ONTARIO POWER GENERATION

Internal Audit

20-12 Compensation Audit

November 3, 2020

Report Rating: **Requires Improvement**

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1.0 EXECUTIVE SUMMARY

1.1 Report Rating and Summary of Findings

Report Rating: **Requires Improvement**

No.	Finding	Risk Type	Risk Rating[1]		
			High	Moderate	Low
1	HR guidelines and tools need to be modified to better support Line Management's compensation decisions.	Operational		X	
2	Instances were noted where merit increases were not sufficiently justified.	Operational		X	
3	Instances were noted where promotional increases were not sufficiently justified.	Operational		X	
Total		**3**		**3**	

1.2 Background

The Compensation & Benefits department within Human Resources ("HR") is responsible for establishing management compensation programs, providing guidance and performing monitoring activities to ensure that these programs are implemented in a consistent manner. The Compensation Leadership and Governance Committee ("CLGC") is the Board Committee that oversees HR and Compensation policies.

OPG's management compensation programs include both fixed and pay for performance components. The design of the programs is guided by OPG's compensation philosophy, which aims to align compensation with market median while supporting the attraction and retention of top talent, reinforce a performance related culture and encourage long-term employment and talent development. They are also governed by various Provincial legislations.

This was a risk-based audit identified in Internal Audit's ("IA's") Audit Plan.

1.3 Objective & Scope

The objective of this audit was to assess whether controls and processes were designed and operating effectively to provide reasonable assurance that compensation associated with management group employees was managed economically and efficiently, and in accordance with internal frameworks and external regulations and legislations.

In order to achieve the audit objective, we reviewed the process and tested whether:

- Appropriate guidelines and processes were in place and effectively applied to manage and monitor compensation costs, trends and outliers. Areas of focus for the audit included:
  - Compensation trend over the scope period;
  - Compensation trend in comparison with staffing levels;
  - Base salary assignments to new hires and subsequent changes; and
  - Pay-for-performance incentive.
- Significant changes to compensation processes and guidelines, if any, were subject to management assessment to ensure that key risks were addressed by the new processes and guidelines;

[1] Please refer to Appendix A for risk rating definitions

- Adequate reporting was in place to enable oversight by senior management and the Board of Directors; and

- Applicable compensation-related governance and requirements were complied with.

As part of our standard audit program, we also assessed fraud risks and potential opportunities for efficiencies within the audited processes.

Scope Exclusion: this audit focused on direct compensation of management group employees. Indirect compensation such as pension and health, dental and group life insurance benefits were not in scope.

Scope Period: the scope included activities from January 1, 2017 to December 31, 2019 to enable data analysis. For the high-level analysis of gender-based wage comparison, May 2020 data was used.

1.4 Conclusion

OPG's management compensation is governed by Board-approved compensation structure and budgets, subject to legislative constraints. Our audit indicated that the organization has controlled the aggregate direct compensation costs for management group employees, evidenced through budget adherence.

While management compensation costs are managed economically and within the confines of the legislative requirements at the company-level, our review identified some findings in the areas of governance and the application of promotional and merit increase programs at the employee-level. Key observations and findings are summarized below.

Positive Observations

- HR Management are well informed of the changes to compensation regulations and responded to these changes in a timely manner. For example, none of the executives had received a merit increase since the *Ontario Regulation 304/16 Executive Compensation Framework* came into effect on August 13, 2018, which imposed a freeze on the base salary for executives;

- HR management had established strong system and monitoring controls to ensure budget adherence. Our audit confirmed that the overall merit and incentive pay budgets, approved by the Board of Directors, were adhered to in each year within the scope period;

- OPG's internal compensation guidelines indicate that no salary increase should be offered for lateral staff movements. Management complied with this expectation, with exceptions comprising less than 1.5% of all lateral movements within the scope period. Further, based on results from sample testing, these exceptions were found to be adequately approved and supported by reasonable rationales; and

- OPG's internal compensation guidelines require that salary increase greater than 10% for promotions be independently reviewed and approved by the Compensation and Benefits team. Our audit noticed a high compliance rate, with only one instance noted from our sample testing where the independent approval was missed.

