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October 17, 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 Reply 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 *Reply Testimony of Ralph Smith on behalf of Northwest Industrial Gas Users and the Industrial Customers of Northwest Utilities to address Commissioner Questions* 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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Of Attorneys for the
Northwest Industrial Gas Users

**BEFORE THE PUBLIC UTILITY COMMISSION**

**OF OREGON**

**UM 1633**

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

**REPLY TESTIMONY OF RALPH SMITH**

**ON BEHALF OF**

**NORTHWEST INDUSTRIAL GAS USERS**

**AND**

**THE INDUSTRIAL CUSTOMERS OF NORTHWEST UTILITIES**

**TO ADDRESS COMMISSIONER QUESTIONS**

**October 17, 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, cross-answering, and opening testimony on behalf of The Northwest Industrial Gas Users ("NWIGU") and The Industrial Customers of Northwest Utilities ("ICNU") (collectively, "NWIGU-ICNU").

## II. PURPOSE AND SUMMARY OF TESTIMONY

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

A. On September 25, 2014, NWIGU-ICNU filed opening testimony regarding accounting for pension costs on a cash basis, as did Staff, CUB, Idaho Power, NW Natural Gas ("NWN"), and the Joint Utilities. My testimony will therefore address the positions of the other parties.

**Q. Do you have a general response to the other parties' testimony on cash accounting?**

A. Yes. There appears to be a general consensus that the Commission continue to use FAS 87 for reflecting pension costs in ratemaking. While the Joint Utilities are categorically opposed to a switch to cash accounting for regulatory recognition of pension costs unless they are allowed full recovery of their existing prepaid pension assets, the other parties – Staff, NWIGU-ICNU, and CUB – all agree that allowing full recovery of existing utility pension assets would overcharge customers. Accordingly, a switch to cash accounting appears likely to be untenable from at least one party's perspective.

## III. RESPONSE TO JOINT UTILITIES

**Q. Please respond to the testimony of the Joint Utilities at page 3 which states that:**

> **The Joint Utilities continue to request that the Commission allow recovery of their pension-related costs through the recovery of FAS 87 expense, as well as their costs to finance the prepaid pension asset created by the timing differences between when cash is contributed to pension plans and when that cash contribution is recovered in rates. FAS 87 is a time-tested methodology for the recovery of pension expense that has worked well historically and, with the additional recovery of financing costs, provides reasonable pension cost recovery. To date, no party has provided a persuasive reason to fundamentally change how pension costs are recovered; nor has any party disputed the existence of financing costs associated with the prepaid pension asset.**

A. I agree with the Joint Utilities that FAS 87 is a time-tested methodology for the recovery of pension expense that has worked well historically. I disagree, however, with the attempt by the Joint Utilities, and the timing of their attempt, to commence including prepaid pension assets ("PPA") in rate base, for the reasons previously explained in my earlier testimony. As the Joint Utilities have not historically recovered their pension financing costs, I believe FAS 87 can continue to be a time-tested methodology for the recovery of pension expense without any rate base inclusion of utility pension assets going forward. It should be clear that utilities should not be allowed to charge ratepayers for any financing costs on utility pension assets that have not been, or cannot be, demonstrated to have been funded by investors.

**Q. Do you agree with the Joint Utilities that there is not a good reason to fundamentally change how pension costs are recovered, such as by switching to a cash-contributions method?**

A. Yes. I do agree with the Joint Utilities that there is no persuasive reason to fundamentally change how pension costs are recovered, such as changing the methodology to a cash method.

**Q. The Joint Utilities request, at page 4, that if a switch is to be made to a cash contribution method, that their entire prepaid pension assets be amortized and recovered over five years, with the unrecovered balance accruing interest at each company's authorized cost of capital. Do you agree with that request by the Joint Utilities?**

A. Absolutely not. The Joint Utilities have failed to demonstrate to date whether and to what extent their existing PPAs have been funded by investors. That threshold question must first be demonstrated before any recovery of or on the utility pension assets is considered. Additionally, this type of switch, with an amortization and a return on at the utilities' overall rate of return, would be fundamentally unfair to ratepayers, as described in my earlier testimony, as well as in the testimony of CUB and Staff witnesses.

