SOCIETY *of*
UNITED PROFESSIONALS
IFPTE 160

10th August, 2018

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VIA Canada Post, email and RSS Filing

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
P.O. Box 2319
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Toronto, ON
M4P 1E4

Re: EB-2017-0049 Hydro One Networks Inc. HONI)
Application for Approval of Distribution Rates 2018-2022
<u>Society of United Professionals' Final Submissions</u>

Dear Ms. Walli,

Please find attached the Society of United Professionals' (SUP) Final Submissions in the Hydro One Networks Inc. EB-2017-0049 Application for Approval of Distribution Rates 2018-2022.

Two (2) hard copies of this submission have been sent to your attention.

Sincerely,

[Original signed by]

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Copy by email: interested parties

Society of United Professionals'
FINAL SUBMISSIONS

EB-2017-0049 Hydro One Networks Inc.

Application for Approval of Distribution Rates 2018-2022

10th August, 2018

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EB-2017-0049: Society of United Professionals' Final Submissions

Introduction:

This is the Final Argument of the Society of United Professionals ("the Society") in the Hydro One Networks Inc. Application for Approval of Distribution Rates 2018-2022, EB-2017-0049. This Argument is organized in the same manner as the Ontario Energy Board Staff Submission in this proceeding, dated the 3rd of August, 2018 which is by issue number.

Rather than put forward positions on all issues, The Society has chosen to limit itself to those largely which it considers to be of primary concern to its interests and where it can provide a different perspective for the OEB's consideration in reaching its decision in this proceeding.

A. GENERAL

A.6 Does Hydro One's First Nations and Métis Strategy sufficiently address the unique rights and concerns of Indigenous customers with respect to Hydro One's distribution service?

A.6-1 Anwaatin and DER

On June 15, Hydro One filed in the EB-2017-0049 Distribution proceeding the settlement proposal reached between Anwaatin and Hydro One in the EB-2017-0335 Anwaatin Motion to Review the Decision in the HONI Transmission EB-2016-0160 proceeding. This was marked as Exhibit K4.4. The settlement proposal outlines a two phase DER [distributed energy resources] initiative by Hydro One:

> i) The first phase of the Project will complete the technical assessment of potential energy storage facilities/ solutions that may provide cost-appropriate ways to improve reliability in the communities served by HONI's F2 Feeder that serves the Nakina area. Energy storage facilities for Phase 1 are targeted to be in- service by March 31, 2019. This is capped at $5M of redirected HONI Dx capex . Additional government funding through subsidies or grants will also be sought to either supplement or offset this HONI funding. The Pilot Project is intended to provide HONI with an opportunity to assess whether similar and repeatable approaches may be used in other remote areas of its system that are experiencing poor reliability conditions.
>
> ii) the second phase of the Project will look at doing something similar at the locations served by HONI's F1 and F3 feeders. This will be based upon the results of Phase I.
>
> iii) The potential use of the Pilot Project, if successful, to facilitate reliability improvements in similarly situated communities and HONI/Indigenous community cooperation.

The Society supports the implementation of this settlement proposal. In particular, it is vital that the OEB in its Decision direct Hydro One to investigate the implementation of economically justified DER solutions not only in Anwaatin and other indigenous communities, but other northern communities facing similar reliability issues.

Further, in its Argument in Chief (AIC) filed on July 20, Hydro One outlines "that the reliability experienced by the Anwaatin communities is 15.3 hours of average SAIDI per year, including loss of supply and force majeure [as compared] to a Hydro One system average of 14.9, and a First Nations average of 14.0" [Ref. AIC p. 27 ln29-32]. These comparative SAIDI figures unintentionally seem to minimize the impact of poor system reliability on Anwaatin communities as well as other indigenous communities. In its submitted evidence, Anwaatin outlines the hardships endured by its communities due to poor distribution system reliability. This includes, amongst other things, the full loss of most refrigerated foods; loss of significant quantities of frozen traditional foods; the loss of significant amounts of time (to hunt and harvest) in order to obtain replacement traditional foods to the degree that it is possible; the financial losses to replace some traditional food sources with store-bought foods, and; the physical hardship on those who rely on electricity for home heating, in particular the elderly and very young [Ref. Evidence of Anwaatin dated April 13, 2018 pp 4-6]. Economically, the Anwaatin and other indigenous communities generally would be in the lower quartile, if not the lower decile, of those individuals served by the Hydro One Distribution. So the economic consequences and hardships suffered by Anwaatin and other indigenous communities through poor distribution system reliability would be disproportionally far more impactful on them than it would be on the vast majority of other Hydro One Distribution customers.

