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**Credit Ratings**

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## Unfunded Postretirement Liabilities Could Pressure Select Canadian Corporates

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Rising levels of unfunded pension and other postretirement obligations have generated greater concerns about the credit quality of corporate entities. To take account of deterioration in benefits-plan funding levels and to ensure global consistency in the application of its ratings criteria, Standard & Poor's Ratings Services reviewed certain U.S. and European industrial companies earlier this year, which resulted in CreditWatch reviews, ratings actions, and outlook revisions on certain companies. A similar analysis was undertaken for all Canadian corporations rated by Standard & Poor's. This article will: 1) highlight key features of Canadian pension accounting; 2) discuss the regulatory framework governing funding of pensions in Canada; 3) summarize Standard & Poor's analytical approach for postretirement obligations; and, 4) disclose the results of Standard & Poor's review of the impact of unfunded postretirement obligations on Canadian corporate credits.

### Understanding Canadian Pension Accounting

Although some of the terminology is different, accounting standards for pensions and other employee future benefits in Canada are similar to standards in the U.S. The Canadian accounting standards governing pensions and other benefits are set out in CICA (the Canadian Institute of Chartered Accountants) Handbook Section 3461 Employee Future Benefits, which became effective in 2000. (Standard & Poor's has summarized pension accounting standards in several jurisdictions in "Navigating the International Pension Accounting Maze," published May 7, 2003, on RatingsDirect, Standard & Poor's Web-based credit analysis system, at [www.ratingsdirect.com](http://www.ratingsdirect.com).)

In broad terms, current Canadian accounting standards require companies with defined pension plans to calculate annually the accrued benefit obligation (ABO) which is consistent with the calculation of the projected benefit obligation (PBO) under U.S. GAAP. It is important to highlight here that the calculation of ABO under Canadian GAAP is not the same as the accumulated benefit obligation as defined under U.S. GAAP, which also is commonly referred to as ABO. To clarify, the U.S. GAAP accumulated benefit obligation calculation considers only the pensions earned by employees as of the reporting date, based on their current salary levels. In contrast, the accrued benefit obligation under Canadian accounting rules takes account of future salary increases.

Consistent with the PBO calculation in the U.S., the calculation of the ABO is subject to considerable uncertainty due to the use of estimates of future wage trends, employee turnover, mortality rates, and retirement dates. The discount rate used for calculating the ABO is typically equivalent to the observed interest rate for high quality corporate bonds. The benchmark interest rates should be a weighted average rate derived from bonds with terms that match the timing of the expected future benefit payments, which depends on the age of the workforce; companies with plans covering employees of a higher average age should generally have lower discount rates than plans covering younger workforces.

Canadian companies are usually required under government regulations (discussed below) to fund pension liabilities, although funding of other postretirement benefits is normally done on a pay-as-you-go basis. The plan manager invests the plan assets in a mix of equities, bonds, and other instruments or assets. The market value of the pension assets is measured annually and is netted against the ABO to determine the plan's funding status (in other words, pension surplus or deficit). The funding surplus or deficit is off-balance-sheet, unless it exceeds a certain threshold, at which time it is amortized into the income and an asset or liability is created.

Consistent with U.S. accounting standards, Canadian standards contain mechanisms designed to reduce the earnings volatility caused by changes to the funding status of a company's pension plans. Gains and losses affecting the funding status can occur as a result of changes in the underlying assumptions used and the variance between actual and assumed rate of returns on plan assets (collectively referred to as actuarial gains and losses), or from changes to the benefits payable under the plan (known as past service costs). Canadian accounting standards permit companies to amortize these gains and losses into the income statement over the estimated remaining service life of the plan participants.

Transitional provisions applied when Section 3461 of the CICA handbook was adopted led to the creation of unrecognized transitional assets or transitional obligations. Transitional assets and obligations are amortized into the income statement expense and balance-sheet obligation in the same way that the other gains and losses are amortized. As a result of the amortization mechanism, the pension liability reported on the balance sheet can be well below the actual pension deficit. In some cases, the transitional accounts can be so large that a company with a pension deficit might actually report a pension asset on its balance sheet--clearly a counterintuitive result.

