EB-2015-0040

Ontario Energy Board

IN THE MATTER OF the *Ontario Energy Board Act, 1998*, S.O. 1998, c. 15, Sch. B, as amended;

AND IN THE MATTER OF a consultation by the Board with respect to Pensions and Other Post-Employment Benefits.

Comments

Energy Probe Research Foundation

July 31, 2015

Consultation on the Regulatory Treatment of Pensions and Other Post-Employment Benefit Costs

Comments of Energy Probe Research Foundation

Background

By Letter Dated May 14, 2015 the Board announced its intention to review the regulatory treatment of Pensions and Other Post-Employment Benefits (OPEBS) for the Electricity and Gas Sectors.

The Letter indicates that historically, the OEB has addressed pension and OPEB issues on a case-by-case basis. The objectives of the consultation are to develop standard principles to guide the OEB's review of pension and OPEB costs in the future, to establish specific information requirements for applications that will be incremental to current filing requirements, and to establish appropriate regulatory mechanisms for cost recovery which can be applied consistently across the gas and electricity sectors for rate-regulated entities. In conducting this consultation, the OEB will also take into consideration the Government of Ontario's ongoing review of pensions any actions which arise from that initiative that may overlap with the OEB's consultation.

Introduction

The Ontario Energy Board's ("Board") mission, as stated, is to create a "viable, sustainable and efficient energy sector that serves the public interest and assists consumers to obtain reliable energy services that are cost effective." The growing cost to ratepayers – as a result of defined benefit pensions for employees at some of the province's regulated utilities, particularly in the electricity sector – makes this a perfect place to better align the cost of public sector pension plans to those of the private sector and support the Board's stated mission for a more cost-effective energy sector.

The main concern from ratepayers and the public in general regarding pensions for employees in Ontario's electricity sector relates to the *perception* that these components of compensation are materially higher than in other economic sectors, particularly those in the private sector. This concern arises largely because regulated utilities can recover employer pension contributions through rates and are, therefore, less constrained than private sector employers in transferring pension costs to ratepayers. Secondly, the public largely perceives that employees in regulated industries receive better post-retirement benefits than other pensioners.

The growing cost of pension benefits for employees of regulated utilities and the negative perception ratepayers have of these costs are both critical to this review and any proposed changes to post-retirement benefits that might occur as a result. Any review of pension benefits for employees in the regulated utility sector should consider the "public interest" and ensure benefits are compared not only to a "similar peer group" in the public sector, but also to private businesses.

The Board should also consider others changes to post-retirement benefits being discussed, such as announcements for an Ontario Pension Plan and changes to the Canada Pension Plan. Both the cost and the enhanced benefits that these plans might offer employees should be considered when making changes to pension benefits in the regulated utility sector.

Ultimately, Energy Probe's evidence presented below shows that an increasing number of employers in the private sector are moving towards defined contribution pension plans. Regulated public utilities in Ontario should follow suit.

The Cost of Defined Benefit Pension Plans to Ratepayers

Defined benefit pension plans in Ontario are increasingly out of line even with other public sector employees and are becoming increasingly costly for both ratepayers and taxpayers. According to the "Report on the Sustainability of Electricity Sector Pension Plans to the Minister of Finance"[1] by Jim Leech, pension plans in Ontario's electricity sector are "generous, expensive and inflexible."

"They generally require lower contributions from employees, while providing substantial benefits. Furthermore, electricity sector employers are responsible for a larger share of pension contributions compared to most other public-sector employers," the report said.

While pension costs are an ongoing risk for electricity ratepayers, who are charged for employer contributions through higher rates. Any pension cost not covered through rates – such as a deficit caused by a downturn in capital markets or a change in interest rates – would result in lower net income to the province or municipalities that are the majority owners of these companies. That deficiency must then be covered through special one-time payments on the part of the employer. If that deficiency can't be covered directly by ratepayers it then drains money from the energy sector and results in higher rates charged to ratepayers to ensure electricity infrastructure is maintained to an adequate standard of reliability.

[1] http://www.fin.gov.on.ca/en/pension/electricity-sector.pdf

The report by Jim Leech also noted that many of the electricity sector pension plans are in a precarious position with regard to funding and sustainability.

