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

September 2016 Submission of The Society of Energy Professionals

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1.0 Introduction

In its August 10, 2016 letter to participants in the Board's Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs (Board File Number EB-2015-0040), the Board elected to effectively split the remainder of the stakeholder consultation process into two sequenced stages. In its letter, the Board requested comments on the first stage cost (i.e. recovery options for pension and other post-employment (OPEB) costs and potential related set-aside mechanisms) by September 22, 2016. The other two issues being left for later resolution are information requirements and transitional considerations. This is consistent with a suggestion made by the Society of Energy Professionals (Society) representatives on July 20. The Society concurs because it makes sense to leave reporting and transition for consideration at a later date as the assessment of alternatives is contingent on the final cost recovery and set-aside recommendations.

The following comments represent the Society views on the stakeholder process to date with a focus on the first two issues – cost recovery methods and the need for a set-aside mechanism for employee benefit costs in general and for OPEBs specifically.

2.0 General Comments

2.1 KPMG's Report

KPMG has delivered a lengthy report (KPMG Report to the Ontario Energy Board – Report on Pension and Other Post-Employment Benefits May 2, 2016) and useful one to stimulate thought and discussion. In this report, KPMG has provided valuable background information on accounting and ratemaking considerations affecting the employee future benefits topic area both domestically and internationally. The Society has reviewed the report and has commented on the specific alternatives presented by KPMG. While much of the Society's comments may appear to be critical of the proposed alternatives, the Society believes the report has been a good tool to stimulate discussion and analysis by participants in this consultation.

KPMG made several important comments in the Preface and Disclaimer to the report commissioned by the Board. Several of these bear repeating and a more detailed discussion.

- KPMG stated (page 1) that it is not advocating positions in its report. This is consistent with the fact that the Report does not include a full comparative analysis of the pros and cons of all of the various options under discussion. While the absence of a detailed comparison of the relative advantages and disadvantages appears to be consistent with the terms of KPMG's engagement, the Report does seem to contradict the assertion that KPMG is not advocating a specific alternative. The Society believes that KPMG has implied a preferred alternative to the Board with the manner in which it has described and focused on the Modified Funding Contribution method for pensions and the Adjusted Pay-as-You-Go method for OPEBs. Both of these methods are positioned as being preferable to the more traditional contribution and accrual-based methods currently in use.

- This positioning of the modified funding contribution method and adjusted pay-as-you-go method as the implied preferred alternatives for registered defined benefit pension plans and unfunded defined benefit OPEBs is even more pronounced in KPMG's presentation delivered to the attendees at the July 19 stakeholder conference (OEB Public Consultation – KPMG Report on P&OPEB Costs Alternatives Identified July 19 – 20 2016).
- In the presentation, these are the only alternatives identified and discussed in detail for these types of employee benefit plans. The Society is concerned that despite its disclaimer, KPMG has in substance put its weight behind these alternatives. In addition, the Society is concerned that this has been done without sufficient discussion of these alternatives versus the other available options.
- KPMG also stated that "the goal of achieving greater consistency should not over-ride the OEBs' statutory mandate to set 'just and reasonable' rates. In certain cases, a 'one-size fits all' approach is simply not desirable or justifiable (p. 1)." The Society agrees with this point, and previously argued in its earlier submission (EB-2015-0040 Consultation on the Regulatory Treatment of Pension and Other Post-Employment Benefit Costs – The Society's Initial Submission) that the Board's understandable desire for consistency should not be treated as a trump consideration. A desire for consistency for its own sake is not a sufficient basis for making potentially costly and confusing changes in status quo pension and OPEB regulatory accounting treatments, especially when consistency would appear not to be achievable anyway. The Society is unconvinced that a reasonable case has been made that anything is drastically wrong with the current regulatory model. Even though there are admitted inconsistencies between different utilities, there appear to be sound reasons for this.
- The Society was pleased to see KPMG remind participants that pension and OPEB benefits are part of a combined compensation package and as such, "should not be viewed in isolation." While several intervenors seemed to want to have employee benefits costs reviewed and benchmarked in isolation at the initial submission stage of this proceeding, there seems to have been consensus acceptance of KPMG's statement at the July 19 and 20 stakeholder sessions.
- Another important point made by KPMG in its report and amplified at the July session was that over time, there is no difference between total pension and OPEB costs recovered under differing regulatory accounting methods in use. Nor is there a general rule that would lead one to conclude that either cash or accrual is naturally preferable due to a lower rate impact at any given time. The Society's view is that the major difference in the various methods is that of cost allocation to different rate years. This raises the importance of continuing to meet the intergenerational equity principle to ensure that customers get the fairest cost allocation possible based on cost causality and benefit considerations.

2.2 Principles and Sequencing of Process

In its initial communication requesting participant input on May 14, 2015, the Board asked for ideas on which principles should be adopted for addressing the rate treatment of pension and OPEB costs. Most participants, including the Society, responding to the Board's request provided suggestions on the specific principles they thought would be applicable in arriving at

the optimum rate setting framework for employee benefit costs and on the related rationale for their views.

While many attributes of these principles were substantively in common across respondents' submissions, there were also some significant differences. The Society believes that it is very important that Board Staff take this input to develop and provide a draft list of principles that will be recommended and applied in the final report. As noted above, the Board wisely decided to leave information requirements and transitional considerations for later consideration because it is too soon to discuss these issues until specific proposals are made. Similarly, the Society believes that effective sequencing of the remainder of this process would require that principles be adopted, at least in draft, before final recommendations for the regulatory tools are made. This is because such principles form the theoretical foundation against which the effectiveness of recommended regulatory accounting and rate making proposals must be compared and measured. The Society believes that it is important that a final set of principles, agreed by participant consensus if possible, be included in the final report both for the benefit of the Board in its review of any recommendations and for future reference. This approach worked very well with the previous IFRS stakeholder process run by the Board (EB-2008-0408).