The pension expense is calculated in a similar manner under Canadian and U.S. standards. A company's pension expense is calculated according to the formula:  $\text{service cost} + \text{interest cost} - \text{expected return on plan assets} \pm \text{amortization of actuarial gains/losses} \pm \text{amortization of past service costs} \pm \text{amortization of transitional accounts}$ .

As noted previously, the effect of various gains and losses on the plan, including those arising from plan amendments, actuarial variances, deviations on asset returns in comparison with estimated returns, and transitional amounts, are tracked by the company, but are not reflected in the balance sheet and income statement. These accounts represent the accumulation of the future income statement effect of the various gains and losses.

One primary smoothing mechanism is the use, for accounting purposes, of an assumed rate of return on plan assets instead of the actual rate of return. Accounting standards allow companies to apply an estimated long-term average rate of return on the plan's investment portfolio. Nevertheless, the actual rate of return in any given year is likely to deviate from the assumed long-term rate. Therefore, surpluses or deficits are aggregated and are not reflected immediately on the balance sheet or income statement. These differences, in addition to other actuarial gains and losses, past service costs, and transitional gains and losses, are accumulated, and when the unrecognized deficit (or surplus) exceeds the greater of 10% of fund assets or 10% of the ABO, any excess must be amortized into income over the estimated average remaining service life of the employees. This 10% range is commonly referred to as the corridor.

## Regulatory Funding Requirements

Accounting standards do not play a direct role in determining how Canadian companies fund their pension plans. Rather, funding is determined by various regulations and regulatory bodies. Funding of other postretirement obligations generally is not regulated but funded on a pay-as-you-go basis.

Regulation of Canadian pension plans generally falls into three categories:

- Federal regulations. Canadian law requires that pension plans for Canadian employers in industries such as rail, air transportation, or shipping be regulated by the Office of Superintendent of Financial Institutions (OSFI).
- Provincial regulations. All Canadian provinces, with the exception of Prince Edward Island, have individual pension regulation and regulatory bodies. The specific jurisdiction that applies is usually the province where the majority of the employees are located.
- Foreign regulations. Canadian companies may have employees in foreign jurisdictions with separate defined benefit plans. Typically, the laws and regulations of that country apply to these plans.

It is not uncommon for large companies to have many different pension plans that are individually governed by different jurisdictions.

The primary federal and provincial regulatory principals regarding funding of pension plans are similar. Most regulators prescribe that pension plans must be funded in accordance with an independent actuarial valuation. The actuarial valuations usually must be completed at least once every three years. Among other things, the actuarial valuation will determine whether the plan is in a funding deficit or a surplus on both a going-concern (assuming the plan continues) and solvency basis (assuming the plan is terminated).

The presence of a solvency deficit usually results in a requirement to fund the deficit within five years. It also requires the actuarial valuation to be completed annually until the solvency deficiency is erased. Companies with unfunded pension liabilities, but not a solvency deficit, are generally granted longer periods (up to 15 years) to fund the liability.

It is worth noting one exception to the above. Most regulatory jurisdictions provide for special funding reviews even before the passage of the three-year period. Such reviews can be triggered at the discretion of the regulator, presumably in response to specific concerns about sudden adverse changes to the pension funding status or the fiscal health of the plan sponsor.

## Standard & Poor's Treatment of Postretirement Commitments

Standard & Poor's views Canadian pension accounting and funding standards as substantially similar to the U.S. standards, and has adopted the same methodology for adjusting the Canadian financial statements as it uses in analyzing U.S.-based, rated companies (see "Standard & Poor's Criteria for Assessing Postretirement Obligation", published March 20, 2003, on RatingsDirect, and "Pitfalls of U.S. Accounting and Disclosure" March 3, 2003).

Pension and other postretirement employee benefits (OPEB) related adjustments are made to the balance sheet, income statement, and cash flow. For the balance sheet, the primary adjustment is the addition of the unfunded ABO (net of tax) to debt to reflect Standard & Poor's view that these obligations are debt-like in nature. A similar amount (less the amount of the pension liability already reported on the balance sheet) is subtracted from shareholders' equity.

