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March 12, 2014

**VIA ELECTRONIC FILING AND FIRST CLASS MAIL**

Public Utility Commission of Oregon  
3930 Fairview Industrial Drive SE  
Post Office Box 1088  
Salem, Oregon 97308-1088

Attn: Filing Center

Re: Docket UM 1633 – Investigation into Treatment of Pension Costs in Utility Rates

Northwest Natural Gas Company, dba NW Natural (“NW Natural” or “Company”), files herewith Reply Redacted Testimony of NW Natural/Brody Wilson the above-captioned docket. Enclosed are an original and five copies.

A copy of this filing has been served on all parties to this proceeding as indicated on the enclosed Certificate of Service

Please call me with any questions.

Sincerely,

*/s/ Mark R. Thompson*

Mark R. Thompson

enclosures

cc: UM 1633 Service List



## CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing REPLY REDACTED TESTIMONY OF NW NATURAL/BRODY WILSON upon all parties of record in the UM 1633 proceeding by electronic mail.

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DATED at Portland, Oregon, this 12th day of March 2014.

*/s/ Kelley C. Miller*  
Kelley C. Miller  
Rates & Regulatory Affairs  
NW NATURAL

BEFORE THE  
PUBLIC UTILITY COMMISSION OF OREGON  
**INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY  
RATES**

**UM 1633**

**REDACTED**  
**Reply Testimony of**

**Brody Wilson**

**EXHIBIT 100**

March 12, 2014

**EXHIBIT 100 – REPLY TESTIMONY – PENSIONS**

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1 I. **INTRODUCTION AND SUMMARY**

2 **Q. Please state your name and position.**

3 A. My name is Brody Wilson. I am Controller and Chief Accounting Officer at Northwest  
4 Natural Gas Company (“NW Natural” or “Company”).

5 **Q. Have you previously filed direct testimony in this case?**

6 A. Yes. I was one of the witnesses who filed Joint Direct Testimony of Portland General  
7 Electric, PacifiCorp, Avista Utilities, Cascade Natural Gas, and NW Natural Gas  
8 (collectively, “Joint Utilities”).

9 **Q. What is the purpose of your reply testimony?**

10 A. The purpose of my reply testimony is to respond to the opening testimony of Staff of the  
11 Public Utility Commission of Oregon (“Staff”), the Citizens’ Utility Board of Oregon  
12 (“CUB”), and the joint opening testimony filed by the Northwest Industrial Gas Users  
13 Association (“NWIGU”) and the Industrial Customers of Northwest Utilities (“ICNU”)  
14 (collectively, “NWIGU-ICNU”). These parties have argued that the utilities should not be  
15 allowed to add their prepaid pension assets to rate base in part because the utilities  
16 have, or may have, over-recovered FAS 87 expense in the past. Their reasoning  
17 appears to be that the prepaid pension assets were built up over a period of time when  
18 the utilities’ rates included more than their actual FAS 87 expense—particularly when  
19 FAS 87 was negative—and so it would not be fair to add the prepaid asset to rate base.  
20 The parties also suggest that the utilities’ prepaid pension assets either were or could  
21 have resulted from negative FAS 87 or higher than expected market returns, and  
22 therefore do not truly represent utility shareholder investments. To make this point, CUB  
23 in particular presents carefully selected and incomplete data that tell only a partial and

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1 misleading story. Thus, the purpose of my reply testimony is to present a complete data  
2 set with regard to the NW Natural's pension plan ("Plan") that demonstrates that the  
3 Company has historically recovered less FAS 87 expense in its rates than it has actually  
4 experienced. Furthermore, customers have benefitted from the Company's contributions  
5 in the form of lower FAS 87 expense included in rates, including negative FAS 87  
6 expense when test year expense was negative. In the end, I hope to demonstrate that  
7 the Company's prepaid pension asset represents an investment of shareholder dollars  
8 that should be afforded a return on investment.

