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September 30, 2013

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 Direct Joint Testimony of Portland General Electric, PacifCorp, Avista Utilities, Cascade Natural Gas and NW Natural ("Joint Utilities") 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

Enclosure

cc: Service List

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing JOINT DIRECT TESTIMONY OF JOINT UTILITIES, upon all parties of record in the UM 1633 proceeding by electronic mail.

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DATED at Portland, Oregon, this 30th day of September 2013.

/s/ Kelley C. Miller
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 Direct Testimony of

Portland General Electric,
PacifCorp,
Avista Utilities,
Cascade Natural Gas,
NW Natural Gas
("Joint Utilities")

EXHIBIT 100

September 30, 2013

EXHIBIT 100 – DIRECT TESTIMONY – PENSIONS

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1 **I. INTRODUCTION AND BACKGROUND**

2 **Q. Please state your names, positions, and relevant history.**

3 A. My name is Douglas Stuver. I am Senior Vice President and Chief Financial Officer at
4 PacifiCorp, d/b/a Pacific Power. My qualification statement is provided as Exhibit 101.

5 My name is Brody Wilson. I am Controller and Chief Accounting Officer at NW Natural.
6 My qualification statement is provided as Exhibit 102.

7 My name is Patrick Hager. I am Manager, Regulatory Affairs at Portland General
8 Electric. My qualification statement is provided as Exhibit 103.

9 My name is Ryan Krasselt. I am Director of Finance and Assistant Treasurer at Avista.
10 My qualification statement is provided as Exhibit 104.

11 My name is Michael Parvinen. I am Director of Regulatory Affairs at Cascade Natural
12 Gas. My qualification statement is provided as Exhibit 105.

13 **Q. What is the purpose of this docket?**

14 A. The Commission resolved, in Order No. 12-408, to open an investigation to "review the
15 treatment of pension expense on a general, non-specific-utility basis."[1] The purpose of
16 this docket is to complete that investigation, and to establish an appropriate policy for
17 rate recovery of pension-related costs on a prospective basis.

18 **Q. What is the main issue that has given rise to this docket?**

19 A. In several recent proceedings, utilities have requested that the Commission expand its
20 approach to pension cost recovery to include costs that current policy does not address.
21 Specifically, the utilities have pointed out that the current recovery policy, based only on

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[1] P. 4.

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1 the expense determined under FASB Financial Accounting Standard 87 ("FAS 87
2 expense"), does not recognize significant financing costs incurred by the utilities in
3 carrying out their legal obligations to fund their pension plans.

4 **Q. Are the Joint Utilities seeking rate recovery through this proceeding?**

5 A. No. The Joint Utilities understand that the purpose of this docket is to investigate the
6 ratemaking treatment of pension-related costs and to determine policy for how utilities
7 will recover these costs going forward. Once the Commission has established its
8 recovery policy, the Joint Utilities expect to seek ratemaking treatment in the appropriate
9 utility-specific proceedings. We anticipate that within those individual proceedings the
10 Commission will determine the appropriate amounts to be included in each utility's rates,
11 based on the information specific to each utility.

12 Despite the generic nature of this docket, our testimony does present some
13 relevant data specific to individual utilities. We do not present this information so that
14 utility-specific rate determinations can be made in this docket. Rather, we provide this
15 information as background for the Joint Utilities' request, and because it demonstrates
16 that the changes we are proposing are required to address a significant problem.

17 **Q. Please summarize the Joint Utilities' proposal.**

18 A. The Joint Utilities are requesting that the Commission continue to allow them to recover
19 their FAS 87 expense. We are also requesting that the Commission allow for the
20 recovery in rates the financing costs that the Joint Utilities incur as a result of timing
21 differences between cash contributions to their pension plans and the recognition of
22 expense. As discussed later in our testimony, a prepaid pension asset or accrued
23 liability is generated as a result of these timing differences. The Joint Utilities are

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1 requesting that the ongoing financing costs of the prepaid asset be recovered on a
2 prospective basis only. Finally, the Joint Utilities raise the topic of the recoverability of
3 expenses that may occur in the future if a utility prudently chooses to freeze or exit a
4 pension plan.

5 **Q. Please explain how the remainder of your testimony is organized.**

6 A. The testimony is presented as follows:

7-10
- Sections II and III describe, at a high level, the relevant points of pension administration and accounting. In these sections, we also refer to testimony provided by Dr. Ken Vogl, a certified actuary with the professional services firm Towers Watson.

