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March 12, 2014

VIA ELECTRONIC FILING & U.S. MAIL

Oregon Public Utility Commission
Attn: Filing Center
Public Utility Commission of Oregon
3930 Fairview Industrial Dr SE
Salem, Oregon 97302-1166

Re: In the Matter of Oregon Public Utility Commission – Investigation into Treatment of Pension Costs in Utility Rates
Docket No. UM 1633

Dear Filing Center:

Enclosed please find the original and five (5) copies of the Cross-Answering Testimony of Ralph Smith on behalf of Northwest Industrial Gas Users and The Industrial Customers of Northwest Utilities. A copy is being served on all parties to this docket listed on the attached Certificate of Service.

Thank you for your assistance with this filing. Should you have any questions, please feel free to contact me.

Very truly yours,

Tommy A. Brooks

TAB:sk
Enclosures

cc: UM 1633 Service List

CERTIFICATE OF SERVICE

I CERTIFY that I have on this day served the foregoing document upon all parties of record in this proceeding via electronic mail and/or by mailing a copy properly addressed with first class postage prepaid.

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Dated in Portland, Oregon, this 12th day of March 2014.

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Of Attorneys for the
Northwest Industrial Gas Users

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1633

In the Matter of	)
	)
THE PUBLIC UTILITY COMMISSION OF	)
OREGON	)
	)
Investigation into Treatment of Pension Costs	)
in Utility Rates	)
____	)

CROSS-ANSWERING TESTIMONY OF RALPH SMITH

ON BEHALF OF

THE NORTHWEST INDUSTRIAL GAS USERS

AND

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

March 12, 2014

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I. INTRODUCTION

Q. Please state your name and business address.

A. Ralph C. Smith. I am a Senior Regulatory Consultant at Larkin & Associates, PLLC, 15728 Farmington Road, Livonia, Michigan 48154.

Q. Are you the same Ralph C. Smith who previously filed Reply Testimony on behalf of the Northwest Industrial Gas Users ("NWIGU") and the Industrial Customers of Northwest Utilities ("ICNU")?

A. Yes.

I. PURPOSE OF TESTIMONY

Q. What is the purpose of your Cross-Answering testimony in this proceeding?

A. As described in my Reply Testimony, Oregon Public Utility Commission ("Commission") Order No. 12-408 opened an investigation to "review the treatment of pension expense on a general, non-utility specific basis."[1/] I am advised by counsel that the purpose of this docket is to complete that investigation and to establish an appropriate policy for ratemaking treatment of pension costs on a prospective basis. The purpose of my Cross-Answering testimony is to respond to recommendations in the Reply Testimony filed on December 19, 2013 by the Citizens' Utility Board of Oregon ("CUB") witnesses Bob Jenks and Jaime McGovern (CUB/100), and Staff witness Brian Bahr (Staff/100).

1/ Re: Northwest Natural Gas Company, Request for a General Rate Revision, Docket No. UG 221, Order No. 12-408 at 4 (October 26, 2012).

II. RESPONSE TO CUB

Q. Please summarize your understanding of CUB's recommendations.

A. CUB's findings and recommendations are presented on pages 39-43 of CUB/100 (Jenks/McGovern Reply Testimony), and can be summarized as follows:

- Each utility made an independent decision to offer its employees pensions (in the form of a defined benefit pension plan), and by doing so each utility took on certain risks associated with offering pensions in this form.[2/]

- Oregon's investor-owned utilities, including PacifiCorp, have in the past settled rate cases through stipulations that include pension recovery limited to FAS 87 costs; according to CUB, in agreeing to those stipulations, Portland General Electric Co., PacifiCorp, NW Natural Gas, Avista and Cascade Natural Gas (collectively, "Utilities") also agreed that the ensuing rates were fair, just and reasonable.[3/]

- Total pension expense (FAS 87 and FAS 88)[4/] over the life of the pension will equal the pension cost, based on accrual accounting. The total of cash contributions over the life of the pension plan also represents the full cost of the pension to the Company, based on cash accounting. CUB asserts that the Utilities' requested rate treatment would result in a pension cost that is greater than the total of the pension expense or cash contributions incurred by the Utilities because it would be based on the total cost of the pension expense with the addition of a return on much of the cash contributions and negative pension expense.

