



Ontario
Energy
Board | Commission
de l'énergie
de l'Ontario

SEPTEMBER 14, 2017

Report of the Ontario Energy Board

Regulatory Treatment of Pension and Other Post-employment Benefits (OPEBs) Costs

EB-2015-0040

Contents

- Introduction and Context 1
- Principles and Practices 3
- Description of Recovery Methods 5
 - A. Pensions 5
 - B. OPEBs 7
- Policy of the OEB 8
 - A. Accrual Method 8
 - B. Variance Tracking Account 9
 - C. Interest Rate..... 12
 - D. Accounting Frameworks..... 12
 - E. Set-Aside Mechanism 13
- Appendix A: Examples of differential between accrual and funding/cash methods 16
- Appendix B: The Consultation Process 17
- Appendix C: Accounting Guidance 20
- Appendix D: Journal Entries 24

Introduction and Context

This Report describes the policy of the Ontario Energy Board (OEB) for the regulatory treatment of the cost of pension and other post-employment benefits (OPEBs) incurred by rate-regulated Ontario energy utilities as part of the overall compensation paid to their employees. Specifically, this Report addresses the manner in which approved pension and OPEB costs are recovered from customers, and establishes principles for the review of the level of these costs for future rate proceedings.

Ontario energy utilities, such as electricity and natural gas distributors and Ontario Power Generation, recover their labour costs in the rates or charges their customers pay. The compensation packages utilities offer their employees include pension plans and OPEBs such as health and dental care. The OEB, consumer advocates and the general public have raised concerns about the generosity of the pensions and benefits offered by utilities.

It is not the role of the OEB to design or require a particular compensation package that utilities must offer. It is the role of the OEB to ensure that the costs that go into the rates paid by customers are reasonable. In deciding what is reasonable, the OEB has to consider present and future ratepayers, as well as the financial health of the utilities. Customers are not well served if a utility cannot afford to maintain reliable service or if they are unable to attract employees with the necessary skills to operate and manage the utility.

This Report does not address the magnitude or level of these costs. The longer term intention of the OEB is to use benchmarking, comparing a utility's proposed costs to those of similar businesses, to assess whether costs are reasonable. The labour costs of utilities, whether outsourced or internal, could be compared to the labour costs of others in the energy industry, and to businesses with employees with comparable skill sets outside the energy industry. The determinations made in this Report are intended to facilitate benchmarking, or at least not to hinder it.

This Report is the conclusion of the consultation on the issues identified by the OEB regarding the recovery of utility pension and OPEB expense. The materials from the consultation are available on the OEB's [website](#). This Report provides principles to guide the review of the costs, addresses mechanisms by which costs are to be presented to the OEB, and considers customer protection from the risk of over-charging both now and in the future.

In summary, this Report establishes the use of the accrual accounting method as the default method on which to set rates for pension and OPEB amounts in cost-based¹ applications. A panel of the OEB can use another method if accrual accounting does not result in just and reasonable rates. This Report also provides for the establishment of a variance account to track the difference between the forecasted accrual amount in rates and actual cash payment(s) made, with an asymmetric carrying charge in favour of ratepayers applied to the differential. The variance account will be effective January 1st, 2018, unless otherwise ordered by the OEB.

For some utilities, the OEB has set rates using the cash method and used variance accounts to keep these prior periods open to further adjustments pending the outcome of this consultation. For these utilities, disposition of the variance account would be considered in the next cost-based rate application, if the OEB approves the accrual method to recover pension and OPEB costs in rates. In addition, the new variance account provided for in this Report will be effective upon a transition to the accrual method (if approved) as of the date of a utility's next cost-based rate order.

The OEB will continue to assess compensation strategies in cost-based applications when establishing revenue requirements. As the OEB updates filing requirements for utility rate applications, it will consider the extent to which additional information filings are required to support the assessment of pension and OPEB costs as part of a utility's total cost of compensation.

¹ Cost of Service or Custom Incentive Rate-setting

Principles and Practices

The regulatory principles developed in this Report are intended to guide the OEB, rate regulated utilities, and other stakeholders in evaluating proposals for the recovery of pension and OPEB costs in rates and charges. The OEB reviewed three main sources in establishing the principles:

- Principles put forward by KPMG in a report prepared for the OEB consultation (see Appendix B for consultation process)
- Submissions made by participants in the consultation
- Principles enunciated by the OEB in its [Report of the Board: Transition to International Financial Reporting Standards](#)

The OEB has concluded that there is no need for separate and distinct principles to guide its approach to the treatment of utility pension and OPEB costs. The regulatory treatment of pension and OPEB costs will be based on established regulatory principles. These principles are:

- fairness
- minimizing intergenerational inequity
- minimizing rate volatility
- appropriate allocation of risk
- transparency
- providing value to customers

The OEB believes that adherence to these principles should achieve a stable, reasonable and efficient level of these costs for ratepayers, and a predictable and fair level of recovery of these costs by utilities. The objective of approving or setting just and reasonable rates will continue to be the primary driver of the regulatory treatment of pension and OPEB costs. The OEB has and will retain the authority to establish regulatory requirements and rate setting methods consistent with these principles.

