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BY COURIER

September 22, 2016

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

Dear Ms. Walli:

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

Hydro One Networks Inc. ("**Hydro One**") makes this submission in response to the Ontario Energy Board's ("**OEB**" or "**Board**") letter dated August 10, 2016 regarding the consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefits ("**OPEB**s"). The letter invited participating parties to submit their respective views on several options considered within the proceeding. In this submission Hydro One will provide its views on the following:

1. The principles to be considered in assessing pension and OPEB costs in rate applications and for the selection of appropriate rate mechanisms for cost recovery;
2. The cost recovery options proposed by KPMG for pensions and OPEBs;
3. Set–aside mechanisms – their necessity for OPEBs (if accrual accounting values are used for rate setting), focusing on two options (rate base reduction or tracking account);
4. Whether either of the two mechanisms in 3,above could be implemented for pension costs; and
5. Our views on KPMG's modified funding contribution method (as well as any method other than a pure accrual accounting method as the basis for cost recovery).

Consistent with the Board's August 10 letter, transitional issues and information requirements have not been addressed in this letter with the understanding these will be addressed at a later time. We do anticipate potentially significant transitional issues related to certain of the KPMG options.

Hydro One's views regarding the recovery of Pensions and OPEBs are as follows:

Hydro One currently reports and recovers its pension expense on a cash basis. Hydro One believes this is beneficial to its customers, and that, for Hydro One, this treatment should be maintained, as it is more predictable. Hydro One recognizes and supports that the use of alternative approaches may be appropriate for other individual utilities.

With respect to OPEBs, Hydro One maintains that the accrual method, which it currently uses, appropriately reflects the costs incurred during the time period, and as such more accurately attributes those costs to the appropriate rate payers. The modified method proposed by KPMG tends to defer costs into the future, creating intergenerational inequity.

The considerations that inform our views are discussed below.

1) Key Principles for Consideration

Hydro one submits that the OEB should consider the following principles when assessing pension and OPEB costs and the rate mechanism for cost recovery:

a) The OEB's statutory objectives (including protecting customers' interest and ensuring viability of the natural gas / electricity sectors);
b) General rate making principles, specifically:
    i) Fairness to both ratepayers and utilities, and
    ii) Fairness within the ratepayer population (intergenerational equity) where responsibility for costs is allocated based on cost causation;
c) Alignment with accepted accounting principles and standards as employed by each utility;
d) Stable cost principles (i.e. smoothing out rate increases – to the extent possible); and
e) Minimizing the regulatory burden on utilities and on the Board to the extent possible, absent a compelling reason to do otherwise.

Hydro One believes consistency over time should play an important role in the cost recovery mechanism as changes in recovery can create transitional issues for utilities and fluctuating rates for rate payers.

2) Cost Recovery options proposed by KPMG for Pensions and OPEBs

KPMG in its report: "KPMG Report to the Ontario Energy Board – Report on Pension and Other Post-Employment Benefit Costs" dated May 2, 2016 identified an alternative option for the accounting and cost recovery for each of pension and OPEB costs: the Modified Funding Contribution method for pensions; and the Modified Accrual Basis for OPEBs.

Pensions

The Modified Funding Contribution method (MFC) would represent the minimum amount of contributions required to be made by a sponsor of a registered pension plan that is subject to the requirements of pension legislation in Ontario under the Pension Benefits Act (PBA), modified to the extent that only the employer's normal cost contribution and any going concern special payments (amortized over 15 years) would be included in current period rates. Any other special payments required under the PBA (e.g. Solvency Payments) and payments in excess of the minimum funding requirements required under the PBA would be recorded in a deferral account and recovered in rates in future periods, likely over the estimated average remaining service life (EARSL) of the employee group.

In evaluating this method consideration should be given to the proposed Solvency Funding reforms that the Government of Ontario is considering as released in the consultation paper “Review of Ontario’s Solvency Funding Framework” dated July 26, 2016. This consultation paper is open to comment until September 30, 2016 and the results of the consultation may have some impact on the proposed MFC method.

Issues such as the method by which deferred amounts are recovered over the EARSL and maintenance of rolling balances create complexity and unless simplified, Hydro One does not believe this is a viable option, due to its complexity and level of administrative burden, particularly considering that the current method of recovery is beneficial to both the Company and its customers.

Hydro One is currently reporting, and recovering through rates, its pension expense on a cash basis. Hydro One believes this is beneficial to ratepayers as it results in a lower cost recovered through rates compared to the accrual method. The cash method is also less volatile with the ability to predict the effect on rates for up to a three year period, as a pension plan valuation has to be filed at a minimum on a triennial basis with the Financial Services Commission of Ontario. Transitioning from the cash basis to an accrual method would also result in the pension offset (cumulative difference between the cash and accrual basis which is $952 million as at December 31, 2015) having to be recovered in rates, which would have a material negative rate impact for customers.

Recognizing that each utility has different pension plans and accounting methods, Hydro One proposes that it continue recovering on a cash basis, and that the best basis of recovery for other utilities be followed depending on that utility’s unique situation. To the extent that utilities are in common circumstances, Hydro One would support consistent rules for comparable utilities.

OPEBs

KPMG proposed a modified “pay-as-you-go” option, which may be more appropriately referred to as a modified accrual basis. Under this approach a modified accrued expense, consisting of the annual required cash OPEB payments plus an ‘additional amount’, would be recognized as the annual expense for both accounting and rate recovery purposes. The difference between the current period costs recovered in rates and the accrued expense for the period would be set up as a regulatory asset to be recovered over the EARSL. In order for this method to meet US GAAP requirements the following criteria must be met:

- A rate order, policy statement or generic order from the regulator allowing deferral of and subsequent inclusion of those deferred costs in the entity’s rates;
- The Period of deferring additional costs not to exceed 5 years;
- The combined deferral-recovery period authorized by the OEB will not exceed 20 years; and
- No back-end loading of the deferred costs.

