July 31, 2015

Ms. Kirsten Walli
Board Secretary
Ontario Energy Board
2300 Yonge Street, 27th Floor
Toronto, ON M4P 1E4

Dear Ms. Walli:

Re: Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs
Board File No. EB-2015-0040

Union Gas Limited (Union) hereby makes its submissions to the Ontario Energy Board (OEB) in connection with the consultations related to the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs in the electricity and natural gas sectors.

Union maintains registered and non-registered, contributory and non-contributory defined benefit (DB) and defined contribution (DC) pension plans as well as other post-employment benefits (OPEBs). Union's pension plans are single-employer pension plans (SEPPs) for which Union is responsible for the balance of costs over and above any employee contributions.

The accounting expense for Union's DB pensions and OPEBs is determined in accordance with the U.S. Financial Accounting Standards Board's ASC 715 – Compensation – Retirement Benefits which provides guidance on the disclosure and other accounting and reporting requirements related to single-employer plans[1].

Union's responses to the specific questions posed by the Board are provided below. In summary, Union's key recommendations are as follows:

- Long-term stability of pension and OPEB costs is desirable in order to support intergenerational equity and stability of rates.

- Benchmarking of pensions and benefits can provide useful comparative information, but needs to be considered within a total compensation framework. A simple comparison of pensions and OPEBs may be misleading if not considered in the context of total compensation which may include base pay, incentive compensation and paid time off, pensions and savings plans, group

[1] Union's 2013 cost of service rates application (EB-2011-0210) was filed on the basis of US GAAP. Union applied for and received Ontario Energy Board approval to adopt US GAAP for regulatory purposes in the Decision on Preliminary Issue dated March 1, 2012.

benefits such as life and accidental death and dismemberment insurance, OPEBs, and short and long-term disability coverage.

- A single cost recovery method (such as cash basis, funding contribution basis, accrual basis, etc.) is inappropriate for all circumstances as pension plan designs and financing arrangements are not consistent among utilities.

- There are several different types of registered pension plans sponsored by Ontario rate-regulated utilities. In addition, these utilities employ varying acceptable accounting standards to recognize the costs of pensions and have varying methods of determining the costs that are recovered through rates. This is the result of having rate-regulated utilities of various sizes that use different bases of accounting for different but legitimate reasons. The OEB should address these differences by acknowledging that the differences themselves illustrate that pensions and related costs and cost recoveries need to be addressed on a case-by-case basis.

General Principles

1. What principles should the OEB adopt in addressing pension and OPEB issues? Potential principles include: consistency across the gas and electricity sectors; intergenerational equity; financial protection for future ratepayers; ensuring the most efficient level of costs for ratepayers; stable cost levels; pension costs which are comparable as measured by other benchmarks, etc.

Union recommends that the following principles be adopted by the OEB in addressing pension and OPEB issues:

- Compliance with existing pension and OPEB accounting standards and regulations;

- Intergenerational equity (i.e., not negatively impacting future generations with decisions being made today) is critical as it applies to the inclusion of pension and OPEB costs charged to ratepayers, with each generation being allocated a reasonable share of costs; and

- Long-term stability of pension and OPEB costs is desirable in order to support intergenerational equity and stability of rates.

In Union's opinion, the principle of consistency is not an appropriate area of focus as the types and levels of pensions and OPEBs vary significantly across the utility industry. In particular, the governance, cost-sharing and risk-sharing arrangements for pension plans varies between single-employer pension plans (SEPPs), jointly-sponsored pension plans (JSPPs) and multi-employer pension plans (MEPPs). The basis of cost recovery may also legitimately vary between utilities depending on the type of pension and OPEB arrangements.

Union believes that emphasis on benchmarking of pension and OPEB costs across the utility sector would provide little value. However, if benchmarking is performed, significant care will be needed to ensure that comparisons are commensurable and take into account differences in employee demographics, pension and OPEB design, governance arrangements and allocation of costs between the employer and the plan members. Further, the comparison of the value of pension and OPEBs needs to be considered within a total compensation framework.

2. Are there other types of costs previously considered by the OEB that provide suitable analogies for the consideration of pension and OPEB issues? (for example: deferred taxes; asset retirement obligations; site restoration costs)

Union does not believe that other types of costs provide suitable analogies for the consideration of pension and OPEB issues. Pension and OPEB costs are unique from deferred taxes, asset retirement obligations and site restoration costs as further described below.

Pensions and Other Post-Employment Benefits

For accounting purposes, Union elected to follow Generally Accepted Accounting Principles, in particular those adopted by the U.S. Securities and Exchange Commission (US GAAP), which prescribe that entities recognize and amortize the costs related to pensions and OPEBs over the period during which services are rendered by the employees covered by the plans. Annual net benefit costs are determined on an accrual basis and year-end obligations are determined as the actuarial present value of obligations accrued to the reporting date. These amounts are determined based on actuarial assumptions adopted by Union management, on the advice of our actuary.

For rate making purposes, Union collects costs for pensions and OPEBs from ratepayers based on the projected annual net benefit costs in accordance with US GAAP.

