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Ontario

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To: Nadine Petsche, Director, Accounting Policy and Financial Reporting, Office of the Provincial Controller

Re: Actuarial Surplus in the Ontario Teachers' Pension Plan

1. Request

You have asked for a legal opinion on the Province of Ontario's (Ontario's) legal rights in connection with a surplus in the Ontario Teachers' Pension Plan (the Plan). Specifically, you have asked for confirmation that Ontario is legally entitled to benefit from the 'Government Portion' of the surplus recognized by Ontario as a pension asset in its 2015-16 Public Accounts ($10.1 billion after adjustments), for example through reduced contributions or a contribution holiday, further to the analysis provided to Ontario by Deloitte LLP in August 2016 through an initial report and supplementary analysis (Deloitte Report).

2. Short Answer

Ontario has an enforceable legal interest in the 'Government Portion' of the identified surplus recognized by Ontario as a pension asset in its 2015-16 Public Accounts.

3. Background

i. Legal Framework for the Plan

The Plan is established by the *Teachers' Pension Act*[1] (TPA). The TPA provides that the Plan is a defined benefit pension plan within the meaning of the *Pension Benefits Act*[2] (PBA). The TPA provides that the governing

[1] R.S.O. 1990, c. T.1
[2] R.S.O. 1990, c. P.8

documents for the Plan are the pension plan established under Schedule 1 to the TPA, along with such other governing documents as may be created or adopted under the TPA or the text of the pension plan.

Section 5 of the TPA provides that the contributions of Ontario and contributing employers, on one hand, and active Plan members on the other hand, are to be approximately equal.

Section 10 of the TPA provides that the Minister of Education and the executive of The Ontario Teachers' Federation (OTF) may enter into an agreement that provides for, among other things, the joint management of the Plan and the sharing of entitlement to gains or surplus under the plan and of liability for deficiencies in the pension fund.

The Minister of Education and the OTF have entered into an agreement for the management of the Plan (Partners Agreement), to which is appended a Funding Management Policy (FMP) that is deemed to form part of the agreement.[3] The FMP provides for the funding of the Plan and how deficits and surpluses will be addressed.

ii. Accounting Treatment for Plan Surpluses

Ontario's audited financial statements have reflected the Province's respective portion of the accrued pension benefit as calculated in accordance with Public Sector Accounting Standards. Consistent with past practice, in the 2015-16 Public Accounts, Ontario continues to report its portion of the pension asset ($10.1 billion as of March 31, 2016.) The Deloitte Report sets out an accounting analysis supporting the recognition of the surplus as an asset for the purposes of reporting the Province's financial position, as assessed in accordance with Public Sector Accounting Standards. Deloitte provides the following rationale in support of this position:

> We have discussed the plan mechanics with OPCD and here are the key factors of the FMP and OTPP plan characteristics that would be considered in support of the Government Expected future benefit coming from surplus withdrawal and contribution reduction:
> • The plan nature is defined to be a 50 / 50 share between employees and employer

[3] Partners Agreement, section 110.

• Looking at the FMP, this principle applies to bad news and good news, hence for deficit and surplus situations
• The employer can benefit from surplus withdrawal and contribution reduction
• The surplus situations could be dealt with permanent and temporary changes, increasing the likelihood of surplus application
• The accounting valuation currently includes a 100% CPI indexing, hence the resulting accounting surplus to the employer portion has already fully restored benefits considered
• Accounting valuation uses best estimate assumptions and therefore the resulting surplus is considered a realistic value[4]

While the Deloitte analysis speaks to Ontario benefitting from surplus withdrawal, the Office of the Provincial Controller Division (OPCD) in Treasury Board Secretariat has advised that the analysis under Public Sector Accounting Standards completed by Deloitte demonstrates that no surplus withdrawal is necessary to support the asset recorded in Ontario's Public Accounts.

iii. Concerns of the Auditor General

The Auditor General of Ontario (AGO) has expressed concerns with Ontario's treatment of the pension asset in the Public Accounts. We understand that the AG believes that the ability to benefit through surplus withdrawals is necessary in order to support recognition of the asset on the Province's books. The accounting treatment of surplus withdrawals is governed by Public Sector Accounting Board (PSAB) standard PS3250.059:

> .059 A key factor in determining a government's expected future benefit from a defined benefit plan with a plan surplus for accounting purposes is the ability of the government to withdraw assets from the plan. <u>The expected future benefit includes amounts to which a government has a legally enforceable right of withdrawal.</u> It excludes any withdrawable plan surplus a government is currently required, or intends, to allocate to employees. A government may not anticipate obtaining a legally enforceable right to withdraw a portion of a plan surplus to which it is not currently entitled, whether on the basis of precedent or otherwise.
> <u>Accordingly, when withdrawal of plan surplus requires the approval of employees or an appropriate regulatory authority or a court of law, a government excludes any amount subject to this restriction from its expected future benefit until such approval has been obtained.</u> A change in the allocation of surplus between a government and its employees is

[4] Deloitte Report p. 14

> incorporated into the calculation of the expected future benefit only when it has been agreed to and, when required, approved by the appropriate regulatory authorities. [emphasis added]

In light of this provision, the AGO has taken the position that Ontario cannot rely on the potential for future surplus withdrawals as a rationale for treating the Ontario portion of a Plan surplus as an asset. Any such withdrawal would be subject to the agreement of Plan members and would require regulatory approval under the PBA.

As previously noted, it is OPCD's position that in accordance with PSAS, the value of the pension asset is sufficiently satisfied by other means of benefiting from the surplus, and that the ability to withdraw any surplus is not a necessary consideration based on the results of the analysis included in Deloitte's Report.