The above option was reviewed by the accounting firms KPMG, PwC and E&Y and all three have indicated that the approach has merit. Hydro One accepts this position, but would like to point out that this is an untested and new interpretation of the US GAAP guidance. The guidance was initially drafted and put in place to transition US regulated entities from a cash basis of accounting to a full accrual basis of accounting for OPEB costs. There is a risk that the implementation of this modified approach could fail to qualify under the US GAAP guidance and result in income statement volatility, potentially increasing the risk profile of the utility which in turn may increase the utility's cost of borrowing.

The recovery of the deferred costs are assumed to be over the EARSL – this is an assumption and one that appears to be principle-based, as it is an objective metric that has a supportable rationale. This approach requires that each year's deferred amount be treated as a discrete item. Multiple calculations are therefore required and there is an associated additional administrative burden. However, if a simplified approach were to be adopted whereby by the deferred costs would be calculated on a rolling basis (deferred cost pool recovered each year over EARSL) it would make the approach less burdensome.

Hydro One maintains that the accrual method appropriately reflects the costs incurred during the time period, and as such more accurately attributes those costs to the appropriate rate payers. The modified method proposed by KPMG tends to defer costs into the future, creating intergenerational inequity.

However, Hydro One does recognize the proposed "modified" approach would reduce rates for customers, and would be supportive of its adoption provided a simplified approach can be determined and that no conflict with US GAAP arises.

3) Set-aside Mechanisms

KPMG in its report suggested four possible set aside mechanisms that could be developed in order to provide customers with "value-for-money" on the cash that is collected in advance of cash disbursed for OPEB obligations (i.e. excess recoveries). The four alternatives identified are:

i. Internally segregated accounts;
ii. Retirement compensation arrangement (e.g. a trust);
iii. Excess recoveries reduce rate-base; and
iv. Continue with the current practice, with any excess recovery recorded in a tracking account that is monitored by the OEB. The excess recovery booked to the tracking account would attract interest as specified by the OEB.

As indicated in the OEB's August 10th letter, there were a number of concerns with the first two options that were raised during the consultation (July 19th and 20th) and as such the consensus was that they were not practical. Hydro One will not repeat these concerns here, and instead will focus its remarks on the remaining two options: (i) excess recoveries reduce rate base; and (ii) current practice with a regulatory account.

Excess recoveries reduce rate base
In Hydro One's case, approximately 50% of the annual OPEB expense is reported as operating expense (OM&A) and recovered in rates over the course of one year. The remainder is capitalized and recovered at the same rate as depreciation, which is on average 2.5%, reflecting a recovery period of approximately 40 years. While the capitalized portion earns a rate of return, as do all costs for capital investments, it also allows for a longer time period to recover the funds from customers. A rate of return is appropriate as it accounts for the time value of money; this approach was reviewed and validated by Hydro One's actuaries. If Hydro One recovered 100% of its OPEB costs through OM&A, it would have an immediate impact on rates.

Hydro One believes this is the appropriate accounting and regulatory treatment as it reflects actual costs incurred to construct the fixed assets within Hydro One's rate base. Reducing rate base by the non-cash OPEB portion of expense is essentially reducing the cost of the benefit that these assets provide to current rate payers and shifts these costs to future rate payers, creating inter-generational inequity.

Current practice with a regulatory tracking account
This mechanism is preferable to the reduced rate base option. It appears to be less administratively burdensome to the Board and utilities and also appears fair to rate payers. There are some uncertainties with this approach that would need to be defined, for example would the tracking account be symmetrical and what interest rate would be used on the balance. Hydro One's view is that consistent with all other deferral and variance accounts, this account should be symmetrical, to ensure fairness to both ratepayers and utilities.

The interest rate applied to this account should reflect the same rate as all other deferral and variance accounts, which is the OEB prescribed short-term interest rate. Considering the deferral and variance account balances represent money owed to and from customers, a consistent rate for all account balances is appropriate.

4) Could these mechanisms be implemented for pension costs?

Whether the above two mechanisms could be implemented for pension costs, would be largely dependent on the basis of recovery a utility uses for pension expenses. If a utility recovers pension costs on a cash basis then there is no need for a set aside mechanism as there are no cash recoveries in excess of expense. This is the case for pension expense for Hydro One.

5) Our views on KPMG's modified funding contribution method (as well as any method other than a pure accrual accounting method as the basis for cost recovery).

Hydro One is of the view that the basis of cost recovery of pension and OPEB costs should be determined on a case by case basis and aligned with accepted accounting principles and standards. For Hydro One, which reports under US GAAP, either the cash or accrual method for pension costs is acceptable. For OPEB expenses the accrual method as defined under US GAAP would be acceptable and possibly KPMG's modified method, were it to qualify under US GAAP rules.

In summary, for pension expenses Hydro One currently uses the cash method for financial reporting and regulatory purposes, and believes no additional changes to this approach are warranted. This is especially true in consideration of the reduced rate impact on customers compared to the accrual method. For OPEB, Hydro One believes the accrual method is the appropriate method to use as it allocates costs to the period in which they were incurred and more accurately attributes cost to the appropriate cohort of rate payers.

Sincerely,

ORIGINAL SIGNED BY ODED HUBERT

Oded Hubert