Union's pension and OPEB liabilities are not included as part of its rate base.

Registered pension plans are subject to significantly more regulation than the cost types mentioned above. The Financial Services Commission of Ontario (FSCO) regulates the minimum annual funding requirements of pension plans registered under the *Pension Benefits Act* based on periodic actuarial valuations.

Pension plans and OPEBs require significantly more governance than the cost types mentioned in the above question. The overall management of Union's pension plans and the investment of pension assets is delegated by Union's Board of Directors to a Management Pension Investment Committee and Union's treasury function.

Pension plan funding and investment take careful planning as the funding of pension plans can be very volatile since they are tied closely to the financial markets. Due to this potential volatility and the complexity of the actuarial assumptions inherent in determining cash funding requirements, the amount that Union is recovering from its ratepayers related to its pension obligations can fluctuate between overfunded and underfunded status.

Deferred Taxes

For accounting purposes, Union elected to follow US GAAP, and therefore must record a deferred tax expense in its financial accounts. This balance is typically a liability which is driven by timing differences of how capital costs are recognized into income for accounting vs. income tax purposes. Income tax regulations typically allow for accelerated depreciation of capital costs and an income tax liability is created that will reverse in the future. As a utility invests in more capital assets, the deferred tax liability does not decline because the deferred tax generated from new plant investment replaces the reversal of previous timing differences.

For rate making purposes, Union is only able to recover in its rates current income taxes (i.e., income taxes payable). Since the income tax expense is ultimately recoverable from ratepayers, Union records a regulatory asset on its books as an offset to the deferred tax liability described above.

Prior to 1997, Union recovered deferred income taxes in rates. In 1997, the OEB directed Union that only current taxes were to be included in rates[2]. As a result, Union was directed to refund amounts previously collected over the next 17 years. The amount being refunded is recorded as a reduction to rate base. This reduction in rate base provides ratepayers a return equivalent to Union's Weighted Average Cost of Capital (WACC), recognizing the fact that ratepayers have funded a future liability.

Asset Retirement Obligations/Asset Removal Costs

For rate making purposes, Union collects from ratepayers depreciation expense in excess of plant useful lives to recognize future asset removal costs over the life of the associated assets. The accumulation of the resulting future plant removal costs is recorded as a reduction of property, plant and equipment for regulatory purposes, and as a result, a reduction of Union's rate base. The reduction in rate base provides the ratepayers a return, equivalent to Union's WACC, which recognizes the fact that a future liability has been funded in advance.

[2] EBRO 493/494 Decision with Reasons dated March 20, 1997, page 188.

A summary table is provided below that compares Pensions and OPEBs to Deferred Taxes and Asset Removal Costs to illustrate why these cost types do not provide suitable analogies:

Cost Type	Accounting Basis vs. Recovery Basis	Typical Ratepayer Funded Position	Impacts Rate Base?	Subject to Additional Regulation?	Degree of Additional Governance Required?
Pensions and OPEBs	Consistent	Varies based on changes in estimates and assumptions	No(1)	Yes	Significant
Deferred Taxes	Inconsistent	Underfunded	No(2)	No	None
Asset Removal Costs	Inconsistent	Overfunded	Yes	No	None

Notes:
(1) All O&M expenses (including pensions) affect the calculation of the Cash Working Capital component of rate base.
(2) Pre-1997 deferred taxes are included as a reduction of Union's rate base (as discussed below).

Information Requirements

3. **Should the applicants be required to compare their pension and OPEB costs to industry norms and/or other benchmarks? (Note: It is the OEB's expectation that the next phase of the consultation will consider the development of a complete set of new or incremental information that should be filed in applications seeking cost recovery for pensions and OPEBs).**

In Union's opinion, benchmarking should only be utilized if an appropriate commensurable comparison can be made. Benchmarking also needs to be considered within a total compensation framework. A simple comparison of pensions and OPEBs may be misleading if not considered in the context of total compensation. The OEB has supported a holistic view of compensation in past cost of service applications.

Pensions and OPEBs are just two components of total compensation. Total compensation may include some or all of the following: base pay, incentive compensation and paid time off, pensions and savings plans, group benefits such as short and long-term disability benefits, life and accidental death and dismemberment insurance, and health and dental benefits, as well as OPEBs.

There are a variety of different methods and assumptions that might be used for benchmarking various aspects of compensation. Depending on the adopted methods and assumptions, the relationship between two different compensation programs can look very different. For example, compensation can be compared based on actual employee demographics or on a sample employee demographic group, the values of pensions and OPEBs can be measured based on the benefits provided to existing employees, existing retirees, new hires, etc., and the relative values of a single-employer defined benefit plan can be compared to a multi-employer cost / risk shared defined benefit pension plan.

Any benchmarking criteria would need to clearly describe the manner in which the methods and assumptions are developed and the components of total compensation to be included in the benchmarking.

The calculations of pension and OPEB expenses require the use of numerous assumptions, including the discount rate, expected long-term rate of return on plan assets, rate of salary increase, rate of mortality and prescription drug cost trends, etc. Benchmarking of these assumptions to other entities may be beneficial in understanding the actuarial (accounting) cost included in rates.

