMG's presentation also highlighted that that OEB could choose to continue using accrual accounting cost recovery for ratemaking purposes, but with a new requirement for timing differences to be tracked in a separate regulatory account that would attract interest as specified by the OEB[44].

Concentric was engaged by OPG to review the treatment of cash versus accrual timing differences in North American regulatory jurisdictions. Concentric reviewed 23 utilities in a broad number of jurisdictions, identifying the same four alternatives identified by KPMG for addressing timing differences. Concentric noted that, in addition to FERC, only one of the other utilities it reviewed (New York) used a method requiring utilities to invest funds and concurred with KPMG's conclusion that set-aside approaches were sub-optimal compared to other

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[42] *KPMG Report*, at 65-69.

[43] *Ibid* at 68-69.

[44] KPMG Presentation, *KPMG Report on P&OPEB Costs Alternatives Identified* 19 July 2016, [*KPMG Presentation - Alternatives*], at slide 14. http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/535222/view/KPMG_OPEB_Presentation_Alternatives%20Identified_20160718.PDF

mechanisms[45]. Concentric interpreted the KPMG Report to state that setting aside money in either an internally segregated fund or an RCA is sub-optimal, agreeing with that assessment.[46]

As noted in the KPMG Report and supported by several utilities' initial submissions and Stakeholder Forum presentations, both the internally segregated account and RCA options present a number of concerns. The OEB's letter dated August 10, 2016 recognized these concerns and provided guidance that the September 22, 2016 submissions should focus on the reduction to rate base and a tracking account options. As such, OPG's submission does not discuss the internally segregated account and RCA options. Details on OPG's views concerning segregated accounts and RCAs can be found in OPG's initial submission in this proceeding, dated July 31, 2015[47]. In summary, OPG agrees with the conclusions of KPMG and Concentric that the internal segregated fund and RCA options are suboptimal.

Concentric found that there was a wide diversity of practice in terms of treatment (if any) of timing differences, with many jurisdictions not providing a ratemaking allowance for timing differences and, when carrying costs were applied, carrying cost rates varied across jurisdictions[48]. Concentric agreed with KPMG's observation that the rate base reduction and the tracking account options could "change the utility's investment and credit risk profile" and could "potentially reduce the utility's credit rating and/or borrowing capacity (or increase its borrowing rates)".[49] Concentric recommended the tracking account approach as it is administratively efficient, provides customers with a specified and predictable return on any funding provided for costs that will be paid in the future, and a tracking account can take into account the underlying nature of the costs that are under consideration (e.g., capitalized or expensed costs).[50] OPG supports Concentric's recommendation.

OPG agrees that a tracking account is administratively simple as D&V accounts are a practice used by all utilities regulated by the OEB and as it could be incorporated into existing OEB D&V account reporting (i.e., no incremental reporting of rate base is required). A tracking account

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[45] OPG Presentation, *Pension & OPEB Stakeholder Forum Presentation*, July 19, 2016, [*OPG Presentation*], at slide 21. http://www.rds.ontarioenergyboard.ca/webdrawer/webdrawer.dll/webdrawer/rec/535174/view/OPG_OPEB_Presentation_20160718.PDF

[46] *Ibid,* slide 21

[47] *OPG Initial Submission*

[48] *Ibid* at slide 20.

[49] *Ibid* at slide 22 and *KPMG Report*, at 67.

[50] *Ibid* at 22.

has the added benefit of being able to accommodate utility-specific circumstances including different cost rates for different portions of the timing differences. For example, a tracking account provides the flexibility to associate a different financing cost for portions of the account for the capitalized portion of timing differences. In OPG's opinion, there is no need for the rate base approach as it would be less flexible in allowing different rates to be associated with different portions of the timing differences and introduce incremental administrative requirements.

OPG notes that the OEB addressed the treatment of P&OPEB in the past in RP-1998-0001, the first application by Ontario Hydro Service Corporation (OHSC) to set rates for its transmission and distribution operations. OHSC applied for rate base treatment for P&OPEB asset and liability amounts. The OEB did not accept inclusion of either pension or OPEB amounts in rate base. This is not uncommon, given Concentric's findings that, in many jurisdictions, there is no ratemaking allowance for timing differences[51].

