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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:

1. Reply Joint Testimony of Portland General Electric, PacifCorp, Avista Utilities, Cascade Natural Gas and NW Natural ("Joint Utilities"); and
2. Reply Testimony of C. Kenneth Vogl in 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 JOINT TESTIMONY OF JOINT UTILITIES and REPLY TESTIMONY OF C. KENNETH VOGL, 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
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BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY RATES

UM 1633

Joint Reply Testimony of

Portland General Electric,
PacifiCorp,
Avista Utilities,
Cascade Natural Gas,
NW Natural Gas
(“Joint Utilities”)

EXHIBIT 300

March 12, 2014

EXHIBIT 300 – REPLY TESTIMONY – PENSIONS

Table of Contents

I. INTRODUCTION AND SUMMARY

Q. Please state your names.

A. Our names are Doug Stuver, Brody Wilson, Patrick Hager, Ryan Krasselt, and Michael Parvinen.

Q. Are you the same witnesses who filed direct testimony in this case?

A. Yes. Our Joint Direct Testimony was filed as Joint Testimony/100.

Q. What is the purpose of your reply testimony?

A. The purpose of our testimony is to respond to the testimony of Staff of the Public Utility Commission of Oregon ("Staff"), the Citizens' Utility Board of Oregon ("CUB"), and the joint testimony filed by the Northwest Gas Users Association ("NWIGU") and the Industrial Customers of Northwest Utilities ("ICNU") (collectively, "NWIGU/ICNU"). In addition to our own testimony, the Joint Utilities are also filing reply testimony from Dr. Kenneth Vogl. Certain individual utilities are also filing testimony addressing various factual claims made by the parties that relate to each utility individually.

Q. Please summarize your testimony.

A. The Public Utility Commission of Oregon ("Commission") opened this generic docket to consider whether—as a matter of policy—it is appropriate for a utility to recover the financing costs associated with the prepaid pension asset as a component of overall pension cost recovery.[1] In several recent rate cases, individual utilities have requested recovery of the prepaid pension asset, and have presented detailed information relevant to their specific circumstances, including the status of their prepaid pension asset, their history of contributions to pension plans, and their historical recovery under FAS 87.[2]

[1] *Re NW Natural Request for a General Rate Revision*, UG 221, Order No. 12-408 at 4,12 (Oct. 26, 2012) ("We will open a docket to review the treatment of pension expense on a general, non-utility-specific, basis.")

[2] *See* Order No. 12-408 at 4; *Re PGE Request for a General Rate Revision*, UE 215, Order No. 10-478 at 2-3 (Dec. 17, 2010).

Ultimately, the Commission concluded that it wished to take a step back and consider whether *as a general matter* the cost to finance the prepaid pension asset represents a legitimate aspect of pension cost—reserving individualized determinations for utility-specific ratemaking proceedings.[3]

Staff and NWIGU/ICNU filed testimony that supports the view that the prepaid pension asset represents an investment financed by utility shareholders on which a return should be earned—subject to an investigation into the specific circumstances of utility pension contributions and recovery. To the extent Staff and NWIGU/ICNU reject the Joint Utilities' position, that rejection is based largely on concerns about the specific circumstances they believe might suggest that some portion (or conceivably all) of the prepaid pension asset might not represent a legitimate shareholder investment. In particular, Staff and NWIGU/ICNU argue that before including a prepaid asset in rate base, the Commission must first consider a utility's history of how the prepaid asset built up over time, whether contributions to pension funds were prudently made, and whether at any point the utility's FAS 87 expense included in rates was greater or less than actual FAS 87. Even CUB (who is the only party advocating that the prepaid pension asset should under no circumstances be added to rate base[4]) appears to base its opposition to the Joint Utilities' position on such utility-specific concerns.

The bottom line is that there appears to be a general agreement on the part of most parties that the prepaid pension asset either represents or conditionally represents a shareholder investment, in which case rate base treatment is appropriate. As

[3] Order No. 12-408 at 4, 12; *See* UG 221, Staff Supplemental Brief at 2 (Oct. 5, 2012) ("[A] change in pension policy may also have far-reaching impacts for other utilities. For all of these reasons, Staff is open to pursuing alternatives to pension expenses, but believe such alternatives should be carefully weighed and vetted in a future proceeding and not in this rate case.")

[4] CUB does propose the inclusion in rate base of the deferred tax liability associated with the prepaid pension asset. As described below, this asymmetric treatment is fundamentally unfair and not required by statute.

discussed below, the Joint Utilities do not agree that it is necessary or appropriate for the Commission to look back at a utility's historical recovery of pension expense before adding the prepaid asset to rate base. However, if the Commission finds that such considerations are relevant, these utility-specific considerations are not properly addressed in this generic docket and should instead remain the subject of individualized ratemaking proceedings.

