OEB Public Consultation

KPMG Report on P & OPEB Costs

Introduction

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Agenda - Introduction

1. Purpose and KPMG's role in the Public Consultation
2. Preface and Disclaimer
3. Overview of P&OPEB Plans
   - Types of P&OPEB plans operated by utilities in Ontario
   - Key accounting differences
   - Key regulatory accounting requirements
4. Survey of Other Jurisdictions
5. Questions?

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Purpose & KPMG's role in the Public Consultation

- The OEB began a consultation in May 2015. Our understanding of the ultimate objectives of the Consultation are:
  - To develop standard principles to guide the OEB's review of P&OPEB costs in the future;
  - To establish specific information requirements for applications; and
  - To consider appropriate regulatory mechanisms for cost recovery which could be applied consistently across the gas and electricity sectors for rate-regulated entities.
- KPMG is not here to advocate positions
- Our role today is to table the various options (methods) of recovering P&OPEB costs and related Information Requirements that could be used to develop a proposed common principle-based framework
- We hope that you will find this presentation and information in the KPMG Report useful to help the OEB, utilities and other interested parties to develop their positions

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Preface & Disclaimer

- **However, in order to derive the greatest value, users of the KPMG Report should also acknowledge the following issues which are important to the discussion:**
  - Benefits offered through P&OPEB plans are a form of deferred compensation and 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;
  - There is no guarantee that one method (accrual accounting versus cash payments) will *always* result in higher (or lower) costs for a given period than the other;
  - Despite periodic differences in P&OPEB costs for the two methods, in the fullness of time, the cumulative cash (or funding) costs for a plan (or arrangement) is generally expected to equal that plan's cumulative accrual accounting costs (timing issue only);
  - The goal of achieving greater consistency should not over-ride the OEB's statutory mandate to set 'just and reasonable' rates. In certain cases, a "one-size fits all" approach is simply not desirable or justifiable. For this reason, the principles and requirements should offer flexibility in some areas;

Should consistency be the guiding principle?

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Preface & Disclaimer

- **However, in order to derive the greatest value, users of the KPMG Report should also acknowledge the following issues which are important to the discussion (continued):**
  - While KPMG has identified various options with 'value-for-money' in mind, the results of any 'value-for-money' analyses would vary from utility to utility; as such, detailed, quantitative 'value-for-money' assessments are outside the scope of the KPMG Report;
  - The accounting guidance does not address all issues relating to P&OPEB costs neither is it intended to address in detail all the accounting requirements under the various accounting frameworks; and
  - We have prepared for consideration methods for recovering P&OPEB costs and related Information Requirements that, if adopted, should lead to greater consistency in the regulatory treatment of P&OPEB costs that are included in rates. KPMG is not responsible for determining which, if any, of these methods for recovering P&OPEB costs and related Information Requirements get adopted by the OEB.

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Preface & Disclaimer

- **Disclaimer is addressed on page 3 of the KPMG Report. Key ones are**
  - The KPMG Report is made available for information purposes only at the Consultation
  - The KPMG Report may not be edited or relied upon by any other person than the OEB without the express written permission by KPMG
  - The accounting guidance contained in the KPMG Report is general in nature and is not intended to apply to every fact pattern. Like other issues relating to reporting in general purpose financial statements, it is possible to make different judgments based on specific facts and circumstances and materiality of the amounts involved
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What was KPMG asked to do?

OEB retained KPMG to provide assistance to the OEB on technical issues with respect to pension and OPEB (P&OPEB) costs and prepare a report ("KPMG Report")

KPMG Report contains information that participants at the stakeholder forum could find useful to refer to, including:

- Regulatory practices for P&OPEB costs in other jurisdictions;
- Possible methods of recovering P&OPEB costs in the rates charged to customers and related Information Requirements;
- Accounting requirements for P&OPEB costs in general purpose financial statements; and
- Possible set-aside mechanisms that could be developed if accrual accounting is used to recover P&OPEB costs in rates.