4. **What other relevant information should the Board evaluate in order to effectively assess the pension and OPEB costs that a rate-regulated entity is seeking to be included in the rates charged to customers?**

   Other information that should be evaluated includes:

   - Type of pension plans (single-employer pension plans (SEPPs), jointly-sponsored pension plans (JSPPs), multi-employer pension plans (MEPPs), etc.). In particular, how the governance, cost-sharing and risk-sharing arrangements varies between the types of pension plans;
   - Employee demographics;
   - Funding arrangements, including investment policy and asset allocation for funded pension plans;
   - Assumptions used in determining net benefit cost and minimum required contributions; and
   - Total compensation.

Accounting and Recovery in Rates

5. **a) Should the OEB establish accounting and recovery methods for both the electricity and gas sectors?**

   In Union's opinion, the OEB should not prescribe the accounting method. The accounting for pension and OPEB expenses should be based on the accounting standards adopted by the entity.

   The OEB should establish the basis for cost recovery for both the electricity and natural gas sectors but, as outlined above, the varying types of pension plans require that the recovery method be specific to the individual utility.

   b) What criteria should be considered to determine the appropriate approach?

   The key criteria to be considered are inter-generational equity and stability of costs as outlined above in response to question 1.

c) If one method is adopted, what should it be: cash (pay-as-you-go) basis, funding contribution basis, accrual (accounting cost) basis or another method?

- **"Pay-as-you-go" cash payment: is equal to the benefit payment to the plan beneficiaries, as specified by the terms of the plan**
- **Funding contribution: the minimum amount of contribution required to be made by a sponsor of a registered pension plan that is subject to the requirements of pension legislation in Ontario under the Pension Benefits Act, Ontario (PBA), and related rules and regulations**
- **Accounting cost: this is the accrued cost determined by accounting rules (in accordance with a given accounting framework) and recognized and reported in general purpose financial statements (ultimately split between capital expenditures and operating expenditures)**

A single cost recovery method is inappropriate in all circumstances as the pension plan design and pension funding vehicles employed by regulated utilities are not consistent.

For Union, the most appropriate cost recovery method is the accounting net benefit cost as Union sponsors defined benefit single-employer pension plans. Under US GAAP, pension and OPEB costs are allocated in a rational and systematic manner over the period during which employees are expected to render service. This methodology is consistent with the principles of inter-generational equity and stability. Any actuarial and investment gains and losses are subject to deferral and amortized in a systematic basis over the expected average service life of the covered employees. In many respects, this approach is similar to the depreciation of assets where the cost of a long-term item must be best-matched to individual, smaller reporting periods.

Attached as Appendix A is an opinion letter from Towers Watson supporting the position that the costs of pensions and OPEBs for employees of Union should be recognized in rates based on the annual accrual accounting expense used by Union for financial reporting purposes.

For a utility that participates in a MEPP, a more appropriate method of cost recovery could be the funding contribution method. In many cases, employers that participate in this type of plan simply record the amounts contributed to the plan as expense as there is no allocation of the assets or liabilities of the plan to an individual participating employer.

In Union's opinion, the "pay-as-you-go" cash payment method is not an appropriate method since pensions and OPEBs by their nature are provided after cessation of employment. This approach inappropriately allocates the cost of current employees to future generations of ratepayers.

The funding contribution method is not appropriate for DB single-employer pension plans as cash contributions to registered pension plans are typically driven by short-term solvency considerations which are not an appropriate basis for allocating long-term costs. This is especially relevant in Ontario due to the onerous 'grow-in' provisions under the windup rules in the *Pension Benefits Act* which result in overstated solvency liabilities. Therefore, cost recovery based on cash contributions would result in a much higher rate of recovery from current ratepayers compared to future generations of ratepayers.

Furthermore, cash contributions are typically calculated as a range based on a minimum amount required under the *Pension Benefits Act* and a maximum amount based on the *Income Tax Act* (Canada) rather than a specific amount. In recent years, the minimum funding rules have been subject to periodic change and they include temporary and optional funding relief measures that may be utilized by some but not all utilities.

d) Should the method for recovering costs relating to registered pension plans be different from that used for unregistered pension plans and OPEB plans?

Although the cost recovery methodology could be different for registered pension plans, unregistered or supplemental pension plans and OPEB, for single-employer plans the accounting basis is most appropriate for all three as it systematically allocates the cost over the period the employee is expected to render service, is consistent with financial reporting requirements and is the best option to provide intergenerational equity and stability of rates.

6. a) Should the OEB take into account impacts on financial reporting (US GAAP, ASPE and IFRS), legal, and tax matters?

Yes, the OEB should take into account impacts on financial reporting, legal and tax matters. Consistency in reporting to all stakeholders and users of financial information is important for comprehension, reliability, comparability and credibility purposes.

b) If so, what are the issues that should be considered when determining the appropriate approach?

