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

On May 18, 2017 the Report of the Ontario Energy Board Regulatory treatment of Pension and Other Post-employment Benefits (OPEBs) was issued. In its transmittal letter of May 18, 2017, the OEB stated that it would be assisted by comments on six implementation issues. OPG has provided comments in the attached submission on each of the six issues requested by the OEB.

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,

"original signed by"

Chris Fralick
Vice President, Regulatory Affairs
Ontario Power Generation

cc: Randy Pugh (OPG) via e-mail
Lindsey Arseneau (OPG) via e-mail
John Baeuchamp (OPG) via e-mail
Charles Keizer (Torys) via e-mail
Crawford Smith (Torys) via e-mail

1. Introduction

On May 18, 2017 the Ontario Energy Board ("OEB") issued its Report on the Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs (the "Report"). The Report is the conclusion of the OEB's consultation on the issues identified by the OEB regarding the recovery of utility pension and OPEB expense.[1]

In OPG's view, the two year consultation process was comprehensive and thorough, and the Report reflects a thoughtful, flexible, balanced regulatory treatment of pension and OPEB costs. Accepting cost recovery on an accrual basis as the default treatment for recovery of pension and OPEB costs is a principled approach. Providing a tracking account to provide value to customers through application of a carrying charge at the OEB's prescribed rate for Construction-Work-In-Progress ("CWIP") is a balanced treatment that did not exist for customers in the past. The flexibility in treatment to reflect utility-specific circumstances provides a reasonable compromise given the broad range of utility policies and benefit programs.

OPG has two concerns that relate to implementation matters raised in the Report:

1) **<u>Timing of OEB decision on cost recovery approach</u>**: The Report states that the OEB will consider whether accrual accounting will be used as the basis of cost recovery at the utility's next cost-based rate application.[2] OPG is of the view that approval of the accrual approach should occur as soon as practicably possible, as should the recovery of balances accumulated in cash to accrual variance accounts for utilities that currently have them in place as an interim measure; and

2) **<u>Application of carrying charges to historic accrual to cash differences:</u>** OPG agrees with the stated position that the new variance account will track differences between cash and accrual on a go-forward basis and that the account will not capture differences that occurred in the past.[3] However, the requirement to record the recovery of balances in the currently approved cash to accrual variance accounts in the new variance tracking account[4] should be limited to cash to accrual differences arising on or after June 1, 2017. If the new variance account records the recovery of cash to accrual differences arising prior to June 1, 2017, it would effectively result in retroactive implementation of a new OEB policy and would create differences in policy implementation across utilities, due to different start dates for applying carrying charges to cash to accrual differences.

2. Comments on Implementation

The OEB's transmittal letter to stakeholders issued in conjunction with the Report requested comments on six implementation matters by June 22, 2017. The two concerns OPG identified above are both implementation matters and are addressed in the context of the six implementation matters outlined by the OEB.

[1] EB-2015-0040, Report of the Ontario Energy Board, Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs, 18 May 2017, [Report], p. 1.
[2] Cost of Service or Custom Incentive Rate-setting.
[3] Report, p. 19
[4] *Ibid*, p. 21

2.1. Effective date of the new variance tracking account:

The Report recognizes that the effective date of the new variance account will differ, depending on the basis upon which utilities' current rates are established. The Report states that a control variance account (with appropriate sub-accounts) will be established on a generic basis effective on the 1st of the month following issuance of this Report for utilities without an existing cash to accrual variance account.[5]

Appendix C of the Report provides that this "account will track the differences between the forecast accrual amounts recovered in rates and the actual cash payments made for both pension and OPEB's in one account, on a go-forward basis from the date the account is established. The account will not capture differences that occurred in the past".[6] Approved rates for most utilities reflect recovery of pension and OPEB costs on an accrual basis, and the tracking account approach is administratively simple to implement; therefore an effective date of June 1, 2017 is reasonable for most utilities. OPG agrees with the Report's stated approach to prospective implementation of the new OEB policy.