The Society submits that the OEB must direct Hydro One to factor in this disproportionally high economic impact of poor distribution system reliability on indigenous communities when preparing economic assessments of DER options as well as "traditional" wires solutions to improve distribution system reliability.

F. OPERATIONS MAINTENANCE & ADMINISTRATION COSTS

F.40 Are the proposed 2018 human resources related costs (wages, salaries, benefits, incentive payments, labour productivity and pension costs) including employee levels, appropriate (excluding executive compensation)?

F.40- 1 OEB staff proposed pension contribution holiday

Hydro One Networks' Distribution business still records its pension contributions as OM&A expense or capital, consistent with the cash basis of accounting, despite the OEB's decision in EB-2015-0040 that the accrual method should be used in the absence of a specific exception being granted. OEB staff have submitted that

Networks has met the threshold under the EB-2015-0040 report for an exception allowing it to continue use of the cash method of accounting.

"OEB staff notes that the evidence provided by Hydro One in support of its continued use of the cash method as the basis to recover its pension costs meets the requirements of the OEB's Report. OEB staff further notes that the OEB's Report clearly states that the intended practice of maintaining a consistent method used to determine recovery over time may be one reason for not adopting the accrual method for rate setting. Stability and predictability in regulation are desirable unless unintended and undesirable effects occur. Hydro One has historically recovered its pension costs on a cash basis and its ratepayers have historically been better-off under the cash method. Therefore, OEB staff submits that the continued use of the cash method by Hydro One to recover its pension costs is justified." (Ref. Staff Argument p. 123).

The Society supports this conclusion and agrees that an ongoing exception to the accrual method should be made for Networks' pension accounting for regulatory purposes,

OEB staff have also aggressively proposed a disallowance of 100% of Networks' forecast pension contributions for the test period.

"The proposed pension fund contributions should not be allowed in rates given that the actuarial valuation provided by Hydro One indicates that no employer contributions are presently required as the fund is in a significant surplus position. This results in an additional $17 million proposed reduction in OM&A and $20 million in capital." (Ref. Staff Argument p. 5).

Essentially, Staff argue that Networks should take a pension contribution holiday for the whole five-year test period based on the most recent actuarial report's pension surplus estimate as at December 31, 2016. This argument explicitly recognizes that Networks may be constrained by collective agreements in taking initiating this full pension holiday but does not mention Networks' evidence that recent changes in pension rules mean that a holiday might not be available for the 2018 and the applicable test years. In the hearing, there was some confusion surrounding the amount of any potential holiday that could or should be taken given these recent changes in pension rules, the impacts of applicable collective agreements that restrict the employer's contributions from falling below those of employees, and the potential for market volatility in short to mid-term economic factors that can lead to rapid changes in the size of Hydro One's consolidated pension surplus. (Ref. Oral Hearing tr.V4 p. 76).

Networks provided that the Hydro One pension plan had a $434M surplus as at the 2016 year-end. OEB staff proposes a full disallowance of Networks' pension contributions for the entire 2018-2022 test period, essentially forcing Hydro One to take a pension holiday and reduce its contributions. This position appears to be based on a view that customers have funded the existing surplus and that this is the appropriate time for it to be returned through a reduction in contributions over the test period. Staff assert that the 2016 surplus is large enough to offset all Hydro One employer contribution amounts in the rate forecast.

Specifically, staff said in its argument (pp. 124/125:

"The actuary had determined that employer contributions are not required in the test period because Hydro One's pension plan was in a surplus position of $434 million at the time the valuation was performed (on a total company basis). This means that the pension plan had more money than it needed, or more specifically, the assets of the pension plan exceeded the liabilities by $434 million. The $37 million in contributions that Hydro One has sought to recover for the test period (or $71 million for Hydro One as a whole) represents the contributions that Hydro One would have had to make to the pension plan had it not been in a surplus position. However given the surplus, the actuary has instead allocated these surplus funds in the pension plan to offset Hydro One's contribution requirement. Holding all else equal, there is enough surplus in the pension plan to offset the minimum employer contribution requirements for the entire five-year term of the application, with some buffer to spare."

The Society asserts that this is not a realistic proposition. On page 127 of the staff argument, an excerpt from Mr. Chhelavda's testimony notes that employer contributions cannot be less than those of the employees under the terms of collective agreements. Therefore, if Hydro One declares a contribution holiday it would be reasonable to conclude that employee contributions would also cease for the duration. The $434 million pension surplus that staff see as a funding source sufficient to accommodate five years' worth of employer contributions would have to accommodate both employer and employee notional contributions. It would not be sufficient to fund the combined pension contributions for the entire rate period. To provide an illustration, if one assumes employee contributions are in the range of $50 million per annum, total contributions would be in the range of $120 million. The reported surplus would only fund about three and a half years of combined employee and employer contributions. A five-year disallowance is not reasonable given this situation.