9 To be clear, as the Joint Utilities explain in their reply testimony, the Company  
10 does not agree that it is necessary or appropriate for the Commission to look back at a  
11 utility's historical recovery of pension expense or contributions in deciding on whether or  
12 not to include the prepaid asset to rate base. Over- and under-recoveries are a natural  
13 product of "regulatory lag" and the Commission should not seek to adjust for such lag  
14 when attempting to craft a durable pension recovery policy for the future. Even if the  
15 Commission finds that such considerations are relevant, this general policy docket is not  
16 the appropriate forum to engage in utility-specific fact-finding. Therefore, the purpose of  
17 my testimony is not to attempt to prove NW Natural's utility-specific case, but rather to  
18 rebut the implication that the utilities have always over-recovered pension expense to  
19 the detriment of customers. My testimony complements the Joint Utilities' joint reply  
20 testimony and reply testimony from Dr. C. Kenneth Vogl.

21 **Q. Please summarize your testimony.**

22 A. In my testimony, I:

- 23
- Summarize why the prepaid pension asset should be included in rate base;

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- 1 • Demonstrate that NW Natural has under-recovered<sup>1</sup> its pension costs in rates; and
- 2 • Explain that NW Natural's prepaid pension asset has increased because of
- 3 shareholder investments.

## 4 II. DISCUSSION

5 **Q. Please summarize the parties' arguments as to why the utilities' prepaid pension**  
6 **asset should not be included in rate base.**

7 A. The parties make two basic arguments as to why the utilities should not be allowed to  
8 earn a return on the prepaid pension asset. *First*, the parties argue that the utilities  
9 either have or may have "over-recovered" pension costs in the past and therefore it  
10 would not be appropriate to allow them to add the prepaid pension asset to rate base.<sup>2</sup>  
11 CUB makes the over-recovery argument most directly, claiming that, because negative  
12 FAS 87 has not been reflected in rates, shareholders have contributed less to the  
13 prepaid pension assets than they have collected in rates.<sup>3</sup> NWIGU-ICNU claims that  
14 utilities previously have not credited customers when FAS 87 was negative,<sup>4</sup> thus  
15 suggesting that the utilities may have over-recovered their pension costs. In addition,  
16 both NWIGU-ICNU and Staff argue that the utilities' request is inequitable because in the  
17 past utilities failed to credit customers the financing costs when the prepaid pension

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<sup>1</sup> The parties use the term "over-recovery" to refer to the situation where the utility has more FAS 87 expense built into rates than it actually experiences, for some time period. Such "over-recovery"—or "under-recovery" for that matter—is inherent in the ratemaking process. For this reason, I believe terms such as "over-recovery" and "under-recovery" in this context seem inapt and I will use such terms with that caveat.

<sup>2</sup> See *e.g.*, CUB/100, Jenks-McGovern/10, 18-19, 32, 37; NWIGU-ICNU/100, Smith/7, 20; Staff/100, Bahr/10.

<sup>3</sup> CUB/100, Jenks-McGovern/16.

<sup>4</sup> NWIGU-ICNU/100, Smith/20.

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1 asset was negative.<sup>5</sup> *Second*, the parties suggest that the utilities' prepaid pension  
2 assets either are not or may not be the result of utility contributions, and therefore the  
3 utilities are not entitled to recover costs to finance the prepaid pension asset. On this  
4 point CUB claims that the prepaid pension asset results from negative FAS 87,  
5 independent of company contributions.<sup>6</sup> Parties also suggest that the prepaid pension  
6 assets have or may have historically increased due to return on investment, independent  
7 of utility contributions.<sup>7</sup>

8 **Q. What is your response?**

9 A. Both of the arguments offered by the parties are flawed. First let me emphasize that by  
10 definition the prepaid pension asset, at any point in time since FAS 87 was introduced,  
11 equals the difference between cumulative cash contributed and the cumulative FAS 87  
12 expense. And, so long as customers pay FAS 87 expense (and get the benefit of a  
13 credit in the event of negative FAS 87 expense), then the prepaid pension asset  
14 represents an actual financing by the utility. In NW Natural's case, customers have paid  
15 for FAS 87 expense, and also been afforded credits when NW Natural had negative FAS  
16 87 expense. Moreover, as I will explain more fully below, over time NW Natural has not  
17 over-recovered its FAS 87 expense. And finally, while the prepaid pension asset can  
18 increase in size due to shareholder contributions *and* negative FAS 87 expense, NW  
19 Natural's prepaid pension asset is the result of contributions.