The Report also recognizes that, for some utilities (including OPG), "the OEB approved the recovery of pension and OPEB costs on a cash basis as an interim measure pending the outcome of the pension and OPEB consultation." The Report states that these "utilities are also required to begin recording entries in the new variance account, effective from the date that the utilities' rates are set based on the accrual amount for pension and OPEBs (i.e., typically the effective date of the rate order of its next cost-based application). These utilities are required to continue to record amounts into the previously approved account(s) until the effective date of a utility's next cost-based rate order".[7]

OPG agrees that, if accrual is not accepted for ratemaking purposes for a utility until its next cost-based rate application, then the effective date of the new variance account will not be required until the effective date of rates resulting from that application. In such circumstances, there is no difference in the amounts recovered in rates and the actual payments made by the utility.[8]

OPG believes it would be appropriate for the OEB to consider, in advance of the next cost-based application, applications for acceptance of accrual accounting and disposition of associated historical cash to accrual variance account balances from utilities currently recovering pension and OPEB costs on an interim cash basis. That would enable disposition of accumulated balances in the existing cash to accrual variance account, if accepted by the OEB, to begin as soon as practicable, before the next cost-based application.[9] To the extent recovery of these balances includes amounts recorded <u>after</u> the June 1, 2017 implementation of the new policy (post-implementation balances); the effective date of the new account would be the date

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[5] Report, p. 11
[6] *Ibid,* p. 19
[7] *Ibid,* p. 11
[8] For OPG the forecast cash to actual cash payments is recorded in a different variance account.
[9] EB-2013-0321 Decision With Reasons, p. 89 states that for OPG "the Board is not setting aside the difference between the cash and accrual amounts for this test period, for purposes of another future prudence review of these costs. The 2014 and 2015 payment amounts will be final in that respect."

that recovery of post-implementation balances begins. That date may occur prior to the effective date of rates resulting from a utility's next cost-base rate application.

The interim cash to accrual variance account balances are material for OPG. As such, OPG has proposed to submit an application for acceptance of accrual accounting and clearance of audited balances recorded in its Pension & OPEB Cash to Accrual Differential Deferral Account at the same time as its application for 2018 hydroelectric payment amounts.[10]

Based on the anticipated timing of that application, OPG does not expect that it would request clearance of any balances recorded in the Pension & OPEB Cash to Accrual Differential Deferral Account on or after June 1, 2017. OPG expects that balances recorded on or after this date would form part of OPG's future application to clear audited balances in all of OPG's deferral and variance accounts prior to the next cost-based application, such as the one proposed in conjunction with OPG's mid-term review process in EB-2016-0152. In such an application, the new variance account therefore would become effective at the same time as the rider arising from that future application that provides for recovery of amounts recorded in the Pension & OPEB Cash to Accrual Differential Deferral Account in respect of the post-June 1, 2017 period.

2.2. Mechanics of the new variance tracking account:

With one exception, OPG is of the view that the mechanics of the new variance tracking account as provided in Appendix C and Appendix D of the Report are reasonable, comprehensive and clear. The new variance tracking account will use the forecast accrual reference amount that will be used to calculate the entries recorded in the new account assuming that the total gross accrual costs as determined by an actuarial valuation is what is recorded in a utility's total OM&A expense.[11]

OPG agrees with the use of forecast accrual amounts reflected in cost-based rates as the basis for comparison against accrual amounts collected in rates (not escalating under IRM), for purposes of determining the amount to be tracked in the account. As discussed in OPG's EB-2016-0152 Reply Argument, Section 10.2.3, OPG believes rate-setting through a price-cap index is intended to decouple payments and costs. Escalating the reference amount for this account (or other account for that matter), maintains the link between a utility's costs and revenues and is therefore fundamentally at odds with a core principle of IRM.[12]

As discussed in section 2.1, the new variance account applies on a go-forward basis from the date it is established. The new account will not[13] capture historical differences. For the majority of utilities, their rates currently reflect the recovery of pension and OPEB costs on an accrual basis. As a result the account will begin to track differences between cash and accrual costs and record carrying costs (as applicable) commencing June 1, 2017. The new tracking account will not record cash to accrual differences prior to June 1, 2017; therefore carrying costs will not apply to differences between cash and accrual amounts arising prior to June 1, 2017.