- FAS 87 based recovery for pension costs has been applied inconsistently by charging customers when FAS 87 has been positive (a net cost) and by not reflecting a benefit when FAS 87 pension results have been negative (i.e., when FAS 87 accrual results have produced pension income). CUB argues utility revenue requirements for defined benefit pensions should be based on FAS 87 whether the FAS 87 results are positive (i.e., pension income) or negative (i.e., a net pension cost).[5/]

[2/] CUB/100, Jenks-McGovern/39 at line 20. As stated on CUB/100, Jenks-McGovern/6 under "Terminology", a defined benefit pension plan is "a pension plan, where final benefits are calculated by a formula using an employee's years of service, age and salary progression." This is distinguished from a defined contribution retirement plan which is defined by CUB as "a retirement benefit plan, defined by monthly or annual contributions, where final benefits are subject to market returns."

[3/] CUB/100, Jenks-McGovern/40 at line 1.

[4/] CUB presents its definitions of these terms at CUB/100, Jenks-McGovern/6.

[5/] See, e.g., CUB/100, Jenks-McGovern/40 at line 21.

- CUB is open to considering the establishment of a FAS 87 tracker, but CUB notes that agreement on a balancing account as FAS 87 cost increases is only a reasonable policy if that balancing account is also maintained as FAS 87 falls.[6/]

- CUB recommends that all deferred tax benefits associated with pensions be passed through to customers, as CUB believes is required by law.[7/]

- CUB cites a Delaware case involving Delmarva Power and Light including a finding indicating that the utility had not demonstrated why it should recover pension expenses when it did not allow ratepayers to enjoy the fruits of good years when it experienced pension income.[8/]

- CUB recommends against engaging in any review of the prudence of prior pension costs (and discretionary funding decisions) as too time-consuming.[9/]

- CUB ultimately recommends that the Commission deny the Utilities' proposed mechanism to change the form of pension ratemaking in Oregon and CUB cautions that allowing a return on the prepaid pension asset would be unfair to customers.[10/]

Q. Please respond to CUB's ultimate recommendation concerning Oregon ratemaking policy for utility defined benefit pensions.

A. Although my reasons are not entirely aligned with those presented in CUB's Reply Testimony, I fully agree with CUB's ultimate recommendation that the Commission should deny the Utilities' proposed mechanism to change the form of pension ratemaking in Oregon and CUB's argument that allowing a return on the prepaid pension asset would be unfair to customers. I also agree with CUB's support for continuing ratemaking based on FAS 87, but applying it fairly and consistently, whether FAS 87 is positive (pension income) or negative (a net cost). That is, to determine utility operating expense in a rate case, I recommend that the FAS 87 approach continue to be utilized for ratemaking

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6/ CUB/100, Jenks-McGovern/41 at line 1.

7/ Id. at line 11.

8/ CUB/100, Jenks-McGovern/41 at line 20.

9/ CUB/100, Jenks-McGovern/42 at line 15.

10/ Id. at line 25.

purposes for utility defined benefit pension costs, but that it be applied to recognize for ratemaking purposes both pension income and pension costs in the determination of utility operating expenses. In Oregon historically, the FAS 87 approach has been applied to expenses and has not included recognition of pension liabilities as a reduction to utility rate base or pension assets as an addition to utility rate base, and generally has not recognized utility pension income under FAS 87 accounting as a reduction to utility operating expenses. The FAS 87 approach, but applied fairly and consistently to recognize pension income as well as pension cost, should therefore be continued. The Utilities have had an opportunity to make and document a compelling case for an alternative. In this case, I agree with CUB that they have not. As I have explained, the Utilities' recommendation that pension assets should now be presumptively includable in rate base should be rejected for several reasons including the following:

- Accrued pension liabilities have not routinely been reflected as rate base deductions in the past, thus the timing of the Utilities' proposal to implement presumptive pension asset recognition is unfair to Oregon utility ratepayers.

- Pension assets can occur on a utility's books under various circumstances, including when there is pension income, which has not generally been recognized for ratemaking purposes in Oregon.

- Pension assets are not tangible assets. In contrast, plant or fuel inventories are tangible assets that are used to provide utility service.