> *"With employer contributions already at high levels, none of the plans have the ability to absorb further market fluctuations, investment performance significantly below actuarial assumptions or the costs associated with increased longevity of its members," the report said. "Should plans go further into deficit, the sponsors, and ultimately ratepayers, will be required to pay even larger contributions. This exposes the plans to volatility."*

While most public sector defined benefit plans have moved to a 50/50 employer/employee contribution, many of the plans in the electricity remain far more generous to employees.[2]

Table 2: Employer and Employee Contributions

For 2012 (millions)	OPG	H1	IESO	ESA**	Total
Employer Contributions (current service costs) ($)	225M	126.2M	7M	6.5M	364.5M
Employer Contributions (going concern special payments) ($)	65M	36.8M	6.5M	3.4M	111.7M
Employer Contributions (solvency special payments) ($)	n/a	0	2.4M	0	2.4M
Employee Contributions (Current Service Costs)	73M	26.9M	3.6M	2.8M	106.3
Employer/Employee Contribution Ratio (Current Service Cost)	76%/24%	81%/19%*	66%/34%	70%/30%	–

Hydro One provides a good test case for the growing cost of defined benefit pension plans for both ratepayers and taxpayers. Hydro One's pension plan currently has a deficit of $498 million, up from $216 million in 2007 – marking a 130% increase over that time.

Those deficits have come even as the company plans to charge ratepayers as much as $1.64 billion between 2010 and 2019 – both past and forecasted payments – to cover its contributions to employee pensions.[3] A portion of that money charged to ratepayers has been levied to cover special one-time payments that are above and beyond the 72%[4] contribution rate that it has already agreed to pay to cover pension costs. Those payments are intended to mitigate the growing deficiency at the pension plan, but have failed to do so to date.

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[2] The graph comes from the "Report on the Sustainability of Electricity Sector Pension Plans", page 35.
[3] http://business.financialpost.com/fp-comment/much-needed-reforms-could-cut-hydro-one-employees-pensions and pulled from annual reports and rate applications.
[4] This figure is larger than the one in the report by Jim Leech as it comes from Hydro One's most recent rate application.

As the Hydro One case illustrates, defined benefit pension transfers the risk of a pension plan away from employees and over to employers, which in the case of Ontario's electricity sector are largely publicly owned. Ratepayers are then on the hook for these plans, as any costs related to a deficiency can be rolled into rate applications.

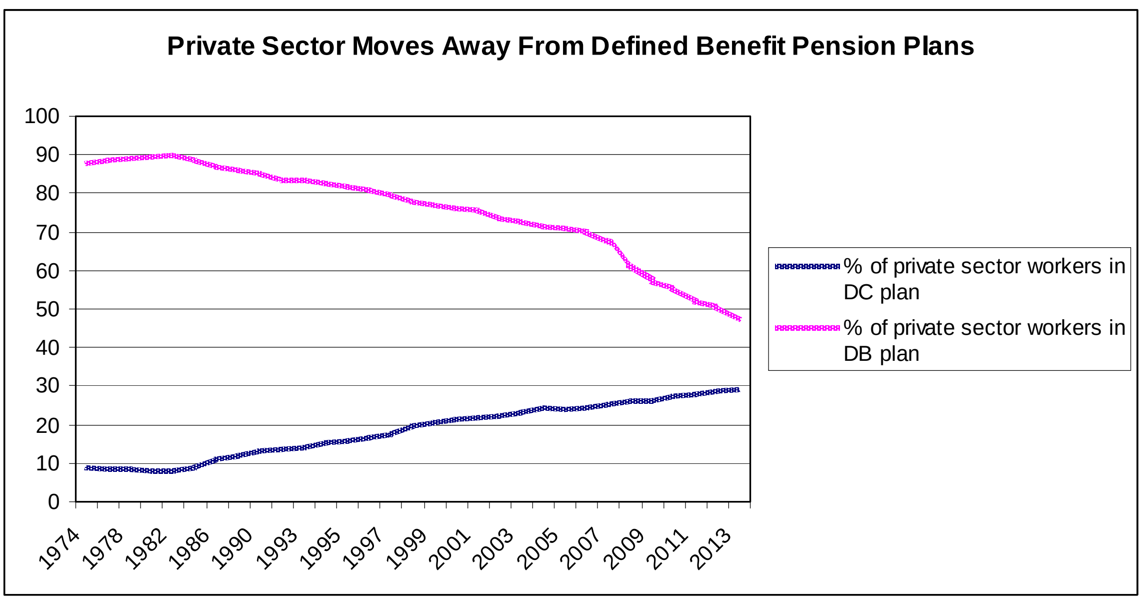
Defined Benefit Plans in the Private Sector Increasingly Becoming a Thing of the Past

The pension situation in Ontario is not unique. Many companies across North America and the United Kingdom have faced – and continue to do so – pension deficits in recent years.