20 **///**

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<sup>5</sup> Staff/100, Bahr/10, NWIGU-ICNU/100, Smith/7.

<sup>6</sup> CUB/100, Jenks-McGovern/14.

<sup>7</sup> Staff/100, Bahr/18, 23; CUB/100, Jenks-McGovern/25; NWIGU-ICNU/100, Smith/7.

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***NW Natural has Not Over-Recovered FAS 87 Expense***

1  
2 **Q. You state that NW Natural has not over-recovered its FAS 87 expense. Please**  
3 **explain.**

4 A. First I would point out that ratemaking is not perfect, and that in any one year the FAS 87  
5 expense incorporated into NW Natural's rates is highly unlikely to match exactly that  
6 year's actuarially-calculated FAS 87 expense. Accordingly, I would expect that there  
7 would be years where the Company received more in rates for FAS 87 expense than it  
8 actually shows on its books—just as I would expect that there would be years where the  
9 Company would recover less than its actual FAS 87 expense. Such “over and under-  
10 recoveries” are a normal part of the ratemaking process and are not relevant to whether  
11 or not the prepaid pension asset should be added to rate base. However, given that the  
12 parties seem to be suggesting that there has been some kind of systemic “over-  
13 recovery,” I will explain NW Natural's historical FAS 87 recovery to demonstrate that  
14 such a characterization is in error.

15 **Q. Please describe NW Natural's history of FAS 87 recovery.**

16 A. NW Natural has been recovering its pension costs through FAS 87 since 1986, which for  
17 the purposes of my explanation I will divide into three periods: 1986 through 1998; 1999  
18 through 2010; and 2010 to the present.

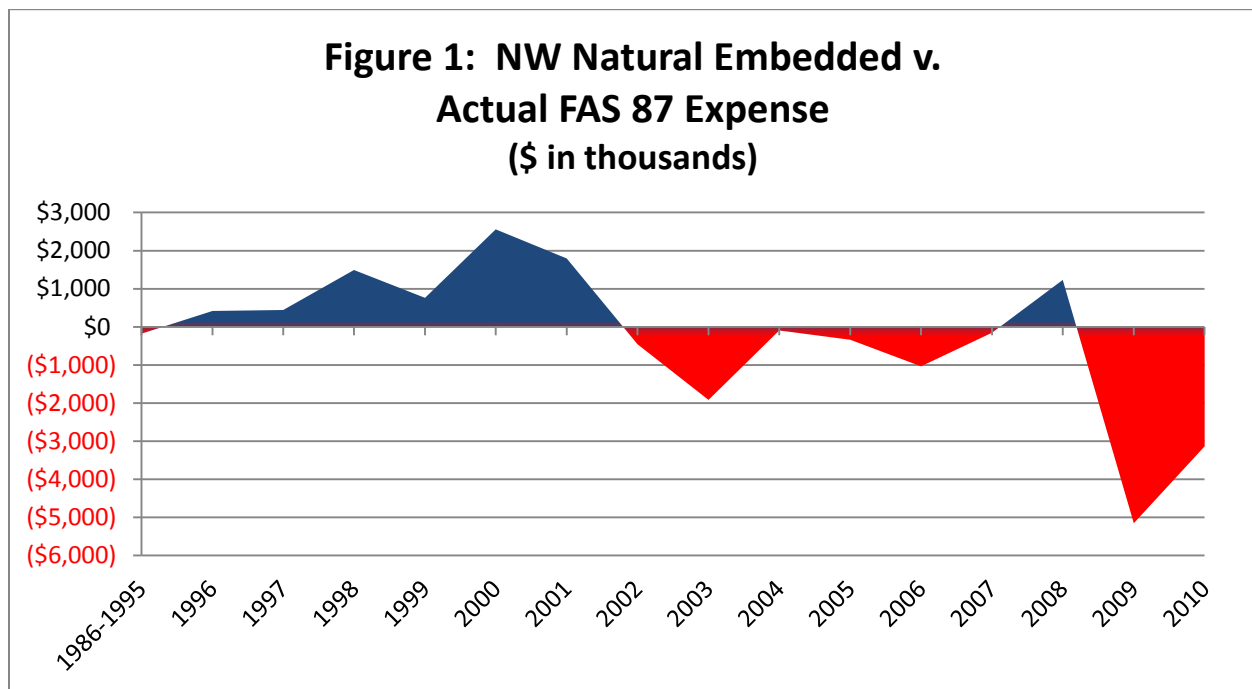
19 For the period of time from 1986 through 1998 we do not have exact information;  
20 however, using the best information available, we have reconstructed all relevant data to  
21 estimate that over these years the FAS 87 expense included in rates exceeded actual  
22 FAS 87 expense by approximately \$2.2 million.<sup>8</sup>