- Just because many utilities have recently been showing pension assets on their books does not mean that the utility's investors have financed such assets. Generally, a fact-specific, utility-by-utility analysis of historical information including a year-by-year analysis of information including (a) FAS 87 recorded amounts, (b) defined benefit plan funding amounts, and (c) amounts included in utility revenue requirements and thus presumptively funded by ratepayers, is needed in order to make such an evaluation for ratemaking purposes. Although such information has been requested in this docket,[11/] such information contains interpretations, is incomplete, and does not appear to be sufficiently reliable to prove that utility investors have funded pension assets. In the current case, I therefore conclude that the Utilities have failed to meet their burden of proving that any pension assets currently recorded on their books have actually been funded by investors. Those pension assets therefore do not deserve rate base recognition. The detailed fact-specific analysis will apparently need to be conducted in each utility's subsequent rate case that includes a utility request for a pension asset. Fact-specific analysis may be extremely difficult, if not impossible, given that many cases have been resolved by settlement that did not contemplate that the utilities would seek to include any future pension assets in rate base.

- Because prior rate case pension cost review has apparently focused on O&M expenses (i.e., on income statement impacts), there are concerns that utility management's discretionary funding of defined benefit pension plans has generally not been reviewed rigorously for prudence in prior rate cases. If balance sheet impacts (e.g., pension assets or pension liabilities) are going to be considered for future potential rate base treatment, the pension funding decisions, the source of such funding, and the prudence and economic consequences of such funding, as well as the prudence of utility decisions to continue providing retirement benefits in the form of defined benefit pensions (as opposed to some other, less risky form) will become much more important considerations to be evaluated in future utility rate cases that include a request by a utility for rate base treatment of pension related costs. Again, given that many past rate cases have been resolved by settlements, it may be very difficult to review the prudence of these past utility decisions.

Q. Please respond to CUB's recommendation that establishment of a FAS 87 tracker should be considered.

A. I recommend against establishment of a FAS 87 tracker for several reasons, including but not necessarily limited to these concerns: (1) (as noted by CUB[12/]) tracker mechanisms violate the general prohibition on single-issue ratemaking, and (2) establishment of a FAS 87 tracker would shift the risk of fluctuations in defined benefit pension cost between rate cases away from investors and place those risks on utility ratepayers, which

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[11/] See, e.g., OPUC Staff DR No. 23 to Avista, OPUC Staff DR No. 24 to Cascade Natural Gas, OPUC Staff DR No. 23 to NW Natural, OPUC Staff DR No. 28 to PacifiCorp, and OPUC Staff DR No. 23 to Portland General Electric. Responses to these DRs were included as Exhibits to my Reply Testimony, NWIGU-ICNU/102.

[12/] See, e.g., CUB/100, Jenks-McGovern/41 at line 3.

could reduce current pressures on utility management to control and manage defined benefit pension costs.

Q. Please explain how establishment of a FAS 87 tracker would shift the risk of fluctuations in defined benefit pension cost between rate cases away from investors and place those risks on utility ratepayers.

A. Prospective establishment of a FAS 87 tracker could reduce incentives for utility control of the costs of their defined benefit pension plans, which can fluctuate significantly from period to period. Allowing a new ratemaking tracker mechanism for fluctuations in defined benefit pension costs between rate cases produces a risk-shift that could reduce existing motivations on utility management to control costs by changing or terminating such plans and/or by pension funding decisions. As I have described in my previously filed Reply Testimony, there is a notable trend away from defined benefit pension plans to provide retirement benefits. Also, alternative forms of retirement benefits (such as defined contribution plans) do not typically entail the substantial fluctuation in pension costs, i.e., do not have the same risk or cost volatility to the employer providing them that defined benefit pension plans have. Keeping the same ratemaking treatment for utility defined benefit pension plan costs that has applied in the past (i.e., providing for recovery of FAS 87 based pension expenses but not increasing shareholder return by including pension assets in utility rate base) and not shifting the risk of FAS 87 cost fluctuations between rate cases away from shareholders (where it currently resides) and onto ratepayers by implementation of a FAS 87 tracker, will maintain existing incentives on utility management to control costs. In contrast, shifting the risk of FAS 87 cost fluctuations between rate cases could reduce existing incentives on utility management to curtail or eliminate a costly and risky defined benefit pension plan as the form of providing retirement benefits. As I have described, utility management has a wide degree of discretion concerning how defined benefit pension plans are funded, and the level of pension cost fluctuation can be significantly influenced by management's discretion on funding.

Q. Are there other potential concerns regarding a pension tracker?

A. I have been advised by counsel that there may be legal issues with the creation of a pension tracker, but that any legal issues will be addressed in briefs.