[10] EB-2016-0152 Reply Argument, Section 10.5
[11] Report, p. 19. Assumes capitalized amounts are not considered material.
[12] *Ibid*, p. 20
[13] *Ibid*, p. 19

For utilities with interim cash to accrual variance accounts, the account mechanics described in Appendix C appropriately recognize that, as the balances in these accounts are recovered, the underlying cash to accrual differences are realized by the utility and therefore are no different than ongoing cash to accrual differences.

OPG agrees with both the concept and the mechanics; however, OPG submits that cash to accrual differences arising prior to June 1, 2017 should not be recorded in the new variance account for any utility, irrespective of whether the utility it was an on an interim cash basis of cost recovery with a variance account or not.

If recoveries of cash to accrual variance account balances arising prior to June 1, 2017 are recorded in the new variance tracking account, utilities whose rates were set on an interim cash basis of recovery for pension and OPEB costs pending the outcome of this consultation would be treated differently than other utilities in the same circumstances (i.e., those who have continued to recover pension and OPEB costs on an accrual basis). OPG believes that the implementation of the new OEB policy should be applied consistently to all utilities. The fact that the cash to accrual difference arising prior to the issuance of the new policy is collected subsequent to the implementation of that policy should not change the prospective effective date of the policy. OPG submits that recovery of balances recorded in an existing cash to accrual variance account in respect of periods prior to June 1, 2017 should not be recorded in the new variance account. Recording these amounts in the new account would be counter to fairness, and consistent application of OEB policy, and result in a retroactive implementation of a policy initiative.

2.3. The manner in which carrying charges are applied to balances tracked in previously established variance accounts

The Report identifies two types of previously established pension & OPEB related variance accounts for specific utilities:

a) **Cash to Accrual[14]:** For certain utilities that historically used accrual accounting to recover pension & OPEB costs, the OEB has previously approved recovery of these costs on a cash basis "as an interim measure pending the outcome of this pension and OPEB consultation. Variance accounts were used to capture the difference between the cash and accrual methods in order to keep the period open for final adjustments once the outcome of the consultation was known." For OPG, the EB-2013-0321 Payment Amounts Order, Appendix G, Page 14 establishes that no interest will be recorded in this account. OPG has not identified anything in the Report that would warrant a review of this approach.

Cash to Cash: For OPG, in EB-2013-0321 the OEB also approved a related variance account to record the difference between the forecast cash amounts used to establish payment amounts and actual cash amounts. The OEB ordered that its prescribed deferral and variance account interest rate apply to this account.[15]

[14] Report, p. 11
[15] EB-2013-0321 Payment Amount Order, Appendix G, Page 15

This account has been approved to continue pursuant to the EB-2016-0152 approved Settlement Agreement, on the same terms as authorized in EB-2013-0321, which requires OPG to

"record interest on the balances in all deferral and variance accounts [not otherwise identified] using the interest rates set by the Board from time to time pursuant to the Board's interest rate policy. OPG shall apply simple interest to the opening monthly balance of the accounts until the balances are fully recovered or refunded."[16]

Entries into this account will continue until such time as the accrual basis of cost recovery is reflected in OPG's payment amounts in its next cost-based payment amounts for the post-2021 period. Given the EB-2016-0152 Settlement Agreement and the limited term expected for this account going forward, there is no compelling reason to revisit the OEB's previous decision and order.

b) **<u>Cumulative actuarial gains and losses[17]:</u>** Utilities recovering pension & OPEB costs on an accrual basis and using an IFRS accounting framework must permanently record certain actuarial gains and losses in Other Comprehensive Income, rather than ultimately amortizing them into net income. OEB has established accounts to record these actuarial gains and losses to enable a utility to recover these amounts in regulated rates. As noted by the OEB, this matter was not the focus of this consultation.[18] OPG is not sufficiently familiar with these accounts to take a specific position with respect to application of interest charges to it. However, it appears that, on the surface, the account is somewhat similar in nature to OPG's existing accrual to accrual variance account[19], on which the OEB ordered no interest charges in EB-2013-0321.