Staff also noted that Networks currently has an OEB-approved, symmetrical pension cost variance account that tracks the difference between the actual pension contributions expensed as OM&A and estimated pension costs approved in rates. (Ref. Oral Hearing tr.V3 pp. 39-40). This mechanism provides assurance that excessive or insufficient pension costs can be returned to or recovered from customers on a timely basis. Presumably disallowance of contributions from rates would disqualify Networks from recording any voluntary contributions in the deferral account, thus forcing Hydro One to trigger a contribution holiday. However, the Society argues that any mandatory contributions in excess of the zero assumed by Staff should still qualify for the deferral account. Currently, it is not known by any stakeholder whether the zero-contribution assumption made by Staff is realistic given several factors discussed in more detail below. Also, it should be noted that any pension holiday would not just affect Networks distribution but would also impact all regulated and unregulated subsidiaries in the Hydro One consolidated entity that have pension plan members.

Hydro One has indicated that it will consider taking such a holiday but that there is currently insufficient information to know if this can be done for 2018 and subsequent test years given recent changes in funding rules. Mr. Chhelavda noted (Ref. Oral Hearing tr.V4 pp. 83) that at this time the challenge with knowing if a pension holiday can be taken comes from new 2018 rules that change the funding ratio. The new rules mean the pension plan has to be in a stronger financial position to be able to take a contribution holiday. It appears to be unclear to Networks how much of a holiday is available for the full test period or whether one is even available in 2018. It should also be remembered that any reduction in, or suspension of contributions also reduces pension contributions that are treated as capital expenditures. The variance account only deals with the non-capital portion of the annual contribution amounts.

It should also be noted that the Board is setting rates for a five-year forecast period. Ceasing all pension contributions based on a pension valuation that is a year and a half old is risky. The next mandatory valuation is due December 31, 2019 and will govern contributions for the years 2020 to 2022. A subsequent valuation effective December 31, 2022 will govern 2023 contributions. If the next valuation(s) show significant contributions are required, a significant balance would be built up in the variance account. If pension contributions are ceased for the whole five year rate period, reintroducing them again in 2023 in parallel with beginning recovery of potentially significant contributions deferred in test years after 2019 could pose a risk of rate shock.

Staff argue that the most recent information should be used to set pension costs in rates and that this is the 2016 valuation. The Society argues that this approach is imprudent given the number of years that will fall under a future actuarial valuation, potential for significant assumption changes including those impacted by financial market volatility, uncertainty about the impact of 2018 pension funding changes, and questions about the scope of any availability of a holiday given collective agreements.

The Society supports the notion that any inclusion of pension costs in rates must be prudent. However, the Society's position is that it is premature for the OEB to reduce Networks' pension to $nil for a five-year period on the basis of an actuarial report that is almost two years old and on a presumption that a contribution holiday can/will be taken. Specifically:

- Pension assets values are high right now and they are supported by equity markets that appear to be at some risk of correction given international economic and political events and tensions;
- A new actuarial report is due at the end of 2019 and, assuming no earlier valuations are triggered, this report and its successor will govern contributions for four of the five test years.
- No precise estimate of the amounts available for a holiday under the existing valuation given new pension rules was provided by Networks so there is no way to know if a 100% disallowance can be implemented through a holiday;
- Pension funding is a Hydro One management stewardship decision and should be based on many considerations, only one of which is customer rate impact;
- Finally, assuming the OEB continues Networks' pension cost variance account, this account will ensure that, if Networks judges it appropriate to trigger a holiday and such a holiday has not been reflected in rates, its bottom line will not benefit and the excess funds recovered in the test years will have to be refunded to customers on a short-term basis.

F.40- 2 The Mercer Study

The following sections address the two Compensation Cost Benchmarking Studies prepared by Mercer ["Mercer studies"]. They were submitted as Exhibit C1-2-1 Attachment 5 (this is the report dated 13 December 2016) and the "Updated Compensation Study" (this is the report dated 04 April 2018) filed on 2018-04-20. The Society submits that revisions must be made to the Mercer 2018 market median impact adjustment to take into account several relevant factors which were not factored in to the Mercer studies.