3.0 Principles

The Society considers that pension and OPEB costs should be assessed for recovery in rate submissions using the same principles that are applied in assessing the recoverability of other types of costs. Prudency is the preeminent consideration. The Society rejects the notion that employee benefit costs should be evaluated using more stringent criteria than other cost types.

For the principles to be applied in designing the appropriate recovery methodology, the Society has not changed its proposals from its initial submission last year. These were:

- Prudency
- Intergenerational equity
- Rate stability
- Cost of Service Model and Capital Recovery
- Consistency

The Society also put forward the following other considerations that may or may not rank as principles:

- Fairness to All Stakeholders
- Element of Balanced Remuneration
- Legal Constraints

Full descriptions and rationale for these proposals are included in the Society's July 31, 2015 Initial Submission.

4.0 Pensions

4.1 Consistency – Defined Benefit Pension Plans Accounted for as Defined Contribution

For pension costs, the stated desire for industry consistency seems to be unachievable unless a cash contribution method is used for all, and the Society does not advocate this. The unlikelihood of achieving complete consistency was apparent early on in the process as the significant differences in accounting and information availability were noted between local distribution companies using Ontario Municipal Employees Retirement System (OMERS) and Ontario's other large gas and electric utilities that operate their own defined benefit plans.

OMERS is a multi-employer defined benefit pension plan. For corporate participants in OMERS, auditable entity-specific pension information is not available on a cost-effective and timely basis that would allow for entity-level defined benefit accrual accounting and reporting. As a result, such individual entity defined benefit pension costs are accounted for and reported as if they were participants in a defined contribution plan. All major generally accepted accounting principles (GAAP) frameworks recognize this practical constraint by allowing such multi-employer plan participants to account for pension costs and prepare their financial statements on a defined contribution basis. Defined contribution accounting is basically a cash basis of accounting where contributions attributable to an accounting period, after taking into consideration any appropriate transactional accruals, are recorded as an expense. Consistent with enterprises applying the accrual method, companies with significant internal construction and development work programs capitalize an appropriate portion of periodic pension expense along with other labour inputs.

It is important to note that one of the large utility participants in this proceeding, Hydro One Inc., is in a similar situation to the Ontario local distributors that are members of OMERS. Hydro One Inc. has its own separate defined benefit pension plan that covers all employees in the consolidated entity. For Hydro One Inc. subsidiary businesses regulated by the Board, the costs of this plan are currently accounted for and reported on a cash basis, consistent with Ontario Energy Board rate orders for these underlying regulated businesses. For consolidated reporting purposes, accrual basis asset and/or liability information is provided with a regulatory offset on the Statement of Financial Position to comply with United States GAAP. Detailed actuarial disclosures in common with KPMG's proposed information requirements are only available at the consolidated group level. These are published in the notes to Hydro One Inc.'s annual financial statements.

Hydro One Inc.'s individual utility activities are regulated by the Board at the individual subsidiary and/or separate regulated business levels. Hydro One Inc. has the following separately regulated participants in the Hydro One Pension Plan: Hydro One Remote Communities Inc.; Hydro One Networks Inc. – Distribution Business; and Hydro One Networks Inc. – Transmission Business. All three regulated entities submit separate audited financial statements to the Board as part of their periodic reporting requirements. Similar to OMERS members, the financial statements of each entity note that their pension costs are accounted for on a defined

contribution plan basis. For example, this excerpt from the notes to 2013's Hydro One Networks Inc. Distribution Business Financial Statements alerts the reader to this treatment:

"Hydro One (Inc.) has a contributory defined benefit pension plan covering all regular employees of Hydro One and its subsidiaries, except Hydro One Brampton Networks Inc. The Hydro One pension plan does not segregate assets in a separate account for individual subsidiaries, nor is the accrual cost of the pension plan allocated to, or funded separately by, entities within the consolidated group. Consequently, for purposes of these financial statements, the pension plan is accounted for as a defined contribution plan and no deferred pension asset or liability is recorded."

This makes clear that, like OMERS participants, separate pension information to allow for accounting and regulation on a defined benefit accrual basis is not reasonably available. While pension asset and liability information could theoretically be separated for Hydro One Inc.'s various legal subsidiaries more easily than the members of OMERS, at some additional cost, there is an additional complication. Hydro One Networks Inc.'s portion of consolidated pension assets and liabilities would have to be allocated between its Distribution and Transmission Businesses on the same carve out basis used to develop the relative balance sheets. The 2013 Distribution Statements make the basis of carving out the separate Distribution and Transmission businesses as follows:

"These Financial Statements have been prepared on a carve-out basis to provide the financial position, results of operations and cash flows of the Company's regulated Distribution Business on a basis approved by the OEB. The Financial Statements are considered by management to be a reasonable representation, prepared on a rational, systematic and consistent basis, of the financial results of the Company's Distribution Business. As a result of this basis of accounting, these Financial Statements may not necessarily be identical to the financial position and results of operations that would have resulted had the Distribution Business historically operated on a stand-alone basis. The Financial Statements have been constructed primarily through specific identification of assets, liabilities (other than debt), revenues and expenses that relate to the Distribution Business."