The policy of the OEB for reviewing utility pension and OPEB costs will be based on principles, and supported by best practices. The OEB will adopt the following practices in its treatment of these costs:

The regulatory treatment of pension and OPEB costs will be aligned with the financial accounting treatment of these costs where that alignment is consistent with sound rate-making principles and the setting of just and reasonable rates.

Pension and Other Post-employment Benefits (OPEBs) Costs

The OEB will generally keep its choice of regulatory treatment of pension and OPEB costs (e.g. method used to determine recovery) consistent over time for any given utility.

The OEB, when assessing the reasonableness of pension and OPEB costs, will consider the entire compensation package of a utility, and will in the future be developing more detailed benchmarking for utility costs.

Description of Recovery Methods

A. Pensions

Pension plans are generally identified as Defined Benefit (DB) or Defined Contribution (DC) plans. In a DB plan, the benefits are defined – the amount to be paid out to the retiree is guaranteed. In a DC plan, the amount to be paid out is not guaranteed. It is the contribution which is defined. The eventual payout will depend on the monies accumulated through the contributions made and the returns generated over time.

Pension plans may be multi-employer or single employer. Enbridge Gas Distribution Inc., Union Gas Ltd., Ontario Power Generation Inc., the Independent Electricity System Operator, Hydro One Networks Inc. and some other utilities have single employer plans. Some of these utilities have DB plans, and others a mix of DB and DC plans.

The *Pension Benefits Act* (PBA) establishes minimum standards for registered pension plans in Ontario, including entitlements under the plan, plan administration and funding. For DB pension plans in particular, the PBA mandates that these plans must be funded; in other words, the plan's assets must be sufficient to pay for its liabilities, as determined by a triennial actuarial valuation. The PBA requirements, however, do not apply to non-registered pension plans such as supplemental employee retirement pension plans. For these types of plans, cash payments are often paid directly from the employer to the plan beneficiaries.

Most municipally-owned electricity distributors are under a multi-employer plan, the Ontario Municipal Employees Retirement System (OMERS) Plan. While OMERS is a DB plan, for accounting purposes, it is effectively treated as a DC plan by the participating distributors. This means that the annual employer contributions made to the plan are the same as the accrual accounting expense recorded for financial statement purposes. OMERS determines the level of contribution required from each of the participating organizations and all plan risks are borne and shared by its participating organizations and the organizations' employees.

Currently, there are two main ways in which pension costs are recovered in rates.

Accrual accounting is the method required for financial statement reporting purposes and is based on the underlying accounting standard for pension costs. On an accrual accounting basis, pension expenses are incurred and recognized when an employee's service is rendered and the benefit is earned, not when the actual benefit payments are made to retirees, nor when the contributions to the plan are made by the employer. Amounts recovered in rates represent the estimated cost of the benefits earned by a

utility's employees in a given year as determined by an accounting based actuarial valuation.

The second method used to recover pension costs is the funding contribution method, sometimes referred to as the "cash" method. Under this method, costs recovered are based on estimated annual employer contributions to the pension plan, calculated through an actuarial funding valuation. The funding valuation calculates the annual contribution necessary to fund the future pension liabilities. It is prepared in accordance with the requirements of the PBA and the assumptions and methods recommended by the actuary as discussed with the management of the utility.

Since most electricity distributors in Ontario participate in the OMERS pension plan, they are not affected by the accrual versus funding contribution debate for recovery of pension costs. As OMERS is accounted for as a DC plan for financial statement reporting purposes, the annual contributions made to the plan (funding contribution method) will equal the accrual accounting cost (accrual method).

However, for those utilities that have single employer pension plans, the difference between the costs calculated under the accrual method and the funding contribution method can be significant (see example in Appendix A to this Report). While these utilities must record the amounts generated by the accrual method in their financial statements, there is no requirement that the OEB must set rates to recover the accrual amount. Because of the current economic situation with persistent low interest rates and other factors, for some utilities with single employer DB plans, the actuarial accounting valuations have led to an accrual number that is higher than the number calculated on a funding contribution basis. However, there is no guarantee that this trend will continue in the future.

The OEB's consultant, KPMG, put forward a third method for recovering pension costs in the rates of utilities with single employer DB or mixed plans. This "modified funding contribution" method uses a subset of the costs included in a utility's required funding contribution as governed by the PBA, along with a deferral account for the remainder (which may include any voluntary payments that a utility may wish to include for strategic reasons²).

² The strategic reasons typically include consideration of such factors as: the corporate tax benefits, market risk management strategy for fund assets, lower Pension Benefits Guarantee Fund fees and the potential to avoid the necessity of an annual funding valuation. (KMPG Report, page 26)

B. OPEBs

Most Ontario energy utilities recover their OPEB costs based on the accrual method. This method, as for pensions, recognizes the cost of OPEBs as an employee's service is rendered and the benefit is earned. An alternative is the cash or "pay-as-you-go" method, in which the OPEB costs for a given year are based on what the utility actually pays to retired employees (or more likely, pays in premiums to an insurer) for OPEBs. The cash method fails to consider the level of post-retirement benefits that a current employee has earned in a given year. Along with the absence of a funding plan, this means that the difference between the OPEB costs calculated under the accrual method and the cash method can be significant for some utilities (see example in Appendix A to this Report).