F.40- 2 A) 5% Deadband

As per the testimony of Mercer expert Mr. Iain Morris, they instruct their clients, who have had a compensation benchmarking study prepared for them, that in application of study results that an organization consider plus and minus five percent around market median to "take into account the fact that it [the benchmarking] is not an absolutely perfect process". This is described by Mr. Morris as "a Mercer industry standard approach". [Oral Hearing tr.V3 pp59 ln3-10].

Based upon this expert testimony, the Society submits that the OEB in its application of the Mercer calculated market median compensation is obliged to take into account the "Mercer industry standard approach" and consider plus and minus five percent around market median to take into account the fact that the benchmarking is not an absolutely perfect process. Hence, the Society submits that a +-5% deadband be applied to the OEB's application of the Mercer calculated market median.

For example, a 5% deadband should be applied to Mercer's estimation that Hydro One compensation is 12% above market median; so the OEB's Distribution OM&A

reduction should be based on 12%-5% = 7% delta from market median ie a $10.77M reduction rather than about $18.46M (Ref. Exhibit I-40-SEC-83 updated 2018-06-07 and confirmed in Undertaking J 3.11 pp1 ln11-13).

F.40- 2 B) **Adjustment for increased employee pension contributions**

Neither the Mercer methodology nor the Hydro One utilization of the 2018 market median impact take into account that Society, PWU and MCP employee pension contributions increase in 2017 and 2018 thus lowering the benchmarked compensation cost of the pension benefit (Ref. Technical Conference tr.V1 pp89 ln5-19 and Exhibit I-40-SEC-83 respectively). The Society submits that Hydro One must make a manual adjustment to the 2018 market median impact to take into account the lower cost of the pension benefit due to increased employee pension contributions.

For example, Society pension plan members have increased their pension contributions for both Tier 1 & Tier 2 Society employees (Ref. C1-02-02 Attachment 1, pp46-47) as follows:

In 2017: An increase in contribution of 0.75 % (below and above YMPE)

In 2018: 0.5 % (below YMPE) and 1.0% (above YMPE)
The Total increase in Society employee pension contributions over the 2 year period is 1.25% (below YMPE) and 1.75% above YMPE.

As per Exhibit C1-2-1 Table 13, annual savings to the **Distribution** business as a result of the increased employee contributions are $10.9M in 2018. This $10.9M figure should be the basis of the manual adjustment to the 2018 market median impact to take into account the lower cost of the pension benefit due to increased employee pension contributions.

F.40- 2 C) **Reduced Net Present Value of Pension Benefit**

As confirmed by Mr. Iain Morris of Mercer in cross examination [Oral Hearing tr.V3 pp61-62] and in submitted evidence (Ref. Exhibit C1-2-1 pp39 ln3-5), the Mercer study does not take into account that beginning in March 2025, the value of the pension benefit changes materially as per labour contract agreements reached by both the Society and the PWU with Hydro One in 2015 (Ref. Exhibit C1-2-1 pp42 ln19-23). However, the Mercer studies do take into account the cost of lump sum payments and employee share grants which Hydro One agreed to in contract negotiations with both the Society and the PWU, which were the trade off the two unions agreed to for the lower pension benefit as of March 2025 (Ref. Exhibit C1-2-1 pp28-30 ln6-21).

Specifically, the Mercer study does not take into account that beginning March 31 2025, for the PWU, a retirement rule of 85 (rather than 82) will apply along with a high five years income average rather than high three years average. For the Society Tier 1 plan members, beginning March 31 2025, a rule of the high five years for final average earnings applies going forward (from the current 3 years average earnings). This lowers the future value as well as the net present value of the pension benefit.

The Society submits that in future compensation benchmarking studies Mercer must revise their pension benefit pricing methodology to reflect the lower net present value of the pension benefit due to the agreed upon labour contract changes.

The Society submits that in the meantime Hydro One should be directed to take the impact of the lower NPV cost of the pension benefit into account in its methodology to adjust proposed 2018 Distribution OM&A to reflect the impact of market median compensation (as outlined in reference Exhibit I-40-SEC-83 updated 2018-06-07 and confirmed in Undertaking J 3.11 pp1 ln11-13).

***F.40- 2 D)* Adjust Market Median Results to take into account EPSCA & CUSW Casual Construction Trades are at market median or lower compensation**

As outlined by the PWU in cross examination of Panel 2 [Ref. Oral Hearing tr.V3 pp26-28], the Casual Construction trades fte's (i.e. EPSCA and CUSW trades) should be included in future compensation benchmarking studies. Specifically, the total Hydro One (ie Distribution and Transmission) Casual Construction numbers are roughly 1400 FTE's, which is about double the regular unrepresented staff fte's (Ref. Exhibit C1-2-1 pp9 Table 1) and the total compensation costs for both is roughly the same $90M level (Ref. Exhibit C1-2-1 Appendix B pp48).