If the OEB requires entities to use a cost recovery methodology that differs from their actuarial (cost) accounting, incremental administration will be necessary to track and maintain the records required to support the cost included in the revenue requirement. Additionally, a regulatory asset or liability may need to be established to account for these differences, and additional financial statement and other disclosures would be required and audited.

Consideration should be given to the fact that registered pension plans, non-registered or supplemental employee retirement plans and other post-employment benefits are very different from each other both from a legal and tax perspective.

Supplemental employee retirement plans (SERPs) typically provide pension benefits above and beyond what an RPP can provide. SERPs are not subject to the *Pension Benefits Act* and are typically either pay-as-you-go or secured with a letter of credit. If funded or secured, they are deemed under the *Income Tax Act* (Canada) to be trusts and characterized as RCAs subject to a special refundable tax regime meant to act as a tax anti-avoidance measure[3].

An RCA arises when assets are set aside in connection with benefits that may be received after termination of employment, such as when a SERP is cash-funded or secured with a letter of credit. The Canada Revenue Agency has opined that an RCA will not, however, arise where the assets remain with the employer, for example in a separate internal account in respect of which the employees do not have a claim but the employer's creditors do[4].

When a "contribution" is made to the RCA custodian under an arrangement that is subject to the RCA rules, the contributing employer must remit an equivalent amount to the Canada Revenue Agency as refundable tax[5]. For example, a contribution of $100 to the RCA custodian requires that an additional $100 be remitted to the Canada Revenue Agency. The refundable tax is repaid by the Canada Revenue Agency to the RCA custodian as the RCA custodian makes distributions from the deemed trust (so, for every $2 distributed, the RCA custodian will receive $1 back from the Canada Revenue Agency).

In addition to the complexities involved in administering an arrangement that is subject to the RCA rules, the cost of the refundable tax mechanism constitutes the loss of revenue which might otherwise have been generated by the amounts remitted to the Canada Revenue Agency. In other words, while refundable tax sits with the Canada Revenue Agency, it does not generate any return for the employer.

Other post-employment benefits (OPEBs) consist of group life and health benefits provided to retirees and their dependents. They are funded on a pay-as-you-go basis. Should assets be set aside in respect of OPEBs, the arrangement would be considered an RCA.

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[3] *Income Tax Act (Canada)*, Part XI.3
[4] For example, see Advance Tax Rulings 9533063, 9909123, 2005-0114001R3 and 2006-0203271R3
[5] *Income Tax Act (Canada)*, paragraph 153(1)(p) and *Income Tax Regulations*, subsection 103(7).

c) For comparative analysis, how should the OEB address differences that arise from (driven by) the basis of accounting that is used by a rate-regulated utility? For example, the treatment of re-measurements under IFRS is different to their treatment under US GAAP and ASPE.

Regardless of the accounting standard adopted by a rate-regulated entity, a comparison of costs is challenging due to the type of pensions plans available (single-employer pension plans (SEPPs), jointly-sponsored pension plans (JSPPs), multi-employer pension plans (MEPPs), etc.), the funding arrangements, including investment policy and other considerations as outlined in our response to Question 4.

There are several different types of registered pension plans sponsored by Ontario's rate-regulated utilities. In addition, these utilities employ varying but legitimate accounting standards to recognize the costs of pensions and have varying methods of determining the costs recovered through rates. The OEB should address these differences by acknowledging that the differences themselves illustrate that pensions and related costs and cost recoveries need to be addressed on a case-by-case basis.

7. **a) Would it be appropriate to establish a deferral or variance account(s) in association with the approaches discussed above in numbers 5) and 6) respectively?**

Should the OEB require a change to the basis of cost recovery currently used by Union (US GAAP accounting basis) then it would be appropriate to establish a transitional deferral account.

To the extent that Union incurs costs related to financial reporting, legal and tax matters related to any change, including the use of consultants to assist with any transition, these costs should recoverable through a deferral account.

If the OEB selects any cost recovery method other than the US GAAP accounting basis, Union will require a new deferral account to capture the risk of variance in assumptions. This deferral account would capture any difference between the amount included in rates and the actual amount incurred.

The establishment of this deferral account ensures that both ratepayers and Union are treated fairly and not harmed by changes related to the recovery of pension and OPEB costs. If a deferral account was not established, the costs mentioned above would flow through Union's utility results and could significantly harm the utility or the ratepayer depending on their magnitude and direction.

It is also important to note that Union's current recovery method for pension and OPEB costs tends to be less volatile than alternate recovery methods like legislated minimum funding requirements. US GAAP accrual accounting amortizes actuarial gains or losses over the period during which services are rendered by employees covered by the plans. Minimum funding requirements are driven by pension regulations and can fluctuate significantly year over year due to changes in investment returns, long term interest rates, other actuarial assumptions, and public policy changes. If Union is required to shift from its current less volatile cost recovery method to a more volatile one, a deferral account will be essential to ensure any harm to the utility or ratepayers is mitigated.

b) How should the account(s) operate?

A transitional deferral account would capture any difference between the OEB prescribed method for cost recovery and the current method. The timing of disposition would be contingent on the amount and the impact on rates. In this regard, it is noted that should the deferral account balance be disposed of on an annual basis, there is little difference between that approach and the current method, albeit with a one-year lag for a portion of the expense.