Some utilities that do not incur material amounts of OPEB costs may not conduct actuarial valuations for accounting purposes, and therefore the OPEB expense reported on their financial statements may be equivalent to the pay-as-you-go amount.

KPMG also put forward a potential third method for recovering OPEB costs in the rates of utilities, the "adjusted pay-as-you-go" method. Under this approach, the cash method would be the starting point and would then be increased by an additional amount that is established by the OEB. KPMG suggested that this additional amount could be based on an approach such as the annual amortization of OPEB costs that are included in Other Comprehensive Income plus a portion of the OPEB costs determined using the accrual accounting method.

Policy of the OEB

A. Accrual Method

The OEB will use the pension and OPEB amounts determined through accrual accounting in rate-setting, unless that method does not result in just and reasonable rates. If the accrual accounting method is used, a variance account will be used to track the difference between the forecasted accrual amount in rates and actual cash payment(s) made. An asymmetric carrying charge sub-account in favour of ratepayers will be used, for the reasons given in the next section.

Aligning regulatory treatment with the financial accounting treatment of the costs supports using the accrual method as the default method for calculating the amount of pension and OPEB costs to go into rates. However, OEB panels are not bound by this policy to use the accrual method for rate-setting if the use of that method produces a result that is not just and reasonable in the circumstances of any given utility. The principles enunciated above can assist the OEB and stakeholders in determining the best method for setting rates.

Utilities currently on the accrual method, and proposing to remain on accrual for rate-setting, are not required to justify the use of that method, but must still file the evidence required by the OEB to support the quantum. The approved accrual amount embedded in rates is not expected to change or escalate during an IRM or Custom IR term except in cases where in a Custom IR term, updated forecasts for subsequent years of the term were approved. The OEB has determined that the actual cash payments (including any special payments for pensions), should be supported by an objective source such as an actuarial report or audited financial statements.

The result of setting rates based on the accrual method could be unacceptable in some cases. As setting just and reasonable rates is the primary driver of the regulatory treatment of pension and OPEB costs, providing value to customers and assuring fairness to both present and future ratepayers is a necessary component of the regulatory treatment of pension and OPEB costs.

Utilities proposing to set rates using a method other than accrual must support such a proposal with evidence giving consideration to these factors, and the principles and practices enunciated in this Report. The intended practice of maintaining a consistent method used to determine recovery over time may be one reason for not adopting the accrual method for rate setting. Stability and predictability in regulation are desirable unless unintended and undesirable effects occur.

The issues raised by transitioning between recovery methods may be serious and difficult to resolve fairly, whether the transition is from or to the accrual method. For example, a change to the cash method could involve a difficult calculation to determine the cumulative amount that a regulated utility has already recovered from customers in the rates charged to date, compared to what would have been collected in the rates to date had these amounts been recovered using the cash method (the cumulative difference to date). The KPMG Report refers to this cumulative difference to date as a potential “windfall” for regulated entities because customers could end up paying for the same cost twice.³

The OEB is of the view that if a particular case demonstrates that a transition is necessary to set just and reasonable rates and the transition issues are manageable for that particular utility, it is open to a panel to require a transition to a recovery mechanism suitable for that utility’s particular circumstances. In such a case, the OEB could require the utility to calculate the cumulative difference to date for disposition.

Having considered the modified funding contribution method for pensions and the adjusted pay-as-you-go method for OPEBs, the OEB has determined that these methods are complicated and involve significant judgement on the part of the regulator. The OEB finds that the accrual method, supplemented with a mechanism to address over-collection, is the best alternative for most Ontario utilities.⁴

While consistency in the choice of recovery method among utilities might be desirable, the movement towards greater benchmarking is not compromised if an inconsistency exists. Benchmarking will be performed on the basis of the figures in utility financial statements, not the amount that is collected in rates in a given year. In addition, pension and OPEB costs are one part of the compensation package offered by a utility and therefore only a portion of its labour costs. The OEB intends to compare costs at a higher level than the pension and OPEB amounts.

B. Variance Tracking Account

The difference between the costs calculated under the accrual method and the cash payment(s) made in a specific time period (e.g. a year) can be significant. There is no

³ KPMG Report, pages 37-38 (pensions) and 78 (OPEBs)

⁴ In its submission, the IESO stated that due to its unique nature and structure as a not-for-profit entity, it does not believe it is practical or beneficial to ratepayers for the OEB to apply the same reporting (and recovery) methods as it may determine for other enterprises with share capital. The OEB is of the view that the IESO is a rate regulated entity and the extent that the mechanism established in this Report (or an alternative mechanism that meets the spirit of this policy) should apply to the IESO will be reviewed and determined in the IESO’s next fees case.

guarantee that any particular method will produce a lower cost in a given year.⁵ Whatever method is selected on which to base cost recovery, the principles of fairness, appropriate allocation of risk, and value to customers dictate that some response to over-collection should be part of the OEB's regulatory treatment of pension and OPEB costs.