**Q. At page 4 the Joint Utilities recommend, if a cash contribution method is used, that either a three- or five-year average of contributions be used, to smooth year-to-year volatility. Please respond.**

A. If the Commission decides to use a cash contribution method, there could be merit in using a multiple year average, to smooth year-to-year volatility. Rather than determine a particular average in this generic docket, I would recommend that the average for each utility (if a cash contribution method is adopted) be based upon the specific pension cost and funding information for that utility and evaluated on a case-by-case basis in its rate case. This will help avoid locking in a large one-year contribution that could be nonrepresentative of current or ongoing conditions. Also, the Commission should consider actual historic cash funding contributions, and not rely solely on future projected forecast amounts.

**Q. The Joint Utilities request, at page 4, "that any difference between each company's actual cash contributions and the amount included in rates be included in a balancing account for later recovery or refund and be subject to a carrying charge equal to each utility's cost of capital." Do you agree with this recommendation by the Joint Utilities?**

A. No. This recommendation by the Joint Utilities would result in basically guaranteeing recovery of utility pension costs, and thus would shift the risk of fluctuations in pension costs between rate cases from investors to ratepayers. Additionally, it would constitute piecemeal ratemaking that singles out only one cost -- pensions -- and ignores other potentially offsetting items.

Furthermore, with respect to their proposal to earn interest on the account at their authorized cost of capital, the Joint Utilities have failed to demonstrate that any "tracking account" balances that might result from this recommendation would be long-term in nature that would justify this rate. More economical sources of financing, such as lower cost, shorter-term based financing could be used finance short-term fluctuations in asset (or liability) accounts. Consequently, the Commission should not pre-approve any carrying charges based on any presumption that long-term capital sources, such as a utility's authorized cost of capital, were being used to finance them. The Joint Utilities' recommendation for balancing account tracking should be rejected in full.

**Q. At page 4, the Joint Utilities also claim that the historical cash contributions, FAS 87 expense, and the resulting prepaid pension asset ... need not be subject to additional prudence reviews in the future. Do you agree?**

A. No. If any change is going to be made in utility recovery of pension costs that would involve adding a new rate base element, such as a utility pension asset, it will likely be necessary to evaluate that in detail in the utility's rate case, not only to review the issue of whether and to what extent the asset was funded by investors (versus other sources), but also to review the prudence of management decisions that have impacted the size of the cost being requested in the utility's rate case. The Joint Utilities are wrong to argue that their prepaid pension assets have already been subject to a prudence review as a consequence of FAS 87 expense being included in past rate cases. The prepaid pension asset represents amounts that have historically not been included in utility rate base and not included in rates and, therefore, has by definition not been deemed prudent. Consequently, the utility's prepaid pension assets should not be presumed to be prudent, and reviewing the prudence of management decisions that have impacted the size of the cost being requested in the utility's rate case will become increasingly important if a new element - rate base return - is being added to the regulatory recognition of utility pension costs prospectively.

Moreover, in the past, because FAS 87 was applied to operating expenses but not to rate base balances (i.e., not to accrued pension liabilities or to pension assets), the prudence of funding decisions has not been a focus of past rate cases. In instances where utility costs are being addressed in future cases, the exercise of management discretion in the management of retirement benefits and how they have been and are proposed to be funded, including prudence issues, may become very important. Consequently, utility past funding and the related exercise of management discretion should not be exempted from prudence review.

**Q. At page 5 the Joint Utilities state: "if the Commission concludes that a prudence review is required, it should perform that review in utility-specific proceedings, not in this general policy docket." Do you agree with that recommendation?**

A. Yes.

**Q. At page 19 the Joint Utilities present what they call a "clarification of misconceptions." In particular at page 19, lines 12-14, they state that "excess asset returns are reflected in expense, thereby reducing the amount recovered from customers under FAS 87-based recovery." Please respond.**

A. The Joint Utilities do not appear to distinguish between (1) pension trust asset returns that have reduced pension expense that was reflected for ratemaking purposes and (2) pension trust asset returns that produced pension income that was not reflected for ratemaking purposes. This is an important distinction, and can have a direct impact on whether a utility's prepaid pension asset had been funded by investors or from other sources, such as ratepayers. As Staff, CUB and I have pointed out in prior testimony, no portion of a utility's pension asset should be allowed to be included in rate base if it cannot be demonstrated by the utilities to have been funded by investors.