11-15
- Section IV explains this Commission's current policy regarding the recovery of pension costs. It also describes why the current treatment does not provide for the recovery of all significant costs associated with pensions. Finally, Section IV sets forth and supports the Joint Utilities' proposal for modifying the regulatory treatment of pension costs going forward.

16-18
- Section V addresses several positions that have been presented to the Commission in other proceedings by the parties to this docket, in which those parties argue against the recovery of utilities' financing costs.

19
- Section VI provides a summary of the Joint Utilities' proposal and conclusions.

20
<u>II. PENSION ADMINISTRATION OVERVIEW</u>

21 **Q. Can you please define a pension plan?**

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1 A. Yes. A pension plan is an employer-sponsored retirement plan through which
2 employees accrue benefits during their years of service to the company and receive
3 specified payments after they retire.[2] This type of employer-sponsored retirement plan is
4 known as a "defined benefit" plan. The payments made under pension plans are
5 guaranteed and an employer must keep the plan funded at a level such that this
6 obligation can be met. In other words, the employer bears the responsibility of ensuring
7 that enough funds are available to pay retirees at a specified level. This obligation is
8 different from retirement plans, such as 401(k) savings plans, where employees (and
9 often employers) make contributions at a predefined level and employees assume the
10 market risk of changes in the value of their investments. These latter plans are known
11 as "defined contribution" plans.

12 **Q. Why do the Joint Utilities have pension plans?**

13 A. The Joint Utilities' pension plans are a component of competitive compensation provided
14 to the employees that carry out the utilities' functions. This benefit has helped
15 companies acquire and retain qualified employees over the years.

16 **Q. Are pension plans regulated?**

17 A. Yes. In order to qualify for a tax deduction (i.e., to be defined as a "qualified plan"), the
18 pension plan must meet the requirements of the Internal Revenue Code including
19 compliance with rules set under the Employee Retirement Income Security Act of 1974
20 (ERISA). ERISA outlines funding requirements and charges the fiduciaries involved
21 with:

[2] Some pension plans allow employees to alternately take a lump-sum payout upon retirement rather than annuity payments.

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1 "…run[ning] the plan solely in the interest of participants and
2 beneficiaries and for the exclusive purpose of providing benefits and
3 paying plan expenses. Fiduciaries must act prudently and must
4 diversify the plan's investments in order to minimize the risk of large
5 losses. In addition, they must follow the terms of plan documents to the
6 extent that the plan terms are consistent with ERISA."[3]

7 The ERISA rules, including the funding requirements of the Pension Protection Act of
8 2006, are intended to provide benefit security for retirees by protecting the assets of
9 pension funds and also guarantee payment of certain benefits in the event of plan
10 termination through the federally chartered Pension Benefit Guaranty Corporation. The
11 ERISA rules also establish certain minimum requirements for pension plans and require
12 that certain information regarding plan features and funding be distributed to plan
13 participants on a regular basis. The employers' contributions, and any returns on those
14 contributions, cannot be remitted from the trust back to the employer unless the plan is
15 overfunded at plan termination, at which point any reverted funds would be subject to
16 significant excise and income taxes.

17 **Q. Who are the fiduciaries referred to above?**

18 A. There are multiple parties with fiduciary obligations. As employers, the Joint Utilities
19 have a responsibility to contribute funds as employees accrue benefits over time.
20 Trustees hold the pension plan assets, while administrators oversee the day-to-day
21 operations. A custodian or fund manager is tasked with managing the portfolio of
22 investments. Auditors and legal counsel are also employed to help ensure compliance
23 with regulatory requirements and the terms of the pension plan.

24 **Q. Please describe how pension plans operate.**

[3] U.S. Department of Labor http://www.dol.gov/ebsa/faqs/faq_compliance_pension.html

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1 A. At a high level, pension plans operate as follows:

2 • The employers (the Joint Utilities in this case) contribute cash or investments to a
3 qualified pension trust;

4 • The funds are added to the pool of plan assets that are invested primarily in debt
5 and/or equity securities;

6 • Returns on these investments increase the pool of assets; and

7 • Retirees are paid from the plan assets.

