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Our File: 20150040

Ontario Energy Board
2300 Yonge Street
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Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2015-0040 – Pensions/OPEBs – SEC Submissions

We are counsel for the School Energy Coalition. Pursuant to the Board's letter of May 18, 2017, these are SEC's submissions with respect to the implementation matters on which the Board has requested input.

Background

The Board has determined that, as a default, pension and OPEB costs will for now be included in rates on the basis of accrual accounting, unless a Board panel otherwise determines in a particular case. Where the accrual amount is different from the cash amount, the Board will require utilities to establish a variance account to track the difference, and where the difference is a cumulative excess of accrual over cash, to accrue and pay interest to ratepayers on the excess money collected.

However, the Board also notes that it is moving in the direction of benchmarking these costs, likely on an overall compensation basis rather than on a "post-employment obligations" basis alone. It will be the benchmarking results that will drive ratemaking, in that longer term scenario. This is a direction SEC supports, and in fact the Board's comments suggest that it is moving more strongly in that direction than even SEC has proposed. Despite the complexities that will inevitably arise in compensation benchmarking, SEC supports and encourages the Board's chosen direction on this.

SEC's comments on the near-term policy determination (accrual plus a variance account) are made within the context of a longer term shift to compensation benchmarking.

The Board has asked for input on six questions. We have organized these submissions on that basis.

Effective Date of Variance Account

The Board has proposed that, for utilities currently recovering these costs in rates on an accrual basis, the new accrual/cash variance account will start on June 1, 2017, the month following the report. For those recovering costs on a cash basis currently, the account would be started at the same time that the Board orders a change to accrual basis, likely the date of the rate order in their next cost of service proceeding.

SEC has one major concern on effective date. The intention of the new account is to track cumulative amounts effectively "lent" by customers to regulated entities through over-collection of pension and OPEB amounts, so that interest can be paid on the accumulated amount.

This has in fact being going on for decades, and the affected utilities are currently in possession of tens or hundreds of millions of dollars of ratepayer funds already over-collected in this category. Although the Board has indicated (Appendix C, at p. 19 of the Report) that past differences will not be captured, this issue is inherent in the effective date discussion. An earlier effective date captures more of these differences, and a later effective date captures less.

In our submission, if a utility has in hand cumulative amounts they have collected at any time from ratepayers for pensions and OPEBs, but have not yet been spent on those purposes (or set aside in a segregated pension or other fund), the cumulative amount should be tracked, and the ratepayers should be compensated for the use of their money.

Therefore, while the set-up date for the new variance account may be later, in our submission the "effective date" for the account should be the earliest date for which accrual/cash differentials started to accumulate.

We note in this regard that this is not just a matter of fairness, but also practicality. If a full cumulative calculation is not done, the new variance account will not true up over time. Conceptually, accrual and cash basis amounts will be the same in the long run. Thus, the "final" balance in this variance account, ultimately, should be zero. That is not the case if it starts today.

Mechanics of the New Account

SEC has identified the following issues of mechanics that, in our view, may need to be addressed by the Board:

Forecast/Actual vs. Accrual/Cash. The new account is intended to capture the difference between rate recovery on an accrual basis vs. on a cash basis. However, as proposed it actually would do two things. First, it would capture the difference between including accrual or cash in rates. Second, it would true-up actual spending to rate recovery over time. The former was the purpose of the consultation. The latter opens up larger issues, particularly where a utility's cash payments are growing rapidly due to labour force growth, customer growth, or other factors.

In the current formulation, the amount that is considered "forecast accrual" included in rates is unchanged until the next COS proceeding. A utility that has increases in gross revenues due to annual IRM adjustments or growth or for any other reason is expected to treat those increases in gross revenues as if they apply to all other costs except pension and OPEBs. On the other hand, the cash amounts they pay – being actuals – will increase as their labour costs increase, all other things being equal. In fact, in recent years pension and OPEBs have actually been a greater than average contributor to overall cost increases.

