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September 25, 2014

Via Electronic Mail and Federal Express

Public Utility Commission of Oregon
Attn: Filing Center
3930 Fairview Industrial Drive SE
Salem OR 97302

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

Dear Filing Center:

Enclosed for filing in the above-referenced docket, please find the original and five (5) copies of the Opening Testimony of Ralph C. Smith to Address Commissioner Questions on behalf of the Northwest Industrial Gas Users and the Industrial Customers of Northwest Utilities.

Thank you for your assistance. If you have any questions, please do not hesitate to contact our office.

Sincerely,

Jesse O. Gorsuch

Enclosures
cc: Service List

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that I have this day served the attached **Opening Testimony of Ralph C. Smith on Behalf of NWIGU and ICNU** upon all parties of record in this proceeding by sending a copy via electronic mail to the following parties at the following addresses.

Dated at Portland, Oregon, this 25th day of September, 2014.

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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	)
____	)

TESTIMONY OF RALPH SMITH

ON BEHALF OF

THE NORTHWEST INDUSTRIAL GAS USERS

AND

THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES

TO ADDRESS COMMISSIONER QUESTIONS

September 25, 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 testimony in this proceeding?

A. Yes, I previously filed reply and cross-answering testimony on behalf of The Northwest Industrial Gas Users ("NWIGU") and The Industrial Customers of Northwest Utilities ("ICNU") (collectively, "NWIGU-ICNU").

II. PURPOSE OF TESTIMONY

Q. What is the scope of your testimony in this proceeding?

A. On July 10, 2014, the Commission requested testimony regarding the following Commissioner questions:

> If the Commission decides to transition to the use of cash contributions to account for pension expense on a going forward basis, then what recommendations do you have to address the existing prepaid pension assets, the transition period, the mechanism to recover the cash contributions, and the mechanism to implement the transition?

My testimony will therefore address: (1) the risks and benefits of allowing Portland General Electric Company, PacifiCorp, Avista Corp., Cascade Natural Gas Corp. and NW Natural Gas Company (collectively, "Joint Utilities") to account for pension costs on a cash basis for ratemaking purposes; and (2) the treatment of the Joint Utilities' existing prepaid pension assets if cash accounting for pension costs is adopted by the Commission for ratemaking purposes.

Note that in prior rounds of testimony in this docket, parties have raised various legal problems with the Joint Utilities' proposal to include the prepaid pension assets in rate base. My testimony here addresses only the technical details of switching to cash accounting from Statement of Financial Accounting Standards No. 87 ("FAS 87") accounting that has traditionally be used in Oregon for recognition of such costs. Should the Commission decide to switch to cash accounting, and include all or a portion of the Joint Utilities' existing prepaid pension assets in rates, my testimony does not take a position on the legality of this approach.

III. ACCOUNTING FOR PENSION COSTS ON A CASH BASIS

Q. In discussing issues related to defined benefit pensions and utility cost recovery, you use various technical terms, such as "defined benefit pensions," "FAS 87," "Net Periodic Pension Cost," "funding contributions," etc. Will you be defining such terms in this testimony?

A. No. My earlier reply testimony in this matter, which was filed in this docket on December 19, 2013, included a detailed discussion of defined benefit pension plans at pages 8-14, a detailed discussion of the components of pension cost for defined benefit pensions under generally accepted accounting principles (Accounting Standards Compiled ASC-715, particularly the accrual accounting under FAS 87) at pages 14-28, and considerations affecting management decisions for funding defined benefit pensions at pages 29-36. Since those discussions have already been presented in my earlier testimony in this proceeding, I will not be re-discussing those terms herein. I would, however, refer the reader to those earlier discussions, and the elaboration in my cross-answering testimony, for a more complete understanding.

Q. Please address the use of cash contributions to account for pension expense on a going forward basis.

A. As I understand it from participating in the workshops and earlier discussions in this proceeding, the Commission is asking parties to comment upon the use of cash contributions for the purpose of recognizing costs related to utility defined benefit pension plans for ratemaking. In other words, the Commission is seeking input on the risks and benefits of using a cash contributions basis for ratemaking purposes, and also seeks detail on transition mechanisms, if this ratemaking change were to be undertaken.

For financial accounting purposes, pension costs would continue to be governed by generally accepted accounting principles. The focus of this inquiry is therefore on the risks and benefits of using cash funding contributions as the basis of ratemaking recognition of utility defined benefit pension costs, as an alternative to the FAS 87 accrual basis method that has traditionally been used in Oregon for recognition of such costs.