Where pension and OPEB amounts collected in rates are higher than payments made by the utility, current ratepayers are in effect lending money to the utility to fund future obligations. KPMG suggested four possible methods to provide value to customers for this loan. Two methods dealt with over-collection and the other two dealt with ensuring solvency. The solvency issue, which primarily concerns OPEBs, is dealt with in the next section of this Report. The two mechanisms suggested for over-collection were a regulatory variance tracking account that attracts carrying charges which would be returned to ratepayers and a reduction to rate base by an amount equivalent to the excess recoveries.

The OEB finds that using a variance account is preferable to adjusting rate base, given the principles established in this Report. A reduction to rate base results in a return to ratepayers at a utility's weighted average cost of capital, which may not be an accurate reflection of what a utility's borrowing cost would be at a point in time. As current ratepayers are in effect lending money to the utility to fund future obligations, the tracking account option would provide the OEB with flexibility to ensure that the value being returned to ratepayers is fair, that it reasonably approximates what the utility would pay for a loan made against its borrowing capacity, and that is within the utility's debt capacity. The OEB also finds that the use of a tracking account provides for greater transparency to facilitate the eventual disposition of the carrying charges.

The application of the carrying charges will be asymmetric, similar to the asymmetric approaches established by the OEB from time to time for capital cost variances and earnings sharing mechanisms. The utility will not be compensated for under-recoveries unless the financial viability of the utility would be compromised by such an arrangement.

The account will be established at a point in time, and for most utilities it is difficult to know with certainty whether over- or under-collection occurred in the past. Whatever the past trends, the utilities had and continue to have, significant control over the costs of their pension and OPEB plans: they design their compensation structure, negotiate collective bargaining agreements, and have input on the actuarial assumptions upon which the costs in the financial statements are based. Ratepayers are required to pay

⁵ See example in Appendix A

the rates the OEB approves based on a review of information filed by the utilities. Therefore, where the amount collected in rates exceeds the monies paid out by a utility for its pension and OPEB plans, ratepayers should be paid a return on the money they have “lent” the utility.

A control variance account (with appropriate sub-accounts) will be established on a generic basis effective January 1st, 2018, to be used by all rate regulated utilities subject to the parameters outlined in Appendix C. The variance account will act as a tracking account and only carrying charges applied to the account will be subject to disposition. Disposition of the carrying charges sub-account should occur during a utility’s cost-based rate application, unless otherwise approved by the OEB. Utility-specific accounting orders will not be required for the use of this account. Guidance is provided with respect to journal entries in Appendix D. It is open to panels of the OEB in future rate applications to issue revised accounting orders if the evidence in a particular case requires deviations from this policy.

For some utilities, the OEB approved the recovery of their pension and OPEB costs on a cash basis as an interim measure pending the outcome of this pension and OPEB consultation. Variance accounts were used to capture the difference between the cash and accrual methods in order to keep the period open for final adjustments once the outcome of the consultation was known. These utilities are required to continue to record amounts into the previously approved account(s) until the effective date of a utility’s next cost-based rate order. Utilities will be expected to dispose of the account(s) at their next cost-based rates application⁶ if the OEB approves the accrual method to recover pension and OPEB costs in rates. However, a utility may request alternate timing for its transition to accrual, and disposition of the accounts, if it provides sufficiently compelling reasons, in its next rate application.

The affected utilities may have to consider mitigation measures if the net impact on ratepayers from the disposition of these accounts is significant. Presuming that the OEB orders that these utilities will recover costs for that interim period based on the accrual method, they will be required to credit to ratepayers the carrying charges on the balance on a prospective basis. Appendix C of this Report provides guidance as to how this is to be done.

These utilities are also required to begin recording entries in the new variance account, effective from the date that the utilities’ rates are set based on the accrual amount for

⁶ This will depend on the timing of a cost-based application (cost of service or Custom IR) and the availability of audited financial statements to support balances.

pensions and OPEBs (i.e. typically the effective date of the rate order of its next cost-based application).

C. Interest Rate

Carrying charges on the new tracking account will be assessed on the monthly opening account balance at the OEB's prescribed Construction Work In Progress (CWIP) rate. Several different interest rate options were considered in this consultation ranging from the low end of the OEB's prescribed rate for deferral and variance accounts (currently at 1.1%) to a utility's weighted average cost of capital (WACC), which may be in the 6.5% range for most utilities. The OEB views the prescribed CWIP rate (currently at 2.53%) as establishing a balance between the longer term nature of financial loans and investments required to support pension and OPEB costs, and the shorter term nature of the time required for a utility to dispose of any carrying charges on the differential between the accrual and cash amounts (typically five years).

The OEB is of the view that ideally, the CWIP rate (representing more of a mid-term rate) could apply for amounts expensed, while a utility's WACC could apply for amounts that a utility may capitalize. However, this approach may not provide sufficient incremental value to justify the added complexity of tracking amounts that are capitalized separately from those that are expensed. Utilities are instead expected to track the gross cost flowing from their actuarial valuations. For utilities that do experience a material impact due to the capitalization of a significant portion of pensions and OPEBs, parties in the applicable rates proceedings may propose an enhanced methodology for determining the account balance and the appropriate carrying charge to be applied.