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<sup>8</sup> Refer to Figure 1.

1 We do have complete and exact information regarding our FAS 87 recovery from  
2 1999 on. Figure 1 below shows both the FAS 87 expense included in rates and actual  
3 FAS 87 expenses from 1986 through 2010.<sup>9</sup> During this time period, in any one year the  
4 Company may have recovered in rates more or less than its actual FAS 87 expense.  
5 However, over the entire 24-year period NW Natural recovered \$5.9 million less in rates  
6 than its actual FAS 87 expense. Thus, for the period from 1986 through 2010 the  
7 Company “under-recovered” FAS 87 expense by approximately \$3.8 million.

8



9  
10

11 **Q. What has happened since 2010?**

12 A. Since 2010, the Company has had a balancing account in place that ensures there is no  
13 under- or over-recovery over time.

<sup>9</sup> The years 1986 through 1996 are aggregated.

1 **Q. Please explain why the balancing account was adopted and how it works.**

2 A. In 2010, in response to substantial increases in pension costs and chronic under-  
3 recovery of those costs in rates, NW Natural filed an Application to defer its excess  
4 pension expenses,<sup>10</sup> and also requested that it be allowed to add its prepaid pension  
5 asset to rate base.<sup>11</sup> The parties to that case did not agree to add the prepaid pension  
6 asset to rate base, but did stipulate that NW Natural would establish a balancing  
7 account, effective January 1, 2011. The purpose of the balancing account is to track the  
8 difference between the actual pension expense experienced by the Company, and the  
9 amount recovered in rates.<sup>12</sup>

10 Pursuant to the stipulation, NW Natural books pension expenses to the balancing  
11 account, and the balance accrues interest at NW Natural's currently authorized rate of  
12 return. NW Natural will continue booking expenses to the account until the balance  
13 becomes negative and then the balancing account will terminate and the Company will  
14 pass on any negative FAS 87 expense in rates.

15 **Q. What do you conclude about the parties' concerns about NW Natural's historical**  
16 **FAS 87 recovery?**

17 A. As I discussed above, ratemaking is not perfect, and that to the extent a utility's revenue  
18 requirements are updated to reflect test year expenses at each rate case, then

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<sup>10</sup> *Re NW Natural Gas Co. Application for Order Approving Deferral of Certain Expenses or Revenues Pursuant to ORS 757.259*, Docket UM 1475, Application to Defer Pension Costs (Mar. 15, 2010).

<sup>11</sup> Docket UM 1475, NWN/100, Miller/7 (requesting that the balancing account include the Company's "carrying costs related to its cash contributions into the Plan, net of tax benefits").

<sup>12</sup> *Re NW Natural Application to Defer Pension Costs*, Docket UM 1475, Order No. 11-051 at 1 (Feb. 10, 2011).

1 differences will exist. However, with respect to NW Natural's past recoveries, overall the  
2 Company has recovered less in rates for FAS 87 expense than it has actually incurred.