On the income statement, an adjusted pension expense is computed that includes

only the current service cost and excludes the interest cost component of the expense (which is viewed as a financing charge). The overriding theme of the adjustments is that unfunded postretirement obligations are debt-like in nature, and that the smoothing mechanisms applied in pension accounting should be stripped away to better assess the economic situation of the company. Table 1 uses Alcan Inc. to illustrate the typical adjustments.

<b>Table 1 Analysis of Unfunded Pensions and Other Postretirement Obligations*</b>				
<b>Alcan Inc.</b>	<b>--Results for year ended Dec. 31, 2002--</b>			
<b>(Mil. US\$)</b>	<b>Unadjusted</b>	<b>Adjustment</b>	<b>Adjusted</b>	<b>Comments</b>
Revenues	12,540.0	0.0	12,540.0	
Net income from cont. oper.	374.0	(236.1)	137.9	Net Income-[(Change in Interest Expense)+(Change in Pension Expense)*(1-tax rate)]
Operating income	1,967.0	66.0	2,033.0	Operating Income+(Change in Pension Expense)
Funds from operations (FFO)	1,491.7	(278.2)	1,213.6	FFO+[(Contributions-((Serv.+Int. costs)-return on plan assets))x(1-tax rate)]
EBIT	1,140.3	66.0	1,206.3	EBIT+(Change in Pension Expense)
EBITDA	1,934.3	66.0	2,000.3	EBITDA+(Change in Pension Expense)
Gross interest	224.3	453.0	677.3	Interest Expense+(Interest cost-the actual return on plan assets)
Pension expense	197.0	(66.0)	131.0	All but the current service cost are elim. from benefits expense
Total debt (incl. STD)	4,430.3	1,012.0	5,442.3	Total Debt+[(1-Tax Rate)x(Unfunded Obligation)]
Shareholders' equity	8,775.0	(621.60)	8,153.4	Equity -[(1-tax rate)x(Unfund. obligation - Liab. recog. on balance sheet)]-[(pension asset)x(1-tax rate)]
Total capital	13,205.3	197.6	13,402.9	

\*Adjusted by capitalizing operating leases and unfunded obligations (including tax effects). Pension information is based on most recent annual reports (fiscal year-end 2002 or 2003, if available). STD--Short-term debt. OPEB--Other postretirement employee benefits. N/A--Not applicable.

The impact on credit statistics for some companies with large unfunded obligations can be quite dramatic. Nevertheless, it is emphasized that postretirement obligations are difficult to value because, unlike conventional debt, their value is dependent on a number of subjective assumptions and actuarial estimates, and can vary widely from period to period. The adjusted leverage derived from the adjusted amounts is considered as additional perspective--not the definitive perspective--of viewing leverage. Furthermore, the profitability measures that result from the use of the adjustments can be extremely volatile, with benefits-related effects often obscuring operating results. For this reason, Standard & Poor's views such measures as supplementary.

Where large unfunded amounts exist, cash flow impacts are often of greater concern to Standard & Poor's than the impact on adjusted leverage. Canada's regulatory environment prescribes fairly rapid funding of deficits of plans that are classified as being in solvency deficiency. Therefore, the analytical focus often shifts to understanding the regulatory regimes that govern the plans, the potential for the plans to be designated for funding on an accelerated basis, and the extent to which the company has allowed for this in its forecasts.

Pension assumptions are an important part of Standard & Poor's analysis. As a whole, Canadian companies do not show large variances in pension assumptions. The method used to calculate the discount rate applied to calculate the present value of the benefit obligations is prescribed fairly narrowly by the accounting

standards, and variances among companies are generally attributable to differing average ages of the workforces. Greater variance is observed in plan asset return assumptions. In rare cases, companies apply a return assumption exceeding 9%. For the most part, however, return assumptions vary between 7% and 9%, with a median of 7.5%.

The use of expected rates of return is one component of the pension expense that is examined fairly closely. It is apparent that many companies base their expectations of future returns partially on their experience of past returns. Accordingly, as the past two years have produced negative market returns, some companies have started to reduce their expectations for future returns. Still, reflecting typical fund asset mixes that have a slightly greater proportion of equity than bonds, most Canadian companies would appear to be assuming equity returns of between 8% and 12%.