Findings and Recommendations

- HR Management indicated that the direction is to move away from a prescriptive to a more discretionary model, where Line Management may exercise more discretion when applying compensation-related guidelines, provided that the approved budget envelope and pay ranges are not exceeded. The move towards a more discretionary model aligns with the ONEOPG culture shift, which promotes efficiency and good judgement. To support the discretionary model, HR compensation guidelines and tools need to be modified to provide more clarity with specifics / examples (e.g. acceptable justifications to exceptions) to guide Line Management with their decisions and documentation. IA noted 47 cases where the documentation was insufficient to support the promotional or merit increase decisions;

- The 2019 merit guideline provides an overall range of increase between 0.0% and 4.5% for Line Management's consideration, based on an individual's performance rating and placement on band. IA noted 9 cases where an employee had received a merit increase of at least 8.0% or more. In addition, while 373 out of 946 (39%) eligible employees received merit increases greater than the merit guideline, the overall budget allotted for merit was not exceeded. This demonstrates that the merit guideline was not calibrated properly to fully utilize the modest budget that was set aside. Management should set a cap for individual merit increases, recalibrate the merit guideline to better align with budget and consider establishing different exception thresholds to allow HR and Line Management to focus their due diligence efforts in larger variances; and

- Non-standard promotions involving salary increases greater than 10% were 8% of all promotions in 2017, 10% in 2018 and 14% in 2019. In 2019, we noted a higher number of senior executive appointments brought about with the change in CEO that year. Over the 3-year period, seven cases were noted where the greater than 10% increase had placed an employee's base salary towards the upper end of the new band, with two at or very close to band maximum. Two cases were noted where the employees had received successive promotions, which resulted in base salary increase of greater than 20% within six months. HR Management should strengthen the justification requirements to include supporting evidence (e.g. comparison against the external market for similar positions, comparison against peers within the organization) and exercise due diligence over multiple salary increases within short timeframes.

The findings noted in this report have been reviewed with management and they have committed to specific action plans. Please refer to Section 2.0 for specific details of the above findings along with the associated risk impact, audit recommendation and management action plan.

Opportunity for Improvement

While we performed a high-level analysis of the base salaries of management group employees and noticed some anomalies in pay between male and female employees, there could be numerous drivers leading to the differences other than gender (e.g. years of service and experience of employees, uneven gender representation in certain roles / industry segments).

Management may wish to consider engaging an external subject matter expert to assess if gender-based wage gaps do indeed exist in the organization and develop plans to narrow the gaps as necessary. Other minority groups may also be included in the analysis.

2.0 DETAILED AUDIT FINDINGS

Internal Audit identified the following detailed findings which have been risk rated based on the definitions outlined in Appendix A.

1. HR guidelines and tools need to be modified to better support Line Management's compensation decisions.	Moderate

HR's Compensation and Benefits team develops various guidelines and tools to provide the framework for compensation decisions. These guidelines and tools are available to Line Management, or used internally by HR professionals who provide advice and support to Line Management. Among the various guidelines and tools are the Compensation Guidelines for Management Group Offer Letters (the "Compensation Guidelines"), the Merit Job Aids / Videos / Frequently Asked Questions ("FAQs") and the Merit Matrix. The following were noted with respect to these guidelines and tools:

- The Compensation Guidelines identify compa-ratio[2] as a consideration in determining the appropriate size of increases for job changes, and indicate that a "compa-ratio of 100% (midpoint) represents the targeted level of pay for a fully competent, seasoned performer." The Compensation Guidelines have not identified other consideration factors to assist Line Management in determining promotional increases;

- Internal non-standard offers require business justification and exception approval. Of the 32 non-standard offers granted, IA sampled ten offers (from 2017 to 2019) and found two instances where the business rationale was insufficiently documented. In each of these cases, the rationale was increased scope of work, which should apply to all promotions. Without additional context, the rationale was insufficient to justify the non-standard size of increase (i.e. greater than 10%);

- The Merit Matrix sets forth merit increase guidelines based on an individual's performance rating (scale of "1" to "5"[3]) and placement on band ("Low", "Middle" and "High"). Increments within the "5x3" Merit Matrix are small, with the overall range of increase between 0.0% and 5.0% for 2018, and 0.0% and 4.5% for 2019. In 2018, 222 out of 969 (23%) eligible employees were assigned with increases greater than the Merit Matrix. In 2019, the number had increased to 373 out of 946 (39%). Although Line Management are authorized and encouraged to apply discretion when forming merit recommendations, recommendations in excess of the Merit Matrix are considered "exceptions to guidelines" requiring documented rationale. This resulted in a significant number of "exceptions" and documentation, as even small variances would require documented rationale;