To the extent carrying charges are applied to account balances, OPG notes that the manner in which they are applied is consistent with OEB's Prescribed Interest Rate policy established in November, 2006 as summarized in the EB-2013-0321 Payment Amounts Order, Appendix G, Page 15 and cited in this section for the cash to cash variance account.

The approach discussed above is for carrying charges for previously established variance accounts. In the Report, The OEB specifically stated that "carrying charges on the new tracking account will be assessed on the monthly opening account balance at the OEB's prescribed Construction Work In Progress (CWIP) rate"[20] and those carrying charges would be "calculated using simple interest applied to the monthly opening balances in the primary sub-account."[21]

OPG supports this approach as it is consistent with the deferral and variance account policy noted above.

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[16] EB-2013-0321 Payment Amount Order, Appendix G, Page 15
[17] Report, p. 12, 13
[18] *Ibid*, p. 13
[19] No amounts are being added to the accrual to accrual account from since OPG became subject to cash basis of recovery on an interim basis.
[20] Report, p. 12
[21] *Ibid*, p. 20

2.4. The requirement to track only the gross accrual cost as opposed to identifying amounts expensed vs. capitalized

The Report states that the OEB is of the view that ideally the CWIP rate could apply to amounts expensed, while a utility's WACC could apply to amounts that a utility capitalizes. However, the OEB also recognized that "this approach may not provide sufficient incremental value to justify the added complexity of tracking amounts that are capitalized separately from those that are expensed".[22] The Report states that utilities "are instead expected to track the gross cost flowing from actuarial valuations".[23] The Report then indicates that a different approach may apply to utilities that do experience a material impact "due to the capitalization of a significant portion of pensions and OPEBs".[24]

OPG agrees that materiality is an important consideration in determining whether capitalized amounts should be treated separately from the expensed (OM&A) amounts. OPG believes that the percentage of pension & OPEB timing differences capitalized should be used as the basis for determining whether to provide a different treatment for capitalized pension & OPEB costs. The OEB's approach is consistent with OPG's September 22, 2016 submission in this consultation ("OPG's Submission") that "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".[25]

The added complexity of separating capitalized versus non-capitalized timing differences noted in the Report is significant. It requires:

<u>**Additional tracking**</u>: The Pension & OPEB Forecast Accrual versus Cash Payment Differential account and contra account that utilities are required to establish[26] would need to be divided into capitalized and non-capitalized accounts or subaccounts. As capitalized amounts are depreciated, the corresponding portion of the underlying historical timing differences would be transferred from the capitalized account to the non-capitalized account.

<u>**Additional determinations (realizing capitalized pension & OPEB costs):**</u> Capitalized costs are attributed to projects involving many asset classes which typically have different asset class lives. It is important to note that capitalized amounts are not collected from customers until these costs are reflected in the depreciation expense that is recovered in rates. Utility specific circumstances would need to be considered to determine the extent to which detailed tracking would be possible and/or warranted or whether a proxy should be used and, if so, how that proxy should be developed.

<u>**Additional determinations (allocation of cash payments):**</u> Cash payments are not capitalized and therefore, in any given year, would need to be attributed to the corresponding capitalized accrual amounts and notionally "depreciated" to match the capitalized accrual cost, in order to determine the cash to accrual difference. OPG expects that developing mechanisms for determining, tracking and "depreciating" the appropriate

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[22] Report, p. 12.
[23] *Ibid*.
[24] *Ibid*.
[25] EB-2015-0040, OPG Submission, 22 September 2016, [OPG Submission], p. 38.
[26] Report, p. 20

portion of cash payments could be a complex exercise involving judgment and would need to be considered in the context of the OEB's ratemaking principles.