Q. Can you briefly summarize the Joint Utilities' proposal in this case?

A. Yes. In direct testimony, the Joint Utilities explained that the prepaid pension asset represents cash contributions made by the utility in advance of the recognition of pension expense. More particularly, the prepaid pension asset is the cumulative difference between the utility's cash contributions and its FAS 87 expense, and over the life of the pension plan, the total cash contributions will equal the FAS 87 expense.[5] Importantly, the cash contributions act to reduce future FAS 87 expense.[6] Therefore, the prepaid pension asset represents an investment made on behalf of customers on which it is appropriate to earn a return.

Q. Do the Joint Utilities support the continued use of FAS 87 for ratemaking?

A. Yes. Like all the parties, the Joint Utilities support the continued use of FAS 87 expense for ratemaking purposes.

II. DISCUSSION

A. Staff and NWIGU/ICNU Agree a Prepaid Pension Asset May Represent a Shareholder Investment that Should be Included in Rate Base.

[5] Joint Testimony/100, Joint Parties/9; Joint Testimony/200, Vogl 11.This relationship holds true as long as the pension plan reaches its natural end, *i.e.*, the last pensioner receives his or her last pension payment. If the pension plan is terminated early, then a FAS 88 gain or loss may be recognized for up to the balance of the prepaid pension asset or accrued liability. If a FAS 88 gain or loss occurs, then over the life of the plan the cumulative cash contributions will equal the cumulative sum of FAS 87 and FAS 88. This issue is described more fully in Dr. Vogl's testimony.

[6] Joint Testimony/100, Joint Parties/7-8.

Q. You testify above that Staff and NWIGU/ICNU are in general agreement with the Joint Utilities regarding the basic policy issue in this case. Please explain how you conclude that Staff supports the view that the prepaid pension asset represents a genuine shareholder investment on which a return should be earned.

A. Staff concludes that the "financing cost of cash outlays in excess of those recognized under accrual accounting and regulatory recovery mechanisms does represent a real cost to the companies . . ."[7] Consistent with this conclusion, Staff recommends that the utilities earn a return on the prospective prepaid pension asset.[8] While Staff disagrees with the Joint Utilities' proposal to add the *current* prepaid pension asset to rate base—apparently based on concerns about the Joint Utilities' pension recovery history—Staff does accept the view that the prepaid pension asset is an investment made on behalf of customers on which a return should be earned. Staff's recognition that the Joint Utilities' incur a cost to finance the prepaid pension asset confirms the appropriateness of the Joint Utilities' central request in this case.

Q. Please explain how you conclude that NWIGU/ICNU supports the view that the prepaid pension asset can represent a genuine shareholder investment on which a return should be earned.

A. NWIGU/ICNU argues that rate base treatment for the prepaid pension asset may be appropriate, but only upon very specific showings regarding the utility's past contributions, the build-up of the prepaid asset, FAS 87 recovery, and prudence.[9] Like Staff, NWIGU/ICNU's recommendations are intended to ensure that the particular facts

[7] Staff/100, Bahr/20. Staff's conclusion appears informed by its analysis demonstrating the similarities between a prepaid pension asset and a utility investment. The prepaid asset represents a long-term investment that produces benefits by driving down FAS 87 expense. Also, like an investment, the prepaid asset appears on the balance sheet, not the income statement.

[8] Staff/100, Bahr/22.

[9] NWIGU-ICNU/100, Smith/46.

and circumstances support the conclusion that the prepaid pension asset was funded by investors and contributions were prudently made. While we do not agree that these showings are reasonable or appropriate, NWIGU/ICNU's agreement that under the right circumstances it is appropriate for rate base recognition of a prepaid pension asset is noteworthy.

B. Staff's, NWIGU/ICNU's, and CUB's Concerns Relate Primarily to Utility-Specific Matters that Can Be Addressed in Individualized Ratemaking Proceedings.

Q. Are utility-specific factual issues relevant in this generic investigation?

A. No. The policy question in this case is whether a prepaid pension asset should be included in rate base. As discussed above, many of the concerns expressed by Staff, NWIGU/ICNU, and CUB relate to the specific circumstances under which a particular utility's prepaid pension asset built up and whether and to what extent a particular utility's prepaid pension asset represents an investment that was financed by shareholders. For example, CUB relies on various data selected to show that a particular utility over-recovered actual FAS 87 expense during a certain time period, or that market returns and not utility contributions are increasing the prepaid pension asset.[10] The individual utilities will provide testimony to respond to these arguments. However, the larger point is that arguments about how much of a utility's prepaid asset was actually or prudently financed by shareholders is an issue for the subsequent, utility-specific ratemaking proceedings and not relevant to the broader policy issue raised in this docket.

Q. What is Staff's recommendation?

A. Staff's primary proposal is to include in rate base only the *prospective* prepaid pension asset.[11] This proposal appears intended to avoid the investigation into specific utility

[10] CUB/100, Jenks-McGovern/4. 13-14, 23.