One solution to this would be to calculate the forecast difference between accrual and cash at the time of rebasing, and simply record that each year during IRM. This would make the comparison apples to apples (both accrual and cash would be fixed at the original forecast amounts), but would not reflect the inherent volatility of cash payments resulting from actuarial valuations, inflation, and labour cost growth.

In our view, the better and simpler solution is for the utility to record, each month, a credit to the account for the amount it actually accrues in that month for pension and OPEBs (i.e. for accounting purposes), and a debit to the account for the amount of funding/payments actually made for those costs in that same month. The practical effect is that this assumes growth and IRM adjustment are allocated to pension and OPEBs costs either more or less in any given year relative to other costs, just as they have been in the past. Some years, costs are driven more by pension and OPEBs, some years by insurance rates, some years by interest rates, etc. The IRM adjustment, and the growth in billing determinants, capture all of these variations each year in a balanced and aggregated way.

Both solutions result in an apples to apples comparison. We believe that a comparison of actual accrual to actual cash produces an apples to apples to comparison that is simpler to do, and achieves the desired result. It is also much simpler for the Board to verify, since the figures for both cash and accrual are audited figures.

Adjusting the Forecast Amounts. If the Board accepts our view that the variance account should track actual (accrual basis) to actual (cash basis) each year, then the forecast accrual amount is irrelevant, and adjustments to that amount do not have to be considered.

On the other hand, if the forecast accrual amount is to be part of the comparison, then in our submission the amount must be adjusted, upward or downward, for both the IRM adjustment to rates, and the growth in billing determinants that will increase revenues available to cover costs.

If a utility has a 1.5% annual rate increase due to the IRM adjustment, and a 1.5% annual growth rate, the result is 12.65% greater revenues in year five of a five year IRM program. The difference between cash and accrual for pensions and OPEBs will usually be sufficient that 12.65% exceeds the utility's materiality threshold.

In our submission, if the Board determines to compare forecast amounts to actual amounts, then the forecast amounts should be adjusted annually to reflect the increasing rate recoveries available to pay those costs.

O&M vs. Capital Amounts. See SEC's response to the specific question on this issue, below.

Carrying Charge Calculations. In Appendix D, SEC was unable to follow the carrying charges calculation. There appear to be $8 in one year, and $3 in another year, but $75 cleared in the rebasing year.

There is a sentence on page 21 as follows: "Carrying charges will be required to apply against the net balance in the new variance account." This section of Appendix C deals with the previously approved accounts, and thus this sentence appears to suggest that there is some connection between the carrying charges on the previously approved accounts, and the new variance account. We assume this is intended to refer to the fact that, as the balances in previously approved accounts are recovered from ratepayers, they are credited to the new variance account (as they are a difference between accrual and cash), and thus start to attract carrying charges in that account to the extent that the cumulative month-end balances remain in a credit position. If this is not the case, we believe the OEB should clarify the meaning of this part of the Report.

The Board is proposing simple interest on the new variance account. In our submission, over time the amounts could become substantial, and thus the effective of compounding could become substantial as well. At 2.81% per year, the effect of compounding is to increase the total interest over five years from 14.05% to 14.86%, which on large balances could be a substantial sum.

Therefore, SEC proposes that the carrying charges on each new variance account include annual compounding, through calculating interest at the same rate on the year-end balance of the carrying charges sub-account for the following year, or through calculating interest at the end of each year on the average month-end balance in the carrying charges sub-account for the prior year.

Clearance of Account. Page 12 of the Report suggests that a utility will clear out the new variance account every "five years at the maximum", since that is stated to be the longest period the accrual vs cash differential would have to be carried.

This does not appear to be consistent with the Board's conceptual approach to the problem. The Board has determined to use accrual basis, but to compensate the ratepayers for the cumulative amount they are "lending" to the utility. This loan could go up or down, or could go up and stay up over extended periods of time, as it has in the past. There is no basis in the report to assume any five year maximum, unless that is referring to the five year IRM period. However, the IRM period would not be the maximum period the "loan" is outstanding, unless the utility was clearing the balance in the account by, in effect, repaying the loan to the customers. This does not appear to be what the Board had intended.

