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BY EMAIL and RESS

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Our File No. 20150040

Ontario Energy Board
2300 Yonge Street
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Toronto, Ontario
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Attn: Kirsten Walli, Board Secretary

Dear Ms. Walli:

Re: EB-2015-0040 – Pensions/OPEBs – SEC Submissions

We are counsel for the School Energy Coalition. Pursuant to the Board's letter of August 10, 2016, these are SEC's submissions with respect to rate recovery of utility costs relating to pension and other post-employment benefits. We apologize for filing late, which was due to overseas internet connection issues.

At the stakeholder session on July 19th and 20th, there was extensive discussion of the detailed issues relating to pension and overall accounting. To the extent that the Board needs to get into those detailed issues, we believe that most of the issues have already been canvassed by KPMG and others. These SEC submissions, instead, focus on the higher-level issues that, we believe, go directly to the Board's statutory mandate and evolving rate-making policies.

It is SEC's overall view that, once the Board focuses on its own mandate, many of the detailed issues are either solved, or identified as irrelevant or immaterial in the context of rate regulation. A simpler solution to pension/OPEB costs is available, and appropriate.

Overview – What Is the Question?

At the July stakeholder discussions, and in the submissions that preceded those discussions, a number of detailed issues dominated:

1. ***Plan Type Issues.*** The differences between defined benefit and defined contribution retirement benefit programs.

2. ***Funding Issues.*** The differences between funded and unfunded retirement obligations, including
    a. The impact of funding shortfalls where obligations are supposed to be funded.
    b. The use of rate recoveries based on accrual accounting for unfunded obligations, and proper accounting and rate-making treatment of the accumulated over-collection that can arise.
    c. The financial viability of utilities as unfunded future obligations grow.

3. ***Accounting and Tax Issues.*** Different methods of accounting for pensions and OPEBs, including
    a. Differences between CGAAP, USGAAP, IFRS, and other accounting regimes in the requirements for reporting pension and OPEBs costs and liabilities.
    b. For each accounting regime, the extent to which the accounting costs and liabilities are or can be driven by assumptions or other decisions that are within the purview of management, as opposed to those imposed externally.
    c. For each accounting regime, the effect on the balance sheet and income statement of differences between cash and accrual amounts, and/or between accrual amounts and recoveries in rates.
    d. For at least one utility, OPG, the extent to which it should be treated as a going concern for pension and OPEB purposes.
    e. For each accounting regime, the tax consequences of any differences between amounts recognized for tax purposes and recoveries in rates.

4. ***Volatility Issues.*** The inherent levels of volatility of cash and accrual methods, and the extent to which volatility is affected by
    a. accounting regime,
    b. management assumptions and decisions,
    c. short-term market variations unrelated to pensions and OPEBs (like interest and discount rates), or
    d. longer-term market/demographic trends specifically impacting pensions and OPEBs (like changes in mortality and in retirement patterns).

5. ***Regulatory Issues.*** Regulation of pension and OPEB costs, liabilities and financing by other regulators, including
    a. Pension and OPEB regulation outside of energy that impacts regulated utilities (such as FinSCO), and by implication the extent if any to which the Board is required to accept and/or implement the regulatory decisions and policies of those regulators.
    b. Pension and OPEB regulation by other energy regulators (such as FERC or OFGEM).
    c. Ontario legislative requirements that may limit the Board's discretion (such as OReg53/05 in the case of OPG).

In SEC's view, while these are all useful and important background for the Board, they are not the main questions that the Board needs to address when considering rate recovery of pension and OPEB costs. They all miss the central question: "What is a reasonable level of pension and OPEB costs to include in the rates of regulated utilities that the customers will be required to pay?" This is about quantum, not accounting.

Although things like accounting, and taxes, and funding, are all relevant, those are all driven by rules that take no account of just and reasonable rates, and do not have as any part of their purpose protecting customers:

- ***Accounting rules*** relate to fair and complete disclosure of financial information. They are not designed to protect customers. They are designed to protect investors by giving them consistent and understandable information.

- ***Tax rules*** relate to government revenue generation, and thus are designed to defend against tax leakage, and to ensure that all taxpayers are treated fairly. They are not designed to protect customers. They are designed to protect the fiscal authorities, and the economy as a whole.

- ***Funding rules*** relate to the financial integrity of pension and similar funds. They are also not designed to protect customers. They are designed to protect employees, and indirectly to protect employers.

The entity that has the mandate to protect the customers, in the energy context, is the Ontario Energy Board. That means necessarily that the Board must take a different perspective from the accounting bodies, the tax authorities, and the pension regulators.