8 **Q. How do the employers determine the amount to contribute?**

9 A. Employers rely on actuaries to calculate the level of funding necessary to meet specified
10 targets. These targets are typically guided by federal minimum funding requirements
11 based on the value of plan assets and the projected future obligation. Each year, the
12 actuaries project the future obligation based on benefits accrued to date. In his
13 testimony, Dr. Vogl explains this in further detail.[4]

14 **Q. Can employers withdraw funds from their pension plans?**

15 A. No. As mentioned earlier, ERISA rules prohibit the funds from being used other than to
16 pay retirees or pay plan expenses. The only exception to this rule is in the case of an
17 overfunded plan upon plan termination, in which case the employer is allowed to
18 withdraw the overfunded portion. However, such withdrawals are heavily taxed,
19 incurring as much as 88% in taxes and fees, and are therefore highly disincentivized.

20

[4] *See* Exhibit 201.

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1 **III. PENSION ACCOUNTING OVERVIEW**

2 **Q. How do the Joint Utilities recognize and account for the costs of their pension**
3 **plans?**

4 A. The "expense" associated with a pension plan is determined in accordance with FASB
5 Financial Accounting Standard 87 which has been subsequently codified into FASB
6 Accounting Standards Codification Topic 715, Compensation – Retirement Benefits
7 (ASC Topic 715). This expense is therefore often referred to as FAS 87 expense, which
8 is how we refer to it in this testimony.[5] Dr. Vogl's testimony discusses the components
9 of FAS 87 expense in detail.

10 In addition to FAS 87 expense, the Joint Utilities account for the funded status of
11 the pension plan and the amount of unrecognized pension expense on their financial
12 statements. The difference between total cumulative contributions made to the pension
13 trust and the cumulative FAS 87 expense recognized over the life of the plan equals
14 either a prepaid pension asset (contributions in excess of FAS 87 expense) or accrued
15 pension liability (FAS 87 expense recognized in excess of contributions). Dr. Vogl's
16 testimony provides an in-depth discussion of the prepaid pension asset, as well as the
17 external factors that have caused the Joint Utilities' prepaid pension assets to grow.

18 **Q. Please explain what, if any, correlation exists between the FAS 87 expense**
19 **recognized and the cash contributions made by the Joint Utilities.**

20 A. There is one major correlation between contributions and FAS 87 expense. That is, to
21 the extent contributions are made by the Joint Utilities, those contributions act to reduce

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1 future FAS 87 expense. Contributions and FAS 87 expense however do not match and
2 are not designed to match. FAS 87 expense represents a cost of pension plan funding
3 that is smoothed out over time. However, the Joint Utilities are required to make
4 payments (contributions) to their pension plan funds that are often significantly different
5 than their FAS 87 expense in any given year, and that are much more sporadic in
6 nature. This timing difference is what leads to the financing costs for which we are
7 seeking rate recovery.

8 **Q. Besides FAS 87 expense and the financing costs of the prepaid pension asset, are**
9 **there any other costs of the Joint Utilities' pension plans?**

10 A. Yes. In the event a utility either freezes or terminates its pension plan, significant one-
11 time charges could be imposed under Financial Accounting Standard 88, which has
12 been codified into ASC Topic 715. When a plan is frozen, the plan participants no
13 longer continue accruing benefits and only the benefits earned up to that date will be
14 paid out upon retirement. Under the accounting rules, a curtailment charge is
15 recognized at that time.[6] A plan termination could take multiple forms, including
16 transferring the pension assets and obligations to another party through the purchase of
17 annuities, or providing lump-sum settlements to the plan participants. In this instance, in
18 accordance with FAS 88, the prepaid pension asset would be charged all at once as an
19 expense to the income statement. Dr. Vogl discusses this subject further in his
20 testimony.

[6] The curtailment charge could be either a gain or loss and, as such, the utilities would request to either recover or refund this amount.

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1 **Q. Over time does the cumulative amount of FAS 87 and FAS 88 expense equal the**
2 **cumulative cash contributions to the trust?**
3 A. Yes, over the life of the pension plan total contributions are expected to equal total FAS
4 87 and FAS 88 expenses. While at any point in time there would be a difference
5 between pension expense and cash contributions—which creates a prepaid asset or
6 accrued pension liability—upon plan termination and the final payment from the pension
7 trust, the prepaid pension asset or accrued pension liability would be eliminated. Dr.
8 Vogl also discusses this subject further in his testimony.