- The Merit Job Aids / Videos / FAQs describe merit as an annual opportunity to increase base salary to reflect employee performance, skills, capabilities and contribution over time. As informed by HR Management, it is considered acceptable for Line Management to factor in the following when making merit increase decisions: pay relativity to subordinates and peers; retention / flight risk; employee's potential; and external competition for talent. These additional factors are not described in the Merit Job Aids / Videos / FAQs for R1 Managers' consideration when providing their initial merit recommendations;

- There were 373 cases where merit increases were greater than the Merit Matrix for 2019, and it was noted that at least 45 of these 373 cases did not have sufficient information to explain the size of increase. For example:

[2] Compa-ratio is a compensation metric that compares an employee's salary to the midpoint of the salary range of the position. In other words, it identifies where along the pay band the employee is placed relative to midpoint.
[3] OPG has a five-tier performance rating system as follows: 1 – does not meet expectations; 2 - meets most expectations; 3 - fully meets all expectations; 4 – exceeds some expectations; 5 – exceeds all expectations.

- Management comment indicated "CNO Adjustment." Rationale for the adjustment was not documented; and

- Management comment indicated that "employee's performance warrants merit increase," when the performance score for the employee was "2 out of 5."

Potential Cause & Impact

Potential Causes:

- Broader guidelines were maintained to provide Line Management with latitude to exercise discretion, provided that the approved budget envelope and pay ranges were not exceeded;
- A Merit Matrix with narrow increments was used to provide a conservative baseline for Line Management to base discretions on; and
- The Merit Matrix was not well calibrated, resulting in significant number of deviations from the matrix although overall budgetary threshold was not exceeded.

Impact:

- In the absence of clearer guidelines (e.g. clarity of consideration factors), Line Management's compensation decisions may lack transparency and not supported by adequate documentation; and
- While the Merit Matrix is a guideline, the requirement to explain all variances from the matrix may give a perception that a significant number of exceptions were taken, which is not good management practice in an effectively controlled environment. The low threshold also creates documentation burden (with respect to insignificant variances) and takes focus away from items that deserve the attention.

Recommendation

HR Management should:

- Improve upon the existing guidelines to provide better clarity. For instance, the guidelines should identify factors to consider when determining promotional and merit increases, and provide examples of justifications for exceptions in order to help Line Management apply the guidelines and improve on documentation; and
- Recalibrate the Merit Matrix to better align with budget and emphasize it is a guideline. Consider establishing different exception thresholds to allow HR and Line Management to focus their due diligence efforts in larger variances.

Management Action Plan

HR Management will build upon existing guidance to managers to include other relevant considerations and justifications in addition to performance ratings and compa-ratio.

Given that existing controls effectively manage the overall approved merit budget, and the generally conservative nature of OPG's merit budget compared to external market, HR Management will calibrate the merit matrix guidelines in order to address and establish threshold merit guidelines that limit documentation requirements to more significant merit increases than those observed in 2017-2019. HR Management will continue to calibrate the merit matrix to reasonable limits, considering industry relevant compensation practices, to allow for an appropriate level of management discretion, while requiring documented rationale for merit increases higher than guideline.

Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources

Target completion date: March 31, 2021 (for merit increases effective January 1, 2021)

2. Instances were noted where the merit increases were not sufficiently justified.	Moderate

OPG management group employees have an annual opportunity to receive base salary increase through the regular merit cycle. OPG executives are not entitled to receive merit increases. The company's annual merit increase is capped by the Board-approved budget. The merit increase system (i.e. MyPower) includes hard stops that prevent Line Management from granting increases that exceed the budget, or exceed the salary band cap at the individual employee level.