What is interesting in this context is that the Board has been moving steadily in the direction of emphasizing objectivity in the assessment of the reasonableness of utility costs and rates. The whole outcomes-based approach is driven by empiricism and objective analysis. It is in essence the Board's answer to utilities' requests for more "light-handed regulation". In the outcomes-based approach, the Board does not have to delve into every dime that a utility plans to spend. In the perfect scenario, a utility that gets to the objectively-determined "right answer" has their rates approved on that basis, without the need to look all that closely under the hood.

Of course, the devil is in the details, and the Board is not at this perfect situation yet. However, it is still the Board's chosen policy direction, the foundation of the RRFE and the Board's regulatory philosophy generally.

Against this background, the utilities in the July stakeholder discussion consistently took an in-the-weeds, detailed approach to rate recovery for pensions and OPEBs. In every case, without exception, the starting point was the various ways that the pension and OPEBs costs of the utilities could be accounted for and calculated. From their point of view, once you get the accounting and calculations right (in some consistent way), the rates naturally flow from that result. There was no acceptance of a reasonable level of pension and OPEB costs, and in fact the utilities consistently reject the notion of benchmarking of those costs. To their minds, every utility is unique, and you can't compare them. (This same resistance to objective comparisons is seen in many aspects of the RRFE, and OEB regulation generally.)

What is most striking about this is that pension and OPEB costs are one area in which benchmarking and inter-company comparisons are already widely used, including by the very companies that argue against benchmarking. Union contracts are negotiated based on benchmarking costs such as pensions and OPEBs to a peer group. Labour arbitration is based almost entirely on benchmarking in its many variations. Non-union salary and wage levels, and in particular benefit plans, are established by reference to what is on offer by other companies competing for the same people. In the case of senior management, HR committees routinely require compensation studies to ensure that the various components of executive compensation are comparable to the utility's peers.

In short, the components of compensation, including in particular pensions and OPEBs, are among the most routinely benchmarked costs of the utilities regulated by the Board. In resisting benchmarking in the context of rate regulation, the utilities are not in fact saying that benchmarking is a bad idea. They do it themselves. What they are saying is that they don't want empirical comparisons to affect their rates.

In SEC's submission, the question of rate recovery of pension and OPEB costs must start with the question of just and reasonable rates. It must therefore start with the reasonableness of the level of spending, before any accounting and other complications are thrown into the mix. The focus is, and must remain, on the rates. There are other regulators to ensure that the accounting and funding are done properly. That is not the Board's primary concern.

The Allowance for Retirement Obligations

SEC therefore proposes that the Board establish an allowance for retirement obligations, which is the amount to be included in rates for all pension and OPEB costs and liabilities of a utility. Like the working capital allowance, this would be a formula (likely a predetermined percentage of gross cash compensation) applied as a matter of policy to all utilities in the ratemaking process. It would replace all actual pension and OPEB costs and liabilities, both capital and operating, and would be allocated to capital and operating costs in the same proportions as gross cash compensation (like an overhead uplift). It would be an absolute amount, not a timing difference. No deferral or variance accounts would be required.

The analogy is the working capital allowance, although return on equity is another policy-based rate component that has some similarities. SEC proposes that the Board engage specialists to study the predictable percentage of cash compensation that companies similar to regulated utilities spend on pension and OPEB costs. Details of the study may well be contentious, but we would expect that it would include utilities in both Canada and the US, and larger competitive companies (to bring in the effects of market pricing as a control over pension and other compensation costs). It may also include information from compensation specialists, who regularly develop "benefits as a percentage of compensation" benchmarks to use in union and other negotiations.

A good starting point for such a study would be the municipally-owned LDCs, since virtually all are OMERs participants, and so will have a narrower band of pension and OPEBs costs. However, the study should also include investor-owned utilities, like Enbridge and Union and CNPI and Great Lakes, and provincially-owned utilities like OPG and Hydro One. It should also probably go outside Ontario, to other Canadian and US utilities. In addition, pension and OPEBs costs at other large companies, both in Ontario and elsewhere, will show patterns of spending that are regulated by market forces, rather than by rate regulation. This provides a useful context for the retirement-related spending of utilities.

Another reason the working capital allowance is a good example is that, like any policy, it is subject to exception based on evidence showing that a different answer is more appropriate for a given utility. In the case of WCA, the accepted approach is a lead-lag study, which shows that the working capital needs of a particular utility are in fact different from the norm established by the Board. If those needs can be demonstrated to be the result of exogenous factors (e.g. a higher percentage in the franchise area of businesses with financial challenges, and therefore payment delays), a different WCA is ordered.