Neither the Distribution nor the Transmission businesses of Hydro One Networks Inc. have separate dedicated employees or pensioners so the basis for any assignment of pension assets and liabilities would be very difficult to develop and maintain. As a result, the Society believes that the regulated subsidiaries and businesses operated by Hydro One Inc. and Hydro One Networks Inc. are effectively in the same positon as local distribution company members of OMERS and that the Board has no realistic alternative to continuing to regulate them on the basis currently used - i.e. as defined benefit plans accounted for on an accrued contribution (i.e. cash) basis.

There is also a possibility that the recommendations of the 2012 Morneau Report will drive government-owned utility pensions plans to move to larger jointly sponsored or multi-employer pension plans. This is alluded to in the KPMG Report. The potential impact of such changes should also be considered by the Board. In the event that the creation of larger consolidated pensions obscures individual member company pension asset and liability detail to the extent of

effectively making them multi-employer plans like OMERS, a move to defined contribution accounting may be the unavoidable result.

4.2 Generic Deferral Account for Pensions?

In its report, KPMG noted that some regulators do support such a generic deferral account on an industry-wide basis. KPMG notes that "the OEB may wish to seek input through the consultation whether it is appropriate to grant a generic deferral and/or variance account to P&OPEB costs…" (KPMG Report p. 110). To date, no significant public discussion has occurred on this issue to the Society's knowledge. The Society supports the adoption of such a mechanism.

Specifically, the Society agrees with KPMG that the Board should consider the issue of whether there is a basis for a generic deferral account to be put in place for all utilities subject to lengthy performance based regulation windows under the Renewed Regulatory Framework. This is particularly the case as pension cost variances occurring in a lengthy performance based regulation (PBR) period can be increases or decreases and therefore have the potential to materially impact the utility's bottom line either favourably or unfavourably. As pension legislation and financial regulation requirements result in a requirement for triennial actuarial revaluations at a minimum, material changes in pension costs are very likely to be triggered in rate years between periodic rebasings. These changes in pension cost levels may result in the addition or reduction of costs. Such changes are clearly externally triggered, are outside of the control of management and cannot reasonably be foreseen at the date of periodic rate rebasings. A generic industry deferral account would increase consistency and ensure that utilities and consumers pay the actual cost of pensions.

4.3 Pension Cost Recovery Options

KPMG identified several regulatory models in its report and analyzed pension plans in three general categories: (i) defined contribution and multi-employer defined benefit plans accounted for as defined contribution; (ii) defined benefit registered plans, and (iii) defined benefit unregistered plans such as SERPS.

In addition, KPMG evaluated four general accounting models for including pension costs in rates. These are:

- Funding contribution method;
- Accrual cost method;
- Pay-as-you-go method;
- Modified funding contribution method

The first two have both been used successfully by the Board and other North American regulators in regulating major utilities under their respective scopes of review. Both have relative strengths and weaknesses under varying fact patterns. The pay-as-you-go method is discounted as inappropriate for general regulatory use by KPMG and the Society agrees with this assessment. Many of the reasons are included in the section below dealing with the discussion of alternatives for OPEB accounting.

KPMG did not put forward any suggested changes from the status quo for defined contribution plans or defined benefit plans that are accounted for as defined contribution plans (p. 26). The Society agrees with this view based on the fact that there is no realistic alternative available and given that regulatory objectives are generally met. This means that even large Ontario local distribution companies like Toronto Hydro Electric System Limited, and the regulated businesses operated by Hydro One Inc., should continue to be have their pensions costs included in rates on a funding contribution basis. As the funding contribution basis includes the effect of transactional accruals for amounts paid in a subsequent period in respect of the current period, this term is preferred to the "cash basis" which is sometimes used instead.

The KPMG Report proposes the use of something called the modified funding contribution method for other single employer registered defined benefit pension plans. As noted above, the Society believes that it is appropriate to exclude the regulated businesses operated by Hydro One Inc. from this group. The proposed modified funding contribution method artificially separates annual pension costs into two populations. These are loosely defined as follows: (i) the normal funding contribution amount on a going concern basis plus going concern special payments amortized on a fifteen-year basis; and (ii) solvency special payments and other payments such as voluntary additional contributions. The costs in the first group are identified by KPMG as being relatively stable from year-to-year while the second group is potentially more volatile. The proposed funding contribution method isolates the first group as costs of each rate year while recording the second group of costs in a regulatory account for review and disposition by the Board in a future rate year, likely in aggregate with several years' similarly deferred amounts.

Before discussing the specific advantages and disadvantages of the proposed method, the Society states that it has reservations with KPMG's apparent positioning of the modified funding contribution method as the only alternative that meets the Board's stated needs. This is especially the case given KPMG's assertion in the Report's preface that it has not made any recommendations. The report presents the modified funding contribution method as a generally accepted model with equal credibility to the traditional funding contribution and accrual cost methods. But when questioned by the Society's representatives at the July 19 and 20 sessions whether there was precedent for the use of this method in other jurisdictions or whether it was created specifically for the Board, KPMG agreed that to its knowledge the method has not been used elsewhere. KPMG agreed that it has been designed specifically for the purposes of this proceeding. It is a creative solution that could be designed to give the Board greater capability to smooth pension costs but it should not be assumed be tried and tested.