As a result, in Canada, the United States and the UK, an increasing number of private companies have ditched defined benefit pensions in favour of defined contribution pensions.

In Canada, the percentage of Registered Pension Plans (RPP) in the private sector offering *defined benefits* has fallen from 88% in 1974 to 47% in 2013. The percentage of employees in a defined contribution plans has increased from 9% to 29% over the time. As more baby boomers hit retirement age, that trend is expected to continue.[5]

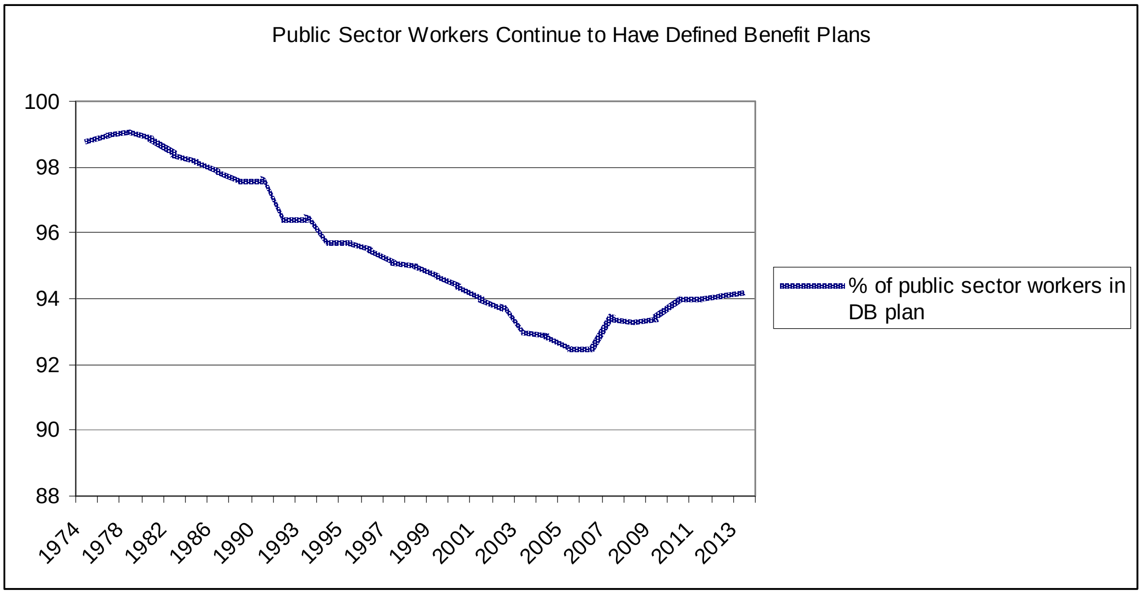
Figure 1



[5] The data and graphs come from Statistics Canada, table 280-0016

The public sector has largely been immune to this change. The percentage of public sector workers in an RPP in Canada that offers defined benefits has largely remained stable, falling from 99% in 1974 to 94% in 2013 – and has been increasing in recent years. Meanwhile, the percentage of public sector workers on a defined contribution pension plan has increased from 1% to 5% over that time.

Figure 2



It's a similar situation in the United States and the United Kingdom, where private sector employers have increasingly moved away from defined benefit to defined contribution pension plans (see Appendix).

In Canada, the United States and the United Kingdom, the trend is clear: defined benefit plans in the private sector are largely becoming a thing of the past. The risk to employers of defined benefit plans is particularly acute in the current low interest rate environment. According to one firm, the number of fully funded defined benefit pension plans fell to 18.5% in 2014 from 26% the previous year – largely as a result of low interest rates.[6]

The growing risk of maintaining defined benefit plans has increasingly led to more companies turning to defined contribution plans to try and mitigate that risk.

[6] http://business.financialpost.com/news/fp-street/low-interest-rates-deal-blow-to-canadian-defined-benefit-pension-plans-in-2014

Wages and Salaries in Electricity Sector Already High

One of the main concerns surrounding pensions in the regulated utility sector is the perception that employees in these sectors already enjoy better benefits than their private sector counterparts, while also receiving above-market wages.