As summarized in the table below, OPG is of the view that the tracking account option aligns with many of the ratemaking principles identified in Section 3.

Table 1: Alignment of Tracking Account Option with Principles

Principles	Tracking Account Alignment
Alignment with Required Financial Accounting and Reporting	Consistent with industry use of D&V accounts to track regulatory differences
Fairness	Provides "value for money" to customers (or utilities) to compensate for positive (or negative) timing differences
Universal Requirement with Utility-specific Issues Considered in Individual Applications	Can be applied to all impacted utilities and has the flexibility to address utility-specific circumstances
Balancing Effects on Both Customers and Shareholders	Considers the impact on the shareholders by allowing recovery of accrual costs incurred by utilities, while providing a "value for money" at an OEB-prescribed rate to customers

Legal Compliance	Accepted practice with many precedents
Consistency and Simplicity	Administratively efficient and easy to implement and can be incorporated into existing reporting

OPG submits that a tracking account is the superior option in terms of providing flexibility, balancing the effects on both customers and shareholders, and being simple and practical to implement.

6.2 Financing Cost Rate

To address the “value for money” issue, OPG assessed timing differences applying the ratemaking principle of balancing the effects on both customers and shareholders. Specifically, OPG considered the following:

- Should a financing cost rate apply to the tracking account?
- If a cost rate should apply to the tracking account, what should that default rate be?
- If a default cost rate is approved, should exceptions apply?

As discussed below, OPG believes it is reasonable that a financing cost rate should apply to the tracking account and that the OEB’s prescribed quarterly rate should apply if the tracking account balance is material. Exceptions to the quarterly prescribed rate could apply in utility-specific circumstances, for example if the capitalized portion of P&OPEB timing differences is material.

Should a Financing Cost Rate Apply to the Tracking Account?

OPG is of the view that it is reasonable for a financing cost rate to apply to the tracking account if the timing difference is material and is not addressed through another regulatory mechanism.

In OPG’s case, timing differences for P&OPEB costs are material. OPG understands that regulated utilities have very different P&OPEB plans and obligations; therefore timing differences may not be material for all utilities. For instance, registered pension plan related timing differences do not exist for the majority of utilities regulated by the OEB, as they participate in the OMERS plan where funding contributions and accounting costs are effectively the same. As a practical matter, OPG is of the view that if a utility can demonstrate that timing differences are not material, additional regulatory mechanisms to address “value for money” considerations would not be necessary in the circumstances.

Timing differences for P&OPEB costs are not addressed through another regulatory mechanism in Ontario. P&OPEB costs are not physical assets included in working capital (e.g., inventories, supplies) and are not part of cash working capital in Ontario. Recovery of P&OPEB costs on an accrual basis is not a timing difference included in an operational cost lead/lag study supporting a cash working capital allowance in rate base. As a result, there is currently no allowance for P&OPEB timing differences in setting rates.

While the discussion of timing differences by KPMG was limited to OPEB costs, as noted in Section 5, OPG believes it is reasonable that the consistent application of the principle of balancing the effects on customers and shareholders would apply equally to pension timing differences. OPG therefore submits that it would be reasonable to expand the scope of the tracking account to include funded pension costs and that there would be little incremental administrative complexity to doing so.

If a cost rate should apply to the tracking account, what should that default rate be?

Concentric found that a number of jurisdictions did not provide a ratemaking mechanism to address P&OPEB timing differences (i.e., a 0% carrying cost)[52]. They also identified jurisdictions that had applied a long-term debt rate, and other jurisdictions that had used the WACC[53]. Concentric observed that P&OPEB timing differences had some similarities with other variances for which the OEB has established D&V accounts and recommended that "it is reasonable for the OEB to follow the current practice of applying the prescribed deferral and variance account rate."[54] Concentric observed that the use of deferral accounts over longer-term periods would not be unique from an OEB rate-making perspective and that current accounts already in use reflect longer-term resolution of accumulated balances[55]. Concentric noted that its recommendation to apply the OEB's current prescribed rate considered the impact of this decision on the overall financial health, financing needs and risk profile of affected utilities[56]. OPG agrees with Concentric's recommendation.