Hydro One refers to Casual Construction as being at market median compensation as they are paid industry standard wages or wages that are either competitive and in some cases less than other rates in the industry (Ref. Exhibit C1-2-1 pp30 ln17-18). In the case of CUSW the wages are generally lower than those paid to similar classifications represented by the International Brotherhood of Electrical Workers (IBEW) (Ref. Exhibit C1-2-1 pp31 ln5-7).

To take into account that Hydro One employs roughly 1400 Casual Construction fte's annually who are paid market median compensation or lower, the Society submits that in the meantime Hydro One should be directed to take this impact into account in its methodology to adjust proposed 2018 Distribution OM&A to reflect the impact of market median compensation (as outlined in reference Exhibit I-40-SEC-83 updated 2018-06-07 and confirmed in Undertaking J 3.11 pp1 ln11-13).

***F.40- 3* Diversity**

Over the past several decades, assorted studies have been prepared by universities and consultancies which have found that increased diversity results in better results whether financially or decision making or overall performance[1]. As summarized by McKinsey & Company in their report issued earlier this year:

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[1] For example: Tufts University "Racial Diversity Improves Group Decision Making In Unexpected Ways, According To Tufts University Research." ScienceDaily, 10 April 2006; Northwestern, Stanford & Brigham Young Universities "Is the Pain Worth the Gain? The Advantages and Liabilities of

Companies in the top-quartile for gender diversity on their executive teams were 21% more likely to have above-average profitability than companies in the fourth quartile. For ethnic/cultural diversity, top-quartile companies were 33% more likely to outperform on profitability. [2]

Hydro One witness Mr. Keith McDonell stated that his company is in agreement that strong diversity and inclusion will improve business results: "And, I mean, diversity and inclusion is just not a nice thing. I do actually believe -- or I would agree with part of your comment that having a strong diversity and inclusion environment can improve the business results. It is not just a "nice to have". We are doing it because there is some positive business outcomes as a result of it." [Ref. Oral Hearing tr.V3 pp68-9]

Based on the above, the Society submits that, based upon the McKinsey & Company study results, Hydro One's profitability is likely to improve materially if its staff diversity increased substantially from 2017 year end levels over the 2018-2022 test period. This would be to the advantage of ratepayers as Hydro One proposes to establish an Earnings Sharing Mechanism ("ESM") providing 50% sharing of revenues in excess of 100 basis points over approved Return on Equity ("ROE") with ratepayers (Ref. AIC pp10 ln8-22).

As noted by McKinsey & Company in their report on gender diversity issued last year[3]:

Corporations need to embrace a holistic set of initiatives while focusing on implementing them well and sustaining the efforts over time. In Canada, best-in-class companies use five initiatives to drive progress:

> *1) Go beyond a vocal commitment to diversity by cascading a clear business case for change. More than half of companies consider gender diversity a top ten strategic priority, but only 14 percent have clearly articulated a business case for change.*
>
> *2) Set targets, track performance, share results, and hold leaders accountable. Fifty- five percent of companies lack targets for female representation, and 75 percent do not track female recruitment nor reward leaders for fostering gender diversity.*

Agreeing With Socially Distinct Newcomers" December 29, 2008; Credit Suisse Research Institute "Gender diversity and corporate performance" July 2012; McKinsey&Company "Delivering through Diversity" 2016; Harvard School of Public Health "Why Diversity Matters" April 24, 2018.

[2] McKinsey&Company "Delivering through Diversity" January 2018, p8 as provided in EXHIBIT NO. K3.2: SUP CROSS-EXAMINATION COMPENDIUM FOR HONI PANEL 2 pp15.

[3] McKinsey & Company Canada, "The Power of Parity: Advancing Women's Equality in Canada", June 2017 p8 and provided in Exhibit K3.2 pp16**.**

3) Create formal sponsorship programs to help promote women. Men are 50 percent more likely to attribute their advancement to a senior leader than women are, yet 80 percent of companies lack a formal sponsorship program.

4) Make flexibility compatible with promotion. Most companies offer long-term leave or part-time programs, but 58 percent of employees believe that taking advantage of them hurts their career progression.

5) Raise awareness of, and combat, unconscious bias to create a truly inclusive environment. Women comprise only one-quarter of senior leaders, but 80 percent of employees think their company is inclusive.