A deferral account would also be used to capture any costs related to transition, as outlined above. This account would be disposed of as part of Union's annual deferral account disposition process.

c) Should interest be applied to the account(s), and if so, why?

It is uncertain at this point what the impact would be of changing cost recovery to a basis other than the accounting basis currently followed by Union. If this change resulted in an amount owing from/to ratepayers once funding has been already received/owed then the balance should be included in rate base. If an amount has not yet been funded by either the company or ratepayers, no interest should be applied to these accounts as no cash is involved.

If Union incurs costs related to the transition, interest should apply to the deferral account at the OEB prescribed rate.

d) How should the transition from the current practice to the new method of recovery be addressed?

i. Should the transition be phased-in, applied retrospectively with catch-up adjustments for prior periods, prospectively with no adjustments for prior periods or a combination of any of these methods?

Any transition impacts should be calculated retrospectively to the point in time that Union began recovering all pension and OPEB costs in rates consistent with the principles of accrual accounting standards. By calculating the change to this point in time, both Union and ratepayers would be made whole in terms of the costs associated with any new recovery method mandated by the OEB. That is, any change should be implemented as if that change had been in place since the commencement of the current method.

Applying the transition prospectively with no adjustments for prior periods is not an appropriate approach for utilities that currently use the accrual basis of accounting to recover pension and OPEB costs. The accrual basis of accounting is designed to amortize actuarial gains or losses over the period during which services are rendered by employees covered by the plans. If a change in this recovery method is mandated in which any transition impact is calculated prospectively, the costs associated with these employees will be recognized inconsistently over their years of service. Prospectively adjusting recoveries for impacts calculated retrospectively will ensure that the Board's desired approach to recovering pension and OPEB costs is applied consistently.

ii. Should a generic approach be used or should the transition be addressed on a case-by-case basis?

The transition to a new approach would require careful analysis and consideration on a case by case basis. In Union's opinion, a generic approach would not be appropriate in all circumstances.

Given that Union is under an incentive regulation framework, any change in method that the OEB may impose should not be made until rebasing occurs for 2019 rates.

8. **a) Would it be appropriate to establish some form of segregated fund or similar set-aside mechanism for amounts which are collected from ratepayers before they are paid out?**

No, as explained below, it would not be appropriate to establish some form of segregated fund or similar set-aside mechanism for amounts collected from ratepayers before they are paid out.

b) What tax, legal, accounting or other issues arise?

It is unclear what legal form such a mechanism would take. If it takes the form of a trust, the nature of the trust and the identity of the trust beneficiaries would have to be determined. The portion of the amounts collected from ratepayers in order to pay employee benefits might be viewed as being held by the custodian of such amounts (whether an employer or any other custodian) for the benefit of the employees. Such a mechanism might therefore be viewed as enhancing employee rights, which may not be an intended consequence.

The tax characteristics of the mechanism would also have to be determined. For example, trusts are considered to be separate taxpayers under the *Income Tax Act* (Canada) and taxed on their earnings at the highest individual marginal tax rate, subject to certain trusts with special purposes being subject to special tax rules[6] (retirement compensation arrangements (RCAs) being one example as discussed

[6] *Income Tax Act (Canada),* subsection 104(2)

below). In addition, because trusts are taxpayers, most of them must file a tax return on a yearly basis.

As discussed above, registered pension plans (RPPs) are heavily regulated and subject to both the *Pension Benefits Act*, which imposes minimum funding obligations on plan sponsors, and the *Income Tax Act* (Canada), which grants to RPPs special tax-deferred status. By law, RPP fund assets are held by a third party. Typically, a DB RPP's fund assets are held in trust, with the RPP members as beneficiaries of the trust.

In addition, the *Pension Benefits Act* deems a sponsoring employer to hold in trust an amount of money equal to employer contributions due but not yet made, and the RPP administrator has a lien and charge against the employer's assets in such amounts. If there was a mechanism which took the amounts collected from ratepayers out of the employer's own property and into a pool of assets subject to a trust in favour of the employees, the employees could be viewed as overly protected, first by the fact that amounts are held in trust and also by the *Pension Benefits Act's* deemed trust/lien mechanism against the employer's assets, in such amount.

If the portion of the amounts collected from ratepayers in order to pay employee benefits were viewed as being held for the benefit of the employees, it might be viewed as being subject to the RCA rules and the refundable tax regime, with the punitive requirement that an amount equal to the amounts held by the RCA custodian be remitted by the employer to the Canada Revenue Agency. Otherwise, they might be viewed as *inter-vivos* subject to the normal tax rules.

c) How should the transition to the new practice be addressed?

> **i. Should the transition be phased-in, applied retrospectively with catch-up adjustments for amounts collected from ratepayers to date but not yet paid out, prospectively with no adjustments for prior periods or a combination of any of these methods?**
>
> **ii. Should a generic approach be used or should the transition be addressed on a case-by-case basis?**
>
> i. & ii. There are no fully tax-efficient vehicles available for setting aside or segregating the funds collected in rates. As a result, transition to this approach is not appropriate. Given this and the issues raised above, Union and, presumably, other rate-regulated entities would want a reasonably long lead time in which to analyse the requirements and take appropriate measures.