During the Stakeholder Forum, OEB staff asked OPG whether an interest rate other than the OEB-prescribed D&V account rate could apply, suggesting that the OEB-prescribed CWIP

[52] *OPG Presentation*, at slide 23.
[53] *Ibid.*
[54] *Ibid* at slide 24.
[55] *Ibid.*
[56] *Ibid.*

interest rate may be more appropriate given the long-term nature of the OPEB timing differences. Concentric found examples where a long-term debt rate was applied to timing differences. OPG accepts that there is merit to applying a generic industry-wide long-term interest rate to D&V account balances that are long-term in nature (i.e. not simply P&OPEB timing differences). OPG is of the view that the OEB's prescribed CWIP interest rate would constitute a reasonable generic long-term D&V account rate given that the CWIP interest rate was established through the same policy initiative used to establish the existing D&V account prescribed interest rate and is based on a long-term index[57], the values of which are reviewed quarterly It would be practical and administratively simple to apply the OEB's prescribed CWIP interest rate to long-term D&V accounts and, in the context of material P&OPEB timing differences, this would achieve the principle of balancing the effects on both customers and shareholders.

If a default cost rate is approved, should exceptions apply?

P&OPEB costs may be capitalized. OPG has historically capitalized less than 5% of its P&OPEB timing differences. OPG's understanding is that many utilities either do not capitalize P&OPEB costs (or capitalize very small amounts) while some capitalize P&OPEB costs to a much greater extent. These inherent differences in utility capitalization support the consideration of utility-specific circumstances in setting the cost rate attributable to the P&OPEB timing differences tracking account.

When P&OPEB costs (and by extension, timing differences) are capitalized and placed in service, they become part of rate base. Capitalized costs therefore earn the WACC. If customers are paying the WACC on capitalized expenditures, OPG believes it would be reasonable for them to receive the WACC on the capitalized portion of the timing difference.

If a specific utility has material timing differences that are capitalized, the OEB could apply the WACC to the capitalized portion of the timing differences, and apply the generic prescribed interest rate discussed above to the non-capitalized portion. If the capitalized timing differences are not material, simplicity would dictate that the prescribed interest rate apply to the full amount of the timing differences. OPG notes that the OEB has approved either separate capital and operating accounts, and has issued guidance on how such accounts should operate (e.g., Article 480 of Accounting Procedures Handbook for Electric Distributors). The application of a

[57] OPG does not have access to the index used by the OEB; however comparison to an exchange traded fund that tracks that index indicates the underlying securities average approximately 7-8 years in duration.

different rate for the capitalized portion of timing differences (i.e., WACC) and the non-capitalized portion of timing differences (i.e., generic prescribed interest rate) is a matter the OEB is experienced in addressing.

In summary, OPG agrees with Concentric's recommendation that "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[58]." OPG accepts that material capitalization of timing differences is one generic utility-specific consideration that could warrant a separate rate for the capitalized portion of the P&OPEB timing differences.

[58] *OPG Presentation*, at slide 24.

7 Conclusion

OPG's submission can be summarized as follows:

- Remain on accrual for cost recovery of P&OPEB costs as it is the most principled and optimal approach. Utilities can apply a different cost recovery approach if it can be justified in their specific circumstances;
- Provide "value for money" to customers on material timing differences (both positive and negative) for pensions and OPEBs to be monitored using a tracking account;
- A financing cost could be applied to the tracking account at the OEB's generic prescribed interest rate as amended from time to time (i.e., the CWIP interest rate could apply if the OEB's generic policy was modified to enable the CWIP interest rate to apply to D&V accounts of a long-term nature); and
- If utilities capitalize a material portion of timing differences, the capitalized portion could be tracked in a sub-account or a separate tracking account, and earn the WACC.