The appropriate rate of return currently is possibly the most contentious issue in the discussion of pension accounting. From a debt ratings perspective, Standard & Poor's does not have a specific view on what the appropriate rate of return should be. Nevertheless, Standard & Poor's is cautious as equity markets do not move in predictable patterns in the short to medium term, and hence future returns could potentially fall significantly below current assumptions. Thus, even if current return assumptions were to be validated in the very long run, companies can face significant funding pressure in the medium term due to regulatory requirements.

Different investments composition and capital market environments make crosscountry comparisons regarding the appropriateness of estimated rates of return on plan assets difficult. Nevertheless, in Canada, comparisons between companies can be appropriate. Accordingly, peer analysis will increasingly form part of Standard & Poor's analysis. If a company is using a significantly higher assumed rate of return on plan assets than its peers, the basis for this assumption will be explored with company management, and if there are no compelling reasons to use a higher rate, Standard & Poor's could assume a lower rate of return in its analysis and adjust the ratios accordingly.

## Standard & Poor's Survey of Canadian Industrial Companies

As part of Standard & Poor's coverage of Canadian corporate credits, a survey was undertaken, based primarily on publicly available financial information. The screening was applied to virtually all Canadian industrial companies that are rated by Standard & Poor's and used the methodology summarized above.

Initial screening eliminated many companies from further investigation. Companies in this category generally had well-funded plans, or had plans that were in deficit but that were small relative to the firms other obligations. This was particularly true of most pipeline and utility companies. Although many of these companies offer defined benefit pension plans, they are not particularly labor intensive, the size of their plans are relatively small in comparison with their other obligations, and some companies benefit from regulatory environments that allow them to pass through increased pension costs.

No specific downgrade, outlook change, or CreditWatch actions resulted from the survey.

Nevertheless, a group of companies were identified as candidates for further monitoring. These companies were considered to have 1) unfunded liabilities that materially affected their credit ratios on an adjusted basis, but were not significant enough to affect the ratings in the absence of other negative factors, or 2) modestly underfunded obligations, but were considered very sensitive to pension plan

performance due to large gross pension obligations (this was the case with Canadian National Railway Co.). The companies in this category and key credit statistics are listed in Table 2.

Changes in postretirement obligations of companies in this category will be monitored actively and commented on as part of Standard & Poor's regular surveillance. While movements in interest rates and asset returns cannot be predicted, it is recognized that further periods of low fund returns or reduced interest rates could exacerbate the current deficits, lead to accelerated funding of deficits, and materially affect financial profiles.

Whether further adverse changes could prompt ratings changes or outlook revisions is dependent on the severity of any changes and would also have to consider the many other factors affecting the business and financial risk evaluations that determine a company's rating. (See Table 2 for a list of monitored companies.)

<b>Table 2 Analysis of Unfunded Pensions and Other Postretirement Obligations*</b>						
<b>(Mil. C\$; at Dec. 31, 2002)</b>	<b>Abitibi-Consolidated Inc.</b>	<b>Alcan Inc.¶</b>	<b>Aliant Inc.</b>	<b>Bombardier Inc.</b>	<b>Canadian National Railway Co.</b>	<b>Canadian Pacific Railway Co.</b>
Rating	BB+/Stable/--	A-/Watch Neg/A-2	A/Stable/A-1	BBB-/Stable/--	BBB+/Stable/A-2	BBB/Stable/-
<b>Summary</b>						
Pension obligation	3,287.0	7,198.0	1,379.5	5,805.7	11,243.0	5,993.1
OPEB obligation	199.0	241.0	159.7	313.0	444.0	423.8
Pension plan assets	2,496.0	5,777.0	1,081.8	3,152.2	11,182.0	5,129.6
Unfunded pension obligation	791.0	1,421.0	297.6	2,653.5	61.0	863.5
Unfunded OPEB obligation	199.0	238.0	159.7	313.0	444.0	423.8
Unfunded total postretirement obligation	990.0	1,659.0	457.3	2,966.5	505.0	1,287.3
Cash balance (March 31, 2003)	92.0	111.0	286.6	402.4	84.0	505.7
Pension obligation as a % of total assets	30.1	40.5	33.4	27.9	49.9	59.8
Unfunded postretirement obligation as a % of EBITDA	117.0	85.8	46.2	203.7	19.8	104.1
Cash employer contribution (2002)	119.0	128.0	9.0	209.5	92.0	92.8
EBITDA	846.0	1,934.3	989.2	1,456.0	2,545.4	1,236.6
<b>Assumptions</b>						
Discount rate (pension; %)	6.5	5.8	6.8	5.8	6.5	6.8