As outlined by Hydro One witness Mr. Keith McDonnell, Hydro One does not have 2018 diversity targets nor does Hydro One hold its managers or executives accountable for increasing the diversity of the company's employees [Ref. Oral Hearing tr.V3 pp63 and pp71 ln6-8]. However, as outlined by Mr. McDonnell, Hydro One is touching upon elements of the five initiatives identified by McKinsey & Company to drive progress in diversity [Ref. Oral Hearing tr.V3 pp70 ln16- pp 72 ln1].

In Exhibit I-40 SEP-16, Hydro One provided its diversity profile between 2010 and 2017 for Women, Indigenous, Visible Minorities and workers with Disability and the Hydro One total of these as well as by employee group (ie MCP, Society and PWU). Over the seven year period the proportion of Hydro One Women increased by 7%; Indigenous employees increased by 4%; Visible Minorities increased by 12%; but workers with Disability decreased by 44%. Of note is that the proportion of MCP Women and Visible Minorities increased by more than 10%, as did the proportion of Society represented Women and Indigenous employees.

The Society submits that in order for ratepayers to gain the advantage of improved Hydro One financial results through improved workforce diversity via the ESM noted above, the OEB should assign improved diversity targets to Hydro One and put at risk a portion of ROE if the diversity targets are not met. With a financial incentive to drive improved diversity, an improvement of 10 to 15% in Hydro One's 2017 year end diversity profile should be achievable by 2022 year end (this is for each of the four diversity categories monitored by Hydro One - Women, Indigenous, Visible Minorities and workers with Disability - as well as the total of these).

The Society submits that it would be reasonable to put something in the range of 25 to 100 basis points of ROE at risk to incent the company to improve its diversity. The Society proposes that this would be 25 to 100 basis points of ROE AFTER the ESM calculations for the year(s) being considered so that ratepayers do not inadvertently subsidize the penalty to Hydro One of not meeting its diversity targets. In this context, in order to drive improved diversity at Hydro One, the OEB may wish to consider setting a diversity improvement target of 5 to 7.5% for year end 2020 with the same range of 25 to 100 basis points of ROE at risk. The Society assumes that Hydro One would incent their management staff and executive to achieve the improved diversity targets by tying an appropriate portion of their at risk pay (ie performance bonuses) in their performance contracts to achieving improved diversity targets.

To summarize, this proposal ties into the 2nd of the five initiatives put forward by McKinsey and company summarized several paragraphs earlier. That is, unless companies are required to establish improving diversity targets and then incented financially to improve, nothing will materially change. And this will afford the opportunity for ratepayers to gain the advantage of improved Hydro One financial results through improved workforce diversity via the ESM.

F.43 Are the methodologies used to allocate Common Corporate Costs and Other OM&A costs to the distribution business for 2018 and further years appropriate?

F.43-1 **Capitalization of overhead costs**

In their submission, OEB staff repeated their prior criticism put forward in the last Transmission case that Hydro One regulated businesses should be required to align their overhead capitalization policy with that of most other Ontario regulated entities, essentially conforming to the requirements of Modified International Financial Reporting Standards (MIFRS). Staff have not suggested an immediate change in policy given the adverse impact on revenue requirement.

In OEB staff's view, alignment between regulated entities in terms of the expectation to a consistent and more conservative capitalization practice seems to be a key underpinning to establishing an equitable foundation for ratemaking and enabling relevant total cost benchmarking across the sector. Ratepayers would benefit from not having to pay weighted average cost of capital (WACC) on what some consider to be liberally capitalized overhead costs.

In EB-2011-0399, the OEB approved Networks request to use US GAAP rather than MIFRS as the financial accounting basis for distribution rate regulation in full knowledge that this would represent an exception that would create comparison issues with other Ontario regulated entities. Similar decisions were made separately for Hydro One's Transmission and Remote Communities regulated businesses in EB-2011-0268 and EB-2011-0427 respectively. The decision was heavily influenced by a desire on the part of the company, intervenors and the OEB to minimize adverse rate impacts on customers. Unlike most Ontario local distributors, Networks had an existing depreciation policy that was consistent with the requirements of IFRS. As a result, it did not have a waiting revenue requirement offset or "natural hedge against IFRS" available that would reduce the net impact of changing its capitalization policy to one acceptable under MIFRS. The Hydro One request to adopt US GAAP in place of MIFRS and to leave in place its historical policy for the capitalization of overheads and indirect costs was approved, in large part to avoid a massive adverse rate impact.