SEC submits that the Board should clarify that the balance in the new variance account is to continue year over year on a cumulative basis, as indicated in Appendix D, and is not intended to be cleared. The only balance that would be cleared is the carrying charges sub-account.

<u>**Carrying Charges on Previous Accounts**</u>

SEC sees no reason why carrying charges should apply to previously approved accounts that tracked the difference between cash amounts included in rates, and accrual amounts. These are not cash expenditures, so there is no cost to the utility to collect only cash rather than accrual each year. This is consistent with the Board's longstanding policy that the utility is not compensated with interest on non-cash amounts.

In this regard we note the Report's statement, at page 21 "No carrying charges will apply on the existing account after disposition…" This implies that carrying charges are appropriate before disposition. SEC disagrees.

Capitalized Compensation vs. O&M

Our understanding of the proposed policy is that the Board is requiring the utility to include all pension and OPEB costs in the variance calculation, whether expensed or capitalized. Some will be recovered from customers immediately as operating costs. Some will be recovered from customers, through rate base, over time.

Where pension and OPEB costs are expensed, recording the differential in a variance account and paying the CWIP interest rate to customers for the use of the funds is a reasonable compromise.

On the other hand, where pension and OPEB costs are capitalized, the effect of recording the differential in the variance account is that the customers are paid the CWIP rate for the use of their money, but are at the same timing paying the utility at the WACC rate (plus associated PILs or tax) for the same money as part of rate base. The amounts are the same, and from the same calculation, but the ratepayers pay a net differential that will typically be 4-5% of those costs annually. This does not seem fair.

This is then compounded by the Board proposing that the utility should be given the right to propose an alternative methodology, but why would they do that? They are being offered a free ride, in which they borrow from the customers at 2.81%, but get paid for the same funds, by the same customers, at more than 7%.

The utilities to which the new variance account would apply all have very substantial capital programs, and much of their capital work is done by employees. Thus, for most of them (e.g. Enbridge, Union, OPG, Hydro One), the capitalized pension and OPEB costs would be material. Since they have to record those amounts anyway for their own accounting purposes, there would seem to be no reason why the ratepayers cannot be compensated for that part of the differential at WACC (plus PILs/tax). This is not administratively difficult, and it would have the effect of leaving the ratepayers in a neutral position, rather than lending at one rate, and paying at a much higher rate, on the same money.

Transition from Cash to Accrual

We agree with the Board's proposal that cash to accrual, if it is to occur, should take place on rebasing. Aside from the desire to avoid a multiplicity of proceedings, the only utilities that have significant differences – the big ones – are all coming up for rebasing shortly. This is a problem that thus solves itself very quickly.

With respect to the remaining utilities that are currently on a cash basis, and are on IRM, their cash basis will only be for OPEBs. The amounts involved are therefore not sufficient to justify a special application for the Board to determine whether the policy on accrual should apply to that particular utility.

Disposition of Accounts

Consistent with our comments above, there does not seem to be a circumstance in which the cumulative principal balances in the new variance accounts can be cleared. They are self-adjusting over the long term, and until they self-adjust the utility has the use of the cumulative funds collected from customers on which carrying charges should be paid.

With respect to the previously approved accounts, we agree with the Board that the logical time to deal with clearance is at the next rebasing application. For the utilities with large balances, this will be in the next year or two in any case.

Conclusion

SEC appreciates the opportunity to participate in this follow-up phase, and to provide comments on the implementation matters raised by the Board.

Yours very truly,
Shepherd Rubenstein

Jay Shepherd

cc: Wayne McNally, OESC (by email)
Ted Antonopoulos, OEB (by email)
Mark Rubenstein, Shepherd Rubenstein (by email)
Interested Parties