[11] Staff/100, Bahr/22.

circumstances altogether. Staff also proposes to exclude on a prospective basis that portion of prepaid pension asset that is attributable to excess investment returns, rather than shareholder cash contributions, and that the prepaid pension asset be offset by the proportionate amount of accumulated deferred taxes.[12] Staff also offers an alternative proposal, recommending that only the portion of the current prepaid pension asset that has accrued since 2008 be included in rate base, thereby limiting (although not eliminating) the historical review of each utility's prepaid pension asset. Additionally, as in its primary recommendation, Staff proposes that the prepaid asset balance exclude amounts attributable to excess investment returns and be netted down by the proportionate amount of accumulated deferred taxes.[13]

Q. Do you agree with Staff's recommendation to allow the prepaid pension asset in rate base beginning with a zero balance, accumulating only based on prospective pension expense and contributions?

A. No. The Joint Utilities believe it is neither necessary nor helpful to attempt to adjust the amount of the prepaid pension asset included in rates. If it is conceptually appropriate to include the prepaid pension asset in rate base—as Staff's testimony appears to concede that it is—then there is no reasonable basis to exclude the current prepaid pension asset.

Q. Is Staff's recommendation an improvement on the current treatment of prepaid pension assets?

A. No. As previously discussed, the prepaid pension asset will return to zero over time through FAS 87 expense (and FAS 88 if terminated early). While the impact will vary

[12] Staff/100, Bahr/23.

[13] Staff/100/Bahr 24. In this alternative, Staff also proposes that the prepaid asset balance would be subject to a true-up of pension costs in rates and actual FAS 87 expense and be subject to a rate of return that is lower than the authorized rate of return.

from utility to utility, artificially setting the current balance to zero as Staff proposes would cause the utilities to be worse off than continuing to exclude the prepaid pension asset from rate base. Staff's proposal would result in reduced recovery of prudently incurred costs because it would lead to an accrued pension liability, thereby reducing rate base while the utilities continue to incur financing costs. This concern is discussed further in Dr. Vogl's testimony. In addition, Staff proposes to exclude the portion of the prepaid pension asset associated with excess returns[14] but does not appear to include the effect of returns *below* the expected rate of return or the corresponding impacts to FAS 87 expense. Later in this testimony, we will discuss why the prepaid pension asset should not be adjusted for excess asset returns.

Q. Is Staff's alternative recommendation preferable to the current treatment?

A. No. Although Staff's alternative recommendation begins with a positive prepaid asset balance and thus may not be as harmful as Staff's primary recommendation, the alternative has other significant drawbacks as follows:

- Staff proposes to adjust for differences between actual FAS 87 expense and amounts included in rates.[15] We discuss the implications of this "true-up" later in testimony.
- Staff offered no example of how its alternative recommendation would be calculated, making the potential outcomes largely uncertain.
- Staff proposes to exclude excess investment returns from the prepaid pension asset, raising the same concerns as with the primary recommendation.

[14] Staff/100, Bahr/21, lines 7-8

[15] Staff/100, Bahr/21, lines 5-6

- Finally, Staff proposes a lower rate of return than the Commission-authorized rate, but does not explain why this is reasonable and offers no guidance on what that reduced rate might be.

As with Staff's primary recommendation, artificially reducing the prepaid pension asset will result in reduced recovery of prudently incurred costs. Further, this alternative recommendation presents significant uncertainties and complexity, including complexities with creating a regulatory view of the prepaid pension asset that departs from well-established accounting principles.

Q. Do you agree with Staff's recommendation to exclude that portion of the prepaid pension asset that is attributable to excess investment returns, rather than shareholder cash contributions?

A. No. As addressed in more detail in Dr. Vogl's rebuttal testimony, it is unreasonable to adjust the prepaid pension asset for one element of pension cost. Under a FAS 87 expense basis of recovery, investment returns, including any amounts in excess of what is expected, benefit customers by reducing both FAS 87 expense and contributions. Furthermore, to the extent customer rates are reduced as a result of excess investment returns being amortized through FAS 87 expense while the prepaid pension asset is excluded from rate base, the utility has less cash available to fund other costs and in turn fully bears the financing cost.

Q. What is NWIGU/ICNU's recommendation?

A. After acknowledging that a prepaid pension asset may represent a legitimate shareholder investment, NWIGU/ICNU argue that the Commission should not alter its policy to recognize the prepaid pension asset in this generic docket because the utilities have failed to provide the detailed utility-specific data that would shed light on the specific circumstances of each utility's prepaid pension asset.[16] This rationale is

[16] *See e.g.* NWIGU-ICNU/100, Smith/7.

unreasonable because NWIGU/ICNU are prejudging the outcome of the specific utility proceedings before they take place.

The real takeaway here should be that like Staff, NWIGU/ICNU agrees that it may be appropriate to add the prepaid pension asset to rate base under certain circumstances. If the Commission agrees, then it should first confirm that, as a general matter, the prepaid pension asset will be included in rate base, subject to review. The Commission can dictate the standards for such a review in individual ratemaking dockets.