In its EB-2011-0399 decision, the OEB noted: "In the application, Hydro One estimated that the 2012 notional Hydro One Distribution revenue requirement would be $166 million higher if Modified International Financial Reporting Standards ("MIFRS") were utilized rather than USGAAP. This would result in an approximate rate increase of 14% in 2012 if MIFRS were used for rate making instead of USGAAP." In response to an OEB order, Networks also prepared and filed a detailed study entitled "Distribution Business – Review of Overhead Capitalization Policy" in EB-2013-0416 as Exhibit C1-5-2 Attachment 2. This study provided additional rationale and benchmarking supporting the retention of the existing accounting policy. It was not challenged in the 2013 hearing.

In its response to a Society IR (Ref. Exhibit I, Tab 43, Schedule SEP-19), Networks confirmed that it has not updated the old cost or rate impact estimates of changing its Distribution overhead policy to conform to MIFRS. Networks also confirmed that it had not updated the EB-2013-0416 study, that the impact of a mid-term change in capitalization policy would be significant enough to qualify as a "z factor" event, and that significant effort would be required to derive new high-quality estimates of impacts.

In the last Transmission proceeding EB-2016-0160, Networks estimated the total combined impact of moving to a MIFRS capitalization policy as approximately $310 million reduction in capex and increase in OM&A per annum for both its Transmission and Distribution businesses[4]. Given that this is a recurring annual impact, there is very little opportunity for meaningful phase-in or mitigation.
The Society's position is that nothing material has changed since this issue was reviewed in detail in 2011 in the IFRS proceedings referenced above. All of the negative aspects on ratepayers that would result from forcing a MIFRS capitalization policy remain. The only benefit would seem to be that it satisfies Staff's desire for regulatory consistency. Admittedly ratepayers would pay less WACC with a MIFRS-based capitalization policy but this would come at the cost of an onerous recurring bill impact.

A major concern about entities like Networks remaining on US GAAP was that it could impinge on benchmarking. However, one can see from the discussion between Mr. Fenrick and Mr. Shepherd (Ref. Oral Hearing tr.V 2 pp. 139 – 143) that high level adjustments to normalize between US GAAP and IFRS are possible to allow for comparisons on a macro basis. The Society would be very surprised if a high-level adjustment to build in the effects of a US GAAP capitalization policy is not achievable on a top-down analytical basis, accepting some imprecision.

[4] Proceeding EB-2016-0160 Exhibit I-1-75

The Society position is that the OEB should not initiate a generic process for all Ontario utilities that are regulated on a US GAAP. This would appear to be a Hydro One issue rather than a generic issue and a generic process would likely be a waste of other utilities' time. The Society would also caution the OEB not to presume that Hydro One is doing something wrong or aggressive because it capitalizes more overhead than most other utilities. As can be seen from the Black and Veatch study (Ref. Exhibit D1, Tab 3, Schedule 1, Attachment 1), the capitalization of overheads is based on sound regulatory principles of causality and benefit, with the intent that appropriate customer generations pay for costs. Company-specific reasons for the higher than expected overhead capitalization percentage are addressed in the previously filed study.

In the EB-2016-0160 Transmission Decision, the OEB indicated that it will consider whether it should initiate a policy review regarding USGAAP and capitalization of overhead amounts. Presumably the OEB will reconsider this issue when arriving at the decision in this Distribution proceeding. OEB staff has argued that the issue should be studied in the next Distribution case for 2023 rates (ref. Staff argument p. 167). The Society would encourage the OEB to either drop this issue or if it feels the need to revisit it, to include it in the scope of the next Transmission proceeding rather than addressing it on a generic basis. It may be appropriate to consider it in tandem with the OPEB US GAAP issue that the OEB has also determined will be deferred until the next Transmission hearing (please refer to the Society submission on issue J.57-1 starting on page 13).

G. REVENUE REQUIREMENT

G.44 Is Hydro One's proposed depreciation expense for 2018 and further years appropriate?

G.44-1 Fosters Depreciation Study

Hydro One has determined that the depreciation rates of its Distribution Business should not be revised despite being in receipt of the findings of its independent external expert who recommended specific changes. Networks provided a written opinion from its external depreciation consultant agreeing that leaving depreciation rates unchanged from those recommended in his previous review would be allowable and defensible within general depreciation theory (Ref. Oral Hearing tr. V3 p. 133). Networks argued in favour of its position by asserting that its approach avoids fluctuation in rates and that the submitted depreciation study is backward looking and ignores the impact on asset service life from future capital investments. The impact of implementing the recommended new rates was calculated as $21.9 million per annum in increased depreciation, or a rate impact of about plus 2%.