D. Accounting Frameworks

As noted in the KPMG report, a utility's accounting framework would affect the level of accrual expense a utility recognizes for its pension and OPEBs. This is partially due to the difference in the accounting treatment of actuarial gains and losses, which are the gains and losses that arise from experience adjustments and changes in actuarial assumptions. Under United States Generally Accepted Accounting Principles, a utility can choose to recognize these gains and losses immediately in net income, or initially in Other Comprehensive Income (OCI) and then amortize them into net income over time. Under International Financial Reporting Standards (IFRS), a utility must recognize all actuarial gains and losses in OCI, but these amounts are never amortized into net income. Under Accounting Standards for Private Enterprises, all actuarial gains and losses are immediately recognized in net income. As the pension and OPEBs accrual amount that is recovered in rates is derived from the accounting expense recognized in

net income, utilities who are recovering their pension and OPEB costs on an accrual basis under IFRS will not be able to dispose of any amounts pertaining to actuarial gains and losses because they will never form part of net income.

The OEB recognizes that this issue may not affect a large number of utilities because most utilities under IFRS participate in the OMERS pension plan, where the accrual expense equals the employer contributions made to the plan. Furthermore, for those utilities with OPEB plans, their OPEB expense and any actuarial gains and losses may not be significant relative to other costs incurred by these utilities. For some utilities, the OEB has already approved the use of a deferral account to capture the cumulative actuarial gains or losses in post-retirement benefits.

As at the date of this Report, one utility with this deferral account has had the account approved for disposition.⁷ Utilities may propose disposition of the account in future cost-based rate proceedings if the gains and losses that are tracked in this account do not substantially offset over time.

This matter was not the focus of this consultation and therefore, the OEB has not made a determination on a generic approach to the regulatory treatment of actuarial gains and losses under IFRS. The OEB will consider the potential need for further analysis and guidance on this matter in due course.

E. Set-Aside Mechanism

Solvency of the pension and OPEB plans of Ontario utilities is important: will the money be there to provide the promised benefits to future retirees? The OEB is not the regulator responsible for ensuring solvency of pension plans. In Ontario, the PBA legislates the solvency requirements for defined benefit pension plans and, in particular, requires that a registered defined benefit pension plan must be fully funded (the assets of the plan are adequate to cover its liabilities). The funding status of a plan is determined by a triennial actuarial valuation. If the valuation identifies a funding shortfall (liabilities greater than assets), then the PBA requires that the employer make special payments in addition to the employer's usual contributions to the plan, over a specified period of time in order to fund this shortfall. In addition, due partially to the funding requirements of pension plans, it is likely that neither the accrual nor cash (funding contribution) method will consistently produce a higher cost. The direction of the variance would generally be expected to reverse over time (see Appendix A: example of

⁷ Four of the seven utilities with this deferral account have had the opportunity to request disposition of this account but three utilities have proposed to defer disposition.

OPG's pension costs for the next five year period). No set-aside mechanism is necessary for pensions at this time.

Regulations and requirements for OPEBs and unregistered pension plans are less rigorous than for registered pension plans. There is no legislative requirement imposed on plan administrators to ensure that these plans are adequately funded. Most utilities have used amounts collected in rates for OPEBs for example, to pay benefits to employees who are already retired, and where the amount collected exceeded the amount needed for this purpose, the excess has been used for "general corporate purposes", e.g. to fund capital investments or ongoing operating costs.

KPMG suggested two possible set-aside mechanisms that could be used to ensure the funds collected for future OPEB costs remain available for their intended purpose: a separate trust fund, similar to a retirement compensation arrangement, or an internally segregated account.

The OEB recognizes that the disadvantages to these set-aside mechanisms could include:

- Tax implications: Neither mechanism is tax-efficient, and the taxes paid by utilities (and recovered from ratepayers) may increase
- Potential implications for credit risk: Internally segregated funds remove cash from general funds. This means the utility may need to increase its debt, possibly affecting its credit risk profile
- Potential increase in debt costs: Costs to ratepayers could increase to cover increased debt costs

In its letter following the consultation,⁸ the OEB recognized the concerns with internally segregated accounts and retirement compensation arrangements.

The OEB will not prescribe a set-aside mechanism for OPEBs as part of this policy. However, the OEB expects that utilities will manage and accept the risks inherent in funding OPEB plans. Utilities have the responsibility to manage their cash flows over time. The OEB expects that utilities will not seek further recovery from ratepayers if their cash requirements exceed their accrual expense in the future.

The OEB monitors the performance of utilities and the financial viability of the sector. For some utilities, OPEB costs can be a significant component of their overall compensation envelope and have the potential to adversely affect the financial health of

⁸ August 10, 2016

utilities if not managed appropriately. The OEB will consider if and how a further reporting mechanism related to OPEBs can assist in enhancing the OEB's existing monitoring of overall financial viability. The OEB will consider the best way to monitor how a utility is demonstrating accountability for management of OPEB funding and the steps taken to ensure that it will have sufficient cash available as a corporation when its cash needs exceed accrual amounts in any given year.

