

- 1 **Q. Please file a copy of pages 29 to 35 of the Direct Testimony of John T. Browne of**
2 **August 1, 2001 filed with the Board on behalf of Newfoundland Power pertaining to**
3 **Hydro’s Employee Future Benefits.**
4
5 **A. Attachment A contains the requested excerpt from the Direct Testimony of John T. Browne**
6 **as filed with the Board in August, 2001.**

Direct Testimony of John T. Browne, August, 2001
Pages 29 to 35

1 Where costs are to be allocated, they should be allocated on the basis of causality – costs
2 should be allocated to the cost object that caused them to be incurred. Fixed common
3 costs cannot be allocated on the basis of causality but should be allocated where the cost
4 allocation is used to support inter-corporate charges. Where they should be allocated, the
5 fixed common costs should be allocated on the basis of beneficiality, which is often
6 approximated by relative usage.

7
8 Hydro should be required to support its inter-corporate charges and cost allocations. As a
9 first step, it should identify the goods and services it provides or acquires from non-
10 regulated affiliates. It should then develop policies and procedures for determining the
11 transfer prices or cost allocations to cover these transactions, or at least each type of
12 transaction, and compliance procedures for ensuring that the policies and procedures are
13 followed. Where appropriate, the procedures should include the cost allocation
14 methodology. The policies and procedures should be developed so that the transfer
15 prices and cost allocations can be objectively verified, at least to the extent practical.

16
17 *Employee Future Benefits*

18 **Q. How does Hydro deal with post employment benefits other than pensions**
19 **(“OPEBs”)?**

20 **A.** It is my understanding that in the past Hydro employed the “pay-as-you-go” or cash
21 method for both financial reporting purposes and for rate setting purposes. With this
22 approach, the cost of the benefits is recognized when they are paid.

1 With the introduction of the new Section 3461 of the CICA Handbook – Accounting
2 (“Handbook”), Hydro has moved to the accrual method for financial reporting purposes
3 and is proposing to do so for rate setting purposes.

4

5 Under Section 3461, which became effective for financial years starting January 1, 2001
6 (although earlier adoption was encouraged), it is no longer acceptable for financial
7 reporting purposes to employ the cash method. Instead the accrual method must be used.
8 However, at the current time, if the cash method is required by a regulatory board, a
9 utility could set up a regulatory asset to reflect the expected amounts that will be
10 recovered through future allowed rates. Alternatively, it could continue to employ the
11 cash method. In either case, the impact on net income and net assets would be the same.

12

13 Under the accrual method, the present value of the future obligation is expensed and
14 recognized as a liability in the period that the service giving rise to the liability is
15 rendered. In addition, interest on the liability is recognized each period so that, when the
16 payments are made, the amount expensed (present value plus interest) will equal the cost
17 of the benefits paid out.

18

19 **Q. How do you deal with the transition from the cash to the accrual method?**

20 A. The transition from the cash to the accrual method gives use to a transitional obligation.
21 This obligation represents the present value of the liability for future OPEB payments at
22 the time of the transition.⁵

⁵ That is, the present value of the future cash payments on account of past service at the time of the transition.

1 According to Section 3461, a company can deal with the transitional obligation either
2 retroactively or prospectively.

3

4 (1) If applied retroactively, the company's financial reports are presented as if it had
5 always employed the accrual method.

6 (2) If applied prospectively, an entity should amortize the transitional obligation in a
7 rational and systematic manner over an appropriate period of time, which is
8 normally the average remaining service period of active employees expected to
9 receive benefits under the benefit plan.

10

11 **Q. How has Hydro decided to deal with the transitional obligation?**

12 A. Hydro decided to apply the change to the accrual method retroactively and reduced its
13 opening retained earnings for 2000 by the amount of the transitional obligation. In effect,
14 Hydro is saying that it will never attempt to recover this cost through allowed rates.

15

16 **Q. Is it appropriate for a utility to write-off the transitional obligation for rate setting
17 purposes?**

18 A. Under the cost of service standard, a utility should have a reasonable opportunity to
19 recover its cost of providing service. The transitional obligation represents the cost of the
20 OPEBs that a utility has not had an opportunity to recover through allowed rates at the
21 time of the transition to the accrual method. Therefore, under the cost of service standard,
22 it should be allowed to recover the cost of transitional obligation through future rates.
23 Of course, a utility should normally be allowed to exclude certain costs in determining its
24 revenue requirements. This is especially true of public sector utilities that may be

1 attempting to pursue social objectives of its owner. Therefore, I do not see a problem in
2 Hydro writing off the transitional obligation.