KPMG identified various options for consideration by stakeholders and the OEB but is NOT making recommendations. The OEB will determine which, if any, methods and Information Requirements are adopted

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Types of P&OPEB Plans

- **Defined contribution ("DC") plans**: no legal or constructive obligation to pay further contributions if the fund does not hold sufficient assets to pay for the benefits relating to employee service in the current and prior periods

- **Defined benefit ("DB") plans**: provide a known or pre-determined benefit in a future period. As such, the sponsor of the plan is responsible for the plan's:
  - Actuarial risk
  - Investment risk

- **DB plans accounted for as DC plans**: these are typically plans in which several employers pool their assets and provide defined benefits to employees of more than one entity on the basis that contribution and benefit levels are determined without regard to the identity of the entity that employs the employees concerned (e.g. OMERS):
  - Although these are DB plans, accounting standards provide a practical expedient to account for these costs similar to DC plans

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Types of DB P&OPEB Plans

- **Single-employer registered pension plan ("RPP")**: must be funded in advance in accordance with rules which are enforced by the Financial Services Commission of Ontario ("FSCO") and the Canada Revenue Agency ("CRA"), requires statutory funding valuation at least every 3 years

- **Non-registered pension plan ("SERP"):** no requirement to register or fund in advance, some employers may choose to fund

- **Other post-employment benefit plan ("OPEB")**: no requirement to register or fund in advance

- **Multi-employer pension plan ("MEPP", e.g. OMERS)**: registered and funded in advance, similar to RPPs, however actuarial results are available at the plan level but not the individual employer level

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Landscape in Ontario

Type of defined benefit ("DB") plans	Method used by entities for cost recovery	
	Accrual accounting	Cash payments / funding
Registered pension plan (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	

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Costs of the Large DB Plans in Ontario

n.a – not available; Source: 2014 annual financial statements

(in millions)	Hydro One		OPG		Union Gas		Enbridge		IESO	
	Pension	OPEB	Pension	OPEB	Pension	OPEB	Pension	OPEB	Pension	OPEB
Assets	6,299	-	12,407	-	829	-	960	13	455	-
Liabilities	7,535	1,582	15,986	3,143	863	67	1,046	117	452	69
Funded status (deficit)	(1,236)	(1,582)	(3,579)	(3,143)	(34)	(67)	(86)	(104)	3	(69)
Net periodic costs	158	134	554	202	20	4	25	6	14	8
Charge to P/L	81	62	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Amortization period of OCI (years)	11	12	12	13	10	n.a.	n.a.	n.a.	13	14

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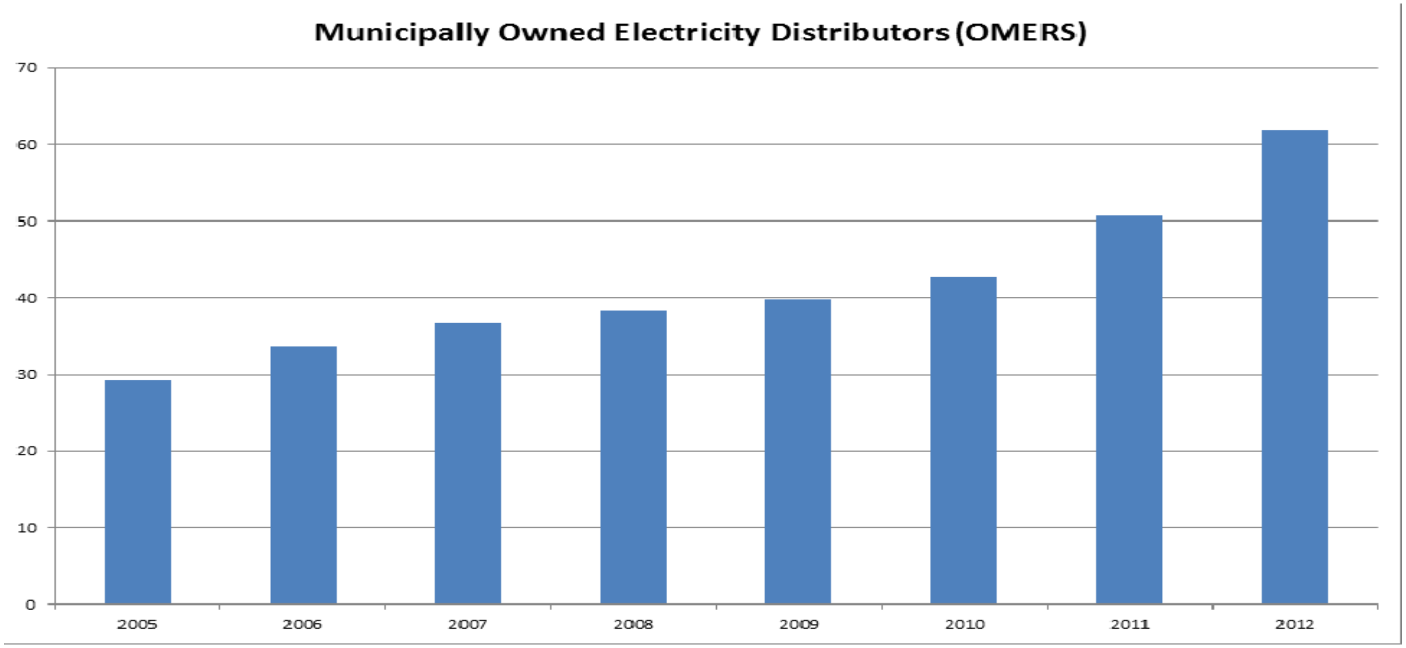
Annual Contributions to OMERS