Hydro One Distribution's recent rate application confirms those perceptions.

Hydro One has three major groups of employees in its distribution business: the Power Workers Union (PWU), the Society of Energy Professionals (Society) and Management (MCP). Of those three groups, the PWU and Society account for about 64% of the company's total employees and nearly 67% of all compensation paid out to employees.[7]

The table below details the wage increases for the three groups of employees between 2010 and 2013.[8]

The total wage increase for PWU workers – including overtime and benefits – was 12% over that time. The same figure for Society workers and management was 14.1% and 2.1%, respectively.

The median total income for Ontario households, meanwhile, increased by 6.9% over that period[9].

[7] All information found at EB-2013-0416, Exhibit C1-3-2, Attachment 2, Page 1 of 5
[8] While data is available after 2013, we used this cut-off date as it aligns with the most recent household data from Statistics Canada.
[9] http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/famil108a-eng.htm

	2010	2011	2012	2013	% change (2010 - 2013)
PWU Regular employee (average base wage+overtime and incentive bonus)	$96,438	$102,364	$102,814	$108,739	12.8
SOCIETY Regular employee (average base wage+overtime and incentive bonus)	$95,513	$100,962	$104,403	$108,974	14.1
MCP Regular employee (average base wage+overtime and incentive bonus)	$135,408	$137,009	$137,116	$138,221	2.1
PWU Regular employee (average base wage)	$76,808	$79,645	$81,969	$84,917	10.6
SOCIETY Regular employee (average base wage)	$89,705	$94,776	$98,193	$101,273	12.9
MCP Regular employee (average base wage)	$114,189	$114,721	$114,594	$117,163	2.6
Median total income in Ontario	$71,540	$73,290	$74,890	$76,510	6.9

The Board should consider whether it's equitable to have ratepayers – who consist of both high-income and low-income earners – paying high rates to sustain retirement benefits for employees who already enjoy wages that provide a household income that is above a typical Ontario household.

RECOMMENDATION: Compare public utilities to private sector

Competition among private sector companies creates greater efficiencies and, ultimately, lower costs for consumers. This should be the basis of the Board's ruling on pension costs. The role of any regulator of utility monopolies should be focused on how to design regulation that ensures the competitive instincts – and the cost savings of those instincts – are realized in a monopoly setting.

The best way to realize this in terms of pension benefits for Ontario's electricity distribution companies and employees is to benchmark them to the private sector where efficiencies naturally occur as a result of competition. As our data shows, there has been a growing divergence in Canada between pension plans offered to public sector employees compared to their private sector counterparts. While an increasing number of private companies have turned to defined contribution pensions, most public sector employees continue to participate in defined benefit pension plans.

Ontario’s energy sector is no different.

The reasons why private sector companies have turned to defined contribution pension plans vary, but the underlying result is the same: these plans transfer risk from the employer – in this case a public monopoly – to the employee. Ratepayers benefit as any risk that is transferred from a government-owned monopoly to its employees will result in lower pension costs being added to hydro bills. But employees also benefit, as a defined contribution plan allows them the opportunity to generate higher returns. It’s not possible to predict future returns and so a defined contribution plan allows employees to gauge what kind of risk they prefer – through the types of investments they choose – and enjoy the potential benefits that could occur.

OTHER COMMENTS

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.***

The Statement includes the main principles:

- Consistency across regulated energy sector
- Intergenerational equity
- Financial protection for future ratepayers
- Stable cost levels
- Comparability as measured by other benchmarks

The Transition from Defined Benefit to Defined Contribution Plans (for new employees) may require Legislation and should be implemented across the regulated energy sector.

Another useful exercise would be to establish an inventory/data base on present Pension and OPEB Plans for the Ontario regulated energy sector. Such a data base would include information at a utility level on the type of plans Defined Benefit (e.g. OMERS), and Defined Contribution; plan enrollment and annual employer/employee contributions for both Pension and OPEBs. To facilitate this inventory, the Board with assistance of KPMG, should develop a computer questionnaire to be completed by each utility.

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).

The largest utilities (Hydro One, OPG) have routinely provided compensation benchmarking as part of rebasing applications. Periodically, a subset or separate study of Pensions and OPEBs has been provided. The sample group has included larger Ontario utilities and a sample of other Canadian utilities.

