OEB Public Consultation

KPMG Report on P & OPEB Costs

Alternatives Identified

July 19-20 , 2016

Agenda - Alternatives Identified

1. Pension Plans
2. OPEB Plans
3. Set-Aside Mechanisms
4. Information Requirements

Landscape in Ontario

Type of defined benefit ("DB") plans	Method used by entities for cost recovery	
	Accrual accounting	Cash payments / funding
Registered pension plan ("RPP") (funded)	OPG, IESO, Enbridge Union Gas	Hydro One (funding)
Non-registered pension plans ("SERP") (unfunded)	Majority	A few entities (cash payments)
OPEB plans (non-registered) (unfunded)	Majority	A few entities (cash payments)
Multi-employer pension plan (OMERS)	Majority of LDCs	

What Alternatives were Identified for Pension Plans?

- **Pension plans accounted for as DC plans (including OMERS plan):**
  - Accrual accounting cost values

- **Unregistered pension plans accounted for as DB plans (e.g. SERP):**
  - Accrual accounting cost values; and
  - Amount in OCI is amortized and included in rates based on the expected average remaining service life of the members of the pension plan

- **Registered pension plans accounted for as DB plans:**
  - Modified Funding Contributions ("MFC");
  - Amount in excess of MFC is included in future rates as determined by the OEB; and
  - Amount in excess of MFC is recorded in a separate deferral account and attracts a return

Modified Funding Contributions

- **Modified Funding Contributions (MFC):**
  - The MFC amount represents the minimum amount of contributions 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 PBA, modified by the fact that only an employer's normal cost contribution and going concern special payments using the 15-year amortization period are included in the current period's rates
  - Any other special payments (incl. the solvency special payments) required under the PBA and other additional payments beyond the minimum funding contributions required by the PBA that an employer chooses to make would be recorded in separate deferral accounts, and be recovered in the rates in a future period as determined by the OEB
  - The overall result is that the amount calculated under the MFC method would be less volatile than the amount calculated using the (traditional) funding contribution method

Pros & Cons of Alternatives Identified for Pension Plans?

- **Unregistered pension plans accounted for as DB plans:**
  - Pros:
    - ✓ Most utilities already use accrual accounting cost
    - ✓ The size of these plans is less significant, therefore changing the practice may not result in significant impact on rates
    - ✓ Adopting a possible set-aside mechanism could provide customers with 'value-for-money' on the cash collected in advance of disbursements
    - ✓ Under IFRS, the amounts recorded in OCI are included in rates in a systematic and rational manner
  - Cons:
    - ✓ Differences in accounting framework can be significant
    - ✓ Although this method includes smoothing for recovering the amount recorded in OCI, volatility could still arise as the amount inside the 'corridor' is also being recovered

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Pros & Cons of Alternatives Identified for Pension Plans?

- **Registered pension plans accounted for as DB plans:**
  - Pros:
    - ✓ More understandable as the path from cash costs to amounts included in rates is less complex and easier to explain to stakeholders. No set-aside mechanism for 'excess cash recoveries' is necessary
    - ✓ Differences from the various accounting standards are eliminated as a source of variability, thereby ensuring greater comparability among utilities
    - ✓ Some independent review of the assumptions used by utilities through the reviews conducted by FSCO
    - ✓ Although smoothing would still be retained under US GAAP, this method ensures that all amounts recorded in OCI (including those inside the 'corridor') are being recovered
  - Cons:
    - ✓ Going concern basis includes an element of conservatism. This could bring costs forward in time
    - ✓ Adopting this method could create a significant issue on transition for the affected utilities

Questions on Alternatives for Pension Plans?

What Alternatives were Identified for OPEB Plans?