IA examined merit increases over the 2-year period from January 1, 2018 to December 31, 2019[4]. Although the aggregate increase was within the Board-approved budget for each year, when IA reviewed the 2019 merit increases at the individual employee level, there were some which warrant additional attention by management. These are outlined below:

- 373 out of 946 (39%) eligible employees received increases greater than the Merit Matrix guidelines. In majority of the cases, the percentage of increase assigned to these individuals was modest (i.e. 258 of the 373 (69%) received an increase of 3.50% or less, compared to the maximum of 4.5% set by the Merit Matrix guidelines). However, nine employees received an increase between 8% and 10%. Of these nine employees, one of them had received greater than 8% merit increase for two consecutive years. While all these individuals were sitting on the lower end of the compa-ratio, the size of the increase was equivalent to standard promotions; and

- Five out of 13 employees who were promoted on or after November 1, 2019 received merit increases. As per the Merit Form FAQs, employees who received a base salary change after November 1st are not eligible for an additional merit increase. Except for one case where the merit restriction was explicitly waived in the employee's offer letter, the other four cases were not supported by documented and approved exemptions.

Potential Cause & Impact

Potential Causes:
In an effort to retain talent and/or to address pay relativity issues, Line Management might award greater increases to high potential employees where permitted by budget.

Impact:
Merit increase decisions may not drive a "pay for performance" culture or impact employees' morale given the very public nature of OPG employees' compensation.

Recommendation

HR Management should:
- Set a cap for maximum merit increase at the employee level that to prevent excessive increases;
- Monitor merit increases against established parameters to ensure that higher risk decisions are flagged for additional review. Higher risk decisions may include increases exceeding a defined percentage and awards to individuals who have not fully met performance objectives for more than one performance year; and
- Ensure the "post November 1" restriction is adhered to.

[4] In 2018, a new merit increase system was implemented with enhanced control features compared to the previous system. As such, IA had excluded 2017 from our merit increase analysis.

Management Action Plan
1. Human Resources will continue to evaluate salary surveys annually and make recommendations to the Board on merit budget accordingly. The last annual survey was completed and recommendations will be made to the Board in the November 2020 meeting. Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources Target completion date: November 30, 2020 2. As a further control to the merit budget and merit matrix guideline, HR Management will consider the appropriate maximum to merit increases. HR management will establish enhanced review to prevent excessive increases. HR Management will review the top 5% of merit increases to ensure appropriate rationale is documented. Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources Target completion date: March 31, 2021 3. Given that the November 1st rule is to limit administrative burden during year end processes, HR Management will review requests for exceptions to November 1 rule and ensure documentation includes rationale. Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources Target completion date: March 31, 2021

3. Instances were noted where promotional increases were not sufficiently justified.	**Moderate**

The Compensation Guidelines identify promotions resulting in a salary increase greater than 10% as non-standard, which requires exception approval from Compensation and Benefits.

IA analyzed promotion-related salary changes over the 3-year period from January 1, 2017 to December 31, 2019 and noted the following:

- Non-standard salary increases greater than 10% occurred in 8% of all promotions in 2017 (7 out of 92), 10% in 2018 (8 out of 80) and 14% in 2019 (14 out of 100). HR Management indicated that the higher percentage in 2019 might be attributable to the significant reorganization activities across the organization, including several new executive team appointments in the year. It should be noted that promoted individuals' new salaries did not exceed those of their predecessors;

- Seven instances were noted where a salary increase greater than 10%, ranging from 13% to 24%, had placed the employee above the salary midpoint. Two of them were placed at or very close to the new band maximum;

- IA noted one instance where the exception approval was not obtained. In this specific instance, the employee received 12.85% increase for a promotion through two separate transactions – first a 10% increase upon promotion, then an additional 2.85% backdated to the date of promotion. Though the aggregate increase for the promotion was greater than 10%, a compensation compliance package was not prepared as required. This was contrary to typical HR practice and could be perceived as circumventing the exception approval process;

- IA noted five instances where an employee had received successive promotions within a short period of time, resulting in significant pay increases. Details are as follows:

    - One employee was promoted two months after the initial promotion, as the position was re-assessed to a higher band by an external party. Pay was adjusted although there was no change in portfolio noted. This resulted in a total base salary increase of 28%, and placement at midpoint of the new band;

    - One employee was promoted twice in five months, resulting in a total base salary increase of 21%; and

    - Three employees were promoted twice within an 18-month period, resulting in a total base salary increase greater than 25% in each case.

Potential Cause & Impact

Potential Causes:

- Greater than 10% increase was offered for some promotions to retain key talent and align with external market; and
- Increased reorganization activities in 2019 resulted in increased personnel movements.

Impact:

Promotional increase decisions may place an individual close to band max immediately upon promotion, or result in significant pay increases within a short period of time.