So, here, each utility competes for talent using a particular compensation mix. If they are overweight on pension and OPEB costs, it is open to the utility to demonstrate that their more attractive retirement compensation policies result in a recruitment advantage, and that as a result the outcome to ratepayers (for example, through better reliability or customer service, or reduced gross salary and wage costs) is improved. Because of this, including 9% in rates for pension and OPEBs, instead of the 8% mandated by the policies, is in the interests of the customers of that utility.

In reality, most utilities would be above or below the standard level, and would not have a specific justification for that result. This operates much like a market price for a company's goods operates.

If a company has pension and OPEB costs that exceed the norm – as may be the case for OPG and some others, for example – then they can either bring those costs into line with industry standards over time, or elect to let those costs eat into ROE. What they can't do is ask customers to pay for costs that are above an empirically determined standard, without, as described above, showing that the ratepayers are benefitting from that higher spending.

Conversely, if a company has pension and OPEB costs that are lower than the norm, they have a choice of taking that signal to improve their benefits package for employees, or they can simply keep the extra money. If they choose the latter, though, they would expect to see resistance from employees, on the one hand, and on the other hand tighter scrutiny from customers concerned that undercompensated employees may produce less attractive outcomes – such as reliability and customer service – for customers.

As with all benchmarking, the likely result is to move the outliers towards the norm, and over time to narrow the band of actual levels of pension and OPEB spending. This is, in fact, what the competitive markets do as well, so in achieving this result the Board would be implementing its traditional role as a market proxy.

The default working capital allowance, and the standard return on equity, both have as one of their purposes and results a simplification of the regulatory process. We no longer have to reinvent the WCA or ROE in every proceeding. We spend less time on lead-lag studies, and less time on CAPM and betas. Utilities and customers accept that there is a norm for WCA and for ROE, and for 90% or more of utilities the norm is appropriate. If there is a concern, it is about the norm, and is dealt with in a more generic way.

So, too, the Board has in recent years had to reinvent the pension and OPEB wheel in one proceeding after another. A standard allowance for retirement obligations (ROA) would remove that complicating factor for most rate-making proceedings, and produce an improvement in regulatory efficiency (in addition to the greater quality resulting from the empirical analysis in the first place).

Utilities will, of course, argue that by setting a standard the Board would be allowing them to recover in rates an amount different from their cash or accounting costs. This is, of course, the same as many other aspects of revenue requirement that are different from their accounting costs: debt costs (based on deemed debt levels and often deemed interest rates), net profits (based on deemed equity thickness and a deemed ROE), working capital allowance (basically an add-on that is ultimately reflected in accounting interest costs), and others. Further, since even cost of service rate-making is on a forward forecast basis, and utilities do not have to spend in accordance with forecast, actual utility costs are never the basis of rates, and that is even more pronounced in IRM years. Rates are not currently based on recovery of actual costs. They are based on recovery of an allowance for the reasonable costs to deliver the regulated service.

Finally, the other necessary implication of this approach is that the Board declines to micromanage the utilities on pensions and OPEBs. Once the Board gets into the weeds on accounting, tax and funding issues, it is in our submission starting to tread on the turf of other regulators, and/or the prerogatives of utility management and owners. Sometimes that is necessary in the pursuit of the Board's mandate. It is not necessary here.

In this case, the Board can focus on its core mandate – which, in this context, is rates – by ensuring that the amount included in rates is reasonable. That can be determined empirically, through a thorough benchmarking study. This area is uniquely suited to establishing a reasonable benchmark, since that is done so often outside of the regulatory process. Once the benchmark is established, and a default value created, only a few of the implications of that will concern the Board. Most of the implications, while contextually relevant, are either no longer problems, or are not problems for the Board to solve.

By way of example, volatility is a big issue, but with an ROA the only volatility would be based on volatility of gross salary and wage costs. That is likely to be a very low level of volatility. Similarly, tax issues have been raised as a concern. When an ROA is used, the tax issues are timing differences, almost identical to the difference between depreciation and capital cost allowance. The Board deals with this by forecasting actual tax payable, rather than simply assuming taxable income is the same as ROE. ROA would be handled the same way.

Other Issues

This leaves two other issues that have been raised in the July discussion and submissions.

Cumulative Overpayments of Pension/OPEBs in Rates. The first issue is what to do in the situation in which the utility collects in rates an amount to cover an unfunded future liability? Some want to require that the amount be set aside in a fund. Others want to give the ratepayers a return on that payment, since the payment is in effect a prepayment of a future utility obligation.

The problem with requiring that the funding be set aside is that the Board is not in the business of regulating utilities' future obligations. If there is a need to have OPEBs money set aside in a fund, or more pension money set aside than the cash payments currently being made, that is for others to regulate. It is, in SEC's view, not appropriate, and not really practical, for the Board to move into the business of regulating the funding of utility future obligations. If it does so, then it will have to look at pensions as well as OPEBs, and it will have to develop an actuarial and other expertise that is not really necessary.