9 **IV. CURRENT AND PROPOSED REGULATORY TREATMENT OF PENSION COSTS**

10 **Q. Please describe the current regulatory approach in Oregon to recovering pension**
11 **costs.**
12 A. Currently, the Commission allows utilities to recover their FAS 87 expense in rates.
13 **Q. Do the Joint Utilities propose that they continue to recover their FAS 87 expense**
14 **in rates?**
15 A. Yes. A fundamental objective of FAS 87 is to recognize the expected cost of an
16 employee's pension benefits over the employee's remaining years of service. FAS 87
17 matches the changes in benefit obligations (due to market changes, salary and wage
18 adjustments, benefit payments, etc.) with the accounting expense while smoothing the
19 changes over time. FAS 87 expense is an appropriate component of pension recovery
20 because it represents the utility's actual expenses, as required by financial accounting
21 standards, and helps to allocate the pension costs over the period that the employees
22 are providing service to utility operations.

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1 **Q. What change to the current policy are the Joint Utilities proposing in this case?**
2 A. The Joint Utilities are requesting that they continue to be allowed to recover FAS 87
3 expense because this represents a reasonable return of the accounting expense the
4 utilities incur annually for pension benefits earned by their employees. The utilities are
5 also requesting that the Commission provide for the recovery of the financing costs
6 associated with utilities' required investments in pension funding. To implement this
7 recovery of the financing costs, the utilities are requesting that the Commission allow
8 them to recover their cost of capital on the amount of pension contributions that they
9 have made in excess of FAS 87 expense. This amount is captured as the utilities'
10 individual prepaid pension asset. Specifically, the Joint Utilities request that their
11 prepaid pension assets be added to rate base.
12 **Q. Why should the Commission change its current policy to allow the Joint Utilities**
13 **to recover their costs to finance the prepaid pension asset?**
14 A. The Joint Utilities are requesting a change in the rate recovery methodology because
15 changes in federal funding requirements (through the Pension Protection Act), coupled
16 with financial market downturns, have significantly increased the Joint Utilities' required
17 contributions to their pension plan funds and have accelerated the timing of such
18 required payments. As a result, the Joint Utilities have incurred significant costs to
19 finance these accelerated payments until they can recover these payments through the
20 recognition of FAS 87 expense. This increased financing requirement is demonstrated
21 by growing prepaid pension assets for the Joint Utilities. In short, recovery of FAS 87
22 expense only—with no recovery of the financing costs—has resulted in pension cost
23 recovery that is no longer fair or reasonable.

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1 **Q. How significant are these financing costs?**

2 A. Over approximately the last five years, the balance of the Joint Utilities' prepaid pension
3 assets have grown substantially and the related carrying costs of the assets are likewise
4 significant. The table below shows the balance of the Joint Utilities' prepaid pension
5 assets as of December 31, 2012.

Utility	Prepaid Pension Asset as of December 31, 2012[7] (millions)
Pacific Power	$282.4
NW Natural	$35.4
Portland General Electric	$108
Avista	$62.9
Cascade Natural Gas	$15.1

6

7 Please note that while the specific circumstances of the utilities' pension plans differ
8 (e.g., if and when the plan was closed and/or frozen, whether the prepaid pension asset
9 prior to 2007 was actually an accrued pension liability, etc.) the utilities' prepaid pension
10 asset balances have all grown—as a result of the new federal funding requirements
11 becoming effective and the significant market and interest rate decline that subsequently
12 occurred.

[7] We note that in some instances, the amount of the prepaid asset added to rate base may be affected by the applicability of deferred taxes as an offset, depending on whether a utility has already included such deferred taxes in rate base separately.

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1 **Q. Are these significant financing costs expected to continue in the immediate**
2 **future?**
3 A. Yes. While any prepaid pension asset (or accrued pension liability) is expected to
4 reduce to zero over the life of the plan, based on the current funding requirements and
5 market conditions, the Joint Utilities' prepaid pension asset balances are not expected to
6 reverse in the near future. Dr. Vogl covers this further in his testimony.
7 **Q. Is the Joint Utilities' proposal consistent with the Commission's current approach**
8 **to regulation?**
9 A. Yes. The Joint Utilities' proposal involves a straightforward application of the
10 Commission's standard regulatory principles. Currently, the Commission recognizes
11 that in order to provide for recovery of utility costs that involve an investment (i.e., a
12 contribution of cash that is expensed over a number of years), it must provide for cost
13 recovery of two things—1) the expense, and 2) the financing costs. For example, to
14 implement cost recovery for physical assets, the Commission allows a "return of" the
15 investment (through the recovery of depreciation expense) and a "return on" the
16 investment (representing the utility's cost of capital to finance the investment, through
17 adding the net investment to rate base).
18 In the case of pension costs, however, the Commission is currently allowing for
19 the ***return of*** the investment through FAS 87 expense that is collected in rates. It has
20 made no provision for a ***return on*** the investment through a recovery of the financing
21 costs.