Q. How do you respond to concerns that have been raised over the prudence of the Joint Utilities' historical pension contributions?

A. Cash contributions are a key input to the determination of FAS 87 expense. Therefore, it would be reasonable to conclude that the prudence of each utility's historical pension contributions has already been determined in prior rate cases, given that the resulting FAS 87 expense was already reviewed. That said, the Joint Utilities are not opposed to parties raising issues of prudence in the context of specific cases where the Commission will review the prepaid pension asset for inclusion in rate base.

Q. The parties also raise a concern regarding the historical recovery of FAS 87 expenses and whether there is a need for a true-up of the historical FAS 87 expenses included in rates to actual FAS 87 expenses to offset the prepaid pension account balance that is included in rate base.[17] How do you respond to this concern?

A. This concern relates primarily to regulatory lag and is irrelevant to the issue presented in this case. Ratemaking is imperfect, and the fact that regulatory lag may create a differential between actual expense and actual recovery should not be determinative of

[17] Staff/100, Bahr/19. *See also* CUB/100, Jenks-McGovern/28-29; NWIGU-ICNU/100, Smith/7-8.

whether a prepaid pension asset should be included in rate base. When rates are set, they account for the FAS 87 expense that is expected at the time. In between rate cases, a utility's actual FAS 87 expense will differ from the amount in rates. This difference, however, cannot be isolated from other differences between the cost of service expected at the time of setting rates and the actual cost of service, and certainly does not suggest that rates in effect were not just and reasonable. On the contrary, rates approved by the Commission are presumed reasonable unless and until the Commission changes those rates in a subsequent proceeding.[18]

For these reasons, in determining the prepaid pension asset that is included in rate base, the actual amount of the asset—based on actual contributions and actual FAS 87 expense—should be utilized. Should individual utility circumstances call into question the prudence of historical activities, those questions should be addressed in utility-specific proceedings.

Q. What is CUB's position regarding the inclusion of the prepaid pension asset in rate base?

A. CUB is the only party to this case that categorically rejects the idea that the utilities should recover the financing costs of the prepaid pension asset under any circumstances. CUB's conclusions and recommendations rely extensively on CUB's misunderstanding of the historical facts, which is the result, in part, of CUB's selective use of historical data. CUB's testimony obfuscates the fundamental policy question presented in this case and instead focuses on the fact-specific inquiry that will follow in individual utility ratemaking proceedings—if the Commission deems them relevant. To the extent the Joint Utilities have specific responses to CUB's erroneous factual assertions, those responses are set forth in each utility's individual testimony.

[18] *See e.g. Re Portland Gen. Elec. Co.*, Dockets UE 47/48, Order No. 87-1017, 1987 WL 257942 (Sept. 30, 1987).

Q. CUB also relies on a 2011 decision from the Public Service Commission of Delaware to support its position that it is never appropriate to add the prepaid pension asset to rate base. Does the Delaware case CUB cites support CUB's position?

A. No. CUB claims that the Delaware commission rejected the utility's request to include the prepaid pension asset in rate base.[19] However, the Delaware case did not address a request to place a *prepaid pension asset* into rate base. Rather, the utility, Delmarva Power and Light Company ("Delmarva"), requested permission to create and amortize a regulatory asset, consisting of the roughly $9 million difference between the utility's pension expense included in rates and the actual pension expense incurred by the utility in a single year.[20] The issue in the Delmarva case was the recovery of actual pension *expenses* in excess of the amount included in rates—which is significantly different from the inclusion of a prepaid pension asset in rate base. Moreover, contrary to CUB's claims, it appears that Delmarva's prepaid pension asset was actually included in rate base and therefore this case appears to support the Joint Utilities' position.[21]

By erroneously relying on the Delmarva case, CUB ignores the many state regulatory commissions that have actually examined the issue in this case—whether to allow a return on a utility's prepaid pension asset—and have found in favor of the Joint Utilities' proposal. In addition to the examples cited in our direct testimony,[22] the

[19] CUB/100, Jenks-McGovern/41.

[20] *Re Delmarva Power and Light Co.*, PSC Dockets 09-414 and 09-276T, Order No. 8011 at 48-60, 2011 WL 3863101 (Del. P.S.C. Aug. 9, 2011).

[21] *Id.* at 57 (noting that the Delaware commission has previously rejected arguments to exclude the prepaid pension asset from rate base); *Id.* at 59 (noting that Delmarva's "argument ignores that the related pension asset was included in rate base, and that the revenue requirement thereon produced a net additional revenue requirement to ratepayers.")

[22] *See* Joint Testimony/100, Joint Parties/13-14 (District of Columbia, Michigan, New York, Oklahoma, Ohio, and Texas all allow a return on a prepaid pension asset).