KPMG's arguments in favour of the modified funding contribution method are outlined on pages 27 and 28 of its Report. Each of the arguments presented by KPMG in favour of the modified funding contribution method is addressed in detail below:

1. KPMG states that the modified funding contribution method is more understandable as the path from costs to rates is clearer. The Society accepts that the method may be more understandable by stakeholders for the normal annual funding costs and going concern special payments portion of the annual pension cost. The Society is not convinced that understandability of total pensions costs attributable to a given year is improved by

splitting off two potentially material cost elements (i.e. other special payments and voluntary contributions) into a deferral account for later Board review. All of the various elements of the pension cost calculation still need to be understood holistically for an appropriate regulatory decision to be made. Deferring review of some of the costs to a later period could actually reduce understandability by participants in a specific rate proceeding and jeopardize the completeness and consistency of review. This is especially true under the proposed methodology as the review of an applicant's total annual pension contributions would be carried out at two different points in time, likely involving two separate Board panels and potentially two groups of hearing participants.

2. KPMG's general findings (p.24) were that most North American regulators base the inclusion of pension costs in rates on accrual accounting cost rather than on a contribution-based method. One stated perceived weakness (p. 20 and p.25) in the use of the accrual method is that it can result in different accounting expense due to subtle differences in accrual accounting rules under different GAAP models (e.g. US GAAP versus IFRS). However, this theoretical weakness appears not to be a significant risk for the greater proportion of single employer pension plans belonging to utilities under the Board's eye. KPMG confirms that Ontario Power Generation Inc. (OPG), Hydro One Inc., Union Gas and Enbridge all currently carry out their accounting under US GAAP. So does the Independent Electricity System Operator. All but Hydro One Inc. have their pension costs regulated on an accrual basis, although at the Board's order OPG is currently on a different basis, at least pending the outcome of this proceeding. Ontario local distribution companies are members of OMERS and account for their pension costs under IFRS. These companies, and Hydro One, are likely to continue to have their pension costs regulated on a funding contribution basis based on KPMG's assessment. For these reasons, the Society believes that there is minimal risk of different GAAP frameworks leading to differing rate treatments for entities regulated under an accrual cost regime. The issue appears to be a red herring.
3. KPMG asserts that underlying assumptions for the modified funding contribution method will be more comparable as they are set by actuaries under Financial Services Commission of Ontario review rather than by management. This may be the case, but it should be noted that any management assumptions are subject to independent external audit and confirming disclosure. In addition, they are usually internally benchmarked across other similar utilities and industry prior to adoption. As management's assumptions are subject to external audit, this inherently includes a test of reasonability versus assumptions made by other companies. For these reasons, material estimating errors, inconsistencies or deliberate misstatements in the selection of management assumptions are unlikely to present a significant risk in the Society's opinion.
4. KPMG notes that the corridor method used under US GAAP has the effect of deferring the recognition of some pension cost variances that are within the corridor (to a maximum of 10%). This is true, but there is no assurance that this will represent a long-term deferral given that estimated pension obligations can increase and decrease from period to period and amounts within the corridor can fluctuate or even reverse quickly. The Board will have to determine whether this issue is sufficiently material in terms of

potential misallocation of amounts to individual customer years. It should be noted that the non-recognition of amounts in the corridor has not been considered a major regulatory issue of concern in the past for utilities applying the accrual method with a corridor under US GAAP or legacy Canadian GAAP. Why does this represent a compelling intergenerational equity issue now?

KPMG only identifies one disadvantage to its proposed modified funding contribution approach. They observe that the going concern funding approach, which forms the basis of the proposed modified funding contribution approach, includes an element of conservatism that is absent from the accrual method. This attribute could adversely impact the appropriate allocation of accounting costs to customer rate years by artificially drawing costs forward. This identified risk is essentially a corollary for the risk identified with respect to the corridor method (see 4 above). In that case, costs outside the corridor are not recorded and are artificially deferred rather than drawn forward. Neither result is desirable.

The Society has identified several other issues and possible disadvantages associated with the proposed method. There are likely others that have yet to be identified.

- The approach is presented by KPMG as the single alternative that best achieves greater consistency. This is questionable as the method seems to be focused more on achieving rate stability and smoothing than on consistency between utilities. KPMG identify the portion of pension costs to be included in year as generally stable and those to be deferred for future smoothing as inherently more volatile. While the Society agrees that rate stability is an important regulatory concept and goal, the Society is concerned that this stability could be purchased at the cost of drastically reducing intergenerational equity in the assignment of annual pension costs to customer years. Under the proposed method, a potentially material portion of annual pension funding contributions costs that are attributable to a specific year will be deferred and bundled with similar costs of other rate years. The total multi-year net balance will be deferred for a potentially significant period of time and then artificially assigned to later rate years as the regulatory account is cleared. Consistency will be a challenge given the potential for varying recovery periods.
- KPMG has not indicated what type of deferral account should be used for the elements of pension costs to be deferred under the modified funding contribution method – will it be Type I or Type II? A Type I account will be cleared more frequently during PBR periods assuming net material amounts are accumulated in total Type I accounts. If Type II is adopted, disposition will potentially be deferred even longer, to rebasing years, and a prudency review aspect will be introduced. Such a review could create uncertainty as to the ultimate recoverability of costs, especially where the costs may be in respect of a voluntary additional contribution that is made for valid and prudent business reasons. Such uncertainty affecting material amounts could present utilities with uncertainties that could impact credit metrics.
- As almost all utilities capitalize a portion of their pension and OPEB costs as a component of the labour charged to their internal capital work programs, the

proposed method raises the question of how the deferred portion of pension costs would be treated for in-year capitalization purposes, especially if it is subject to a later prudency review. This does not appear to have been specifically addressed by KPMG. If all special and voluntary payments in excess of going concern special payments are deferred for future Board review, this implies that a portion of these costs cannot be capitalized in the year that the contributions are actually made. The bifurcation of pension costs into what is essentially an allowable and a questionable population for capitalization purposes increases accounting and reporting complexity and causes uncertainty. Including a portion of the additional special payments in capital upon successful Board review, subsequent to the year of actual cost incurrence, would represent a regulatory accounting override to GAAP for property, plant and equipment costing. This would involve increased accounting complexity and complex disclosure.