Q. How have defined benefit pension costs been treated for ratemaking purposes for the Joint Utilities historically?

A. In general, the Joint Utilities have been and are currently recovering pension costs under FAS 87, an accrual accounting method that recovers total pension costs over time, but does not necessarily match cash contributions in any particular year. Cash accounting, on the other hand, would base the regulatory recognition of pension costs in any given year on cash funding expenditures, rather than accrual accounting.

Q. Does the FAS 87 accounting result in a prepaid asset or a pension liability being recorded?

A. Yes. The FAS 87 accounting has resulted in what are currently prepaid pension assets of varying amounts for the Joint Utilities (but also has resulted in accrued pension liabilities in past years).

Q. What was the focus of earlier rounds of testimony in this proceeding?

A. In the earlier rounds of testimony, the focus of all parties was on whether there is an investor-funded pension asset that should be included in rate base, and whether the historic treatment of pension cost (where pension liabilities were not used to reduce rate base and where there is evidence that pension income was not used to reduce operating expenses) would make it equitable to start including historic pension assets in rate base at this time. The Joint Direct Testimony filed on September 30, 2013, by the Joint Utilities, at pages 2-3, presented the Joint Utilities' proposal that the Commission continue to allow the utilities to recover their "FAS 87" expense. There was no request by the utilities at that point to convert ratemaking recognition of utility defined benefit pension costs from the FAS 87 accrual basis method to a method that would be based on cash funding contributions.

Other than this focus on what to do for ratemaking purposes with the pension asset amounts that had been recorded on the books of some of the Oregon utilities, the parties seemed to be in general agreement that continued use of FAS 87 accrual accounting for the operating expense portion of pension should continue. Thus, continued adherence to FAS 87 remains a viable option for the Commission and, ultimately, I recommend that the Commission make no changes to the current system of pension cost recovery in rates.

Nevertheless, to address the Commission's questions regarding a switch to cash accounting for pension costs, the remainder of my testimony provides an overview of the risks and benefits of, and the potential mechanisms for implementing, such a switch.

A. Risks and Benefits of Using Cash Accounting

Q. Please address the first question: What are the risks and benefits of allowing utilities to account for pension costs on a cash basis (as opposed to FAS 87)?

A. Again, for clarity, I understand this question to be the following: What are the risks and benefits of allowing utilities to prospectively base the ratemaking recognition for defined benefit pension costs on a cash basis (as opposed to FAS 87)? I will first address the apparent benefit. I will then address various risks associated with this change.

Q. What are the benefits of allowing utilities to use a cash basis (as opposed to FAS 87) for regulatory recognition of pension costs?

A. Switching to cash-based recognition of pension costs for ratemaking prospectively would minimize differences between the utility's cash payments for pension funding and the ratemaking recognition of pension costs. This is because cash accounting reflects the anticipated contributions the utilities will make to their pension plans in a particular year.[1/]

Q. What are some of the risks of allowing utilities to use a cash basis (as opposed to FAS 87) for regulatory recognition of pension costs?

A. There are a number of risks, which include: (1) cash funding contributions for a given period are subject to a wide range, with the funding amounts being heavily dependent upon management discretion; (2) a switch to cash accounting would leave the current prepaid pension assets on the utilities' books, and thus the switch in regulatory method

[1/] As I discuss below in this testimony, if year-to-year fluctuations in cash funding contributions are large, a multi-year period may need to be used as the basis for a "normal" level of pension cost recognition for regulatory purposes.

could result in additional tracking mechanisms or surcharges being imposed upon ratepayers or could result in accounting impairments to the utilities' existing pension assets, depending on how the transition is handled; (3) a shift from accrual basis to cash basis for regulatory cost recognition would be contrary to a general trend in accounting for financial reporting to have costs recognized on an accrual basis, as opposed to a cash or "pay-as-you-go" basis, which, similar to the current situation, could result in utility requests for cost recovery of deferral balances related to the discrepancy between regulatory recovery and financial reporting; (4) risks of pension cost fluctuations between rate cases could be shifted from investors to ratepayers; and (5) current pressures on utility management to contain and curtail defined benefit pension costs could be removed or diminished.