In future, at rebasing, both compensation and pensions and OPEBs benchmarking studies be filed for larger utilities. To save costs this should be done periodically on a generic basis under Board/Staff overview. It is suggested that the Board, with assistance of KPMG, provide a specification for the benchmarking studies, including appropriate profiles of comparison sample type and size. We suggest that *both* energy industry peer group benchmarks *and* a separate external government and private business sample be included using available data bases for the latter sample

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?

Once the new Regulatory Policy Framework is in place the main requirement is to conduct a detailed review as part of Rebasing.

During the IRM Plan term, Reporting under RRRP with compliance checks by the Board Accounting and Compliance Groups.

7. Would it be appropriate to establish a deferral or variance accounts?

The regulatory purpose of Deferral and Variance accounts is to address the uncertainty with forecasts of Pension Plan and OPEBs costs. Currently most forecasts are based on current period Actuarial data including Pension Plan contributors, retirements etc.
The most difficult component to forecast is the financial performance of the plans. History tells us that market volatility is unpredictable.

The account(s) should operate to:

Accommodate *material* changes in the pension Actuarial data and accumulate material changes in pension plan financial performance relative to forecast.

The working assumption is that all utilities will be under some form of Incentive Regulation Plans with only annual reporting for up to five years. All accounts should be symmetrical (no win/lose).

The major consideration regarding how the transition is phased-in is that retrospective ratemaking should be avoided and prospective deferral/variance accounts put in place.

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

The RRRP Guideline should be updated to require reporting on changes to pension plan and OPEBs actuarial data and financial performance.

Respectfully Submitted at Toronto, July 31, 2015.

Energy Probe Research Foundation

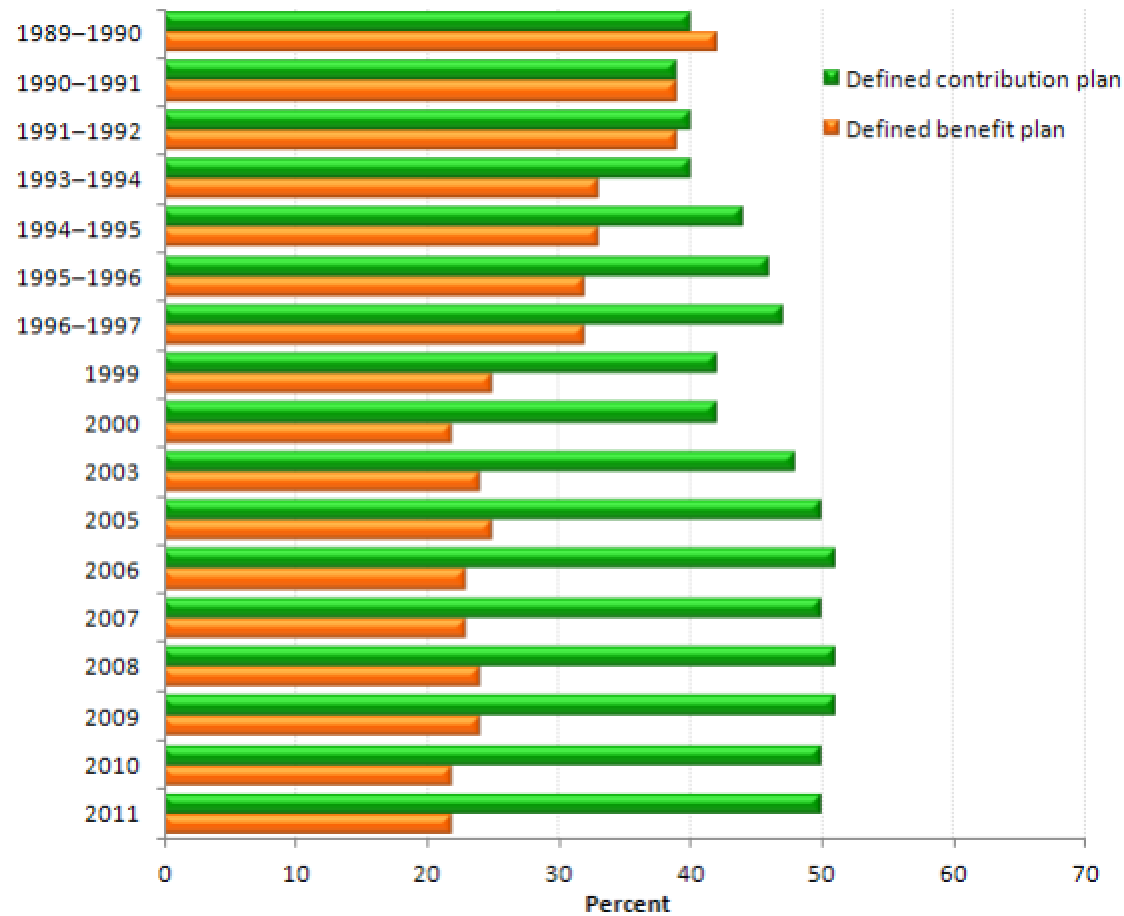
APPENDIX: Pensions in the United States and the UK