Washington Utilities and Transportation Commission recently agreed that PacifiCorp should add the prepaid pension asset to cash working capital, thereby allowing PacifiCorp to earn a return on its asset.[23]

C. Single Issue and Retroactive Ratemaking will be Addressed in Briefs.

Q. Parties raise legal and policy questions regarding single issue and retroactive ratemaking.[24] How do you respond to these concerns?

A. The Joint Utilities will address both these issues in briefing. However, it is important to reiterate here that the Joint Utilities are not seeking to change a single component of the revenue requirement in this proceeding, nor are the Joint Utilities seeking to true-up or otherwise modify historical rates. The Joint Utilities are requesting the prospective financing costs associated with the current and future prepaid pension asset. As Staff recognizes, the prepaid pension asset represents a utility investment[25] and therefore inclusion of the current prepaid pension asset in rate base does not constitute illegal retroactive ratemaking.

D. CUB's Deferred Taxes Proposal Fails to Account for the Fact that FAS 87 Expense, not the Utility's Cash Contributions, is Included in Customer Rates.

Q. CUB also claims that by law the Joint Utilities are required to pass through to customers the deferred tax benefits associated with the prepaid pension asset.[26] How do you respond to this claim?

A. CUB's legal and policy claims are in error. As CUB correctly testifies, the deferred tax benefits are the result of the utility's contribution to the pension fund. However,

[23] *Wash. Util. & Transp. Comm'n v. PacifiCorp*, Docket UE-130043, Order 05 ¶¶ 233-40 (Dec. 4, 2013).

[24] *See* CUB/100, Jenks-McGovern/27; Staff/100, Bahr/15.

[25] Staff/100, Bahr/22.

[26] CUB/100, Jenks-McGovern/31.

customers provide recovery of the utility's FAS 87 expense, not the utility's cash contribution, and therefore should receive the tax benefits associated with only those costs that are included in rates. Concurrent with the recognition of FAS 87 expense, customers receive income tax benefits associated with the FAS 87 expense on which recovery is based. It is one-sided to pass through the deferred tax benefits associated with the prepaid pension asset if the asset itself is excluded from rate base.

In addition, while we will reserve the legal argument for our brief, it appears on its face that CUB inappropriately relies on ORS 757.269 to support its recommendation. That statute requires rates to include only the accumulated deferred income taxes "that are based on revenues, expenses and the rate base included in rates and on the same basis as included in rates."[27] Again, if the prepaid pension asset is excluded from rate base, as CUB recommends, then there is no basis for including the associated accumulated deferred income tax liability in rate base.

Q. Does this conclude your testimony?

A. Yes.

[27] ORS 757.269(2)(b).

BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY RATES

UM 1633

Reply Testimony of

C. Kenneth Vogl

EXHIBIT 400

March 12, 2014

EXHIBIT 400 – REPLY TESTIMONY – PENSIONS

Table of Contents

I. INTRODUCTION

Q. Please state your name, business address and position.

A. My name is C. Kenneth Vogl. My business address is 101 South Hanley, Suite 900, St. Louis, Missouri 63105. My position is Senior Consulting Actuary and Divisional Sales Leader for Towers Watson.

Q. Are you the same C. Kenneth Vogl who submitted Direct Testimony in this proceeding?

A. Yes, I am.

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

A. The purpose of this reply testimony is to address, and in some instances, correct statements made in the direct testimony of the Staff of the Public Utility Commission of Oregon (Staff), Citizens' Utility Board of Oregon (CUB), the Northwest Industrial Gas Users (NWIGU), and the Industrial Customers of Northwest Utilities (ICNU) by emphasizing statements made in my direct testimony. Some key items I will address are: the impact of the Pension Protection Act (PPA) on the prepaid pension asset, why it is appropriate to include existing prepaid pension asset balances in rate base, whether it is reasonable to exclude excess investment returns from the prepaid pension asset and the amortization of the prepaid pension asset.

II. DISCUSSION

Q. Do you still believe, as stated in your direct testimony, that the PPA is one of the primary reasons for the growth in the prepaid pension asset and resulting need for the inclusion of the prepaid pension asset in rate base prospectively?

A. Yes. As indicated in my direct testimony[1], PPA accelerated the period over which pension liabilities are funded. Also as noted in my direct testimony[2], recent economic conditions (including the 2008 stock market crash and subsequent decline in interest rates) had a large impact on the required level of pension funding. Not only did the funded status of plans decline dramatically because of investment losses, the unfunded liability worsened due to lower interest rates. Since PPA required companies to fund their shortfall much more quickly than prior to PPA, these market conditions exacerbated the level of minimum required contributions. No similar changes have been made to how accounting costs are determined for a plan, so the difference between contributions and accounting cost has grown significantly as a result of PPA, and may continue to grow for many utilities. In summary, PPA has front-loaded cash contributions relative to accounting cost, resulting in much larger prepaid pension assets and significant financing costs, and is therefore a key reason for including the existing prepaid pension asset in rate base.