Expected return on assets (pension; %)	8.0	7.1	7.5	8.0	9.0	8.0
<b>Pension-adjusted ratios</b>						
Adj. total debt/capital (%)	72.2	40.6	59.8	82.1	46.9	65.2
Adj. total debt/EBITDA (x)	8.0	2.7	2.5	4.3	2.9	3.8
Adj. FFO/total debt (%)	2.0	22.3	25.3	8.3	21.0	12.0
Adj. pretax interest coverage (x)	0.2	1.8	1.6	0.7	1.6	1.1
Adj. EBITDA interest coverage (x)	1.1	3.0	3.0	1.3	2.0	1.5
Adj. oper. income % of sales	16.5	16.2	38.3	6.9	42.4	35.7
<b>Unadjusted ratios</b>						
Total debt/capital (%)	65.9	33.5	53.8	62.8	44.6	52.9
Total debt/EBITDA (x)	7.2	2.3	2.2	3.2	2.6	3.1
FFO/total debt (%)	5.1	33.7	33.2	23.8	29.7	23.0
Pretax interest coverage (x)	0.4	5.1	3.3	2.3	4.4	3.0
EBITDA interest coverage (x)	1.8	8.6	5.9	4.2	5.6	4.2
Oper. income % of sales	16.5	15.7	39.0	6.6	43.8	36.4
<b>(Mil. C\$; at Dec. 31, 2002)</b>	<b>CHC Helicopter Corp.</b>	<b>Dofasco Inc.</b>	<b>Falconbridge Ltd.</b>	<b>Inco Ltd.¶</b>	<b>Nexfor Inc.¶</b>	<b>Noranda Inc.§</b>
Rating	BB-/Positive/-	A-/Stable/--	BBB-/Negative/A-3	BBB-/Stable/--	BBB/Stable/--	BBB-/Negative/A-3
<b>Summary</b>						
Pension obligation	423.9	983.5	1,037.6	2,172.0	405.0	2,203.0
OPEB obligation	0.0	463.3	260.5	677.0	47.0	364.0
Pension plan assets	316.7	1,031.9	759.2	1,367.0	280.0	1,872.0
Unfunded pension obligation	107.2	(48.4)	278.4	805.0	125.0	331.0
Unfunded OPEB obligation	0.0	462.7	244.4	677.0	47.0	338.0
Unfunded postretirement obligation	107.2	414.3	522.9	1,482.0	172.0	669.0
Cash balance						