According to research from the Bureau of Labour Statistics (BLS), the percentage of full-time, private sector employees in the United States enrolled in a defined benefit plan has fallen from 42% in 1980 to 22% in 2011.[10] That figure, the research suggests, is expected to fall further as 1 in 4 employees in defined benefit plans are in a plan that has imposed a freeze, which typically means it is closed to new workers or has stopped benefit accruals.

In contrast, participation in defined contribution plans for private sector workers has increased from 40% in 1989 to 50% in 2011.

[10] http://www.bls.gov/opub/mlr/cwc/changing-landscape-of-employment-based-retirement-benefits.pdf

Chart 1. Percent of full-time employees participating in defined contribution and defined benefit plans, private industry, 1989–2011



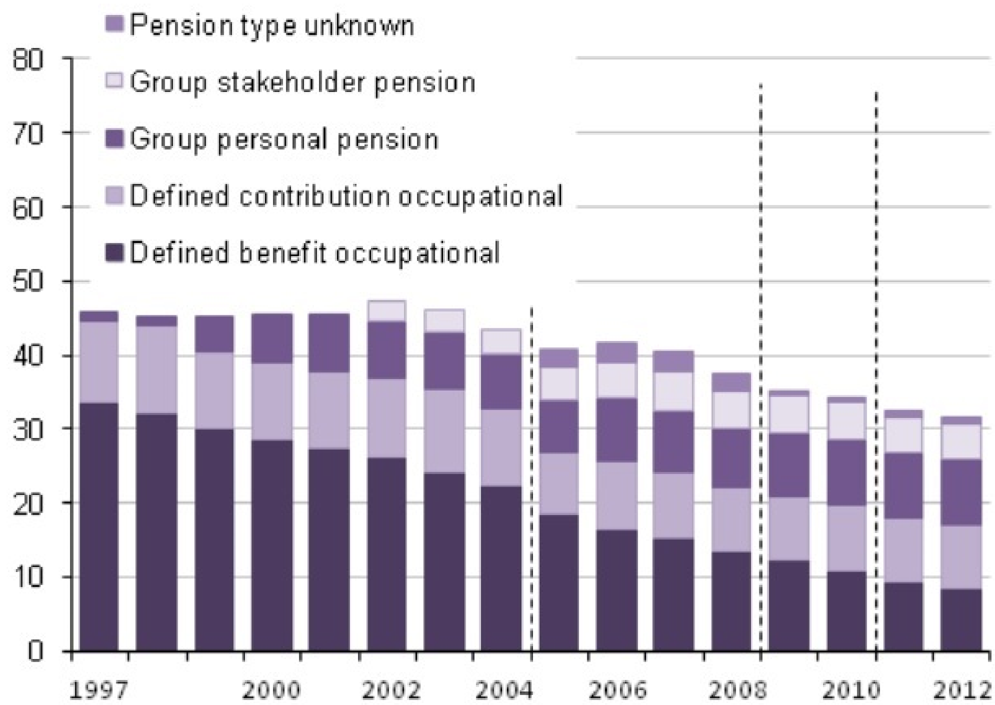
Source: U.S. Bureau of Labor Statistics, National Compensation Survey

In the United Kingdom, it's a similar story. The percentage of private sector workers in a defined benefit pension plans dropped to 8% in 2012 from 34% in 1997. [11]

[11] http://www.ons.gov.uk/ons/dcp171766_314955.pdf

Figure 7.9: Employee membership of a private sector workplace pension: by pension type, 1997 to 2012

United Kingdom, percentages



Source: Annual Survey of Hours and Earnings (ASHE) - Office for National Statistics