If the OEB observes over time that utilities are in general not taking responsibility for adequate OPEB funding and not accepting the risk of under-funding, the OEB will consider a further review of set-aside mechanisms on a generic basis.

Appendix A: Examples of differential between accrual and funding/cash methods

The following is Ontario Power's Generation accrual versus cash differential for pensions and OPEBs:

		2008	2009	2010	2011	2012	2013	Total 2008- 13	2014	2015
	\$ million	Actual	Actual	Actual	Actual	Actual	Actual		Plan	Plan
	Pension									
1	Accrual Basis-recoverable in payment amounts	121.4	141.4	150.1	195.0	286.1	383.3		471.3	405.3
2	Cash Basis	198.6	206.1	208.5	235.5	297.1	242.9		321.9	329.6
3	Difference (1-2)	(77.2)	(64.7)	(58.4)	(40.5)	(11.0)	140.4	(111.4)	149.4	75.7
	Other Post-Employment Benefits									
4	Accrual Basis-recoverable in payment amounts	119.2	162.5	161.0	173.2	203.0	231.3		204.6	212.8
5	Cash Basis	44.2	43.1	43.4	48.4	57.9	61.2		89.6	95.8
6	Difference (4-5)	75.0	119.4	117.6	124.8	145.1	170.1	752.0	115.0	117.0

2008-2013 excludes newly regulated hydroelectric

Source: EB-2013-0321, OEB Decision with Reasons, dated November 20, 2014, Page 84

Updated Forecast of Nuclear Pension and OPEB Accrual to Cash Differential* (\$M)

	2017	2018	2019	2020	2021
Pension	14.4	(28.9)	(77.2)	(84.4)	(86.8)
OPEB	78.7	78.8	78.6	78.4	78.5
	93.1	49.9	1.4	(6.0)	(8.3)

*positive values represent excess of accrual costs over cash amounts

Source: EB-2016-0152, Exhibit N1, Tab 1, Schedule 1, Page 13

Appendix B: The Consultation Process

The OEB used a consultative process to gather information and advice from stakeholders for the preparation of this Report. The OEB dedicated a specific page on its [website](#) to the consultation, which provides links to all materials considered by the OEB.

The main steps in the consultation were:

May 14, 2015 Initiation letter

The OEB issued a letter on May 14, 2015, in which the OEB:

- Set out the objectives of the consultation
- Described the initial steps in the consultation
- Invited registration for participation in the consultation
- Invited applications for cost award eligibility
- Invited submissions on an initial set of questions in three areas: general principles, information requirements, and accounting and recovery in rates of pension and OPEB costs (as well as any other issues participants cared to address)
- Announced the retention of the accounting firm KPMG by the OEB to provide assistance on relevant technical issues

June 10, 2015 letter

In this letter the OEB:

- Noted the registration of 28 participants, including rate regulated utilities, labour unions of energy sector employees and representatives of energy consumers
- Granted cost eligibility to six associations representing energy consumers
- Extended the filing deadline for initial submissions, in response to requests from participants

July 31, 2015 submissions filed

Nineteen registrants filed submissions on July 31, 2015.

Over the following nine months, KPMG prepared a Report for the OEB, and the OEB received the report and considered the next steps for the consultation.

May 19, 2016 letter

By way of a letter dated May 19, 2016, the OEB provided a link to the KPMG Report which was posted on the OEB website, and announced a stakeholder forum to be held July 19 and 20, 2016. With respect to the forum, the OEB:

- Set out the structure of the forum
- Provided a draft issues list for the forum and invited comments on the draft issues
- Invited registrants to indicate their intention to make a presentation at the forum

July 19 and 20, 2016 Stakeholder Forum

The forum was held over two days in July, 2016, and consisted of three parts:

- A presentation by KPMG consultants giving an overview of pension and OPEB accounting, and methods presently used by Ontario regulated utilities for accounting and recovery of these costs
- A presentation by KPMG of the content of the KPMG Report
- Presentations from representatives of five regulated utilities

At each stage of the forum, presenters answered questions posed by forum participants. Participation was available by webcast and telephone.

August 10, 2016 letter

In its letter of August 10, 2016, the OEB provided guidance for written submissions to be filed on September 22, 2016. The OEB asked that participants focus their submissions on:

- The principles the OEB should adopt in considering the regulatory treatment of pension and OPEB costs
- The best options for cost recovery mechanisms for these costs
- Two of the “set-aside” mechanisms proposed by KPMG should accrual accounting values be used in rate setting

September 22, 2016 submissions received

Fourteen submissions were filed by participants on this date. The OEB considered these submissions, as well as the other material obtained through this consultation, in preparing this Report.

May 18, 2017 letter

In its letter of May 18, 2017, the OEB invited all registered stakeholders to provide submissions on the following six implementation matters to be filed by June 22, 2017:

- Effective date of the new variance tracking account
- Mechanics of the new variance tracking account
- The manner in which carrying charges are applied to balances tracked in previously established variance accounts
- The requirement to track only the gross accrual cost as opposed to identifying amounts expensed vs. capitalized
- The timing of the OEB's consideration of a transition to the accrual method for utilities currently on cash
- The timing of the disposition of both the new and previously established variance accounts

June 22 2017 submissions received

Ten submissions were filed by participants. The OEB considered these submissions, as well as other material obtained through this consultation, in preparing this final Report.