Q. How are cash funding contributions for a given period subject to a wide range, dependent upon management discretion?

A. As discussed in my December 19, 2013 reply testimony at pages 29-36, there is a substantial amount of management discretion in determining cash funding payments in any given year. Usually the parameters are defined on one end by ERISA minimum required contributions (which could be zero, depending on the plan's funding status) and Pension Protection Act (PPA) required minimums, and on the other end by the maximum tax deductible contributions (which would represent the maximum for that year). As an illustration, I am aware that for American Electric Power, the degree of management discretion between (1) the ERISA minimum required pension funding contributions and (2) the maximum deductible pension funding contributions, in each year, 2010, 2011 and 2012, has been over $2,400,000,000 annually. The cash funding contributions into a utility's pension trust could thus vary widely from year to year, within this range of management discretion. The prudence and reasonableness of management's pension funding decisions would therefore take on increased importance in each utility rate case.

Q. What regulatory solution may be needed if a utility's pension cash-funding payments are fluctuating significantly from period to period?

A. If pension cost fluctuations are significant from period to period, regulatory cost recognition may need to be based on a multi-year average, rather than a single year amount. The use of a multi-year average to derive a normal, representative amount for regulatory cost recognition purposes could apply to pension costs on either an accrual (FAS 87) basis or on a cash funding basis. I am aware of certain utilities in Washington State, for example, where a four-year average of cash funding contributions has been used for regulatory recognition of defined benefit pension costs in the context of the utility's general rate case.

Q. How could the change in regulatory treatment of pension costs lead to utility requests for new surcharges and cost trackers?

A. Another risk of using cash contributions as the basis for ratemaking recognition of utility defined benefit pension costs is that there would likely be a need for recognition of some "transition" adjustment for the different ratemaking method. This "transition" could involve large amounts of additional cost for past differences between FAS 87 amounts and cash contributions being charged prospectively to Oregon ratepayers, for instance, by creating a regulatory asset for the Joint Utilities' existing pension assets. In other words, the "transition" aspects of a change in ratemaking policy for utility defined benefit pensions could have significant adverse rate impacts on customers in comparison with the FAS 87-based recognition that has been used historically.

Q. How could an accounting impairment to the utilities' existing pension assets occur?

A. Depending on how the "transition" related to the change in regulatory cost recognition method is handled, changing the ratemaking recognition method could entail significant write-offs by the Joint Utilities of existing pension asset balances. Additionally, depending upon whether differences between financial accounting and cash-based ratemaking were allowed to receive special accounting treatment via deferrals, prospective write-offs or additional income could result in subsequent years.

Issues associated with such "transition" impacts would therefore require very careful scrutiny in each utility's rate case, in order to assure that the change from FAS 87-based recognition of utility defined benefit pension costs to a cash method was not producing adverse impacts on customer rates, or resulting in a worse situation than simply continuing the current FAS 87-based method for rate recognition of such costs.

Q. Has there been a general trend in accounting principles to require accrual basis accounting for financial reporting, and to require changes from prior cash accounting or "pay-as-you-go" cost recognition to an accrual basis?

A. Yes. Changes in generally accepted accounting principles over the long term have required switching to an accrual basis for costs such as pension (e.g., this is what FAS 87 did), and for other post-retirement benefit costs (e.g., this is what FAS 106 did), and for other post-employment costs (e.g., this is what FAS 112 did). The long-term general trend in generally accepted accounting principles ("GAAP") and financial reporting has therefore been to require switching from cash-basis accounting to accrual accounting, in order to properly recognize costs in the period in which such costs are incurred.

Q. Would a switch from accrual basis cost recognition of pensions (e.g., under FAS 87) to a cash payment basis be contrary to this trend?

A. Yes. Changing from accrual accounting (FAS 87) to a cash payment method of rate recognition for utility defined benefit pension costs would seem to be counter to the long-term general trend of moving from cash accounting to accrual accounting. Since FAS 87 was initially adopted for financial accounting recognition of pension costs on an accrual basis, and since FAS 106 was initially adopted for financial accounting recognition of other postretirement costs on an accrual basis, the general trend has been for utility regulatory commissions to move to the use of accrual accounting (as opposed to cash or pay-as-you-go accounting) for these types of retirement costs. Switching the ratemaking recognition for pensions from accrual accounting back to cash-based recognition (such as may have existed prior to FAS 87) could be a step backwards and would appear to be contrary to the general trend of using financial accounting-based accrual accounting for utility ratemaking, rather than cash or pay-as-you-go accounting.

Q. If a cash method for pension costs is used for ratemaking prospectively in Oregon, will the utilities continue to be required to use GAAP for their financial reporting?

A. Yes. If a cash method for pension costs is used for ratemaking prospectively in Oregon, the utilities will continue to be required to use GAAP for their financial reporting.