- As the portion of pension costs recorded in a deferral account will be reviewed in different years by potentially different Boards, it is unclear how consistency is improved. Different Boards could make different prudency decisions, apply different disposal mechanisms for different utilities subject to similar business facts, and could order different recovery periods for analogous populations of deferred pension costs. It is unclear how introducing Board judgment to inter-period cost allocation contributes to greater consistency being achieved within the industry.
- The practical issue arises of whether, and how, the deferral of a portion of pension cost in a regulatory account impacts on the successful benchmarking of total labour costs. While the deferred costs could be added back for benchmarking purposes, detailed guidance around this issue would have to be provided and participants in a given rate proceeding would still need to understand the entirety of an applicant's pension costs/contributions in a given year. Benchmarking within Ontario may be achieved in the proposed manner if all utilities are using the adopted method but benchmarking with utilities outside Ontario would be more challenging as it is expected that most of these entities are regulated on an accrual cost basis. In addition, regulatory complexity is potentially increased.

5.0 OPEBs

5.1 OPEB Cost Recovery Options – General Observations

OPEBs are provided in different forms by different utilities under the Board's scope of review. The majority of these benefits are provided on a defined benefit basis and on an entity-specific basis (unlike pensions that are provided on a multi-employer basis by most local distribution companies). In addition, the types and value of benefits and duration of entitlement significantly vary from utility to utility.

KPMG has divided OPEB plans into defined contribution and defined benefit plans and has further divided plans into funded and unfunded classifications. The Society believes that most, if

not all, defined benefit OPEB plans in the Board's scope are unfunded, consistent with KPMG's observation that this is generally the case across North America.

KPMG has "recommended" that defined contribution OPEB plans be included in rates on a basis consistent with an enterprise's financial accounting. This will generally be as an entity's payments to beneficiaries are made (i.e. pay-as-you-go) or as its contributions to a funded plan are made.

Two general options are identified to exist for including the accounting costs of unfunded defined benefit OPEBs in rates. These are the accrual basis, which differs to some extent under different GAAP frameworks, and the cash or pay-as-you-go method. The Society believes that the pay-as-you-go method has serious deficiencies when benefits are delivered after the date employee services that gave rise to them are provided to the employer and indirectly to customers. In many cases, benefits can be provided many years or even decades after they were earned by the employee. Including benefits costs in rates on a pay-as-you-go method results in a serious violation of the principle of intergenerational equity, as material benefits costs may be assigned to later rate years and, literally, to later generations of customers possibly decades after cost incurrence on an accrual perspective. As KPMG points out, this is particularly a risk where a utility has operations using a technology with a finite operating life (e.g. nuclear or fossil). It could also pose serious complications to analysts evaluating utility credit metrics and utility mergers when material but unquantifiable off balance sheet liabilities in respect of OPEBs exist.

The pay-as-you-go method has also been rightfully criticized for being more volatile and pushing potentially increasing benefits costs off to future generations. Actuarially-based accrual methods allow for assumed future increases in the cost of benefits in the amounts estimated and charged to the period when the benefits are earned. These estimates are updated on an ongoing basis so that the cost of estimate changes are recorded on a rationale and systematic basis rather than being left to future rate payers who received no benefits from the original employee services.

A further issue occurs when a utility capitalizes a portion of its benefits costs as an indirect labour input to its own capital programs and projects. Under all forms of GAAP, these costs are an acquisition cost of the assets in the period the employee labour is delivered not of assets constructed or developed in subsequent periods when the benefits are paid out. While this timing difficulty could be handled under the general coverage of regulatory accounting under US GAAP, it is a greater problem for local distribution companies that have adopted IFRS and IFRS 14 "Regulatory Deferral Accounts." This latter standard requires that assets be costed appropriately under core IFRS standards and that any regulatory adjustments be made separately elsewhere in the Statements of Operations and Financial Position. Use of the pay-as-you-go method would represent an unwelcome increase in complexity for utilities but a very difficult one for local distributors operating under IFRS 14.

5.2 OPEB Adjusted Pay-as-You-Go (APYG) Method

KPMG has put forward a refined alternative to the pay-as-you-go method that it terms the APYG method. The KPMG Report describes this as a method that allows the regulator to increase the amount recovered in rates for OPEB beyond the pay-as-you-go starting point. Rather than

providing a theoretical amount to be included, as was the case in the modified funding contribution method proposed for pensions, the KPMG report describes various possible bases that the Board could use to increase OPEB collections beyond the base cash outflows in a period. No specific recipe for the adjustment to be made is provided.