In any case, the allowance for retirement obligations approach SEC is proposing greatly limits the funding issue. If a total allowance for all retirement obligations is established, there will be no specific amount identified for pensions, vs. OPEBs. Thus, any calculation of underfunding would have to be made on a comparison of the total amount included in rates, less the total cash component of the amount expensed (or capitalized in the cost of assets) for pension and OPEBs, to get any net excess of rate recovery over payments. Once you put pensions and OPEBs together, it would not always be true that rate recovery would exceed total cash payments.

The only component of the pre-funding issue that remains problematic is that, in some cases, the utility still will collect more than it pays out in costs, and do so on a consistent basis. If these cumulative prepayments became material, this would be unfair to ratepayers. Ratepayers would be providing utilities with access to additional capital, over and above the additional capital already being provided in the working capital allowance. On the other hand, the solution to this is relatively straightforward. If this cumulative figure gets above a materiality threshold, it can be adjusted through a change to the working capital allowance formula. This change would deduct from the working capital allowance the different between x% (the ROA amount) of total compensation, and the pension and OPEBs cash payments for the year. In effect, the utility has this excess as free capital, and needs an equally lower amount of working capital as a result.

Special Rules for Ontario Power Generation. The second issue is the strange case of OPG.

At the July stakeholder discussion, OPG argued that under OReg53/05, the Board is required to allow OPG to flow through whatever pension and OPEBs costs they book for accounting purposes. Further, OPG went on to imply (but perhaps not actually say outright) that there is a good reason for this requirement: OPG has assets with a finite life, and therefore it cannot be treated as a going concern in the normal sense. There is no guarantee it will continue to be able to fund pension and OPEB liabilities for past employees out of current income.

With respect to the claim of a "pass-through entitlement", as it were, we note:

- OReg53/05 does not mandate accrual accounting – or indeed any specific accounting method - for pension and OPEB costs. While there are certain circumstances in which past costs approved by the OPG board of directors have to be accepted by the Board, this is not one of those circumstances. To interpret OReg53/05 otherwise would be to eviscerate the Board's regulatory function in setting the payment amounts. The Board has discretion under the OEB Act to establish rates in any reasonable manner, and that does not require the inclusion of any specific costs in rates. The LG in Council can, of course, regulate to that effect, but it must do so explicitly, and it has not done so here.

- The thought that OPG might not be a going concern is not an unreasonable one. However, if that were actually the case, there are a lot of other things that have to change at OPG, not the least of which is their financial statements. As of today, OPG remains a going concern, which by definition means that in its accounting it plans to be carrying on business indefinitely. If and when it files audited financial statements that are not on a going concern basis, it may make sense for the Board to consider at that time whether certain of the Board's generally-applicable policies should no longer apply to OPG, including how pension and OPEB costs are recovered in rates. That time has not yet come.

- This is not the first time that OPG has sought a way to attack or limit the Board's authority over OPG's compensation amounts or policies. In the past, those challenges have failed, including notably in a recent case before the Supreme Court of Canada. This reflects a sensible reality. If the Board is not allowed to apply a reasonableness test to OPG compensation, the largest part of its costs, then it cannot regulate OPG effectively. Whether that power is upheld by the courts, or it is reinforced by the government, the Board must have that power to fulfill its mandate. OPG's attempts to limit that power are, in our submission, doomed to failure.

Conclusion

SEC suggested at the July discussion, and continues to believe, that the Board should undertake independent compensation studies to determine the appropriate levels of compensation – and components of compensation – for Ontario utilities. Depending on the outcome of those studies, they could form the basis for compensation envelopes that guide the amount of human resources costs included in rates. In our view, this is consistent with the direction the Board is taking in rate-making generally, including the RRFE.

We accept that this is a major step, and the Board may not be ready to take that step. That having been said, establishing a benchmarked standard for pension and OPEBs costs is inherently a much easier step. It is something that is done regularly by specialists, and by regulated utilities, and there is ample information available to allow the Board to move in this direction. It would also give the Board more experience in benchmarking compensation, so that later if the Board wishes to benchmark the entire compensation envelope, it will be better positioned to do so.

SEC therefore recommends that the Board establish an allowance for retirement obligations (ROA), being a percentage of gross salary and wages that is considered to be the appropriate cost to be included in rates for the pension and OPEB costs of all regulated utilities. Like all default values, it would be subject to direct evidence led by any party that different costs are appropriate, i.e. that, instead of the ROA, higher or lower costs would produce positive outcomes for customers.

All of which is respectfully submitted.

Yours very truly,
JAY SHEPHERD P. C.

Jay Shepherd

cc: Wayne McNally, SEC (email)
Interested Parties