OPG further notes that, for utilities whose rates are established on a US GAAP basis, the types of pension and OPEB costs that can be capitalized may be more restrictive going-forward under recently issued guidance. The new US GAAP guidance, issued in March 2017, may require that only current service cost component of pension and OPEB costs be eligible for capitalization.[27] As a result, the capitalization of costs may be a diminishing consideration going forward.

OPG's Submission stated that "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 pension & OPEB timing differences."[28] In light of the substantial complexity highlighted above, OPG submits that the materiality threshold for consideration of treating the capitalized portion of the pension & OPEB costs separately should be set at a relatively high level to justify such an approach.

2.5. The timing of the OEB's consideration of a transition to the accrual method for utilities currently on cash

The Report states that recovery of pension and OPEB costs on an accrual basis is the default method; however the OEB can use another method "if accrual accounting does not result in just and reasonable rates."[29]

OPG does not believe that acceptance of the principled approach to recovery of pension and OPEB costs for a particular utility needs to be deferred until the next cost-based rate setting process. In OPG's current payment amounts application (EB-2016-0152) OEB Staff acknowledge that utility circumstances may warrant such an approach, submitting that a decision on resuming accrual basis of recovery and disposition of the Pension & OPEB Cash to Accrual Differential Deferral Account may be considered as part of OPG's proposed mid-term review, given that it will be five years until OPG's next cost-based application.[30]

Pension and OPEB costs are one of many costs that the OEB considers in setting just and reasonable rates. The OEB does not set rates for pension and OPEB costs in isolation, rather it considers all costs in its rate setting process. OPG submits that the OEB should have principle-based cost information to set just and reasonable rates. The application of the accrual approach pursuant to the Report provides that context.

Many costs are included in revenue requirement and individual cost item increases may be offset by decreases in other areas. When all costs are aggregated into revenue requirement based on sound ratemaking principles, the OEB can consider broader ratemaking principles such as minimizing rate volatility and customer impact as part of its rate-setting considerations. In OPG's view, rate stability, predictability and other regulatory principles are best considered in

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[27] See Financial Accounting Standards Board Accounting Standards Update No. 2017-07. As disclosed in Note 2 of OPG's first quarter 2017 consolidated financial statements, OPG currently capitalizes the current service component only.
[28] OPG Submission, p. 39
[29] Report, p. 2, p. 8
[30] EB-2016-0152 OEB Staff Argument, p. 135

the context of overall rate setting, rather than the determination of a specific cost recovery methodology for a single aspect of revenue requirement.[31] As a result, OPG submits that the OEB need not defer a decision to approve a principled approach to recovery of pension and OPEB costs on an accrual basis. OPG submits that the OEB does not have to have available to it information on a utility's other costs in order to make this determination. Acceptance of the accrual basis for pension and OPEB cost recovery will not inhibit the OEB's ability to set just and reasonable rates at the time of the next cost-based rate application.

2.6. The timing of the disposition of both the new and previously established variance accounts

The previously established variance accounts were discussed in section 2.3.

a) **Cash to accrual and cash to cash accounts:** The Report affirms that establishing these accounts for some utilities was "an interim measure pending the outcome of this Pension and OPEB consultation" and that the purpose of the variance accounts is "to keep these prior periods open to further adjustments pending the outcome of this consultation".[32] This is true for OPG as stated in the EB-2013-0321 Decision With Reasons: "Until Board policy is established, the Board approves a new deferral account to record the differential between the accrual and cash valuations for pension and OPEB expenses".[33]

As discussed above, the OEB default policy is to use accrual basis of recovery for pension and OPEB. Once accrual accounting is accepted as the basis for setting rates for a specific utility, the timing of the disposition of the account should be based on regulatory principles and regulatory expediency.