3 **Q. NWIGU-ICNU argues that it would be unfair for utilities to include the prepaid**  
4 **pension asset in rate base now if they have not reduced rates due to negative FAS**  
5 **87 expense in the past.<sup>13</sup> CUB specifically makes the point that NW Natural over-**  
6 **recovered by \$6.2 million between 1996 and 2002 when FAS 87 was negative.<sup>14</sup>**  
7 **What is your response?**

8 A. The parties' concerns are unfounded in the case of NW Natural. In the Company's 1998  
9 Oregon rate case (UG 132), NW Natural's FAS 87 expense was established at a  
10 negative \$546,000 and customers were credited with a \$546,000 revenue requirement  
11 reduction. Accordingly, for each of the four years those rates were in effect, NW  
12 Natural's customers received a credit of over half a million dollars, or a total of  
13 approximately \$2.1 million. CUB's concern is that during a specific time period when  
14 FAS 87 was negative, it was actually "more negative" than the amount incorporated into  
15 rates. This point, however, is not well taken. As discussed above, ratemaking is not  
16 perfect and so it should not be surprising that the Company's actual FAS 87 expense  
17 during a limited period of time did not exactly match the amounts credited in rates for  
18 that period. This does not suggest that the rates in effect were unjust or unreasonable  
19 or that customers were shortchanged. Rather, it is a normal part of regulatory lag that  
20 balances out expenses over time—as has occurred for NW Natural. CUB's arguments,  
21 based on its selection of a single short time period and its conflation of regulatory lag

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<sup>13</sup> NWIGU-ICNU/100, Smith/20.

<sup>14</sup> CUB/100, Jenks-McGovern/19.

1 with pension-specific issues, do not overcome the facts presented here that NW Natural  
2 has, in total, under-recovered its FAS 87 expense.

3  
4 ***NW Natural's Prepaid Asset Represents a True Shareholder Investment***

5 **Q. What arguments do the parties make in support of their claims that the prepaid  
6 pension asset either does not or may not represent true shareholder investment?**

7 A. CUB argues that the increase in the prepaid pension asset has not been caused by  
8 utilities' contributions, but by decades of negative FAS 87 that was not shared with  
9 customers.<sup>15</sup> To make this point, CUB offers a graph showing the build-up of NW  
10 Natural's prepaid pension asset and FAS 87 expense from 1996 through 2002, when the  
11 Company had negative FAS 87 expense, and so did not make contributions to its Plan.<sup>16</sup>

12 **Q. Is CUB's argument accurate?**

13 A. No. CUB selected a short time-period that renders its graph misleading. Figure 2 below  
14 shows NW Natural's prepaid pension asset, FAS 87 expense, and Company  
15 contributions from 1995 to the present. Figure 2 makes clear that the growth in the  
16 prepaid pension asset balance has been driven by Company contributions. Large  
17 Company contributions in 2004 and 2005—in response to increases in funding  
18 requirements due to updates for mortality assumptions, described below—and from  
19 2009 to 2012—due to the recession and the Pension Protection Act, as described in  
20 past testimony—correlate with the increase in the size of the prepaid pension asset.

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<sup>15</sup> CUB/100, Jenks-McGovern/14-15, 32.

<sup>16</sup> CUB/100, Jenks-McGovern/14.

1 The FAS 87 expense was consistently positive during those years of increase, so  
2 negative FAS 87 could not have caused the increase in the asset, as CUB claims.

3 Moreover, CUB's argument that "a significant portion of the asset grew out of  
4 negative FAS 87 that was not shared with customers"<sup>17</sup> is incorrect because NW Natural  
5 did share negative FAS 87 with customers. NW Natural has experienced negative FAS  
6 87 for only a few years prior to 2002, when the prepaid pension asset was less than half  
7 its current size. During those years where the Company had negative FAS 87 expense,  
8 we adjusted rates in our rate case to credit customers accordingly. The current size of  
9 NW Natural's prepaid pension asset has been driven principally by large Company  
10 contributions in this decade, not by small negative FAS 87 expenses in the previous  
11 decade. The Company's actuary projects this trend to continue for the next decade, as  
12 can be seen in Figure 2, with the projected prepaid asset balance expected to reach  
13 almost [REDACTED] This  
14 assumes there are no "excess" market returns and that the Plan is almost fully-funded  
15 by 2023.

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<sup>17</sup> CUB/100, Jenks-McGovern/32.