Appendix A: Analysis of Cost Recovery under Adjusted Pay-As-You-Go

Scenario A: OPEB Timing Differences Remain Constant for 20 Years

		2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036	Total	
Accrual		160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	3,200	Total Accrual Costs
Cash		40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	800	Total Cash Costs
Variance		120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	120	2,400	Accrual to Cash Variance
																						Unrecovered Costs	
Current Recovery		60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60	60		
Deferred Recovery	2017	60					5	5	5	5	5	5	5	5	5	5	5	5				0	
Deferred Recovery	2018		60					5	5	5	5	5	5	5	5	5	5	5	5			0	
Deferred Recovery	2019			60					5	5	5	5	5	5	5	5	5	5	5	5		0	
Deferred Recovery	2020				60					5	5	5	5	5	5	5	5	5	5	5	5	0	
Deferred Recovery	2021					60					5	5	5	5	5	5	5	5	5	5	5	5	
Deferred Recovery	2022						60					5	5	5	5	5	5	5	5	5	5	10	
Deferred Recovery	2023							60					5	5	5	5	5	5	5	5	5	15	
Deferred Recovery	2024								60					5	5	5	5	5	5	5	5	20	
Deferred Recovery	2025									60					5	5	5	5	5	5	5	25	
Deferred Recovery	2026										60					5	5	5	5	5	5	30	
Deferred Recovery	2027											60					5	5	5	5	5	35	
Deferred Recovery	2028												60					5	5	5	5	40	
Deferred Recovery	2029													60					5	5	5	45	
Deferred Recovery	2030														60					5	5	50	
Deferred Recovery	2031															60					5	55	
Deferred Recovery	2032																60					60	
Deferred Recovery	2033																	60				60	
Deferred Recovery	2034																		60			60	
Deferred Recovery	2035																			60		60	
Deferred Recovery	2036																				60	60	
Variance Recovery		60	60	60	60	60	65	70	75	80	85	90	95	100	105	110	115	120	120	120	120	630	Total Unrecovered Costs
Cash Recovery		40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40	40		
Total Recovery		100	100	100	100	100	105	110	115	120	125	130	135	140	145	150	155	160	160	160	160	2,570	Total Recovered Costs

Immediate Recovery Rate	50%	Recovery Amounts are less than accrual for 16 years--the period time for the initial deferred amounts to be fully recovered
Deferred Recovery Begins	5	Cost pressures occur in year 17--recovery amounts are the same as accrual, but $630M of costs remain to be recovered.
Deferred Recovery Period	12	

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Scenario B: OPEB Timing Differences Eliminated over EARSL and Subsequently Reverse (Cash > Accrual)

		2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036		
Accrual		160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	3,200	Total Accrual Costs
Cash		40	50	60	70	80	90	100	110	120	130	140	150	160	170	180	190	200	210	220	230	2,700	Total Cash Costs
Variance		120	110	100	90	80	70	60	50	40	30	20	10	0	(10)	(20)	(30)	(40)	(50)	(60)	(70)	500	Accrual to Cash Variance
																						Unrecovered Costs	
Current Recovery		60	55	50	45	40	35	30	25	20	15	10	5	0	(5)	(10)	(15)	(20)	(25)	(30)	(35)		
Deferred Recovery	2017	60					5	5	5	5	5	5	5	5	5	5	5	5				0	
Deferred Recovery	2018		55					5	5	5	5	5	5	5	5	5	5	5	5			0	
Deferred Recovery	2019			50					4	4	4	4	4	4	4	4	4	4	4	4		0	
Deferred Recovery	2020				45					4	4	4	4	4	4	4	4	4	4	4	4	0	
Deferred Recovery	2021					40					3	3	3	3	3	3	3	3	3	3	3	3	
Deferred Recovery	2022						35					3	3	3	3	3	3	3	3	3	3	6	
Deferred Recovery	2023							30					3	3	3	3	3	3	3	3	3	8	
Deferred Recovery	2024								25					2	2	2	2	2	2	2	2	8	
Deferred Recovery	2025									20					2	2	2	2	2	2	2	8	
Deferred Recovery	2026										15					1	1	1	1	1	1	8	
Deferred Recovery	2027											10					1	1	1	1	1	6	
Deferred Recovery	2028												5					0	0	0	0	3	
Deferred Recovery	2029													0					0	0	0	0	
Deferred Recovery	2030														(5)					(0)	(0)	(4)	
Deferred Recovery	2031															(10)					(1)	(9)	
Deferred Recovery	2032																(15)					(15)	
Deferred Recovery	2033																	(20)				(20)	
Deferred Recovery	2034																		(25)			(25)	
Deferred Recovery	2035																			(30)		(30)	
Deferred Recovery	2036																				(35)	(35)	
Variance Recovery		60	55	50	45	40	40	40	39	38	36	34	31	28	25	21	17	13	3	(8)	(18)	(88)	Total Unrecovered Costs
Cash Recovery		40	50	60	70	80	90	100	110	120	130	140	150	160	170	180	190	200	210	220	230		
Total Recovery		100	105	110	115	120	130	140	149	158	166	174	181	188	195	201	207	213	213	213	213	3,288	Total Recovered Costs