- **OPEB plans accounted for as DC plans:**
  - Accrual accounting cost values

- **OPEB plans accounted for as DB plans (both funded and unfunded), either:**
  - Accrual accounting cost values and the amount in OCI amortized and included in rates based on the expected average remaining service life of the members of the OPEB plan
  - This method could be supported by a set-aside mechanism

  Or

  - Adjusted 'pay-as-you-go' cash payments

Adjusted 'pay-as-you-go' cash payments

- Under this method, 'pay-as-you-go' cash payments are the starting point (foundation) for determining the amount that is included in rates. However, such 'pay-as-you-go' cash payments are increased by an additional amount that ensures that utilities are able to recover regulatory assets recognized after taking into account the following criteria:
  - Rate order, policy statement or generic order that allows deferral and for the subsequent inclusion of those deferred costs in the entity's rates
  - Period of deferring additional costs not exceeding 5 years
  - Combined deferral-recovery period authorized by OEB not exceeding approximately 20 years
  - No 'back-end loading' of the deferred costs. Recovery on a straight-line basis is permitted
- The amount in OCI would be recovered as part of the additional amount determined by the OEB

Pros & Cons of Alternatives Identified for OPEB Plans?

- **Accrual accounting cost value method:**
  - Pros:
    - ✓ Most utilities already use accrual accounting cost
    - ✓ The size of these plans is less significant compared to pension plans, therefore changing the practice may not result in significant impact on rates
    - ✓ Costs are included in the period that service is provided by the employees, thereby avoiding issues regarding which generation should pay for the costs
    - ✓ Adopting a possible set-aside mechanism could provide customers with 'value-for-money' on the cash collected in advance of disbursements
    - ✓ Under IFRS, the amounts recorded in OCI are included in rates in a systematic and rational manner
  - Cons:
    - ✓ Differences in accounting framework can be significant
    - ✓ Although this method includes smoothing for recovering the amount recorded in OCI, volatility could still arise as the amount inside the 'corridor' is also being recovered

Pros & Cons of Alternatives Identified for OPEB Plans?

- **Adjusted 'pay-as-you-go' cash payments:**
  - Pros:
    - ✓ More understandable as the path from cash costs to amounts included in rates is less complex and easier to explain to stakeholders
    - ✓ Differences from the various accounting standards are eliminated as a source of variability, thereby ensuring greater comparability among utilities
    - ✓ Although smoothing would still be retained under US GAAP, this method ensures that all amounts recorded in OCI (including those inside the 'corridor') are being recovered
    - ✓ As the OEB determines the additional amounts that are included in rates, the need for a set-aside mechanism for 'excess cash recoveries' could be reduced or eliminated
  - Cons:
    - ✓ Adopting this method could create an issue on transition (risk of customers paying twice)
    - ✓ Requires judgment with regards to the recognition requirements for regulatory assets
    - ✓ Requires great care to ensure that OPEB costs are not unjustly shifted to future generations

Questions on Alternatives for OPEB Plans?

Alternatives for Possible Set-Aside Mechanisms?

Possible set-aside mechanisms could be developed in order to provide customers with 'value-for-money' on *the <u>cash that is collected in advance of cash disbursements</u>* being made on OPEB obligations (i.e. excess recoveries). Alternatives identified are:

- Internally segregated accounts;
- Retirement compensation arrangements (e.g. a trust);
- Excess recoveries reduce rate-base; and
- Continue with the current practice, but record any excess recoveries in a tracking account that is monitored by the OEB.
  - The OEB could choose to continue with the practice of using the accrual accounting cost for ratemaking purposes, but also add a new requirement for any excess recoveries to be tracked in a separate regulatory account that would attract interest as specified by the OEB. To aid double entry book-keeping, the excess recoveries would have an 'offsetting mirror account'

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Alternatives for Possible Set-Aside Mechanisms?

	Legend: ✓ = pro; and ✘ = con	Internally segregated accounts	RCA	Excess recoveries reduce rate-base	Current practice with a regulatory account
1	'Value-for-money' on the cash funds provided by customers is clearly demonstrable as the economic benefits accruing to customers are linked with how a utility uses the excess recoveries in its business	✘	✘	✓	✓
2	No significant adverse tax implications i.e. tax-efficient	✓	✘	✓	✓
3	Set-up and ongoing administrative costs are not significant	✓	✘	✓	✓
4	Tax deduction reduces PILs charged to customers	✘	✓	✘	✘
5	Optimizes a utility's available source of funding	✘	✘	✓	✓
6	Avoids changes to the perceived investment and credit risk profile of a utility	✘	✘	✘	✘
7	Maintains the amount of rate-base and the return earned on rate-base at the same amount	✓	✓	✘	✓
8	Avoids a potentially unnecessary conservative measure	✘	✘	✓	✓
9	Avoids inconsistency with the regulatory treatment of other long-term liabilities (excluding nuclear funds)	✘	✘	✓	✓
10	Treats regulated utilities similarly to other non-regulated entities that provide the same benefits (i.e. not required to set-aside cash for non-registered P&OPEB obligations)	✘	✘	✓ although non-regulated businesses do not use a rate base mechanism	✓ although non-regulated businesses do not use regulatory accounts

Questions on Alternatives for Set-Aside Mechanisms?