Q. In Staff's reply testimony[3], they suggest including the prepaid pension asset in rate base beginning with a zero balance, or alternatively, including in rate base only the prepaid pension asset balance that existed in 2008. Do you believe these alternatives to including the existing prepaid pension asset in rate base are reasonable?

A. No. The existing prepaid pension asset should be included in rate base prospectively as it represents the amount on which the utilities will continue to incur financing costs. To

[1] Joint Testimony Exhibit 200, page 8
[2] Joint Testimony Exhibit 200, page 9
[3] Staff Exhibit 100, page 2

begin with a zero or artificially reduced prepaid pension asset balance in rate base and disregard the existing prepaid pension asset balance would undercut the principle that over the life the plan, contributions equal pension accounting cost. This would lead to unwarranted benefits being provided to customers for the following reasons:

- The Joint Utilities have existing prepaid pension assets, meaning contributions to date have exceeded pension accounting costs.
- The financing costs associated with making contributions in excess of pension accounting costs (for which customers are paying) will continue to be incurred by the utilities as long as the prepaid balance exists.
- Since contributions will ultimately equal accounting costs over the life of the plan, prospective accounting cost will exceed prospective contributions.
- Thus, if the prepaid pension asset is brought into rate base starting at zero or at a reduced level, an accrued liability position would be created over future periods and result in a rate base reduction. This would lead to unwarranted benefits to customers while the utilities continue to incur significant financing costs.

Q. Please provide an example of how a utility could be worse off by including the prepaid pension asset in rate base beginning with a zero balance, or alternatively, by including in rate base only the prepaid pension asset balance that existed in 2008.

A. The following charts illustrate that bringing a prepaid pension asset into rate base at zero rather than its existing balance would result in customers benefiting from the reduced return on rate base despite the utility continuing to incur significant financing costs on the underlying prepaid pension asset balance. These tables assume a pension plan with a life of 20 years, FAS 87 expense of $10 per year and contributions of $15 per year for the first 10 years and $5 per year for the last 10 years. The first chart illustrates that a prepaid pension asset will grow during the first ten years and then decline over the last ten years before reaching zero at the end of the pension plan's life. The second chart illustrates that if the prepaid pension asset was brought into rate base at zero during year 11, an accrued pension liability would start in year one and never reverse even though the utility would be in an actual prepaid pension position and incurring significant financing costs.

Chart 1 showing the prepaid pension asset between years 1 and 20:

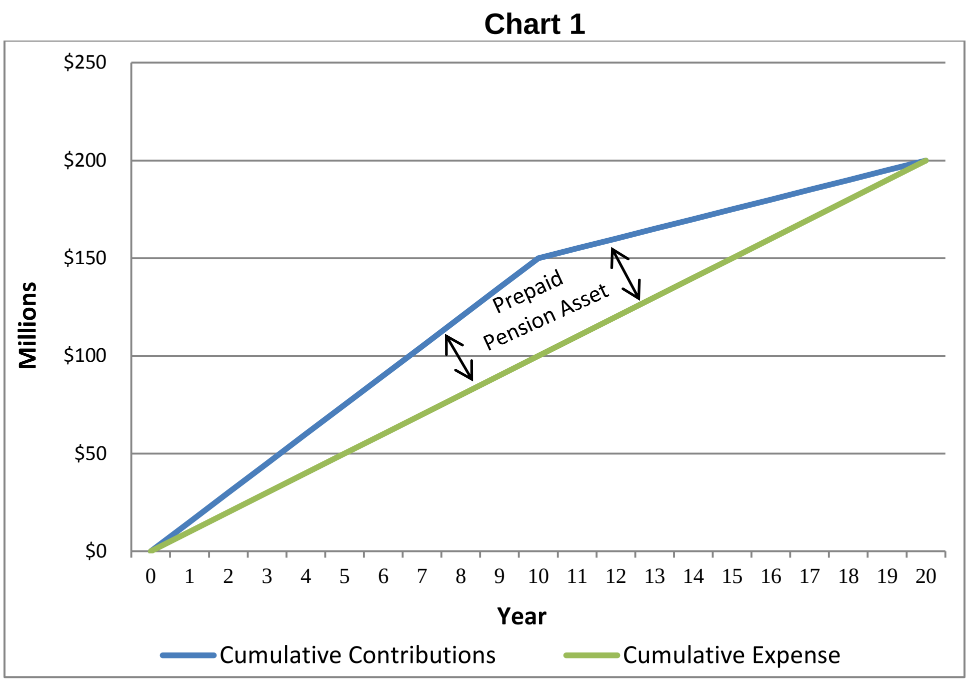
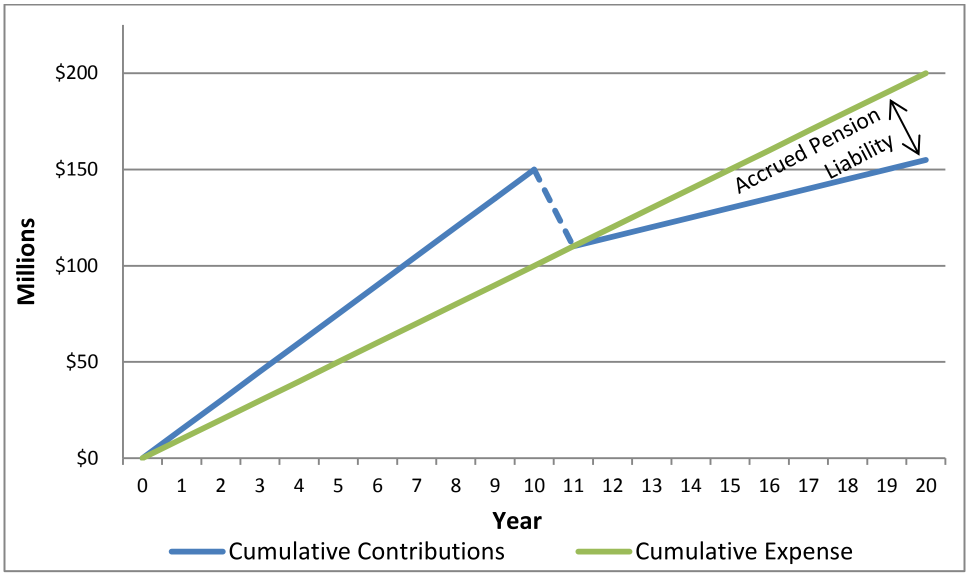