III. RESPONSE TO STAFF

Q. Please summarize your understanding of Staff's recommendations.

A. Staff's recommendations are summarized on page 2 of Exhibit Staff/100 (Bahr Reply Testimony),[13/] as follows:

- Staff's primary recommendation is to disallow the inclusion in rate base of any of the current prepaid pension asset/accrued pension liability ("ppa/apl") account balance. The associated deferred tax asset or liability on the current balance should also be excluded from rates. FAS 87 should continue to be used to as a proxy for pension costs in setting rates, and the utilities should have the opportunity to recover the financing cost of any ppa/apl account balance accumulating prospectively that is not associated with excess pension investment returns achieved. The prospective ppa/apl account balance should be offset proportionately by the associated deferred tax asset or liability and receive a return reflective of a shorter amortization period, as determined through individual ratemaking proceedings for each utility.

- Staff's alternate recommendation is for the Commission to allow the Utilities the opportunity to recover a return on a portion of both the current and prospective ppa/apl account balances and to continue the use of FAS 87 to set rates. However, the current ppa/apl account balance should be netted against the difference between pension costs recovered in rates and actual FAS 87 expense, exclude the portion of the amount accumulated due to excess investment earnings by the companies, and be offset by the proportionate amount of the associated accumulated deferred tax asset/liability. A lower

[13/] See also Staff/100, Bahr/23, "Part III - Recommendations Summary."

rate of return on the amount than the Commission-authorized one is appropriate, and can be determined through individual rate cases based on the circumstances of each utility.

Q. Do you agree with Staff's primary recommendation?

A. I agree with the part of Staff's primary recommendation to disallow the inclusion in rate base of any of the current prepaid pension asset account balance. I am not addressing treatment of the related income tax asset or liability in this proceeding, so I am neither agreeing with nor contesting that part of Staff's primary recommendation.

Q. Do you agree with the part of Staff's primary recommendation that states that "Financial Accounting Statement (FAS) 87 should continue to be used to as a proxy for pension costs in setting rates, and the utilities should have the opportunity to recover the financing cost of any ppa/apl account balance accumulating prospectively that is not associated with excess pension investment returns achieved"?

A. I agree only with the part that states that FAS 87 should continue to be used as a proxy for pension costs in setting rates. I would add to this that FAS 87 should be used for setting rates in situations where there is pension expense <u>and</u> also in situations where there is pension income.

I do not agree with the part of Staff's recommendation that states that "utilities should have the opportunity to recover the financing cost of any ppa/apl account balance accumulating prospectively that is not allocated with excess pension investment returns achieved." My reasons for disagreeing with this part of Staff's recommendation include that it does not include (1) a requirement that the utilities first convincingly demonstrate that a prepaid pension asset has been funded by investors, or (2) a requirement that the utility claiming a pension asset first be required to demonstrate that its prior decisions concerning funding and to provide retirement benefits in the form of a defined benefit pension plan (when other less risky and less volatile alternatives are available and have been accepted in the market place) have been prudent. As I have noted above, this aspect of utility retirement benefit provision (prudence of plan/form of benefit and discretionary funding decisions) appears to not have received rigorous review in prior rate cases where the focus has been on income statement impact of pensions.

Q. Do you agree with Staff's alternative recommendation?

A. No. I note that Staff's alternative recommendation (to allow a return) appears to be fundamentally inconsistent with Staff's primary recommendation (to disallow the inclusion in rate base of the utility's current prepaid pension asset or liability account balances). For several reasons, which have been explained in my Reply Testimony and above in conjunction with my Cross-Answering testimony to CUB's recommendation, I do not agree with the part of the alternative Staff recommendation for the Commission to allow the Utilities to recover a return on current and/or prospective pension assets.

Q. If a pension asset were to be considered for inclusion in utility rate base, what is your understanding of the conditions that Staff has recommended?

A. As summarized in Exhibit Staff/100, Bahr/2 at lines 16-23, and Bahr/24 at lines 4-11, Staff is recommending conditions on such prospective rate base inclusion which apparently include these four components:

- that the current pension asset (or liability) account balance should be netted against the difference between pension costs recovered in rates and actual FAS 87 expense;
- that the pension asset should exclude the portion of the amounts accumulated due to excess investment earnings by the utility;
- that the pension asset be offset by the proportionate amount of associated accumulated deferred income tax asset or liability; and
- that a lower rate of return on the amount than the Commission-authorized one is appropriate and can be determined through individual rate cases based on the circumstances of each utility.