Q. Does GAAP provide for accounting for the impacts of regulation?

A. Yes, it does. FAS 71, now codified in ASC-980, provides for accounting for regulated operations, and contains guidance on accounting for the effects of regulation.

Q. If a switch from accrual accounting to cash or pay-as-you-go accounting is made for utility defined benefit pension costs, is there a risk related to the regulatory treatment of differences between GAAP and regulatory accounting?

A. Yes. If a switch from accrual accounting to cash or pay-as-you-go accounting is made for utility defined benefit pension costs, the differences between accrual accounting for financial reporting purposes and cash accounting for regulatory purposes could lead to deferral balances being built-up on the utilities' books. Presumably, over a sufficiently long period of time, such as over the entire existence of a utility's defined benefit pension plan, the differences between cash and accrual would net to zero. However, during shorter periods, the differences could become large, and there is a risk of how the potentially large differences between cash and book amounts would ultimately be handled for ratemaking. Switching the ratemaking treatment from FAS 87 accruals to cash funding payments could create significant differences between (1) the ratemaking allowance amount (based on cash funding) and (2) the amount reported as Net Periodic Pension Cost (NPPC) under FAS 87 on the financial statements.

As noted above, switching to cash-based regulatory recognition may also therefore entail requests by the affected utilities to establish new regulatory assets to account for the differences between cash-based rate recognition and accrual basis financial reporting. Thus, even if the Commission switched to cash accounting, it could find itself in a similar place to the current one, with the Joint Utilities requesting recovery of costs associated with discrepancies in how their pension costs are reported and recovered.

Q. Please explain how the switch to a cash method could result in shifting risks of pension cost fluctuations between rate cases from investors to ratepayers?

A. Currently, from the use of FAS 87-based accrual cost recognition of utility defined benefit pension costs, the expense fluctuations in pension cost that occur between rate cases are either borne by, or inure to, the benefit of the utility's investors. That is, investors bear the impact of pension expense fluctuations that occur between rate cases. The mere switch to a cash basis for recognition of pension cost for regulatory purposes would not necessarily shift this risk from investors and place it onto ratepayers. However, if the differences between pension costs incurred and those included in rates are subject to trackers or new surcharges on customers, these additional tracking elements would appear to shift the risk of cost fluctuations occurring between rate cases from investors (where it is now) and onto ratepayers (where it would be if all cost fluctuations are ultimately tracked and charged to ratepayers).

Q. Is there also a risk that switching the method of regulatory cost recognition for pensions could remove or lessen existing pressures on utility management to curtail or control the costs associated with providing retirement benefits in the form of a defined benefit pension plan?

A. I believe there is. As described in my December 19, 2013 reply testimony at pages 8-9 and elsewhere, there has been a trend away from the use of defined benefit pension plans for the provision of retirement benefits to other methods, in part due to the cost volatility. Other forms of retirement benefits, such as 401(k) plans and cash balance plans (defined contribution plans) have been accepted in the marketplace. There is a risk that changing the ratemaking recognition of defined benefit pension plan costs from FAS 87-based accrual accounting to a cash method, particularly if accompanied by a form of true-up mechanism that shifts risks to customers, could alleviate currently existing pressure on management to continuously review the form and cost of providing retirement benefits. This could have the adverse impact on Oregon ratepayers of locking in this costly form of retirement benefits, with its inherent risks of large periodic cost fluctuations, for the long term. Ultimately, this is likely to result in higher costs to Oregon ratepayers (versus other forms of retirement benefits) for the duration of the Joint Utilities' defined benefit pension plans.

B. Treatment of Current Prepaid Pension Assets If Cash Accounting Is Adopted for Regulatory Recognition of Pension Costs Prospectively

Q. If the Commission decides to adopt cash accounting for pension costs, what should be done with the Joint Utilities' prepaid pension assets?

A. The use of cash funding for the ratemaking allowance for pension costs could presumably eliminate the need for rate base recognition of prospective pension assets, since that would theoretically minimize differences between cash funding and rate recognition. Nevertheless, such a switch would have no impact on the pension assets currently on the Joint Utilities' books. Addressing recovery of the prepaid pension asset raises many of the same issues parties raised in earlier rounds of testimony with regard to the Joint Utilities' proposal to earn a return on their pension assets. Recovery of this asset in rates represents a new expense for customers, the prudence of which will be difficult, if not impossible, to establish. Moreover, concerns have been raised about how utility pension costs have been funded by ratepayers over the years, and related concerns exist about how, during some of the prior years when some of the utilities were recording pension income under FAS 87, the amounts of pension income were not used (or were not fully used) to reduce expenses for ratemaking purposes.