3
4 **Q. Must a regulated utility follow GAAP as set out in the Handbook?**

5 A. No. The recommendations in the Handbook are designed to support good financial
6 reporting. However, regulators are attempting to set just and reasonable rates.

7
8 In most cases, what is appropriate for financial reporting purposes is appropriate for rate
9 setting purposes. However, differences can arise. For example, where a utility initiates
10 an employee severance program, it would be required to expense the cost of the program
11 in the period that the program was announced. However, for rate setting purposes, a
12 regulator may decide that the cost should be recovered in rates over a five year period
13 because, in its opinion, the resulting rates would be more just and reasonable. Another
14 common example is the treatment of deferred income taxes employed by this Board⁶.

15
16 **Q. Should a utility apply the accrual method for OPEBs in setting allowed rates?**

17 A. If a utility did not have a transitional obligation, I believe the accrual method would
18 normally be preferable to the cash method.

19

⁶ According to Section 3465 of the CICA Handbook-Accounting, companies must recognize the estimated amount of future income taxes that will be payable as a result of the operations in the period. The difference between this amount and the amount currently payable is set up as a future income tax liability. However, many of the energy utilities, such as Newfoundland Power, are required to use the flow through method for rate setting purposes in which only the taxes currently payable are recognized for rate setting purposes. Section 3465 does allow regulated utilities to use the flow through method if they use the method for rate setting purposes; however, this reflects the economic impact of the regulatory decision rather than providing guidance for a regulatory decision.

1 Under the accrual method, the cost of the OPEBs is expensed in the period that the
2 services giving rise to the obligation are rendered. It is therefore consistent with the
3 principle of intergenerational equity. The customers who receive the benefits of current
4 employee services pay for the future costs that will result from those current services.

5

6 **Q. What are the implications of a transitional obligation for adoption of the accrual**
7 **method in setting rates?**

8 A. Where there is a transitional obligation, a board may decide that it is more “just and
9 reasonable” to retain the cash method. With this approach, rates reflect the cost of past
10 service but not current service. If there is a switch to the accrual method, rates must
11 reflect the cost due to current service plus a portion of the cost related to past service
12 through the amortization of the transitional obligation.

13 In deciding on whether to change to the accrual method, there are two key issues that a
14 regulatory board should consider:

15 (1) The first is the impact on rates due to recovering both the current obligation plus a
16 portion of the past transitional obligation. Because of this impact, a regulatory
17 board may decide that a utility should continue with the cash method.

18 Alternatively, a regulatory board may decide to delay implementation of the
19 transition until it can be accommodated with a smaller impact on rates.

20 (2) The other is the risk to the utility. The cash method results in a regulatory
21 commitment to allow a utility to collect through future rates the amount of the
22 future employee benefits when they become payable. However, with a changing
23 environment, at some point in the future, it may become difficult to recover a cost
24 related to the provision of past services.

1 **Q. Will the impact of the switch to the accrual basis, as proposed by Hydro, have a**
2 **material impact?**

3 A. Not in itself, however, consideration should be given to the overall rate increase,
4 including the impact of the RSP

5
6 According to Hydro, its OPEB expense in 2002 with the accrual method will be
7 \$2.2 million while the expense with the cash method would be \$1.2 million. Therefore,
8 the switch to the accrual method will represent 0.31% of Hydro's revenue requirement
9 for 2002 ($1.0 / 318 = 0.31\%$). If the difference were to stay in this range over the next
10 few years it would not have a material impact on rates, in itself.

11
12 However, with the impact of the RSP, Hydro is proposing an increase in 2002 of 12.6%
13 in the wholesale rate to Newfoundland Power, which will have an impact of 7.1%⁷ on its
14 customers. In light of these increases, the Board may question whether this is the right
15 time to switch from the cash to accrual method.

16

17 **Q. Would you please summarize your testimony on OPEBs?**

18 A. Where a utility switches from the cash to the accrual method for dealing with OPEBs, it
19 should be allowed to recover the transitional obligation through allowed rates. A public
20 sector utility may choose not to seek this recovery and Hydro has chosen not to.

21

⁷ Based on press release issued by Newfoundland & Labrador Hydro entitled "Newfoundland & Labrador Hydro Files General Rate Application" dated May 31, 2001.

1 Where the transitional obligation is not material, it is preferable to use the accrual method
2 since it is consistent with intergenerational equity. However, where the transitional
3 obligation is material, a regulatory board may deem that continuation of the cash method
4 is more just and reasonable.

5

6 With Hydro proposing an increase of 12.6% to Newfoundland Power in 2002, there is a
7 question as to whether this is the right time to switch from the cash to the accrual method.

8

9 **Q. Does this complete your evidence?**

10 **A. Yes.**