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EDA
P&OPEB costs

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EDA
The Voice of Ontario's Electricity Distributors

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Introduction

Objective of OEB Consultation

- Arriving at a most appropriate method for recovering P&OPEB cost for utilities
- Develop a framework and standard principles to help OEB review P&OPEB costs in the future
- Develop additional information requirements to support P&OPEB cost recovery process

Principles of ratemaking

Principles	What does it mean?
Intergenerational equity	• Intergenerational inequity arises when costs incurred in providing service in one period (for one generation of ratepayers) are paid in a different (typically future) period by a different generation of ratepayers. Sound ratemaking avoids intergenerational inequity so that future ratepayers do not experience an unfair burden to the benefit of customers in the current period.
Fairness	• A cost recovery should provide for costs that are "incurred "and any other method would be deemed unfair and inconsistent
Minimize rate volatility	• Rate payers should be protected against rate shocks or volatilities in rates arising from P&OPEB cost recovery • Larger retiring workforce may impose volatility under a cash basis as benefits are paid to retirees for services rendered in previous generation

Overview

Pensions overview

- Largely defined contribution (DC) for LDCs being member of OMERS and as such Pension cost recovery is not an issue
- Essentially OMERs members are on a pay-as-you method with real-time payments based on annual funding contributions
- Cash contributions to OMERS is an appropriate basis of recovery in rates reflective of the actual expense in the period

OPEB overview

- LDCs
  - Unfunded OPEB for most LDCs
  - Accrual method for accounting and rate recovery purposes
  - Currently IFRS is used for both
- Larger Utilities
  - Disparity in practice exists (e.g., accrual with or without use of deferral accounts)
  - Different accounting frameworks (IFRS and U.S. GAAP)

- **EDA is concerned that any variation of cash basis recovery will have significant impact on future generation of rate payers and impact long-term sustainability of OPEB obligations**

OPEB's

What are they?

- Part of an integrated compensation package offered to employees
- A form of deferred compensation
- Provide benefits (e.g., medical, dental) to employees after their retirement (mainly until age 65)
- Obligation settles over a long period
  - For example, Toronto Hydro reports the weighted average duration of their obligation is in excess of 17 years *(Source : Toronto Hydro Annual Financial Statement , 2015)*

OPEB's

What's the objective behind the accounting?

- To record
  - a liability when an employee has provided service in exchange for employee benefits to be paid in the future; and
  - an expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits.
- Over the very long term, accounting expense will equal cash outlay
- Accounting challenge is to achieve an appropriate allocation of the benefits over a very long term for a dynamic and changing obligation

OPEB's

How is the accounting objective achieved?

Components of Accrual Basis of Cost

Service cost

Represents retirement benefits earned by current employees by rendering service in the current period.

Actuarially determined method of allocating the eventual expenditure on the benefits to the periods when the employees provide the services

Interest Cost

Represents annual interest accrued on the opening balance of the obligation.

Effectively the employees have financed the utility by accepting some deferred compensation in exchange for current services

Actuarial gains/losses

Actuarial gains and losses comprise the difference between the retirement payments actually made by an employer and the expected amount.

Due to the long term nature of the obligation, changes in circumstances will require periodic updates to the estimate due to changes in demographic and financial assumptions

Retirement benefits

Some facts

- Retiree benefit plans can be expensive and tend to be richer in the public sector than in the private sector
- Demographic changes mean that more and more retirees continue to draw benefits for longer periods
- Industry and government are looking for strategies to reduce the costs
- But this situation has arisen over a number of years and cannot be resolved in the short term

Ratio of active to retired members

Year	1975	1985	1995	2005	2015
Active	**9.9**	**4.4**	**3.0**	**2.3**	**2.0**
Retired	**1**	**1**	**1**	**1**	**1**

- (Source: OMERS 2015 Annual Report)

Rate setting impacts

Between pay-as-you go and accrual basis, which is most reflective of sound principles for rate setting?

	Pay-as-you go	**Accrual basis**
Intergenerational equity	Current customers are paying for services provided by past generations—no cost causality	Current customers pay the actuarially determined costs for services provided in the period they are provided
Fairness	Future customers are subsidizing compensation decisions made for past generations of workers	Costs are allocated to current customers in a systematic way based on current compensation policies

Rate setting impacts

Between pay-as-you go and accrual basis, which is most reflective of sound principles for rate setting?

	Pay-as-you go	Accrual basis
Volatility	Cash cost of benefits will vary based on random factors, such as health of current retiree group and ad hoc changes in health care costs	Volatility will still result as financial and demographic assumptions change; however, it measured and isolated under the accrual method, allowing for rate setting to react appropriately

Rate setting impacts
Other considerations

Cost/benefit analysis	Reduction in rates from pay-as-you-go basis versus accrual basis are unlikely to be significant when spread over a generation of customers; i.e., reduction in current rates would not be significant enough to justify the administrative cost and the added risk put on future generations
Benchmarking	Ability to benchmark total compensation costs between entities is improved under the accrual basis since it provides information about the full cost of benefits provided
Changes in compensation policy	Changes in compensation policy will be reflected in rates under the accrual basis from the point they are made; under pay-as-you-go, amounts included in rates will continue to be a blend of costs resulting from decades old compensation decisions

Rate setting impacts

Other considerations

Integration with other investing and financing matters	OPEB costs are included not just in OM&A but also in the cost of self constructed PP&E Collection of OPEB costs in rates provides a form of financing to the entity since employees have agreed to accept some of their compensation after retirement; collection on a pay-as-you-go basis will affect debt to equity ratios of many utilities

Set-aside mechanisms

Why not a preferred approach?

Generally not in favor of Set-Aside mechanism, because of the following issues

Impact	Reasons
Restricted funds	• Restricts the use of excess recovery for capital or operating expense • Additional borrowing and higher interest costs • Indirectly adding to revenue recovery not beneficial for rate-payers
Tax/Legal implications	• Additional time and cost required for set up and ongoing administration (e.g., significant for RCA)
Negative Impact on credit rating	• Change in source of funding for capital and operations impacts credit risk and investment profile • Negatively impacts borrowing costs

Analysis of different Set-Aside mechanisms (Source: KPMG Report to OEB)

Internally segregated accounts	Retirement compensation arrangements (RCA)	Excess recoveries reduce rate-base (net method)	Accrual accounting with a regulatory account for excess recoveries
Excess recoveries deposited in a separate bank and/or investment account.	Excess recoveries to be set aside with a separate legal entity e.g., a trust.	Excess recoveries be tracked in a separate regulatory account that is used to reduce rate-base.	Continue with the accrual based accounting practice and excess recoveries to be tracked in a separate regulatory account that would attract interest as specified by OEB.
Pros: 3 **Cons: 7**	**Pros: 2** **Cons: 8**	**Pros: 7** **Cons: 3**	**Pros: 8** **Cons: 2**
Separate Bank or Trust a/c		**Separate regulatory a/c**	

In closing

- OPEB's create accounting and rate setting challenges due to their long term nature
- However, the accrual basis provides a superior platform for rate setting than pay-as-you-go due to
  - The short term focus of pay-as-you-go
  - The fact that future customers will subsidize past generations' compensation decisions for many years to come
  - The small amount of rate reductions that might be achieved in the short term do not outweigh the administrative cost and risk of adopting a pay-as-you-go approach
  - The accrual accounting method provides a more stable and reliable platform for benchmarking and other policy decisions around such matters and compensation and cost of services overall