Appendix C: Accounting Guidance

Pension and OPEB Forecast Accrual versus Actual Cash Payment Differential variance account

The OEB provides for the establishment of the Pension and OPEB Forecast Accrual versus Actual Cash Payment Differential variance account on a generic basis in this Report. This account will track the differences between the forecast accrual amounts recovered in rates and the actual cash payments made for both pension and OPEBs in one account, on a go-forward basis from the date the account is established. The account will not capture differences that occurred in the past, although the OEB may have previously approved a variance account to capture the accrual versus cash differential for certain utilities, pending the outcome of this consultation. This is discussed further below.

For most utilities, the account will be effective on January 1st, 2018. For those utilities with a previously approved variance account, the new account will be effective as of their next approved cost-based rate order, if the accrual numbers for pension and OPEB costs are included in rates at that time.

The forecast accrual reference amount that will be used to calculate the entries recorded in this new account assumes that the total gross accrual cost as determined by an actuarial valuation is what is recorded in a utility's total OM&A expense. If a utility capitalizes a material portion of its total pension and OPEB accrual costs, and there is sufficient incremental value to warrant the added complexity of tracking amounts that are capitalized separately from those that are expensed, any party may propose an enhanced methodology for determining the reference amount and the appropriate carrying charge to be applied, including journal entries consistent with the intent of the account as outlined in this Report.

The actual cash payments would include all cash payments a utility makes for its pension and OPEB obligations. For pensions, the word "cash" refers to the funding contribution method.

Utilities who are members of OMERS do not need to post pension entries to the account. Utilities do not need to post OPEB entries if both the amount embedded in rates and recognized on the financial statements is based on the cash paid to beneficiaries for the period. This would likely be the case for smaller utilities with OPEB plans that are not material and therefore, do not warrant the cost of an actuarial valuation.

The account is to be used by utilities that are approved to recover their pension and OPEB costs on an accrual basis. Therefore, pension and/or OPEB entries will not need to be posted to the account if the OEB approves the cash method to recover these costs in a utility's rates.

A primary sub-account (as described) and a second, contra sub-account to enable book-keeping with offsetting entries must be established. When the cumulative accrual amount exceeds the cumulative cash payments, the primary account will hold a credit balance. When the cumulative cash payments exceed the cumulative accrual amount, the primary account will hold a debit balance. The primary account will accrue carrying charges to be returned to ratepayers when the cumulative opening monthly balance of the account is in a credit position. The contra account will not accrue carrying charges. The primary sub-account and contra sub-account are offsetting. Disposition can only result in a credit refund of carrying charges to ratepayers.

Effective January 1st, 2018, utilities will establish three sub-accounts:

- Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential
- Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account
- Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential Carrying Charges

Electricity distributors and transmitters are to establish sub-accounts under Account 1522. Gas distributors are to establish sub-accounts under Account 179.

Separate monthly entries for pension and OPEBs are required to be recorded into the sub-accounts of the variance account. However, utilities may propose an alternate approach, such as to record journal entries on an annual basis, provided that they can demonstrate that ratepayers will not be disadvantaged as a result. Entries will be based on the approved accrual amount embedded in rates (normally a forecast number) and the actual cash payments made. The OEB has determined that the actual cash payments (including any special payments for pensions), should be supported by an objective source such as an actuarial report or audited financial statements. The approved accrual amount embedded in rates is not to change or escalate during an IRM or Custom IR term except in cases where in a Custom IR term, updated forecasts for subsequent years of the term were approved.

Carrying charges shall apply to the primary sub-account only (not the contra sub-account), calculated using simple interest applied to the monthly opening balances in

the primary sub-account. The interest rate shall be the CWIP rate prescribed by the OEB.

Disposition of the carrying charges sub-account is to occur during a utility's cost-based rate application, unless otherwise approved by the OEB.

Previously Approved Accounts: Accrual versus Cash Variances

For some utilities, the OEB approved the recovery of their pension and OPEB costs on a cash basis as an interim measure pending the outcome of this consultation, and directed them to establish a variance account(s) to capture the difference between the cash and accrual methods in order to keep the period open for final adjustments once the outcome of the consultation is known. These utilities are required to continue to record amounts into this account(s) until the effective date of the utility's next cost based rate order. Utilities will be expected to dispose of this account(s) at their next cost-based rate application (unless otherwise approved by the OEB) through a separate rate rider, provided that the OEB approves rates using the accrual method.⁹ Recoveries from this rate rider should be applied against the approved balance within this account(s) until the recovery period has expired. No carrying charges will apply on the existing account after disposition consistent with the OEB's approach to accounts that track non-cash items generally. Any residual balance within the account will not be subject to true-up.