Recommendation
HR Management should: • Continue to enforce the exception approval process, but strengthen the justification by including supporting evidence (e.g. comparison against the external market for similar positions, comparison against peers within the organization); • Perform additional level of review for salary increases within short period of time (e.g. due to successive promotions and retro-adjustments), ensuring that history of salary changes are taken into consideration and proposed increases are reasonable; and • Monitor the exception trend and re-evaluate the pay scales if market condition is deemed to be the primary contributor of the trend.
Management Action Plan
1. HR Management, Compensation group will continue to enforce the exception approval process, requiring supporting rationale as appropriate. This will include providing additional guidance to HR Business Partners through training presentations and communication regarding supplementary documentation requirements to support rationale, with additional consideration for recent promotions or salary changes (other than merit). Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources Target completion date: June 30, 2021 2. Management Group compensation structure will be reviewed periodically. This was last presented and reviewed by the Board at the August 2020 meeting. Changes will be effective January 1, 2021. Action Owner: Saba Zadeh, Director Compensation & Benefits, Human Resources Target completion date: Complete 3. Given the relative infrequency of salary increases within a short period of time, and the accountability that Management has in determining appropriate compensation decisions, HR Management will evaluate different options to give consideration for successive promotions and document the evaluation. Action Owner: Mel Hogg, SVP, Human Resources Target completion date: June 30, 2021.

APPENDIX A – RATING DEFINITIONS FOR AUDIT REPORTS

Finding: *Noted deficiency with potential impacts to the achievement of business unit/process area objectives, assessed using the following criteria:*

	High Risk	Moderate Risk	Low Risk
Safety & Social License	• Potential regulatory non-compliance. • Deficiencies that could result in: ○ Fatality, permanent disability, or lost time injury; ○ Data loss or unavailability of critical systems; ○ Security is compromised in sensitive / multiple areas; ○ Fraud / theft; or ○ Negative media coverage resulting in reputational damage	• Insufficient evidence to support regulatory compliance. • Deficiencies that could result in: ○ Minor injury with no lost time; ○ Temporary data loss or unavailability of non-critical systems; ○ Security is compromised; ○ Fraud / theft with some mitigating controls; or ○ Public escalating concerns to OPG Management or local media.	• Documentation improvements to support regulatory compliance. • Deficiencies that could result in incidents that do not require medical treatment. • Deficiencies that do not result in any media attention negatively impacting OPG's reputation.
Financial	• Potential loss or financial impact =>5% of the sample population's value, or the department's OM&A budget if the former is unavailable.	• Potential loss or financial impact >=2% and <5% of the sample population's value, or department's OM&A budget if the former is unavailable.	• Potential loss or financial impact <2% of the sample population's value, or department's OM&A budget if the former is unavailable.
Operational Excellence	• Governance non-compliance or lack of/inadequate controls that may impact achievement of business or project objectives. • Errors in or insufficient internal reporting that drives senior management decision making. • Test results where =>25% of the sample had deficiencies in the execution of a key control.	• Governance non-compliance or lack of/inadequate controls with alternate controls in place to mitigate the impact to business or project objectives. • Errors in or insufficient internal reporting that could affect management decision. • Test results where >=10% and <25% of the sample had deficiencies in the execution of a key control.	• Governance compliance with procedural concerns or documentation issues which could impact OPG's ability to demonstrate appropriate due diligence. • Errors in or insufficient internal reporting that has minimal decision making impact. • Test results where <10% of the sample had deficiencies in the execution of a key control.

Opportunity for improvement: *Observation with no risk impact that is provided to management for consideration to improve efficiency of processes and documentation (e.g. automation, duplication of activities).*

OVERALL REPORT RATING SCALE

An overall audit rating is assigned based on the number of observations identified for the audit and their assigned risk rating:

	Number of Findings			
Finding Risk Rating	**1**	**2**	**3 - 4**	**=> 5**
High	Requires Improvement	Not Effective	Not Effective	Not Effective
Moderate	Generally Effective	Generally Effective	Requires Improvement	Not Effective
Low	Effective	Effective	Generally Effective	Requires Improvement

APPENDIX B – PROCESS OWNER & DISTRIBUTION LIST

Distribution:

Mel Hogg
Senior Vice President, Human Resources

Saba Zadeh
Director, Compensation and Benefits

cc:

Ken Hartwick	President and Chief Executive Officer
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