Q. Given these facts and concerns, what analysis should be applied to the utilities' existing prepaid pension assets?

A. The Joint Utilities' existing pension assets should be evaluated in each utility's rate case. In these rate cases, I recommend that each of the Joint Utilities should have the burden of proving that these assets were in fact funded by investors. This issue was addressed in the earlier rounds of testimony as well. Prepaid pension assets can grow not only with investor funds, but when a utility's FAS 87 expense is negative, which does not represent an investor expense.[2/] The Joint Utilities should not be able to recover from customers those portions of their pension assets they cannot clearly demonstrate to be investor-funded.

Q. The Commission has asked for comments concerning the transition period, if a cash method is adopted. What are your recommendations about the transition period?

A. The transition period, if a cash method of regulatory cost recognition for utility defined benefit pension costs is adopted prospectively, should start with the utility's next rate case.

The change to cash-based recognition of utility pension costs should not be allowed to cause "rate shock." If the change to a cash method would result in large cost impacts, it may be desirable to phase-in the impacts of this change over a period longer than one rate case cycle. This would have to be evaluated on a case-by-case basis.

Q. What specific mechanism would you recommend be used for regulatory recognition of defined benefit pension costs if the Commission decides to use a cash method?

A. I would recommend that the cost of utility defined benefit pensions continue to be recognized for regulatory purposes as an expense that is recovered pursuant to traditional

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[2/] Recall that the accounting for pension income under FAS 87 was typically a credit to income and a debit to the pension asset (or to the accrued pension liability if one existed at the time).

ratemaking principles. The Commission should not authorize deferrals, trackers, surcharges, or other similar mechanisms to true-up any differences between forecasted pension costs and those actually incurred in any given year. Additionally, recognizing the significant management discretion in pension funding I discussed earlier, the Commission will need to carefully review utility requests for cash pension funding that are above minimum required levels. Otherwise, an incentive could exist for the Joint Utilities to significantly over-forecast their pension costs.

Q. Should the regulatory recognition of pension costs be isolated from other costs?

A. No. The pension cost recognition should be recognized in a manner that is done in conjunction with other utility costs, some of which may be increasing while others are decreasing. A general rate case assures that a wide range of utility costs are reviewed. Pension costs should not be singled out for special rider treatment on a piecemeal ratemaking basis.

IV. FINDINGS AND RECOMMENDATIONS

Q. Please summarize your findings and recommendations.

A. As described above, there are considerable risks to Oregon utility ratepayers associated with prospectively allowing utilities to base the ratemaking recognition for defined benefit pension costs on a cash basis (as opposed to the current FAS 87 accrual accounting-based recognition of such costs). Not the least of such risks is exactly how a transition from FAS 87 based accrual accounting recognition to a cash-based ratemaking recognition of utility defined benefit pension costs would be handled. The issue of exactly how to "transition" from one ratemaking method to another presents major risks to Oregon ratepayers. Switching the ratemaking recognition of defined benefit pension costs prospectively to a cash method (from the existing accrual method) would likely involve requests by the utilities for some form of "transition" cost recognition (which could be very large) and/or utility requests for the creation of new regulatory assets or pension trackers, which could significantly change the existing balance of risks between ratepayers and investors in a manner that disadvantages ratepayers and benefits investors.

Thus, despite these risks and complications, if the Commission decides to switch to cash accounting in recognizing pension costs for ratemaking purposes, it should institute the safeguards I recommended earlier to avoid inequitable results for customers. These safeguards include: (1) only allow for recovery of the portions of the existing prepaid pension assets that each of the Joint Utilities can clearly demonstrate were investor-funded; and (2) do not allow for a tracker or similar true-up mechanism to ensure that the risk of pension cost fluctuations between rate cases remains on the Joint Utilities.

Q. Ultimately, do you recommend that the Commission change to a cash contribution based method of ratemaking recognition for utility defined benefit pensions?

A. No. Rather than changing to a cash contribution-based method of ratemaking recognition for utility defined benefit pensions, I recommend continuing to base the ratemaking recovery of such costs on the utility's accrual-basis FAS 87 expense. As explained in my December 19, 2013 reply testimony, the ratemaking recognition of pension costs under FAS 87 should also include recognition of pension income (i.e., should fully recognize the FAS 87 income statement effects).

Q. Does this conclude your direct testimony to respond to the Commissioner questions on the use of a cash method for ratemaking recognition of utility defined benefit pension costs?

A. Yes.