at March 31, 2003	52.9	360.8	247.6	1,246.0	54.0	402.0
Pension obligation as a % of total assets	32.4	27.4	19.9	25.3	20.6	19.4
Unfunded pension obligation as a % of EBITDA	68.3	59.4	109.3	243.1	115.4	96.0
Cash employer contribution (2002)	0.0	26.9	68.7	67.0	10.0	84.0
EBITDA	157.0	697.9	478.2	609.6	149.0	697.0
<b>Assumptions</b>						
Discount rate (pension)	6.6	6.8	6.8	7.0	6.50-6.75	6.8
Expected return on assets (pension)	7.3	8.0	7.0	9.0	8.0	6.9
<b>Adjusted ratios</b>						
Adj. total debt/capital (%)	64.4	33.5	52.6	47.4	56.4	62.2
Adj. total debt/EBITDA (x)	3.5	1.3	4.5	4.2	6.1	8.9
Adj. FFO/total debt (%)	21.6	48.7	15.3	12.7	8.8	7.2
Adj. pretax interest coverage (x)	2.7	3.4	0.8	1.4	0.4	0.0
Adj. EBITDA interest coverage (x)	3.1	6.1	2.4	2.1	1.7	1.5
Adj. oper. income % of sales	25.9	20.2	22.1	32.6	10.2	12.3
<b>Unadjusted ratios</b>						
Total debt/capital (%)	53.3	26.3	46.6	32.9	50.4	57.9
Total debt/EBITDA (x)	3.0	1.0	4.2	3.2	5.5	7.8
FFO/total debt (%)	24.8	76.1	20.3	26.3	14.0	9.5
Pretax interest coverage (x)	2.7	6.6	1.4	4.6	0.9	0.2
EBITDA interest coverage (x)	3.1	12.2	4.9	7.7	4.0	2.8
Oper. income % of sales	25.9	19.5	20.0	28.6	10.1	13.0
(Mil. C\$; at Dec. 31, 2002)	Norske Skog Canada Ltd.	Nortel Networks Ltd.¶	Quebecor World Inc.¶	Stelco Inc.	Teck Cominco Ltd.	
Rating	BB/Stable/--	B/Negative/C	BBB-/Stable/A-3	B/Watch Neg/--	BBB/Stable/--	

<b>Summary</b>						
Pension obligation	320.4	6,145.0	809.5	3,261.0	835.0	
OPEB obligation	160.1	568.0	92.3	1,082.0	172.0	
Pension plan assets	224.0	4,358.0	404.1	2,611.0	693.0	
Unfunded pension obligation	96.4	1,787.0	405.4	650.0	142.0	
Unfunded OPEB obligation	160.1	527.0	92.3	1,073.0	172.0	
Unfunded postretirement obligation	256.5	2,314.0	497.7	1,723.0	314.0	
Cash balance at March 31, 2003	0.0	4,140.0	6.5	39.0	32.0	
Pension obligation as a % of total assets	11.0	36.5	12.4	107.6	16.8	
Unfunded pension obligation as a % of EBITDA	430.7	(270.8)	53.6	937.6	113.8	
Cash employer contribution (2002)	13.4	177.0	31.4	42.0	31.0	
EBITDA	59.5	(854.6)	929.0	183.8	276.0	
<b>Assumptions</b>						
Discount rate (pension)	6.5	6.3	6.7	6.3	6.5-7.0	
Expected return on assets (pension)	7.5	7.8	8.2	7.8	7.5	
<b>Adjusted ratios</b>						
Adj. total debt/capital (%)	50.4	67.1	55.8	95.8	39.8	
Adj. total debt/EBITDA (x)	15.2	N/A	3.3	8.5	5.5	
Adj. FFO/total debt (%)	(4.1)	(22.8)	18.7	(3.0)	9.8	
Adj. pretax interest coverage (x)	(0.9)	(1.3)	1.9	0.2	0.9	
Adj. EBITDA interest coverage (x)	0.6	(0.7)	3.0	0.6	2.0	
Adj. oper. income % of sales	5.0	(5.2)	15.9	9.4	13.4	
<b>Unadjusted ratios</b>						
Total debt/capital (%)	44.8	54.9	50.7	49.4	35.5	

Total debt/EBITDA (x)	15.4	N/A	3.0	4.4	5.1	
FFO/total debt (%)	(2.4)	(20.7)	23.5	21.2	14.3	
Pretax interest coverage (x)	(1.5)	(5.3)	2.9	0.8	1.8	
EBITDA interest coverage (x)	0.7	(3.2)	4.5	3.0	4.1	
Oper. income % of sales	4.2	(6.5)	15.8	7.9	12.6	
<p>*Adjusted by capitalizing operating leases and unfunded obligations (including tax effects). Pension information is based on most recent annual reports (fiscal year-end 2002 or 2003, if available). ¶Mil. US\$. §Noranda figures include partially owned subsidiaries and joint ventures. STD--Short-term debt. OPEB--Other postretirement employee benefits. N/A--Not applicable.</p>						

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