Immediate Recovery Rate	50%	12 years cash is less than accrual
Deferred Recovery Begins	5	7 years cash is greater than accrual
Deferred Recovery Period	12	While Accrual is $500M higher than cash, recovery results in collecting $88M more than accrual--Customers are owed $88M
		Customers pay less than accrual for 9 years, more than accrual for 11 years.

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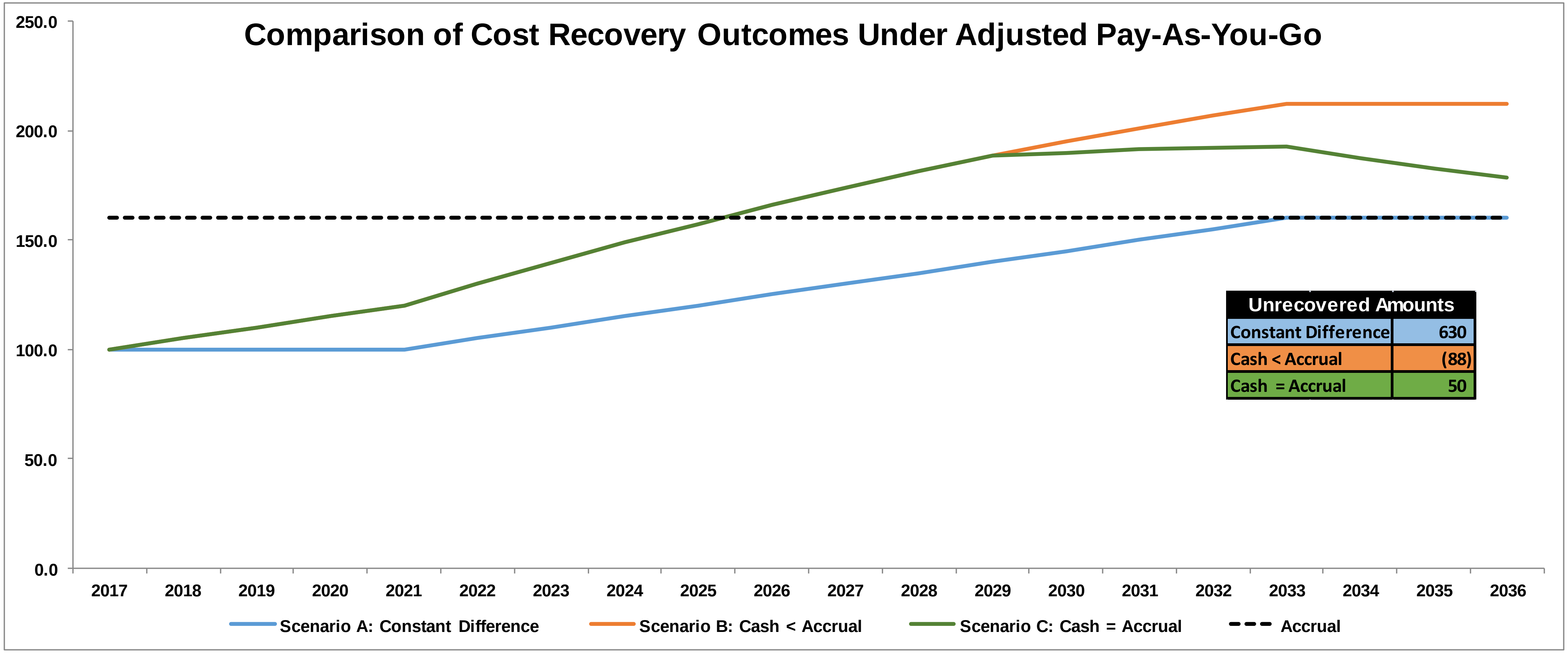
Scenario C: OPEB Timing Differences Eliminated over EARSL and Subsequently Steady State (Cash = Accrual)