The Report states that the regulatory treatment of pension and OPEB costs will be based on six regulatory principles. OPG has discussed the context within which the principle of minimizing rate volatility should be applied as discussed in section 2.5. The principles of providing value to customers and appropriate allocation of risk relate to the tracking account and carrying charges components of the pension and OPEB cost recovery policy. The remaining three principles are directly applicable to the recovery of variance account balances as discussed above. These principles support the disposition of the two accounts listed above in advance of the next cost-based rate application. In clearing the accounts, the OEB will establish the parameters of the rider in the context of the bill impacts and the customer focus objectives of the RRFE.

Minimizing intergenerational equity: As stated in OPG's Submission, the accrual basis of cost recovery recognizes that future benefits are earned as a result of the provision of current service, and recognize the cost in the period the service is provided. Cost recovery on an accrual basis matches the recovery of costs of to the period they are incurred, ensures that customers that receive the benefit of the services pay the cost of those services.[34] Balances in the cash to accrual account are effectively amounts incurred for providing past service that have not been charged to customers receiving that service. Once

[31] OPG Submission, p. 8
[32] Report, p. 2, p. 11
[33] EB-2013-0321, Decision with Reasons, p. 88
[34] OPG Submission, p. 4

the OEB has confirms that pension & OPEB costs are to be recovered on an accrual basis, minimizing intergenerational equity requires the balance to be recovered as expeditiously as possible.

Fairness: 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.[35] As with the principle of intergenerational equity, fairness would support recovery of the existing cash to accrual variance account balance as expeditiously as possible relative to the periods in which the underlying costs were incurred.

The OEB also should take into consideration the mandatory requirements of US GAAP for the recognition of regulatory assets for OPEB costs. The period of deferring these OPEB costs must not exceed 5 years; therefore for OPG, recovery of such costs must begin before November 1, 2019 as the deferral account was established effective November 1, 2014. The other US GAAP requirements are that the combined deferral-recovery period authorized by the regulator must not exceed approximately 20 years with no 'back-end loading' of the recovery of deferred costs (e.g. OEB's typical straight-line method would be acceptable).[36] If any of these criteria are not met, OPG would be required to write off, against net income, the OPEB portion of the variance account regulatory asset.

Transparency: The Report requires that "a separate rate rider"[37] be established for the purpose of tracking the recovery of balances from the existing cash to accrual variance account. Use of a separate rider provides transparency. It also means that, while the account balance could be disposed of in conjunction with a cost-based rate application and/or clearance of other deferral and variance accounts, it does not need to be. The Report makes it clear that the recovery of this variance account should be shown separately from either the cost-based rates or disposition of other deferral and variance accounts. As noted above, OEB Staff recognized that in OPG's circumstances, the OEB could consider OPG's transition back to accrual basis of cost recovery and the disposition of the existing cash to accrual variance account as part of OPG's mid-term review. OPG submits that, as transparency requires a separate rider, the consideration of recovery could occur in a separate process in advance of the mid-term review or cost-based rate application. (i.e., the application for 2018 hydroelectric payment amounts).

b) **Cumulative actuarial gains and losses accounts:** While there is insufficient information in this consultation process to enable OPG to make an informed submission, based on the description of these accounts in the Report and the policy decision to use accrual accounting as the default method of cost recovery, there does not appear to be any impediment to immediate cost recovery based on the same considerations discussed for the cash to accrual and cash to cash accounts.

c) **New variance account:** "The variance account will act as a tracking account and only carrying charges applied to the account will be subject to disposition.[38] Regulatory efficiency would suggest that, absent special circumstances, recovery of the carrying charges

[35] *Ibid*, p. 7
[36] KPMG's Introduction Presentation to the stakeholder meeting on July 19, 2016, page 19
[37] Report, p. 21.
[38] *Ibid*, p 11.

subaccount should be considered in conjunction with the disposition of other deferral and variance account balances.

3. Conclusion

OPG appreciates the opportunity to participate in this follow-up phase, and to provide comments on the implementation matters as requested by the OEB.