1 [BEGIN CONFIDENTIAL]



2  
3 [END CONFIDENTIAL]

4 **Q. What argument do parties make about return on investment?**

5 A. CUB argues that the increase in the prepaid asset balance is primarily driven by return  
6 on investments in the pension plan. CUB concludes that most increases in the plan's  
7 assets "come from market appreciation of assets, not from shareholder contributions."<sup>18</sup>  
8 Staff and NWIGU-ICNU also notes that increases in the plan's assets could be due to  
9 market return on investments, not company contributions,<sup>19</sup> leading Staff to recommend  
10 that "excess investment returns" should be excluded from the amount of the prepaid  
11 pension asset on which utilities could earn a return.<sup>20</sup>

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<sup>18</sup> CUB/100, Jenks-McGovern/25.

<sup>19</sup> NWIGU-ICNU/100, Smith/7, Staff/100, Bahr/18.

<sup>20</sup> Staff/100, Bahr/23.

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1 **Q. What is your response?**

2 A. First, investment returns, both expected and above expected (the parties refer to these  
3 as “excess returns”) do act to reduce FAS 87 expense; however, they constitute only  
4 one of many factors in calculating FAS 87 expense. These market returns benefit the  
5 Company by reducing future required contributions, and more importantly benefit  
6 customers by reducing FAS 87 expense. This is another reason why it’s important that  
7 the Company maintain a well-funded Plan. The net impact on FAS 87 expense and  
8 contributions will equal over time, as FAS 87 expense and cash contributions will be  
9 equal over the life of the Plan. What the parties have failed to acknowledge is that, the  
10 only way to increase the prepaid pension asset is through contributions and negative  
11 FAS 87 expense.

12 Second, Figure 2, above, makes clear that NW Natural’s prepaid pension asset  
13 has increased as a result of large Company contributions totaling well over \$100 million  
14 in the past decade, and is expected to [REDACTED]  
15 [REDACTED] within [REDACTED]  
16 [REDACTED] while FAS 87 expense over that same time period would  
17 total [REDACTED] NW Natural’s  
18 Plan has generated market returns above long-term expectations in many years.  
19 However, in most years, the other inputs into FAS 87 expense, such as service costs  
20 and interest costs, have been greater—resulting in positive FAS 87 expense. In recent  
21 years, market returns have been much lower, and in 2009 our Plan suffered losses of  
22 \$63 million related to the market downturn, requiring additional contributions to recover  
23 from the loss. In addition, low interest rates after the recession contributed to increasing

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1 the Plan liability by \$100 million—a nearly 40 percent increase—at the end of 2013. The  
2 result of these market conditions was that NW Natural’s Plan went from being 100  
3 percent funded in 2007, immediately before the recession, to being \$95 million  
4 *underfunded* in 2013, despite the Company’s contributions totaling almost \$90 million  
5 between 2008 and 2013. Thus, the prepaid pension asset has increased primarily as a  
6 result of large Company contributions.

7 In summary, market returns are one input into FAS 87 expense and into the  
8 calculation of required contributions. While returns can have the effect of creating  
9 negative FAS 87 expense, which does increase the prepaid pension asset, to the extent  
10 that negative FAS 87 expense is credited to customers the prepaid pension  
11 asset represents contributions made by the utility in excess of FAS 87 expense paid by  
12 customers.

13 **Q. Parties have pointed out that NW Natural’s prepaid pension asset preexisted the**  
14 **recession and the Pension Protection Act, implying that these were not really the**  
15 **drivers of increases in the size of the prepaid pension asset. What is your**  
16 **response?**

17 A. The overall trajectory of NW Natural’s prepaid pension asset, illustrated in Figure 3  
18 below, shows two major increases: in 2005, and from 2008 to the present. Both were  
19 caused by Company contributions, shown in Figure 2 above, and not by negative FAS  
20 87 or by market returns.