		2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032	2033	2034	2035	2036		
Accrual		160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	160	3,200	Total Accrual Costs
Cash		40	50	60	70	80	90	100	110	120	130	140	150	160	160	160	160	160	160	160	160	2,420	Total Cash Costs
Variance		120	110	100	90	80	70	60	50	40	30	20	10	0	0	0	0	0	0	0	0	780	Accrual to Cash Variance
																						Unrecovered	
Current Recovery		60	55	50	45	40	35	30	25	20	15	10	5	0	0	0	0	0	0	0	0	Costs	
Deferred Recovery	2017	60					5	5	5	5	5	5	5	5	5	5	5	5				0	
Deferred Recovery	2018		55					5	5	5	5	5	5	5	5	5	5	5	5			0	
Deferred Recovery	2019			50					4	4	4	4	4	4	4	4	4	4	4	4		0	
Deferred Recovery	2020				45					4	4	4	4	4	4	4	4	4	4	4	4	0	
Deferred Recovery	2021					40					3	3	3	3	3	3	3	3	3	3	3	3	
Deferred Recovery	2022						35					3	3	3	3	3	3	3	3	3	3	6	
Deferred Recovery	2023							30					3	3	3	3	3	3	3	3	3	8	
Deferred Recovery	2024								25					2	2	2	2	2	2	2	2	8	
Deferred Recovery	2025									20					2	2	2	2	2	2	2	8	
Deferred Recovery	2026										15					1	1	1	1	1	1	8	
Deferred Recovery	2027											10					1	1	1	1	1	6	
Deferred Recovery	2028												5					0	0	0	0	3	
Deferred Recovery	2029													0					0	0	0	0	
Deferred Recovery	2030														0					0	0	0	
Deferred Recovery	2031															0					0	0	
Deferred Recovery	2032																0					0	
Deferred Recovery	2033																	0				0	
Deferred Recovery	2034																		0			0	
Deferred Recovery	2035																			0		0	
Deferred Recovery	2036																				0	0	
Variance Recovery		60	55	50	45	40	40	40	39	38	36	34	31	28	30	31	32	33	28	23	19	50	Total Unrecovered Costs
Cash Recovery		40	50	60	70	80	90	100	110	120	130	140	150	160	160	160	160	160	160	160	160		
Total Recovery		100	105	110	115	120	130	140	149	158	166	174	181	188	190	191	192	193	188	183	179	3,150	Total Recovered Costs

Immediate Recovery Rate	50%	12 years cash is less than accrual
Deferred Recovery Begins	5	7 years cash is greater than accrual
Deferred Recovery Period	12	While Accrual is $720M higher than cash, recovery results in collecting $50M less than accrual--Utility is owed $50M
		Customers pay less than accrual for 9 years, more than accrual for 11 years.


Comparison of Cost Recovery Outcomes Under Adjusted Pay-As-You-Go
250.0
200.0
150.0
100.0
50.0
0.0
2017
2018
2019
2020
2021
2022
2023
2024
2025
2026
2027
2028
2029
2030
2031
2032
2033
2034
2035
2036
Unrecovered Amounts
Constant Difference 630
Cash < Accrual (88)
Cash = Accrual 50
Scenario A: Constant Difference
Scenario B: Cash < Accrual
Scenario C: Cash = Accrual
Accrual