K2.1

Z Factor – 2012 Pension Funding

Examination-in-chief

Q. What was the key change in Pension Regulations that is requiring the Company to file for Z factor?

On June 23, 2009, the second year of EGD's Incentive Regulation term, Regulatory changes were introduced to the Pension Benefits Act (Ontario). One particular change is very relevant to this Z factor issue. For fiscal years 2009 to 2012, Plan Sponsors taking contribution holidays are required to file a Cost Certificate with Financial Services Commission of Ontario (FSCO) as evidence that sufficient surplus remains to justify the contribution holiday. If a contribution holiday cannot be justified, then contributions must resume in accordance with the most recently filed valuation with FSCO.

Q. Is the Company's plan in a deficit or surplus position?

Based on Mercer's estimate for Dec 31, 2011 valuation, EGD's pension plans are in a deficiency position under the solvency basis. Contributions are triggered when there is a deficit under either the solvency basis or going concern basis.

Q. How did the plan that was in a surplus position before IR move into a deficit position?

The main factors that led to the deficiency position are 1) Contributions were not required to the plan for a long time even though annual service costs were incurred 2) The pension assets performance did not keep up with the increase in pension liabilities 3) The pension liabilities value increased dramatically in the last year essentially due to lower discount rates, which is based on long Canadian bond yields.

EGD is not unique in this regard – the financial position of most pension plans in Canada has declined significantly in the last few years due to weak equity markets and declining interest rates. In fact, EGD has been able to weather the storm better than most employers because the plan was in a healthy surplus position prior to the last few years, whereas many plans were in a deficit position even before the 2008 financial crisis.

Q. What was the requirement for a Plan Sponsor in a deficit position prior to the 2009 Regulation changes?

An actuarial valuation of EGD RPP was filed on Dec 31, 2009. Next valuation must be filed no later than Dec 31, 2012. If not for the regulation changes introduced in 2009, EGD could have been on a contribution holiday until the end of 2012 even with interim deficit positions.

Q. What are the required filings EGD must make with FSCO as it pertains to funding contributions and when do they get filed?

The following must be filed related to funding contributions:

1. Valuation Report – filed once every 3 years. If the valuation report shows a surplus, the plan sponsor can use the surplus to fund the service cost (i.e. take a contribution holiday). If the surplus is sufficient to fund 3 years worth of service cost, the plan sponsor would not be required to make contributions until the next filing in 3 years time (subject to the annual cost certificate requirement noted below). If the plan is in a deficit, contributions to the plan are required.
2. Annual Cost Certificate – filed annually (since 2009) in the years between the 3 year valuation report filing to prove the plan is still in a surplus since the last valuation filing. If the plan is in a deficit, a cost certificate demonstrating surplus cannot be filed and contributions to the plan must commence.

Q. Is the request for $16.6m to bring the Plan to a surplus position?

The legislation change requires the Sponsor to contribute only the current year's service cost if they are unable to file a Cost Certificate demonstrating sufficient surplus at the beginning of the year to fund the service cost for the year. The current request for $16.6m is one year's cost estimate for 2012 only. This funding will not bring the plan to a surplus position as per the current estimates – it is only intended to fund the cost of benefits accruing in 2012 (and avoid the deficit from growing further).

Q. What is the difference between contributions to bring the plan back to a surplus and contributions related to service costs?

EGD last filed a full year valuation report as of December 31, 2009 showing a surplus sufficient to fund the current service costs for at least three years. As such EGD would have been on a contribution holiday until the next required filing as of December 31, 2012. However EGD anticipates the annual cost certificate as of December 31, 2011 will show the plan is in a deficit triggering contributions amounting to the annual service cost for 2012.

Annual service costs are the present value of future benefits earned by employees in the period (or the cost of benefits being accrued by employees in the current year). EGD's request of $16.6M is related to the annual service cost.

Contributions to bring the plan from a deficit to a surplus will not be required until the next full year valuation is filed as of December 31, 2012, if the deficit still exists. These contributions to take the plan to a surplus would occur over a 5 year period.

Q. How were the ratepayers impacted in the last few years related to the Pension issue?

EGD currently follows cash basis accounting for pension costs. The Plan was in a surplus prior to IR period and in the first two years of IR as well. In the past five years, the annual service cost has averaged approximately $13m. Pension cost is a legitimate utility operating expense and because of the fortunate surplus position of the Plan, the Sponsor and indirectly the ratepayers, did not have to incur these costs.

Q. In specific, how does this request qualify as Z factor?

This request qualifies for Z factor as per the criteria established in the IR settlement. In particular -

Criteria ii) The cost must be beyond the control of the Company's management and is not a risk in respect of which a prudent utility would take risk mitigation steps.

Change in regulation to file a cost certificate, is clearly beyond the control of management and the costs being incurred are those that would be incurred by a prudent utility to remain compliant with PBAO and FSCO.

The Company respectfully requests the Board to approve inclusion of $16.6m in pension costs as a Z factor in its revenue requirement for 2012 coupled with a pension cost variance account.