9. What information should the utilities report and how frequently should it be reported?

Union commissions and prepares several reports related to pensions and OPEBs in fulfilling its financial reporting and governance responsibilities. The following reports may be useful and could be filed with the OEB:

Report	Frequency
Year-end accounting report (prepared by Actuary)	Annual
Estimated Net Benefit Costs	Annual
Assumptions Used in Determination of Net Benefit Cost	Annual
Actuarial Valuations	As filed with Financial Services Commission of Ontario (FSCO), at a minimum tri-annually

Should you have any questions, please do not hesitate to contact me.

Yours truly,

[Original signed by]

Patrick McMahon
Manager, Regulatory Research and Records
pmcmahon@uniongas.com
(519) 436-5325

Appendix A

Towers Watson Opinion Letter dated July 20, 2015

TOWERS WATSON

Ashley Witts, M.A., F.I.A., F.C.I.A., F.S.A.
Senior Consulting Actuary

1100 Melville Street
Suite 1600
Vancouver, British Columbia
V6E 4A6

T +1 604 691 1000
D +1 604 691 1007
F +1 604 691 1062

ashley.witts@towerswatson.com
towerswatson.com

July 20, 2015

Ms. Linda Vienneau
Manager, Accounting
Union Gas
50 Keil Drive North
Chatham, Ontario
N7M 5M1
CANADA

Dear Ms. Vienneau,

The purpose of this letter is to respond to your request to Towers Watson to provide our opinion of the appropriate recovery method for costs incurred by Union Gas (Union) in providing pensions and other post-employment benefits (OPEBs) to its employees.

Introduction

Towers Watson is a professional services firm that provides actuarial, pension and benefits consulting services to a broad range of clients, including many of the largest gas and electric utilities in Canada and the United States. I have extensive experience advising rate regulated gas and energy utilities in Canada, and have advised Union for more than 20 years in these matters. I have also provided expert testimony on pension and benefits matters, including cost recovery issues, to the Ontario Energy Board, the Alberta Utilities Commission and the National Energy Board. My biography is provided in the Appendix to this letter.

Pension and OPEB Plans Sponsored by Union

Union maintains registered and non-registered, contributory and non-contributory defined benefit (DB) and defined contribution (DC) pension plans as well as OPEBs. Union's registered pension plans (RPPs) are single employer pension plans for which Union is responsible for the balance of costs over and above any fixed employee contributions. The RPPs are registered under the Ontario Pension Benefits Act (Ontario PBA) and the Income Tax Act (Canada) (ITA).

Union's non-registered pension plans provide benefits in excess of the limits imposed by the ITA. The non-registered plans are not pre-funded and are not registered under either the Ontario PBA or the ITA.

Union's OPEB plans are not pre-funded and are not registered under any specific legislation.

The accounting expense for Union's RPPs, non-registered pension plans and OPEBs is determined in accordance with the U.S. Financial Accounting Standards Board's ASC 715 – Compensation – Retirement Benefits (ASC 715) which provides guidance on the accounting, disclosure and other reporting requirements related to single-employer plans.

Legislated Funding Requirements

Registered Pension Plans

Required contributions to RPPs are subject to the requirements of both the Ontario PBA and the ITA.

The Ontario PBA prescribes the minimum funding requirements for DB RPPs. The funding amounts are determined based on both going concern and solvency actuarial valuations.

Going concern contributions comprise the cost of benefits earned in respect of current services rendered by active employees plus amortization of any past service unfunded actuarial liabilities over a period of 15 years. In addition, if the solvency actuarial valuation reveals a solvency deficiency, additional contributions are required so that the solvency deficiency is amortized over 5 years.

Under the Ontario PBA, the solvency actuarial valuation must include provision for “grow-in” benefits; i.e., benefits that would be provided to active employees upon plan windup. These benefits are unique to pension plans registered under the Ontario PBA and result in significantly higher solvency liabilities for RPPs registered under the Ontario PBA when compared to other Canadian jurisdictions.

Various solvency funding relief measures have been enacted over the last several years. These include extensions to the amortization period for solvency deficiencies and the use of letters of credit in lieu of solvency funding payments.

Maximum permissible contributions to RPPs are determined under the ITA. Generally, an employer may contribute up to the full amount of any going concern unfunded actuarial liability or solvency deficiency in addition to the cost of benefits earned in respect of current services rendered by active employees. Where a plan develops a significant actuarial surplus, contributions may be partially limited or not permitted at all.

Plan sponsors have the latitude to determine the amount of cash funding to RPPs within the lower and upper bounds established by the Ontario PBA and the ITA. As a result of the elevated levels of solvency funding under the Ontario PBA, Union, like most other sponsors of DB RPPs, has elected to make cash contributions to the RPPs equal to the minimum amounts required under the Ontario PBA. However, to date, Union has not elected to take advantage of any solvency funding relief measures.