Chart 2 showing the accrued pension liability for years 11 to 20 resulting from starting with a zero prepaid pension asset balance in year 11:

Chart 2



Q. Should any negative prepaid pension asset (accrued pension liability) be included in rate base prospectively?

A. Yes. To the extent the existing prepaid pension asset is allowed to be included in rate base for a specific utility, there should be consistent treatment of any negative prepaid pension asset.

Q. In Staff's reply testimony, they are recommending no return be provided on the portion of the prepaid pension asset resulting from excess investment returns[4]. Is it reasonable to exclude excess investment returns from the amount on which a return is allowed?

A. No. It would not be reasonable to exclude excess investment returns from the prepaid pension asset. Excess asset returns are a component of FAS 87 expense that benefit customers and impact the prepaid pension asset through a reduction in FAS 87 expense

[4] Staff Exhibit 100, page 2, lines 6-8 and 18-19; page 21, lines 6-7; page 22, lines 3-5; page 23, lines 16-18; page 24, lines 6-8

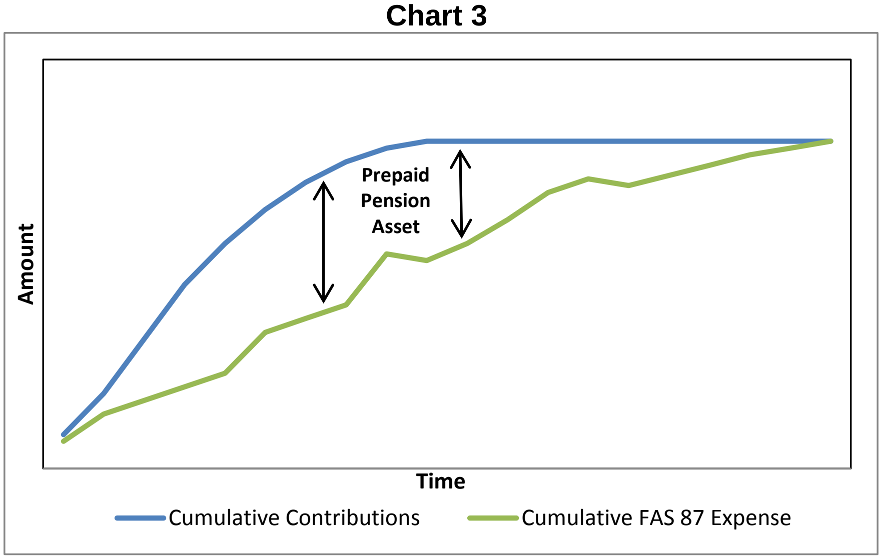
and a reduction in required future contributions. It is not appropriate to isolate and adjust the prepaid pension asset by a single component of FAS 87 expense. To remove excess asset returns from the prepaid pension asset would call into question whether customers should receive the benefits resulting from such excess asset returns through reduced FAS 87 expense and reduced contributions. At any point in time, regardless of what actual or excess returns have been, it remains true that the prepaid pension asset represents the difference between cash paid by the utilities into the plan and the FAS 87 expense recognized by the utilities and paid by customers (assuming FAS 87-based recovery). Additionally:

- **Excess returns do not always increase the prepaid pension asset:** Depending on the funded status of the plan, excess investment returns can increase, decrease or have a minimal impact on the prepaid pension asset. Because investment returns impact funding requirements under the PPA and FAS 87 expense differently and each plan has different circumstances, the corresponding change to the prepaid pension asset will not always be in one direction.
- **Excess returns are just one source of the plan's experience affecting the prepaid pension asset:** There are many reasons for actuarial gains or losses each year, and excess investment returns is just one of these. Other examples include: higher/lower turnover than expected, higher/lower salary increases than expected and higher/lower interest rates. Because the magnitude of these can vary from year to year, it would be inappropriate to focus on just one element and have the return on the prepaid pension asset altered as a result.