**Q. How does a cash method compare with FAS 87 expense recovery over an extended period?**

A. Importantly, if the Commission determines to continue using FAS 87 for recovery of pension costs in rates, the Joint Utilities will continue to have an appropriate regulatory opportunity for rate recovery of their FAS 87 pension expense over the life of their defined benefit pension plans. The issue with a switch to cash accounting, is primarily one of timing, not recovery.

## IV. RESPONSE TO NORTHWEST NATURAL

**Q. What is addressed in the September 25, 2014 testimony of Northwest Natural Gas?**

A. As stated on pages 1 and 2 of Brody Wilson's testimony (NW Natural/200), the purpose of his testimony is to address special issues relating to NW Natural's existing FAS 87 balancing account.

**Q. What does Mr. Wilson state concerning how NW Natural's FAS 87 balancing account was adopted?**

A. He addresses this at page 2 of his September 24, 2014 testimony. In a 2010 application NW Natural requested to defer pension costs and to be allowed to include its prepaid pension asset in rate base. He states that the parties to that proceeding did not agree to the rate base treatment of the prepaid pension asset, but did stipulate that NW Natural would establish a balancing account to track differences between actual FAS 87 pension expense and the amount included in rates. He states that the Commission adopted the stipulation in Order No. 11-051. At page 3, he states that the balance at December 31, 2013 was $25.7 million.

**Q. What does Mr. Wilson state would happen to NW Natural's FAS 87 balancing account, if the Commission finds that the utilities should transition to a cash recovery method for pension costs?**

A. He states at page 4 that: "If the Commission finds that the utilities should transition to cash recovery, the FAS 87 balancing account should be terminated, and the balance amortized."

**Q. What does Mr. Wilson recommend for NW Natural's FAS 87 balancing account, if a cash contributions method is adopted?**

A. At page 4, he recommends that the balancing account balance be amortized over a five-year period.

**Q. Do you agree with Mr. Wilson that, if a cash contributions method is adopted, NW Natural's existing balancing account balance would have to be addressed?**

A. Yes. Addressing the balancing account balance at the time that the account is terminated would appear to need to be addressed. Some amortization of that final account balance would apparently need to be applied. Using a multi-year period for such amortization, to minimize customer rate impacts, would also appear to have merit, although the decision on what amortization period should be used for this purpose would seem to be more appropriately addressed in a NW Natural rate case occurring after the switch to cash-funding for pension cost recovery has occurred.

**Q. Does Mr. Wilson request any carrying costs or financing charges on NW Natural's FAS 87 balancing account balance?**

A. There appears to be no request for carrying costs or financing charges on NW Natural's FAS 87 balancing account balance in his September 25, 2014 testimony.

**Q. Do you agree with Mr. Wilson's request for establishing a specific amortization period at this time for the NW Natural FAS 87 balancing account?**

A. No. There is no apparent need to establish a specific amortization period for NW Natural's FAS 87 balancing account balance at this time or in the context of this generic proceeding. Addressing a specific amortization period for the final balance would seem to be an issue better suited to examination in a NW Natural rate case, where the impacts of using different amortization periods can be examined, along with other matters that affect NW Natural's rates. Consequently, I recommend that the Commission reserve judgment on a specific amortization period for any final balance in the NW Natural FAS 87 balancing account until a NW Natural rate case that occurs subsequent to a change to a cash contributions method for pensions.

## V. RESPONSE TO IDAHO POWER

**Q. What is requested in the September 25, 2014 testimony of Idaho Power, if a cash method is going to be adopted?**

A. As stated on pages 4 and 5 of Bruce MacMahon's testimony (Idaho Power/200), Idaho Power requests that if its Oregon ratemaking recovery of pension costs be adjusted to a cash contribution basis, the method should closely mirror its Idaho treatment, which includes a balancing account, and carrying charges on the unamortized balance of deferred cash contributions. At page 6, he states that because the balancing account balances could accumulate to material levels, he recommends that the Commission should allow utilities to apply a carrying charge equal to their respective current authorized rate of return.