Employer contributions to OMERS by Municipally-Owned Electricity Distributors during the 8-year period that ended in 2012 were as follows (amounts in $m): Source - based on aggregated data provided by OMERS.



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P&OPEB Plans - Key Accounting Costs

- **DC plans**: contributions payable to the plan are recognized as an expense (unless capitalized) as the obligation to make contributions is incurred (generally this is when an employee renders service during each period).
  - No actuarial assumptions in measuring the obligation; no actuarial gains or losses

- **DB plans**: as the sponsor bears the actuarial and investment risks of the plan, the accounting costs recognized in each period include:
  - Cost for service in the current period (present value amount)
  - Impact of any retroactive plan amendments ("past service costs")
  - Interest cost as a result of accretion on the obligation
  - Interest income (returns) on the invested plan assets
  - Actuarial gains and losses: these arise from experience adjustments (i.e. differences between previous actuarial assumptions and what actually occurred), changes in actuarial assumptions and differences between expected and actual returns/ valuation of plan assets

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Accounting for P&OPEB Costs - Key Similarities

The accounting frameworks that are used by utilities in Ontario have the following key similarities for accounting for P&OPEB costs:

- DC plans & DB plans accounted for as DC plans (e.g. OMERS):
  - Contributions payable

- DB plan costs:
  - Cost for service in the current period (PV amount)

  - Interest cost as a result of accretion on the obligation

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Accounting for P&OPEB Costs - Key Differences

- DB plan costs
  - Actuarial gains and losses:
    - ✓ IFRS = recognized in OCI with no recycling to the P&L
    - ✓ US GAAP = initially recognized in OCI. Thereafter, one of 3 methods can be selected. The corridor method is used by most utilities – the amount in excess of the 10% corridor is amortized to P&L over the expected average remaining service life of the plan's members.

      The fair value or market-related value of plan assets can also be used to determine the amount that is amortized to P&L
    - ✓ ASPE = recognized immediately in P&L
  - Impact of any retroactive plan amendments (past service costs):
    - ✓ IFRS = recognized immediately in P&L
    - ✓ US GAAP = initially recognized in OCI, and then amortized on a straight-line basis to P&L over the expected average remaining service life of the plan's members
    - ✓ ASPE = recognized immediately in P&L

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Accounting for P&OPEB Costs - Key Differences

- DB plan costs
  - Interest income (returns) on the invested plan assets:
    - ✓ IFRS = interest income is calculated based on the discount rate used to measure the obligation. Any differences from the actual return on plan assets are recognized in OCI with no recycling to the P&L
    - ✓ US GAAP = the expected return on plan assets is determined based on the best estimate of future long-term returns. This is not required to be the same as the discount rate used for the obligation. Also, the expected return can be calculated based on fair value or market-related value of the plan assets
    - ✓ ASPE = the actual return is recognized immediately in P&L

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Accounting Guidance for Pension Costs under ASC 980

- Regulatory assets and liabilities created by the actions of a regulator are <u>required</u> to be recognized
  - Any regulatory assets and regulatory liabilities that are recognized should meet the general criteria for such regulatory balances. The general criteria for regulatory assets are:
    - ✓ It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making; <u>and</u>
    - ✓ Based on available evidence, the future revenue will be provided to permit recovery of previously incurred cost rather than to provide for expected levels of similar future costs
- <u>*Judgment*</u> is required in determining whether a regulatory asset for the difference in pension costs will be included in future rates
  - Recovering pension costs on a ‘pay-as-you-go’ (PAYG) basis would increase the level of judgment required significantly
  - However, there are no other specific restrictions or thresholds above which regulatory assets would not be recognized
- Regulatory assets and regulatory liabilities are recognized for the amounts that are recorded in OCI provided the general criteria are also met