The Society has reviewed KPMG's stated advantages of the APYG method and has the following comments:

- KPMG has noted that the APYG method allows for a clearer and less complex path from the accounting cost to the setting of rates because the starting point for the method is actual cash payments. While the starting point is clear, the Society does not believe that the simplicity of this mapping is retained once regulatory adjustments are made. If anything, the simplicity of the path from cost to rates is worsened.
- KPMG argues that estimation risk is reduced to a degree due to the method being based on cash amounts. They recognize that there may still be some estimation risk due to potential inclusion of estimate-based elements in the Board's adjustment. The Society believes that there is still significant estimation risk with the proposed methodology. This is discussed further below.
- KPMG also argue that the APYG method increases comparability and consistency due to the avoidance of different accrual accounting methodologies under varying major accounting frameworks. The Society does not believe that this is a convincing advantage for the APYG method because, as it has already noted above under the discussion of pension costs, all of the major gas and electric utilities currently apply US GAAP. While the proposed method would standardize the accounting between smaller Ontario electric utilities and the larger companies, this really only has a benchmarking advantage. As already discussed, there is near consensus that benchmarking should be carried out on a total labour basis rather than on the standalone basis of individual companies' pensions or OPEB benefits. KPMG also argue that the APYG regulatory accounting methods would not be subject to change if core employee benefits accounting standards within GAAP changed over time. The Society does not believe that this poses a major risk as core accounting standards have recently been updated. In any case, accounting standards are always subject to change and regulators need to be ready to react to such changes.
- KPMG notes that the fact that the OEB will 'adjust" the APYG amounts being included in rates and as a result there should not be a build-up of amounts collected in excess of cash payments. That is dependent on what basis the Board uses to adjust base pay-as-you-go amounts and on specific regulatory decisions taken.

KPMG did not include any disadvantages to the use of the APYG method beyond some criticisms of the traditional pay-as-you-go method that the Society has commented on above. However, the Society has identified some additional concerns with the APYG method:

- KPMG has not suggested what adjustments the OEB could or should make to base pay-as-you-go costs and what criteria should be applied in selecting the adjustments. The Society believes that the current description of the method is too imprecise to be helpful. Any existing accrual or cost-based cost recovery amount can be adjusted by the Board

under its existing regulatory powers. KPMG has provided one potential basis for Board adjustment to base pay-as-you-go amounts to illustrate the "various" adjustments the Board could make in applying the method. The Report suggests that the Board could add other amounts to base pay-as-you-go amounts to be recovered. These other amounts could for example recover annual OPEB amortization from other comprehensive income plus "a portion of the OPEB costs that are determined using the accrual accounting costs method" (p.60). It is difficult to see how this specific example retains the stated benefit of being clearer and less complex for hearing participants. The Society believes that introducing what appears to be a hybrid pay-as-you-go and accrual accounting method has the potential to mystify and complicate the accounting beyond the application of well-known existing accrual accounting rules.

- One of the Board's stated aims in launching this proceeding was to increase consistency and comparability amongst regulated utilities under its scope of review. Unless a consistent model is adopted for the specific adjustments to be made to base pay-as-you-go OPEB amounts, the Society believes that the proposed method introduces the potential for an ad hoc approach to regulation, with the Board adjusting base pay-as-you-go OPEB costs differently as it sees fit in different proceedings. This could actually reduce consistency and comparability rather than improving it. If the proposal is to consistently adjust pay-as-you-go amounts to achieve a certain defined objective, the Society believes that the specifics of the proposed adjustment mechanism need to be described and discussed within the scope of the current stakeholder consultation.
- KPMG has not stated whether this method has been developed for discussion specifically in this proceeding or whether it has been used elsewhere in North America or internationally. As the modified funding contribution method for pensions was created specifically for the Board's review, the Society is concerned that the APYG method for OPEB accounting is similarly new and untested. If the method has been used elsewhere, the precedents should be identified and this may aid in identifying the specific adjustments that should be proposed, discussed and potentially approved.
- Under the APYG method, applicants would still need to forecast cash outflows for test years. While the pay-as-you-go method removes the need for some actuarial estimates, the example APYG method put forward by KPMG appears to retain elements of these estimates. It could be challenging for management to make good quality estimates of future annual cash outflows for forecasts in lengthy future PBR periods. The use of a pay-as-you-go method, even when adjusted, for lengthy PBR envelopes would seem to invite the use of symmetrical variance accounts to recognize the fact that cash outflows may not be estimable with reasonable precision.
- The use of an APYG method would seem to have the potential to trigger significant transitional confusion and complexity given that amounts which in the past were collected under the accrual method would under the new method instead be collected in future years. Transitional rules will be required to avoid potential double recovery as well as under recovery. While the Society recognizes that the Board has deferred the discussion of transitional provisions to a later date, it should be recognized that the adoption of this method will necessitate significant work in this area. It is questionable

whether the additional complexity in application and transition is warranted given the generally consistent use of the accrual method currently.

5.3 Set-Aside Mechanisms - OPEB

KPMG provided four potential set aside options for “excess” funds in their report. These were:

- Internally segregated accounts;
- Retirement Compensation Arrangements (i.e. trusts);
- Tracking Accounts (regulatory deferral/variance accounts);
- Rate base adjustment.

The Society strongly believes that the term “excess” should be avoided as it implies some impropriety or imprecision in the accounting and estimation method used to collect OPEB costs from customers. When an accrual basis is used to account for OPEBs, amounts are correctly and unavoidably included in expense and capital in advance of related payments being made to employees. When such an accounting method is used for rate making, amounts are similarly collected from customers in advance of the related cash expenditures being made. This is a function of the fact that the accrual method results in the recognition of a liability and a related cost that is recorded when employee services are provided in a given period. The “excess” collection of cash is better viewed and described as a timing difference between accounting cost recognition and liability settlement.

This type of timing difference is also created in other areas of accounting when other revenues and expenses are recorded and included in rates on an accrual basis that differs significantly from related cash flows. The Board should consider whether the OPEB situation is sufficiently different and material to warrant a specific set-aside mechanism being put in place.