In the recent and current economic environment, where long term bond yields are around 50 year lows, Union’s minimum funding requirements have been driven primarily by the results of the solvency actuarial valuations and have increased significantly as bond yields have continued to decline. The volatility of long bond yields which determine the interest rates used for solvency actuarial valuations has led to significant year to year volatility in Union’s cash contribution levels. The elevated levels of cash funding has also resulted in the development of a significant pre-paid pension asset in respect of Union’s RPPs.

Non-Registered Pensions and OPEBs

There are no legislative requirements for pre-funding non-registered pensions and OPEBs.

Non-registered pensions can be pre-funded using a Retirement Compensation Arrangement (RCA). Under a RCA, contributions are subject to a 50% refundable tax that must be remitted to the Canada Revenue Agency. The refundable tax is then refunded when payments are made from the pension trust. As no investment income is earned on the refundable tax, the use of a RCA to fund non-registered pensions is not tax effective. Data from Towers Watson’s most recent survey of non-registered pensions indicates that among broad-based non-registered pension plans, most (78% of survey participants) plans are not pre-funded and payments are made on a pay-as-you-go basis and only 22% use an RCA to pre-fund non-registered pensions.

Singe employer OPEBs such as Union’s plans are typically not pre-funded as there is no tax efficient vehicle in which to accumulate funds. The vast majority of OPEBs are funded on a pay-as-you-go basis.

Principles for Utility Cost Recovery

The Bonbright[1] principles have guided public utility rate making for more than 50 years. These principles promote rate simplicity, stability of the customer experience, utility revenue recovery, the fair distribution of costs and efficiency of energy use. Within the context of the recovery of pension and OPEB costs, these principles may be distilled to the following key objectives:

- Long-term stability of pension and OPEB costs is desirable in order to support stability of rates and intergenerational equity between ratepayers; and

- Costs should be recognized in rates when the employee services that give rise to these costs are rendered.

Alternative Cost Recovery Methods

There are a variety of methods that may be used to determine the cost recovery of pensions and OPEBs, including a cash basis, funding contribution basis or an accrual accounting basis. A single cost recovery method is unlikely to be appropriate for all circumstances as the plan structure, plan design and funding vehicles employed by utilities are not consistent. We believe the OEB should address these differences on a case-by-case basis.

Cash Basis

For RPPs, the cash basis is usually the same as the funding basis. For non-registered pensions and OPEBs, the cash basis is usually the same as pay-as-you-go.

The primary issues with the cash basis are that amounts are not necessarily determined in a systematic or rational manner and there is considerable latitude when determining the final cash contributions. Whereas the cash basis for RPPs is the same as the funding basis and the product of legislated rules and regulations, it produces results that are inconsistent with the principles for cost recovery by utilities.

For non-registered pensions and OPEBs, cash payments typically only occur after the employee has left the utility, meaning that costs are not allocated to current ratepayers but rather deferred to the account of future ratepayers. Moreover, the profile of cash payments is uneven leading to significant intergenerational transfers of costs between ratepayers.

Funding Basis

The funding regulations under the Ontario PBA require Union to significantly pre-fund its RPPs, primarily as a result of the solvency funding regulations. If the funding basis were to be used, this overfunding would result in today's generation of ratepayers paying a greater share of the cost of these programs than the value they are receiving through the services rendered by these employees.

Accrual Accounting Basis

The fundamental objectives of accrual accounting for pensions and OPEBs include:

- The costs of pensions and OPEBs should be allocated in a rational and systematic manner;

- The compensation cost of employee pensions and OPEBs should be recognized over an employee's service period; and

[1] Principles of Public Utility Rates, James Bonbright (1961)

- Prior service costs, including actuarial gains and losses, are amortized over the expected average remaining service life of employees.

ASC 715 mandates a standardized method for measuring net periodic pension cost that is intended to improve comparability and understandability by recognizing the compensation cost of an employee's pension over that employee's service period and by relating that cost more directly to the terms of the covered plans.

In promulgating the use of revised accounting standards, the US Financial Accounting Standards Board stated, *"The Board believes that the understandability, comparability, and usefulness of pension information will be improved by narrowing the past range of methods for allocating or attributing the cost of an employee's pension to individual periods of service. The Board was unable to identify differences in circumstances that would make it appropriate for different employers to use fundamentally different accounting methods or for a single employer to use different methods for different plans."*

More recently, International Financial Reporting Standards (IFRS) have changed to recognize prior service costs immediately.

In my opinion, ASC 715 is preferable to IFRS as it more closely aligns with the principles for the cost recovery of pensions and OPEBs by rate regulated utilities.

Cost Recovery Methods in other Jurisdictions

While a few jurisdictions in Canada use a cash basis for the recovery of pension and OPEB costs, in most jurisdictions utilities have applied for and been granted recovery on the basis of accrual accounting using ASC 715. The predominant method used for cost recovery of pensions and benefits in the United States is the accrual accounting method based on ASC 715.