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Accounting Guidance for OPEB Costs under ASC 980

- Regulatory assets and regulatory liabilities created by the actions of a regulator are also required to be recognized (subject to specific additional criteria being met)
  - Any regulatory assets and regulatory liabilities that are recognized should also meet the general criteria for such regulatory balances
- Regulatory assets and regulatory liabilities are recognized for the amounts that are recorded in OCI provided the general criteria are also met
- **Specific additional requirements** for OPEB costs:
  - Unlike pension costs, recognizing regulatory assets for OPEB costs when a utility is recovering OPEB costs on a PAYG basis is specifically prohibited
  - Rate order, policy statement or generic order that allows deferral and for the subsequent inclusion of those deferred costs in the entity's rates is required
  - Period of deferring additional costs shall not exceed 5 years
  - Combined deferral-recovery period authorized by the regulator shall not exceed approximately 20 years
  - No 'back-end loading' of the deferred costs. Recovery on a straight-line basis is permitted

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Accounting Guidance for OPEB Costs under ASC 980

- *Judgment* is required in determining whether regulatory assets for the difference in OPEB costs will be included in future rates
  - The specific restrictions were introduced in 1992 when the accounting for OPEB costs was changing from PAYG to accrual accounting (i.e. transition). The restrictions were intended to reduce the likelihood of regulatory assets continuing to increase for many years
  - The restrictions exist under US GAAP to this day. It is not clear how these restrictions should be applied by those utilities that are already on accrual accounting or those utilities that switch to the PAYG basis after having applied accrual accounting for some time. Alternative views on the application of these restrictions are possible
  - If a method other than accrual accounting costs is used, the OEB could influence the recognition of regulatory assets for OPEB costs by adopting a pragmatic view that gives weight to the reasons for the restrictions e.g. by including OPEB costs in rates over a period that is respectful of the 20-year limit and using a method that does not include significant 'back-end loading' of OPEB costs

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Survey of Other Jurisdictions

- Among other things, the purpose of the survey was to:
  - Identify the methods used to include P&OPEB costs in rates
  - Identify if other regulators have separate and distinct principles for dealing with P&OPEB costs
  - Identify what oversight role, if any, rate regulators play with regards to P&OPEB plans

- KPMG prepared a detailed questionnaire. The respondents:
  - Used their ongoing working-knowledge and experience of the regulatory practices in their jurisdiction. No exhaustive research and analyses was requested
  - Assumed no responsibility whatsoever to the users of the questionnaire and the KPMG Report

- Of the 10 regulatory jurisdictions that were included in the survey, 8 provided responses

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Survey of Other Jurisdictions - Key Results

- Regulators did not report that their regulatory practices for P&OPEB costs are based solely on the application of accounting standards. Even in jurisdictions in which accrual accounting is generally used, we noted that:
  - Regulatory accounts are being used for certain variances and cost deferrals
  - FERC, which has issued a policy statement regarding the use of accrual accounting, also requires the amounts collected for OPEB plans to be placed in an irrevocable trust. In addition, the funding contribution method is sometimes used and there are limited situations in which FERC allows recovery on a cash basis. Note that in the United States, LDCs are regulated by state regulators – the methods used by these state regulators vary significantly
  - The validity of any assumption can be reviewed and challenged in the context of a rate case, an accounting review and an audit or investigation
- The practice for recovering P&OPEB costs varies significantly from jurisdiction to jurisdiction and in some jurisdictions, the issue is dealt with on a case-by-case basis. As such, the regulatory practice can vary from utility to utility

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Survey of Other Jurisdictions - Key Results

- Only one regulator (Ofgem) has specified separate, distinct and well documented principles and guidance for pension costs. However, no principles and guidance are specified for OPEB costs
- Regulators rely on actuarial reports as a basis to determine whether the P&OPEB costs that are recognized by a regulated utility are measured in a reasonable manner. Only one regulator (Ofgem) has a detailed and comprehensive approach for reviewing the assumptions used in the valuation reports and identifying outlying assumptions for additional scrutiny
- None of the rate regulators have an oversight role over P&OPEB plans
- Many jurisdictions have been experiencing movement away from DB pension plans to DC plans

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Questions?

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