The term set aside mechanism implies a security mechanism for potential default. At the July 19 and 20 sessions, it became clear that the issue is not so much one of protecting the customer against potential default but is instead to ensure that the utility and its customers are fairly treated from a rate making economics point of view. For this reason, the first two of the four set aside options in the list above were fairly quickly discarded as they generally ensure security and availability of pre-collected funds until the future period when they are required to be paid out. As the utilities within the scope of the Board’s consultation are all expected to remain financially healthy, default does not appear to be seen by consultation participants as a major risk at this time.

Given this, the focus moves to ensuring that a reasonable regulatory treatment is given to funds pre-collected from customers in advance of settling related obligations. The choices are: to retain the status quo; to use the existing deferral and variance account model (also termed tracking accounts); or to mandate a rate base adjustment. The two general options for making a rate base adjustment discussed in the July sessions were: an actual rate base adjustment through use of a regulatory tracking account or including the pre-collection of cash in the existing working capital formula.

The Society believes that for some utilities, OPEBs may be sufficiently material and the associated liabilities may be sufficiently long-term to differentiate them from other long-term obligations where ongoing cash versus accrual timing differences exist. Also, in the case of OPEBs included in rates on an accrual basis, the timing difference between cash collection from customers and ultimate pay out to beneficiaries will almost always be a utility liability. However, putting a special rate treatment in place for pre-collected cash does risk creating an inconsistency with other types of long-term obligations funded through rates such as provisions for asset removal and environmental costs. It also increases administrative complexity for the utility and the Board.

A reasonable case can be made that cash collected in advance of pay outs for OPEB benefits displace borrowing that would otherwise occur. As such, The Society is of the opinion that customers are already getting an appropriate economic benefit from the pre-collection of cash without needlessly over-complicating the regulatory model. The Society presumes that most utilities will reinvest such pre-collected cash in the work programs of the business and borrow at a future date to discharge its related obligations. If cash is not reinvested, it would be held on balance sheet in prudent investments, earning interest to offset interest expense.

If a special rate treatment is considered necessary, three general options exist:

Customer deposit: OPEB-related funds advanced though timing differences between accrual accounting and cash payouts could be considered akin to customer deposits. This option is available in a relatively simple manner and at first seems to have some appeal. But on a closer look it fails to meet several simple tests. Customer deposits are amounts advanced by specific customers for a specific purpose, generally payment security. Essentially they are a loan to the utility. They are defined amounts that do not run through the Statement of Operations, not timing differences, and they are generally advanced for a specified short time. In the Society's view, this model should not be used.

Regulatory account: A regulatory account could be used to capture timing differences between cash payments to employees and accrual cost amounts. Such an account would be interest-affected, likely at the existing short-term rate mandated by the Board, applied on a simple rather than compounded basis. However, the Society believes that the use of a regulatory account, whether termed a tracking, deferral or variance account, would be precedent setting for what is a recurring timing difference between an accounting expense and later cash payouts.

It is important to recall that the standard Board regulatory accounting model, whether tracking, variance or deferral account, is generally to record an amount occurring between PBR or full rebasing rate hearings. That is why a short-term rate and simple interest model is used. In addition, the presumption of a one-year disposal period reinforces this short-term assumption.

Using a regulatory account with a Board standard interest model would not materially compensate customers for timing differences. In addition, as some OPEB costs are capitalized and included in CIP and later in rate base, the calculation of the amount to be included in a regulatory account is not simple accrual expense versus cash payout if one is looking for precision. To be theoretically sound, the capitalization aspect of the timing difference would

need to be analyzed. An analysis of timing differences between the recovery of capitalized OPEB costs via depreciation and actual payouts may need consideration.

Use of an OPEB regulatory account by entities that have adopted IFRS 14 "Regulatory Deferral Accounts" may also increase complexity as these entities are required to construct their financial statements on a basis that presumes regulatory accounting does not exist, and then effectively add the effects of rate regulation below the line. Depending on the regulatory model selected, compliance with IFRS 14 could be very complex and costly.

Rate base adjustment: In the July 20 session, some intervenors strongly pushed the idea of a rate base adjustment. This is not surprising as the OPEB timing difference is generally large, long lasting and unidirectional (i.e. the timing difference will almost always be a utility liability). A rate base adjustment at the full utility rate of return would maximize the amount of any benefit provided to customers. In addition, discussions were held on whether this adjustment should be a working capital adjustment or a direct adjustment to rate base through an offsetting regulatory tracking account. This account would be notional and would not appear as a regulatory liability on the balance sheet.

The Society has serious reservations with the idea of a rate base adjustment, either directly or through an adjustment to the working capital allowance, for two major reasons:

- Amounts received by a utility in respect of periodic OPEB accrual expense (versus cash payments) have no direct theoretical connection to rate base, which is essentially defined as the amount of net book value of in-service property, plant and equipment and intangibles. This, combined with an allowance for working capital, is the amount that a utility needs to finance through a combination of debt and equity. The capitalized portion of OPEB costs is included in rate base as in-service assets and does not form part of the timing difference under discussion. There is precedent for affecting rate base with an offsetting regulatory tracking account.
- USoAs 1575 & 1576 were set up to track legacy Canadian GAAP versus IFRS capital asset costing and deprecation differences. The balance in this account is effectively used as a rate base adjustment. However, the amounts recorded in these accounts are pure capital asset amounts (i.e. property, plant and equipment and intangible assets). In the Society's opinion, these accounts do not provide any precedent for offsetting pensions and OPEB variances against rate base. If anything, the fact that the earlier accounts are the only such adjustments made to date and the fact that they are purely capital asset-related, argues against the widening of this treatment to other non-capital cost categories.
- While treating the timing differential between OPEB accounting expense and cash payments as an adjustment to rate base has a certain appeal from a simplicity perspective, it is a theoretically weak solution as the timing difference amounts are not one-for-one related to the financing of capital assets. The OPEB timing difference is the expense portion of OPEB costs, which is distinct from the capital portion. The Society is also concerned that this proposed treatment opens the door to a potential multitude of other future rate base adjustments that would distort the understandability of a relatively straight forward regulatory model and increase regulatory complexity.