Q. Do you have any concerns regarding these Staff recommended conditions?

A. Yes. I have two primary concerns involving clarity and adequacy.

Q. Please explain your first concern, regarding clarity.

A. First, I am not sure what Staff means by "excess investment earnings" in the second item. If this refers to the situation described in my and CUB's Reply Testimony where FAS 87 pension income was recorded by the utility but was not recognized in the ratemaking process as a reduction to operating expenses, then I would agree that any portion of a pension asset that has been accumulated by recording pension income should not qualify for rate base inclusion. If this refers to deviations above the assumed earnings rate that is used to estimate the FAS 87 component of expected return on assets for the year[14/] it is uncertain to me from reading Staff's filing how this would be applied. As noted in my Reply Testimony at page 15, FAS 87 incorporates provisions to address differences between expected and actual return results. I am unclear from Staff's presentation about how this "excess earnings" component would be applied, or how it would interact with the FAS 87 components of expected return on assets or amortizations of differences between expected and actual returns. Care would need to be taken in the implementation to assure that a measurement of "excess earnings" was not duplicating a component already included in the FAS 87 determination of net periodic pension costs. In summary, this type of "excess earnings" condition identified by Staff might have merit, but I believe it would need to be more clearly articulated as to how it would be measured and applied.

[14/] See, e.g., NWIGU-ICNU/100, Smith/14, line 25 through Smith/15, line 2.

Q. Please explain your second concern, regarding adequacy.

A. I am concerned that the conditions identified by Staff, especially if not combined with other conditions and safeguards, such as those identified in my Reply Testimony and herein, are inadequate to protect Oregon ratepayers from an unfair ratemaking treatment of utility defined benefit pension costs prospectively.

Q. What conditions do you believe are necessary to protect Oregon ratepayers from an unfair treatment of utility defined benefit pension costs prospectively?

A. If utility pension assets or pension liabilities are to be considered for rate base treatment in future rate cases contrary to the primary recommendations of CUB, Staff and myself, an analytical framework should be established that would require the utility to prove a number of elements, including but not necessarily limited to the following:

- that the amounts for pension assets it is requesting be included in rate base have actually been funded by investors, and the specific sources of such funding;
- that the decisions by utility management concerning the funding of the utility's defined benefit pension plan have been prudent and result in the least-cost results;
- that utility management has taken reasonable and appropriate measures to control the defined benefit pension costs that it is seeking to recover from ratepayers; and
- that appropriate corresponding adjustments to pension expense have been reflected.

As explained in my Reply Testimony and above, unless the utility can sufficiently prove these elements in its subsequent rate case, the utility's request for rate base recognition of a pension asset should be presumptively rejected.

IV. FINDINGS AND RECOMMENDATIONS

Q. Please summarize your findings and recommendations.

A. I agree with CUB's and Staff's primary recommendations to disallow the inclusion in rate base of the Utilities' current prepaid pension asset balances.

I disagree with Staff's alternative recommendation which would allow for utility rate base inclusion of pension assets, subject to a number of conditions that Staff has identified. Concerning such conditions, I recommend that Staff's proposed condition concerning excess investment earnings should be clarified. If utility pension assets are to be considered prospectively for rate base inclusion, additional requirements beyond the conditions recommended by Staff are necessary and should be imposed by the Commission to protect Oregon ratepayers from an unfair ratemaking treatment of utility defined benefit pension costs prospectively.

Additionally, while CUB suggests that it would be willing to consider a balancing account for FAS 87 expense, I am recommending against the implementation of a FAS 87 tracker because it involves single-issue ratemaking and would shift the risk of fluctuations in defined benefit pension cost between rate cases away from investors and place such risks on ratepayers. This risk-shifting could reduce existing incentives on utility management to control defined benefit pension costs.

In summary, I have concluded that the portion of the Utilities' proposal for continuing recovery of their FAS 87 expense is acceptable as long as the prospective ratemaking treatment includes recognition of pension income under FAS 87 (i.e., fully recognizes the FAS 87 income statement effects). This method of ratemaking treatment for utility net periodic pension cost pursuant to FAS 87 that is charged to expense has served well for years and should be continued. I note that for some of the Oregon utilities, negative pension cost (i.e., pension income) recorded under FAS 87 has <u>not</u> been reflected for ratemaking purposes. Rather, if a utility had pension income under FAS 87, the ratemaking allowance for pension cost would be set at zero. This resulted in utility rates being set using a higher cost for pensions that was produced by the straight-forward application of FAS 87. Prospective use of FAS 87 income statement impacts should include the recognition of pension income as a reduction to utility operating expenses for ratemaking purposes.

Q. Does this conclude your Cross-Answering testimony?

A. Yes.