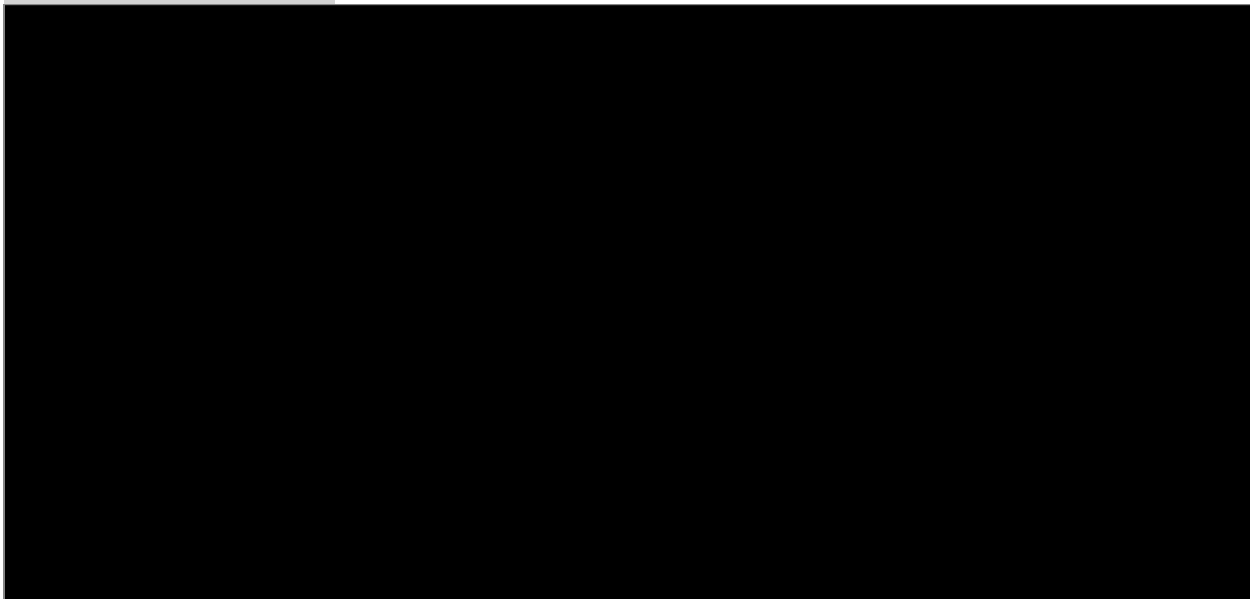
21 **Q. Why did the Company make large contributions in 2005,<sup>21</sup> prior to the Pension**  
22 **Protection Act and the recession?**

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<sup>21</sup> See CUB/100, Jenks-McGovern/9.

1 A. In 2005, the Company adopted new mortality rate assumptions in the pension liability  
2 calculation, which significantly increased the Plan's liabilities. In order to maintain  
3 consistency with our Company funding policy, the Company made additional  
4 contributions totaling \$31 million for Plan Years 2004 and 2005. Figure 3 illustrates that  
5 the mortality rate assumption adjustment in 2005 was a one-time event, and the prepaid  
6 pension asset balance began to normalize back to its previous trajectory in the ensuing  
7 three years. On the other hand, 2008 marks the beginning of a trend that steadily  
8 increases the size of the asset far beyond its previous size. Furthermore, per the  
9 Company's actuarial calculations, assuming the Company is able to fully fund the Plan  
10 within the next 10 years, the prepaid pension asset is expected to increase to almost  
11 [REDACTED] by 2023.

12 [BEGIN CONFIDENTIAL]



13  
14 [END CONFIDENTIAL]

15 ///  
16 ///

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1                    ***Adopting of the Joint Utility Proposal will not Encourage Utilities to Reopen***  
2                    ***or Retain Defined Benefits Plans***

3    **Q.    NWIGU-ICNU is concerned that allowing an opportunity for return on pension**  
4                    **plans could encourage utilities to retain defined benefits plans.<sup>22</sup> What is your**  
5                    **response?**

6    A.    As NWIGU-ICNU acknowledges, NW Natural closed its defined benefits pension plans  
7                    to new participants in 2006 and 2009.<sup>23</sup> If NW Natural were to re-open its pension plan  
8                    we would expect that the parties and the Commission would closely scrutinize such a  
9                    decision for prudence.

10 **Q.    Does this conclude your testimony?**

11 A.    Yes, it does.

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<sup>22</sup> NWIGU-ICNU/100, Smith/13-14.

<sup>23</sup> NWIGU-ICNU/100, Smith/13.