6.0 Conclusion and Society Recommendations

The Society believes that the Board should step back and review whether there is really a need for change.

Pensions are already accounted for on a consistent basis to the extent practicable given that Local Distribution Companies and Hydro One have no real alternative but to account for their plans as defined contribution plans. Most other utilities apply accrual accounting.

OPEBs are generally accounted for and included in rates on an accrual basis. This provides for the sought after consistency and comparability.

The new alternatives put forward by KPMG do not in the Society's opinion meet the tests of being well tested in other jurisdictions, simple to apply or consistent in result. Both seem to invite a good deal of regulatory judgment and intervention in their application and this in itself will increase complexity and reduce consistency. It is hard to see what tangible advantage is gained.

In the Society's view, the Board would be better served by standardizing the current methods of accounting for employee benefits and investing in education in this complex area. As a result, the Society makes the following recommendations:

6.1 Recovery of Pension Costs

- The Society recommends that the Board approve the use of the funding contribution approach for including pension costs in rates for Local Distribution Companies that are members of the OMERS multi-employer plan. This recognizes that there is no reasonable accrual alternative and is consistent with the findings in KPMG's Report.
- The Society also recommends the regulated businesses of Hydro One Inc. continue to have their pension costs regulated on the funding contribution method, consistent with other Local Distribution Companies that are OMERS members. The use of the funding contribution method would recognize the difficulty in applying an accrual cost method to the regulated entities that are part of the Hydro One Inc. pension plan. The Board regulates Hydro One on a subsidiary legal entity and/or carved out regulated business basis. The Society's recommendation is made in recognition that such regulated businesses do not have a dedicated share of consolidated pension assets or liabilities and, in the case of Hydro One Networks Inc.'s carved out Transmission and Distribution businesses, do not have specifically identifiable employees or pensioners.
- The Society is unconvinced of the benefits of the modified funding contribution method as described by KPMG. The method appears to be aimed at achieving rate smoothing rather than consistency and it appears to have fewer advantages than KPMG identified and several disadvantages that have yet to be discussed in this consultation, such as drastically reduce intergenerational equity in the assignment of pension costs to customer years (please refer to the last five bullets of section 4.33 for details). As a result, the

Society recommends that most single entity registered and unregistered (e.g. SERP) defined benefit pension plans continue be regulated on an accrual cost basis, in common with most other North American utilities, many of which, like OPG, Union Gas and Enbridge also apply US GAAP.

6.2 Recovery of OPEB Costs

- The Society recommends that the Board approve the existing accrual method as the preferred option for unfunded OPEB plans. This method is already applied by most utilities, is reasonably well understood and benchmarkable as part of total labour costs across North America.
- The Society recommends that the Board not adopt the adjusted pay-as-you-go method put forward by KPMG as it carries many of the disadvantages of the basic pay-as-you-go method, the worst of which is that it completely fails to meet the important regulatory principle of intergenerational equity. In addition, the method increases regulatory complexity, reduces comparability and creates significant practical hardships for utilities.

6.3 Set Aside Mechanisms – OPEB

- The Society is unconvinced of a need for a set aside mechanism to provide security of payment for OPEB amounts to be potentially settled long in the future.
- If the objective of a set aside mechanism is to provide value for money contributed in advance of the related cash outflows being made, the Society believes that the Board should consider this very carefully. The cash timing difference between the collection of OPEB amounts on an accrual basis and the payments to beneficiaries already displaces utility borrowing requirements, resulting in a benefit to customers. The two alternatives of using a regulatory account or a rate base adjustment increase regulatory complexity and have significant theoretical limitations.
- Based on these considerations, the Society does not support the use of any additional set aside mechanisms for the timing difference in OPEB cash flows for certain utilities.

6.4 Other Issues

- The Society encourages Board Staff to develop and publish a comprehensive list of principles against which the appropriateness of any recommended pension and OPEB recovery mechanisms can be measured. Significant input on suggested principles was provided by participants in 2015. The creation of a consensus list of principles was a key factor in the success of the Board's previous IFRS Consultation EB-2008-0408. This proceeding, which involved the intersection of complex accounting and regulatory issues, can be taken as a useful model for the current one.
- The Society supports the creation of a generic deferral or variance account to record potentially material pension cost variances occurring as a result of actuarial revaluations between periodic rate rebasings. This issue has been identified in KPMG's report but has not yet been actively discussed by participants in the July 19/20 consultation sessions.

The Society considers this to be an important issue within the scope of this proceeding and one that deserves active discussion by the various participants.

- The Society believes that it would be beneficial for the Board Staff to scope out and communicate to participants its intended process and schedule for completing this consultation. This is particularly the case as two major elements have been deferred for future discussion and the Society's view that the principles that will apply to the topic need to be nailed down before final recommendations on regulatory accounting methods are made. Understanding the proposed timetable and process will assist in participants providing their feedback now and in scheduling their resources for future inputs.