**Q. Do you agree with Mr. MacMahon's proposals?**

A. No, I do not. As explained in my prior testimony in this docket and herein, I am not recommending a change from the current Oregon method of regulatory recovery of pension costs using FAS 87 and do not agree that a balancing account is necessary or appropriate in the event the Commission chooses to switch to cash accounting. Importantly, Mr. MacMahon testifies that a balancing account in connection with cash accounting could result in "the same problem of untimely recovery of cash contributed to the plan" as the Joint Utilities claim currently exists with FAS 87.[1] This is yet another reason not to switch from FAS 87.

**Q. Is Idaho Power requesting that the Commission modify the method used to determine its pension costs for recovery as part of this case?**

A. No. As Mr. MacMahon testified:

> The Company believes that the existing regulatory treatment for the recovery of pension cost in the Oregon jurisdiction sufficiently provides Idaho Power with a reasonable opportunity to recover its prudently incurred pension costs <u>at this time</u> and should remain unchanged for Idaho Power.[2]

He goes on to state that Idaho power has a pension liability on its books and is not experiencing financing costs identified by the Joint Utilities in this case.

**Q. What does Mr. MacMahon state concerning the recognition of the pension liability?**

A. At page 2 he states that Idaho Power is not <u>currently</u> proposing rate base treatment for cumulative differences between cash contributions to the pension plan and FAS 87 expense.

**Q. Do you have any comments about this?**

A. Yes. This gets to the timing and fairness issues that have been pointed out in my testimony, as well as by CUB and Staff in this proceeding. Not reflecting any rate base impact from pensions during the periods when a utility has an accrued pension liability,

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1 Idaho Power/200 at 6:10-11.

2 Id. at 2:17-20.

and thus would reduce costs to customers, and waiting to request rate base treatment until a pension asset is being shown on a utility's books, raises issues about both fairness and timing. In contrast, continuing to apply a consistent regulatory cost recognition method for the entire duration of a utility's defined benefit pension plan avoids the unfairness associated with selective, self-serving timing for implementing such a change.

## VI. RESPONSE TO STAFF

**Q. Please respond to the September 25, 2014 testimony of the Commission Staff.**

A. I agree with Staff on several points made in their September 25, 2014 testimony, including the following:

- The Commission should maintain Financial Accounting Standard 87 and the related accounting guidance (cumulatively referred to here as FAS 87) as its method of allowing companies to recover pension costs because FAS 87 is less volatile than cash contributions, causes less administrative burden, and poses less potential risk to customers.[3]
- In the long run, whether a utility uses FAS 87 or cash contributions as its basis for cost recovery, the results should be approximately the same.[4]
- Potential risks of switching to a cash contribution for regulatory recognition of utility pension costs are considerable, and include the potential for generational inequity and concerns about the timing of the change.[5]
- Allowing the utilities to recover the entire amount of their current PPA balances (e.g., by allowing the amount to be amortized into rates) would very likely result in overcharges to customers as it is very unlikely that the utilities' investors funded the entire pre-paid asset.[6]
- Allowing the utilities to receive recovery of none or only a part of their PPA balances, (e.g., the part that the utilities can demonstrate was built up from prudent cash contributions funded by investors) could involve write-offs of the non-recoverable PPA balances by the utilities.[7]

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[3] See, e.g., Staff/300, Bahr/2.

[4] See, e.g., Staff/300, Bahr/5.

[5] See, e.g., Staff/300, Bahr/6.

[6] See, e.g., Staff/300, Bahr/14.

[7] See, e.g., Staff/300, Bahr/14.