OPCD has advised that despite the references in the Deloitte Report, Ontario is not seeking to recognize the value of potential surplus withdrawals from the Plan (which would be subject to the analysis described in PSAB standard PS3250.059). Rather, Ontario is supporting the value of the pension asset recognized through the ability to benefit from contribution holidays to which the government would be entitled under the terms of the FMP. OPCD notes that PSAB Standards PS3250.052 and PS3250.055 provides guidance for determining the amount that is appropriately recognized as a pension asset:

> .052 A government may benefit from an accrued benefit asset either by withdrawing surplus assets <u>or by taking a contribution holiday</u> or receiving a refund of contributions. The accrued benefit asset may become impaired when there is a plan surplus for accounting purposes that the government is not entitled to benefit from fully. For example, there may be a regulatory moratorium on pension surplus withdrawals or uncertainties as to a government's legal right to use a plan's accounting surplus.
>
> .055 The objective of the standard in paragraph PS 3250.050 is to limit a government's accrued benefit asset to the amount it can realize in the future. The expected future benefit is a calculated amount representing the benefit a government expects to realize from a plan surplus. An expected future benefit includes any withdrawable surplus <u>or reduction in future contributions</u>.

The AGO has requested that Ontario provide a legal opinion confirming the government's ability to access/realize benefits sufficient to support the pension asset recognized. While the AGO's questions in connection with the treatment of the surplus have referenced surplus withdrawals, we understand that OPCD is focussing on Ontario's right to apply the surplus toward reduced contributions or contribution holidays.

4. Analysis

i. Plan is a Jointly Sponsored Pension Plan

Section 5 of the TPA provides for Ontario and contributing employers to make contributions to the Plan that are equal to the contributions made by members, and we understand that the Plan is a jointly sponsored pension plan under the PBA. A defining feature of a jointly sponsored pension plan is that the employer's required contributions are fixed and both employer and members are jointly responsible for funding the benefits under the plan.

Regulation 909 under the PBA requires that the documents that create and support a jointly sponsored pension plan must set out the methods by which decisions relating to the terms and conditions of the Plan are to be made. The FMP is the mechanism by which the Plan partners have articulated the manner in which they will share the burden of Plan shortfalls and the benefit of Plan surpluses. As noted in Deloitte's analysis, the FMP provides guidance on how the Plan will be funded in different solvency scenarios. Specific to surplus scenarios, the FMP provides for the actions that may be taken by the partners (i.e. Ontario and the OTF) in two different surplus "zones" - i.e. the Temporary Plan Improvement Zone and the Permanent Plan Improvement Zone.

ii. FMP Framework Governing Surpluses

The FMP expressly anticipates the possibility of contribution holidays in two scenarios:

- Article IV (Temporary Improvements) of the FMP provides for temporary actions that can be taken by the partners when Plan assets are greater than current liabilities (subject to the restorations required in section 3.06 of the FMP having already been provided). Section 4.05 of the FMP provides that in such a scenario, the parties may reduce current contributions, provide temporary surplus distributions or provide a temporary benefit improvement.

- Article V (Permanent Improvements) of the FMP provides for permanent actions that can be taken when Plan assets exceed current liabilities by more than 10% of current liabilities. Section 5.05 provides for actions that can be taken in respect of the amount that assets exceed current liabilities plus the 10% margin noted previously. Such actions can include changes to current benefits, current contributions, or both.

iii. Ontario's Legal Interest in Plan Surpluses

Section 10 of the TPA clearly indicates that the Plan is to be managed jointly by Ontario and the OTF. Further, section 10(1)3 expressly permits Ontario and the OTF to enter into an agreement governing "The sharing of entitlement to gains or surplus under the plan and of liability for deficiencies in the pension fund by the Minister, the employers who contribute under the plan and the active plan members."

Pursuant to this provision, Ontario and the OTF have entered into the FMP. The terms of the FMP do not give either Ontario or the OTF any unfettered ability to apply Plan surpluses for their own purposes. Rather, both parties must agree to any proposed application of Plan surpluses. For this reason, it is clear that Ontario would not have any authority to unilaterally apply the Government Portion of the Plan surplus for the purposes of a future contribution holiday.

However, this does not mean that Ontario would not have a legally enforceable expectation that Plan surpluses should result in future contribution holidays. The Supreme Court of Canada has also held, in *Schmidt v. Air Products Canada Ltd.*[5] and *Nolan v. Kerry (Canada) Inc.*[6] that "unless the terms of [a] plan specifically preclude it, an employer is **entitled** to take a contribution holiday" (emphasis added). There is nothing in the Plan or FMP that precludes a contribution holiday and, in fact, it is explicitly contemplated as a possible use of plan surpluses.

In our view, the need for agreement with the OFT before implementing a specific reduction or holiday does not diminish Ontario's enforceable legal interest in the surplus or Ontario's reasonable expectation that a surplus could be applied to a contribution holiday at some future point. Instead, the FMP creates a framework through which Ontario can protect and realize this interest, including a process for negotiation, mediation and arbitration of disputes. In point of fact, Ontario and the OTF have relied successfully in the past on this framework to deal with Plan surpluses and deficits through mutual agreement, with both parties receiving negotiated benefits (including contribution holidays for Ontario).

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[5] *Schmidt v. Air Products Canada Ltd.*, [1994] 2 S.C.R. 611 at p. 638
[6] *Nolan v. Kerry (Canada) Inc.,* [2009] 2 SCR 678 at para 68.

Based on the forgoing we are of the view that the FMP provides Ontario with a reasonable basis on which to expect to benefit proportionately from Plan surpluses, with the nature and exact extent of that benefit determinable through a fair process of negotiation, mediation and arbitration.

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