As these utilities are collecting amounts from monthly rate riders relating to the previously approved account(s), they will also be required to record a corresponding monthly entry to the new Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential variance account. Generally, the disposition of the previously approved account balance will be a recovery from ratepayers (i.e. the previously approved account is in a debit position). Accordingly, a credit entry to the new Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential variance account will be made with an offsetting debit entry to the contra account on a monthly basis to capture the portion of the previously approved account balance that is now being collected from ratepayers.

Carrying charges will be required to apply against the net balance in the new variance account. The intent is that carrying charges on the previously approved account balance are calculated on the amounts as they are actually recovered from ratepayers on a month to month basis prospectively. Carrying charges will be applied asymmetrically as amounts are recorded in the new Pension & OPEB Forecast Accrual versus Actual

⁹ This will depend on the timing of a cost-based application (cost of service or Custom IR) and the availability of audited financial statements to support balances.

Pension and Other Post-employment Benefits (OPEBs) Costs

Cash Payment Differential variance account in accordance with the accounting treatment outlined for this variance account in the section above. These entries will be recorded simultaneously with the accounting requirements for the new variance account, as described in the section above.

Appendix D: Journal Entries

The following is a simplified example that illustrates the accounting treatment for recording transactions in the sub-accounts of Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential Account. The specific accounting treatment that may apply to a distributor may vary depending on the specific circumstances of the distributor.

Assumptions:

- Pension and OPEB costs are approved for recovery on an accrual basis.
- In utility A's rate application, pension and OPEBs are forecasted to be \$1,000 (\$700 pension, \$300 OPEBs) on an accrual basis and \$700 (\$500 pension, \$200 OPEBs) on a cash basis as supported by the latest actuarial valuation for the test year (Year 1).
- Capitalized pension and OPEB amounts are assumed to be immaterial and therefore, have no impact on the differential calculation.
- After rates have been set and implemented, utility A receives an updated actuarial funding valuation during year 1 that changes the cash payment requirements for years 2 and 3 to \$1,200 (\$800 pension, \$400 OPEBs) and \$1,500 (\$1,000 pension, \$500 OPEBs), respectively. These are the actual amounts the utility pays in years 2 and 3. The utility's accrual versus cash payment differential for years 1 to 3 is summarized as follows:

	Year 1			Year 2			Year 3		
	Pension	OPEB	Total	Pension	OPEB	Total	Pension	OPEB	Total
Accrual in Rates	700	300	1000	700	300	1000	700	300	1000
Cash Payments Made	500	200	700	800	400	1200	1000	500	1500
Difference	-200	-100	-300	100	100	200	300	200	500
Cumulative Difference			-300			-100			400

- In its next rebasing application in year 6, utility A requests to dispose and refund the cumulative net carrying charge balance of \$75 for the most recent audited account balance in the carrying charges sub-account. Disposition of this sub-account is approved.
- Assumes no previously approved variance account to capture the difference between the cash and accrual methods that the OEB approved for some utilities as an interim measure pending the outcome of this consultation. If such an account exists, utilities must follow the accounting treatment in Appendix C.

Pension and Other Post-employment Benefits (OPEBs) Costs

For illustrative purposes, the journal entries required to record the accrual versus cash differential amounts and corresponding carrying charges into the Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential sub-accounts are shown below only for years 1-3. Instead of the required monthly journal entries, the journal entries below are simplified to reflect the cumulative annual amounts that would be recorded in the accounts. Total annual carrying charges would depend on the monthly amounts recorded in the primary variance account.

Also note the asymmetric nature of the carrying charges as shown in year 3, where no carrying charges have been calculated. Recording of carrying charges ceases once the balance within the Pension & OPEB Forecast Accrual versus Actual Cash Payment Differential sub-account is no longer in a credit position (i.e. once the cumulative cash payments equal or exceed the cumulative accrual amount).

Year 1

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account	200	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential		200

To record the difference between the total pension accrual amount approved in rates and the actual cash amount paid

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account	100	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential		100

To record the difference between the total OPEB accrual amount approved in rates and the actual cash amount paid

Dr. Interest Expense	8	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Carrying Charges		8

To record total annual carrying charges on the monthly opening cumulative credit balance in the primary account at the OEB prescribed CWIP rate

Year 2

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential	100	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Contra Account		100

To record the difference between the total pension accrual amount approved in rates and the actual cash amount paid

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential	100	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account		100

To record the difference between the total OPEB accrual amount approved in rates and the actual cash amount paid

Pension and Other Post-employment Benefits (OPEBs) Costs

Dr. Interest Expense	3	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Carrying Charges		3
To record total annual carrying charges on the monthly opening cumulative credit balance in the primary account at the OEB prescribed CWIP rate		

Year 3

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential	300	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account		300
To record the difference between the total pension accrual amount approved in rates and the actual cash amount paid		

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential	200	
Cr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Contra Account		200
To record the difference between the total OPEB accrual amount approved in rates and the actual cash amount paid		

Year 6 - Disposition Year

Dr. P&OPEB Forecast Accrual versus Actual Cash Payment Differential Carrying Charges	75	
Cr. Disposition and Recovery/Refund of Regulatory Balances		75
To record the approved disposition of the cumulative carrying charges		