Recommended Cost Recovery Method for Union

Within this context, and in consideration of the discussion above, in my opinion, the costs of pensions and OPEBs for employees of Union should be recognized in rates based on the annual accrual accounting expense used by Union for financial reporting purposes determined using ASC 715. The following provides the rationale for this opinion:

Pension Plans

- The cash basis and funding basis do not allocate pension and benefits costs in a rational and systematic manner to the periods when services are rendered by employees. In particular, the funding regulations under the Ontario PBA result in volatility of contributions, counter to the goal of stability of pension costs.

- Due to the solvency funding rules under the Ontario PBA, the use of a cash or funding basis would lead to the overcharging of the current generation of ratepayers to the benefit of future generations of ratepayers, and the accumulation of a significant pre-paid pension asset, counter to the goal of intergenerational equity.

- Accrual accounting is the only method that allocates the cost of pensions in a rational and systematic manner to the period when services are rendered by employees.

- Under ASC 715, net actuarial gains (losses) and past service credits (costs) are amortized over the Expected Average Remaining Service life (EARSL) of the active employees. In my opinion, this is an appropriate length of time to support the principles of intergenerational equity (i.e., costs are not unreasonably deferred to future ratepayers) and rate stability (costs are not unreasonably allocated to current ratepayers).

- Union Gas already calculates pension costs under ASC 715, so there are no additional expenses associated with determining the appropriate costs to be recognized in rates.

- As the costs of pensions provided to employees of Union have already been recognized under accrual accounting (including ASC 715) for a considerable period of time, no additional expense will be incurred in transitioning to a new method of recognizing costs in rates. Additional expense in transitioning to a new cost recognition method would involve both the expense of calculating different amounts on an ongoing basis and the expense associated with establishing appropriate deferral accounts to reflect differences in past and future cost recognition methods.

Non-Registered Pensions and OPEBs

- All non-registered pensions and OPEBs provided to employees of Union are single employer sponsored plans where all financing risks are assumed by Union.

- There is no tax effective method to pre-fund non-registered pensions and OPEBs.

- Accrual accounting is the only method that allocates the cost of non-registered pensions and OPEBs in a rational and systematic manner to the period when services are rendered by employees.

- Under ASC 715, net actuarial gains (losses) and past service credits (costs) are amortized over the Expected Average Remaining Service life (EARSL) of the active employees. In my opinion, this is an appropriate length of time to support the principles of intergenerational equity (i.e., costs are not unreasonably deferred to future rate payers) and rate stability (costs are not unreasonably allocated to current rate payers).

- As Union as already calculates the costs of non-registered pensions and OPEBs under ASC 715, there are no additional expenses associated with determining the appropriate costs to be recognized in rates.

- As the costs of Union's non-registered pensions and OPEBs have already been recognized under accrual accounting (including ASC 715) for a considerable period of time, no additional expense will be incurred in transitioning to a new method of recognizing costs in rates. Additional expense in transitioning to a new cost recognition method would involve both the expense of calculating different amounts on an ongoing basis and the expense associated with establishing appropriate deferral accounts to reflect differences in past and future cost recognition methods.

Opinion

In my opinion, with respect to the recovery of the costs of pensions and OPEBs provided to employees of Union, the most appropriate method is the accrual accounting basis, as determined under ASC 715.

Yours truly,

Ashley Witts, *M.A., F.I.A., F.C.I.A., F.S.A.*
Senior Consulting Actuary

Appendix - Biography

ASHLEY W. WITTS, M.A., F.I.A., F.C.I.A., F.S.A

Career Profile

Ashley is a senior consulting actuary with more than 30 years' experience in employee benefits and general human resources consulting. He has been employed by Towers Watson since 1990 in positions of increasing responsibility and is currently the Account Director for a number of key client accounts in the Energy, Transportation and Telecommunications industries.

Ashley has specific experience consulting to regulated utilities involved in the transmission and distribution of electricity and natural gas. He has appeared as an expert witness testifying on compensation, pensions, benefits and related investment and accounting matters on behalf of clients in rate hearings before the National Energy Board, the Ontario Energy Board and the Alberta Utilities Commission.

Education & Professional Qualifications

Bachelor of Arts (Mathematics, Honours)	University of Cambridge (U.K.)	1982
Master of Arts	University of Cambridge (U.K.)	1985
Fellow, Institute of Actuaries (U.K.)		1988
Fellow, Canadian Institute of Actuaries		1990
Fellow, Society of Actuaries		1997

Service on Committees of the Canadian Institute of Actuaries:

Committee on Pension Plan Financial Reporting	1998 – 2003
Program Committee	2004 – 2007
Committee for Rules of Professional Conduct	2004 – 2010
Committee on Professional Conduct	2005 – 2010

Employment History

Bacon & Woodrow (London, England)	Consulting Actuary	1982 - 1988
Eckler Partners (Toronto, Ontario)	Consulting Actuary	1988 – 1990
Towers Perrin (Vancouver, B.C.)	Consulting Actuary	1990 – 1996
Towers Perrin (Vancouver, B.C.)	Principal	1996 – 2010
Towers Watson (Vancouver, B.C.)	Account Director	2010 – Now