

## **UNDERTAKING J14.4**

### **Undertaking**

To elaborate on the operation of the proposed pension/OPEB deferral account, specifically whether the amounts needed in the account would be restricted solely to the impact of a change in discount rates on pension/OPEB expense in the test period, or whether any offsetting changes in other elements of pension/OPEB expense would be included.

### **Response**

As stated in Ex. F3-T4-S1, section 7.3, OPG is seeking recovery of pension and OPEB costs determined in accordance with GAAP that are included in OPG's business plan for the test period. Historically, OPG has experienced material variances between the amounts projected for pension and OPEB costs in the business plan (and used to set payment amounts) and its actual pension and OPEB costs. These variances have largely been due to the fact that OPG is required to forecast, at the time of business planning, a discount rate that will be in effect on December 31 of the year preceding the plan year. This is consistent with GAAP requirements, which are the basis on which the external consulting actuaries determine OPG's pension/OPEB obligations and costs. For example, during the business planning process in the fall of 2007 for 2008 and 2009 plan years, OPG projected discount rates that would be in effect on December 31, 2007 and December 31, 2008. Actual costs for 2008 and 2009 that will be recorded by OPG in accordance with GAAP will be based on the actual discount rates in effect on the above dates, respectively. The actual discount rates are largely a factor of the state of bond markets and, as such, are beyond the control of OPG's management.

The proposed Pension/OPEB Cost Variance Account is intended to record the portion of the variance between pension and OPEB costs included in the revenue requirement and the actual pension and OPEB costs for the test period that relates solely to the difference in the discount rate. The impact of both increases and decreases in the discount rate would be recorded in the proposed Pension/OPEB Cost Variance Account. The clearing of the account would be subject to the \$75M threshold, as discussed in Ex. J1-T3-S1, page 12, lines 12-16 and Ex. L-14-4, page 1, lines 27-28.

The remainder of the variance, if any, between pension and OPEB costs included in the revenue requirement and actual pension and OPEB costs for the test period would not be recorded in the proposed variance account. Thus, it is possible that an amount (positive or negative) could be recorded to the proposed variance account in respect of a period even though there may be little or no variance between the total pension and OPEB costs included in the revenue requirement and the actual pension and OPEB costs for that period. However, it is also possible that no amount could be recorded in the proposed variance account in respect of the test period even though there was a significant variance between the total pension and OPEB cost included in the revenue requirement and the actual pension and OPEB cost for that period, if none of that variance was due to a change in the discount rate. This is an appropriate outcome, as

the intention of the variance account is to address a risk that is beyond management's control (i.e., the discount rate). The risk is material due to the size of OPG's pension and OPEB obligations.

The need for a variance account stems from the fact that the effect of a change in the discount rate will never be "trued up" through the determination of actual pension/OPEB obligations, costs or funding requirements in subsequent periods. The determination of pension/OPEB obligations and costs for subsequent periods would be based on actual pension/OPEB obligations established for prior periods based on the actual discount rates applicable to those periods.

OPG's audited financial statements for 2007 (Ex. A2-T1-S1, Appendix A, Note 12 on page 39, Table "Components of Costs Recognized") set out five components of pension and OPEB costs. OPG's proposed Pension/OPEB Cost Variance Account would capture the impact of the difference between the discount rate used for revenue requirement purposes and the actual discount rate to the extent that it impacts all of these components, as these components form part of the planned costs that are included in the revenue requirement.

The following summarizes how the five components of pension/OPEB costs are affected by a change in the discount rate:

- **Current service costs** – varies inversely with a change in the discount rate, as the current service costs are determined on a present value basis.
- **Interest on projected benefit obligation** – is affected by a change in the discount rate but the direction of the relationship depends on particular circumstances. An increase in the discount rate decreases the benefit obligation because it is determined on a present value basis; however, the higher discount rate is then applied to the lower benefit obligation to determine the interest cost component. The net impact of the offsetting effects of a higher rate being applied to a lower obligation may lead to a higher or lower interest cost.
- **Expected return on plan assets net of expenses** – is not affected by a change in the discount rate.
- **Amortization of past service costs** – is not affected by a change in the discount rate. The impact of any changes on the present value of the past service costs (arising from a pension or benefit plan amendment) is embedded in the amortization of net actuarial loss (or gain) discussed below.
- **Amortization of net actuarial loss (or gain)** – is affected by a change in the discount rate unless the net cumulative unamortized actuarial loss (or gain) remains no greater than 10 percent of the greater of the projected benefit obligation and the market-related value of the pension plan assets. The use of the 10 percent threshold is in accordance with GAAP and is referred to as the "corridor approach", as described in Ex. F3-T4-S1, section 7.3.1. If the unamortized actuarial loss (or gain) is outside of the "corridor", the amount in

1 excess of the “corridor” is amortized over a future period. OPG’s net unamortized  
2 actuarial loss for the pension and OPEB plans has been in excess of the 10  
3 percent “corridor” in 2006 and 2007 and is expected to be in excess of the  
4 “corridor” in 2008 and 2009.<sup>1</sup> As such, a change in the discount rate would affect  
5 this cost component by increasing or decreasing the amount of actuarial loss (or  
6 gain) that is being amortized. By virtue of changing the projected benefit  
7 obligation and the amount of the net unamortized actuarial loss or gain, a change  
8 in the discount rate may also affect whether the net cumulative unamortized  
9 actuarial loss or gain remains in excess of the “corridor” and thus continues to be  
10 amortized altogether.

11  
12 The quantitative sensitivity of pension and OPEB costs to a change in the discount rate  
13 is discussed in the response to undertaking J15.3.

---

<sup>1</sup> With the exception of the long-term disability benefit plan in 2009