Information Requirements

- **Based on our review of information filed by larger utilities in Ontario and information requirements (IR) in other jurisdictions, we identified IR that could help to ensure that sufficient information is made available in rate setting proceedings, especially for the larger utilities**
  - In some instances, the IR represent documentation of existing requirements that have not been previously part of the OEB's regulatory requirements
  - In other instances, the IR do result in new regulatory filing and reporting requirements
  - The impact may be significant; especially for smaller utilities

- **This consultation may wish to consider some or all of these IR and whether the IR for LDCs should vary depending on the size of the plan, and whether certain of the information is best addressed through interrogatory questions as part of rate applications**

What Information Requirements were Identified?

For both P&OPEB plans, the KPMG Report identifies IR that introduce increased regulatory filing requirements in rate applications and additional requirements for ongoing monitoring by the OEB

IR are categorized into 6 general stated objectives:

1. P&OPEB costs provide value for money
2. Governance for P&OPEB plans reflects best practices
3. P&OPEB costs (included in rates) include rate-regulated activities only
4. P&OPEB costs are reasonable
5. P&OPEB cost information is reliable
6. P&OPEB costs are recovered over an appropriate time period

Impact of the IR will vary from utility-to-utility

Key Information Requirements

1. **P&OPEB costs provide value for money**
   - Benchmarking study to demonstrate that total compensation costs and compensation strategy are in line with sector practice
   - Justify the excess contribution to a DB RPP over the MFC amount
   - Disclose amount of costs arising from any plan directed to special categories of employees such as SERPs
   - Demonstrate value and impacts of enhancement of benefits
   - Disclose amount of cost arising from any changes made to P&OPEB plans that reference employee services rendered in the past

Benefits offered through P&OPEB plans are a form of deferred compensation and, often, these benefits are an integral part of the overall compensation that is provided to employees. As such, P&OPEB costs should not be viewed in isolation

Key Information Requirements

2. **Governance for P&OPEB plans reflects best practices**
   - A description of the governance framework it employs to govern its P&OPEB plans (both DB and DC plans) and subsequent updates

3. **P&OPEB costs include rate-regulated activities only**
   - How P&OPEB costs have been attributed to rate-regulated activities and non-rate-regulated activities
   - Provide analysis of the attribution of P&OPEB costs to the ongoing regulated enterprise where the structure has changed
   - Disclose the impact of any instance where a group of employees has transferred into or out of a plan and the amount

Key Information Requirements

4. P&OPEB costs are reasonable

- History over the 10 year period preceding a rate rebasing application for
  - Benefit plan changes
  - Breakdown of total compensation cost and P&OPEB costs showing separately 1) amount attributed to capital expenditures and operating expenditures and 2) funded and unfunded plan costs
  - Assumptions used and benchmark to external reference information
- For OMERS plan provide
  - Funded status
  - Steps being taken to address the deficiency or surplus
  - Any actions to be taken by the members to address the deficiency or surplus
  - Changes in contribution rates

Key Information Requirements

5. P&OPEB cost information is reliable

- Impacts regarding transition to a new accounting framework or funding contribution rules that it has undertaken or plans to take in the incentive regulation period. How any such differences are proposed to be dealt with
- Copies of all oversight reports provided to supervisory authorities with respect to any of its pension plans since its last rates rebasing
- Copies of all actuarial studies and reports provided to the utility (excludes studies or reports related to confidential/proposed changes to plans)
  - e.g. potential change to plan or restructuring of organization - report would only be needed after the event has taken place and can be disclosed

Key Information Requirements

6. **P&OPEB costs are recovered over an appropriate time period**
   - Provide the sensitivity of the P&OPEB cost calculation to changes in the key assumptions used in calculating the amounts, including the potential impact on customer rates

Questions on Information Requirements?

Thank you

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