While the Society has no wish to see an increase in rates due to the allocation of historical sunk cost to future periods where it can be avoided, it is concerned that Networks' argument is technically flawed and that acceptance of it without comment may create an unwelcome industry precedent. Periodic review and adjustment of asset service lives will always produce some degree of cost and rate fluctuation. Depreciation studies always rely on a review of historical data (i.e. they are always to an extent backward looking) and they should take into account the probability of material future events like public policy decisions, investment decisions, obsolescence drivers etc.

It should also be remembered that depreciation is a financial accounting as well as regulatory consideration and Hydro One is a public securities filer. The depreciation rates approved by the OEB should be seen to be based on existing asset service lives or on regulatory considerations. Where these diverge, it should be clear to stakeholders which view has taken precedence and why.

The Society is unconvinced by Networks' arguments that to some degree could be taken to threaten the legitimacy of the specific findings found in the depreciation consultant's report. However, the Society believes that the depreciation rate proposal made by Networks is justifiable and that it should be approved for practical rather than theoretical reasons. As Networks' proposal is acceptable within established depreciation theory and results in significant rate mitigation, it should be accepted. OEB staff has recommended acceptance of Networks' proposal based on the fact that the external consultant was in support and on the mitigating effect on rates. (ref. OEB staff argument p. 137).

J. DEFERRAL/VARIANCE ACCOUNTS

J.57 Are the proposed new deferral and variance accounts appropriate?

J.57-1 OPEB accounting

Recent changes in US GAAP have resulted in Networks having an inability to continue to capitalize many employee benefits costs that are not related to employees' current service. For Networks, the impact is limited to OPEBs as the company's pension costs are currently recovered on a cash basis. In the recent Hydro One Transmission EB-2016-0160 proceeding, Networks requested either a regulatory accounting policy decision allowing continued capitalization of past service costs or approval of a deferral account pending a future policy decision. The regulatory policy decision request was based on seeking to retain sound matching of costs with appropriate customers generations and on a strong US regulatory precedent. Specifically, the Federal Energy Regulatory Commission (FERC) has approved continued capitalization of these disallowed costs for the utilities it regulates (Ref. Oral Hearing tr. V4 p. 59). In the previous Hydro One Transmission OEB proceeding, the OEB determined that a deferral account would be granted pending a full review of the accounting policy issue in the next Transmission proceeding, which may be initiated later this year or next.

In the current Distribution proceeding, Hydro One repeated its request for a regulatory policy decision allowing continued capitalization. Failing that, a deferral account treatment paralleling the one approved in the EB-2016-0160 Transmission proceeding was requested. OEB staff asked Networks if they were agreeable to waiting for the Decision in the next Transmission proceeding for the Distribution issue to be resolved. By way of undertaking response (Ref. J.4.2) Hydro One reiterated their request for a firm decision on capitalization policy in this Distribution proceeding. In the absence of such a decision, Networks continues to support the approval of a Distribution deferral account paralleling that approved in Transmission.

In its argument, OEB staff did not support the use of a deferral account or of capitalization exemption. This despite the fact that the OEB approved a directly analogous deferral account in Networks' most recent Transmission decision. Staff's rationale seems to be limited to a position that capitalization is essentially bad for customers and Networks capitalizes too much given it capitalizes more than other entities in Ontario. The Society asserts that regulatory decisions on capitalization are essentially intergenerational equity issues that must be made on the basis of sound regulatory analysis rather than on simplistic considerations that too much deferral is bad. Appropriate classification of expenditures policy should not be developed as a global top-down philosophy as staff seems to be asserting. Rather, the appropriateness of capitalization of certain costs should be determined on a detailed bottom-up basis taking into account which customers cause or benefit from the costs. The capitalization of OPEB costs should be assessed in concert with Networks' overall accounting policy for cost capitalization.

The Society agrees with FERC in supporting continued capitalization of OPEB costs as it believes appropriate regulatory principles are met by this policy. In addition, the Society is concerned that arbitrary financial accounting standards changes initiated by standard setters in other jurisdictions (whether Washington for US GAAP or London for IFRS) should not impact Ontario ratemaking without appropriate due regulatory process and review. Given this, the Society supports the establishment of the deferral account to accommodate the OPEB costs ineligible for capitalization due to the recent US GAAP change. The Society also agrees that this matter be reviewed in detail at the time of Networks' next Transmission proceeding.

ALL OF WHICH IS RESPECTFULLY SUBMITTED ON THIS
10th DAY OF AUGUST, 2018