Q. In CUB's reply testimony[5], they state FAS 87 does not amortize the prepaid pension asset. Is it accurate to state that the accounting cost does not amortize the prepaid pension asset?

A. No. The total accounting cost will equal the total cash cost over the life of a plan. FAS 87 does amortize the prepaid pension asset through the recognition of annual expense as described in my direct testimony. The growth and/or speed at which the prepaid pension asset is amortized down will depend on many factors, including how a utility chooses to fund the plan, how the plan performs, the impacts of other components of FAS 87 expense (service costs, interest costs and amortization of unrecognized costs) and whether any accelerated recognition of unrecognized costs are triggered through FAS 88. The chart below provides a basic illustration of how cumulative contributions and cumulative FAS 87 expense could behave over the life of a plan:

Chart 3



[5] CUB Exhibit 100, page 19, lines 5-8.

As can be seen in Chart 3, for a plan that continues until that last participant, FAS 87 will continue to increase and amortize away the prepaid pension asset. For a plan that terminates well in advance of reaching its last participant, FAS 88 settlement charges will then ensure the prepaid pension asset amortizes to zero. The chart above also highlights that at any point in time regardless of whether or not FAS 87 expense is positive or negative, the difference between cumulative contributions and cumulative expense is represented by the prepaid pension asset. Assuming customers pay FAS 87 expense and utilities pay contributions, at any point in time, the difference between the two multiplied by the utility's cost of capital would represent the financing cost.

Q. CUB argues that excess investment returns and not contributions are the primary driver of the prepaid pension asset[6]. What is your response?

A. Excess investment returns are not the primary driver of the prepaid pension asset. The primary driver of the prepaid pension asset is the timing mismatch between cash contributions and FAS 87 expense. Over the life of a plan, the combination of cash contributions and investment returns on plan assets will be utilized to pay out all pension obligations. This implies that higher investment returns will lead to less contributions being required. Since accounting costs and cash contributions are equal over the life of a plan, this would also result in lower accounting costs as well. As I stated earlier in this rebuttal, excess returns can increase, decrease or have a minimal impact on the prepaid pension asset in the short term, depending on the funded status of the plan. Therefore, it is incorrect to state that excess investment returns are the primary driver of the prepaid pension asset. It is also important to note that the Towers Watson study mentioned in

[6] CUB Exhibit 100, page 23, line 7 through page 27, line 4

CUB's testimony[7] is taken out of context. The study states that "[t]ypically, the actual return on investments is the main driver in the change of a **pension plan's assets**". A pension plan's asset value is not the same as, and should not be confused with, the prepaid pension asset. Thus, CUB's reference to this statement in the article is completely off point.

Q. If the utilities are allowed to include the prepaid pension asset in rate base, would they be incentivized to contribute amounts in excess of minimums required in order to create additional profits?

A. No. As a plan approaches a fully funded status, the utility would be dis-incentivized from over-contributing to the pension trust. After termination of the pension plan, remaining excess assets would be subject to significant excise and ordinary taxes upon plan termination (unless utilized for another qualifying plan). Thus, it is in the best interests of customers and shareholders to properly manage the plan to minimize these taxes.

Q. CUB argues that if allowed rate base treatment of the prepaid pension asset, then a utility will be tempted to "ask for an additional mechanism that allows for the recovery of the prepaid pension asset"[8]. Have you commented on how the actual prepaid pension asset amount should be recovered in rates?

A. No. It is my understanding this proceeding is intended to address whether or not the prepaid pension asset should be included in rate base. In other words, this docket is focused on addressing the return "on" the prepaid pension asset as opposed to the return "of" the prepaid pension asset. CUB's reply testimony referenced my testimony

[7] CUB Exhibit 100, page 23, lines 14-15
[8] CUB Exhibit 100, page 38, line 19 through page 39, line 7

from a New Mexico case in which both the return “on” and the return “of” the prepaid pension asset were being addressed. Once again, although not the focus of this proceeding, the return “of” the prepaid pension asset was important in the New Mexico case based on the plan’s specific facts and circumstances. As addressed earlier in my testimony, under FAS 87 expense-based recovery, the return of pension costs will occur naturally through recovery of FAS 87 expense over the life of the plan.

Q. Does this conclude your testimony?

A. Yes.