- Utilities should receive a return on their PPA balances only if and to the extent that they can demonstrate that the costs were prudently incurred and to the extent such PPA balances were financed by investors.[8]
- A balancing account for differences between forecasted and actual FAS 87 expense is not warranted.[9]

**Q. Staff witness Bahr states at page 2 that Staff does not recommend implementation of a balancing account to track the difference between forecasted and actual FAS 87 expense. Do you agree with that Staff recommendation?**

A. Yes, but perhaps for different reasons. Staff focuses on the ability of a balancing account to eliminate regulatory lag and notes that the Joint Utilities have not demonstrated that pension costs are difficult to forecast such that a balancing account is warranted. I agree with Staff's point, but I oppose the implementation of a balancing account to track differences between FAS 87 amounts and amounts of pension costs included in rates primarily because this results in risk-shifting from investors to ratepayers. 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. Staff witness Bahr states at pages 19-20 that Staff's recommendation regarding the PPA or Accrued Pension Liability depends entirely on whether the Commission adopts Staff's recommendation to maintain FAS 87 expense for allowing companies' recovery of pension costs. If FAS 87 is used, Staff recommends that companies**

[8] See, e.g., Staff/300, Bahr/2.

[9] See, e.g., Staff/300, Bahr/2.

**receive a return only on a portion of their PPA balances, subject to the certain constraints and conditions that Staff has outlined. Please respond.**

A. I agree with Staff's recommendation that FAS 87 continue to be used for the ratemaking recognition of utility pension costs. While I do not believe that any return on the Joint Utilities' PPAs is warranted, if the Commission does authorize a return, there is substantial merit to Staff's proposal that the amounts upon which a return is allowed be subject to limitations and to the utility having the burden of proving which portions (if any) have actually been funded by investors. Without that type of showing, no return should be allowed on the utility pension assets.

**Q. Staff witness Bahr also states at page 20 that, should the Commission decide to adopt a cash basis of pension cost recovery, Staff similarly recommends that only a portion of Joint Utilities' current PPA balances should be amortized into rates, subject to the constraints and conditions that Staff has described. Please respond.**

A. As described above, I agree with Staff's recommendation that FAS 87 continue to be used for the ratemaking recognition of utility pension costs, and thus am recommending against a switch at this time to a method based on cash funding contributions. I also believe that there is substantial merit, if any return of utility PPAs is going to be considered, such as under a switch to a cash method, that the amounts be subject to limitations and to the utility having the burden of proving which portions (if any) have actually been funded by investors. Without that type of showing, no return of existing utility PPAs should be allowed if a cash-contribution method is ultimately adopted.

## VII. RESPONSE TO CUB

**Q. Please respond to the September 25, 2014 testimony of the CUB.**

A. I agree with CUB on several points made in their September 25, 2014 testimony, including the following:

- The current approach to pension recovery, FAS 87 expense, works.[10]
- If a change is going to be made to a system based on contributions (apparently CUB's preferred method) the timing has a huge impact on the cost of the transition and the transition costs have a large effect on whether such a change is beneficial.[11]
- Shifting to a contribution-based system could be reasonable if no, or only limited, recovery of the utilities' prepaid pension asset is allowed.[12]
- Transition to a contribution-based approach is strongly opposed if it would involve recovery by the utilities of their entire prepaid pension assets.[13]
- A methodology that allows utilities to recover some, but not all, of their prepaid pension asset could be designed, such as to exclude portions of utility PPAs that were from funding contributions above the ERISA minimums, costs that were never incurred, and contributions before a certain date, such as ones made before 2006, or that resulted from utility pension income that was not reflected in rates; however, the details clearly matter.[14]

## VIII. CONCLUSION

**Q. Please summarize your response to the other parties' testimony on the use of cash contributions for recovery of pension costs.**

A. I am in general agreement with the other parties to this docket that a switch to cash accounting for purposes of the regulatory recognition of utility pension costs in the ratemaking process is not warranted. Nevertheless, if the Commission does require a switch to cash accounting, I recommend that the Commission place restrictions on the

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[10] See, e.g., CUB/300, Jenks-McGovern/29.

[11] See, e.g., CUB/300, Jenks-McGovern/29-30.

[12] See, e.g., CUB/300, Jenks-McGovern/30. It is noted that this type of transition could involve write-offs by the utilities.

[13] Id.

[14] Id.

Joint Utilities' recovery of their existing prepaid pension assets similar to those recommended by Staff and CUB (i.e., limiting recovery to investor-funded portions and based on when the prepaid assets were accumulated). Additionally, I do not believe a tracking mechanism or balancing account is warranted for recovery of pension costs.

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

A. Yes.