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1 **Q. Are there other instances where the Commission has found it appropriate to**
2 **provide recovery for a utility's financing costs on investments other than physical**
3 **plant assets?**
4 A. Yes. For example, when prudent utility practice requires a utility to "pre-purchase"
5 materials and supplies for later use, Commission practice is to allow the utility to recover
6 the cost of financing the purchase of the materials and supplies. One example is the
7 Commission's treatment of a utility's costs of fuel stock for a coal plant. A coal plant
8 consumes massive amounts of coal that must be on hand in sufficient quantity to keep
9 the plant running without interruption. Thus, a utility arranges for large deliveries of coal,
10 perhaps enough to keep the plant running weeks or months at a time, and finances the
11 purchase through equity and long-term debt. As a result, at any one time the utility
12 maintains a large stock of fuel. In this example, the utility incurs two types of costs
13 associated with the coal. First, the utility incurs the "expense" at the time the coal is
14 actually burned. Accordingly, Commission policy it to allow the utility to recover coal
15 expense as a component of its power costs. Second, the utility incurs the cost of
16 financing the stock of coal that has been purchased and is waiting to be
17 burned. Accordingly, the Commission policy is to allow the utility to earn its authorized
18 rate of return on that pre-purchased coal, as a component of Fuel Stock. The prepaid
19 pension asset balance represents pre-payments of FAS 87 expense that are analogous
20 to the stock of coal.
21 **Q. Do other jurisdictions allow a "return on" the prepaid pension asset?**
22 A. Yes. We understand that many utilities in a number of states have been allowed to earn
23 a "return on" the prepaid pension asset, including in District of Columbia, Michigan, New

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1 York, Oklahoma, Ohio and Texas.[8] Additionally, in response to Staff's "Pension
2 Treatment in Rate Making Survey," 16 commissions reported that they recognize a
3 "Prepaid Pension Asset/Liability" through allowing "a return on amount invested in
4 asset." An additional three commissions reported that they include cash contributions in
5 "Working Capital," and six other commissions used a "Combination of Methods." Of
6 those using multiple methods, several mentioned including pension costs in rate base, or
7 otherwise earning a return on the asset.

8 **Q. Why is the Joint Utilities' request reasonable?**

9 A. The request is reasonable because it provides for nothing more than the recovery of the
10 costs associated with pensions. Specifically, the continuation of FAS 87 expense
11 recovery provides for the return of the investment utilities are required to make. And,
12 adding the prepaid asset to rate base provides for the return on that investment that is
13 necessary in order to allow utilities to collect their financing costs.

14 **Q. If the Commission were to allow the utilities to add their prepaid pension assets to**
15 **rate base, wouldn't it be risking the double recovery of certain pension costs—**
16 **through the expense *and* the financing of the prepaid pension asset?**

17 A. No. By definition, the prepaid pension asset is the difference between cumulative
18 contributions to the pension fund and cumulative FAS 87 expense. Thus, as FAS 87
19 expense is recovered, that recovery reduces the prepaid pension asset. There is no
20 double recovery—just as there is no double recovery of costs when the Commission

[8] This list is by no means intended to be exhaustive.

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1 allows a return on rate base items and a recovery of depreciation expense on the same
2 items.

3 **Q. Earlier, you stated that the Joint Utilities wished to address a matter regarding**
4 **expenses associated with the prudent termination of an existing plan. Please**
5 **explain further.**

6 A. As described above, when a utility terminates its pension plan, it would recognize an
7 immediate expense, in accordance with FAS 88. We raise this issue because the
8 Commission is considering the appropriate regulatory treatment of pension costs in this
9 generic proceeding, and this issue is likely to become relevant for some or all of the
10 utilities in the future. At that time, we would expect that such an expense, if prudently
11 incurred, would be recoverable through rates, perhaps amortized over a number of
12 years.

13 V. POSITIONS PRESENTED IN OTHER PROCEEDINGS

14 **Q. Are the Joint Utilities aware of other parties' positions on these issues?**

15 A. Yes. Individual members of the Joint Utilities have made similar proposals in other
16 dockets and the parties have, in those proceedings, offered comments and arguments
17 relevant to the Joint Utilities' proposal. Although those parties may revise their positions
18 in this docket, we believe it makes sense for us to take this opportunity at the beginning
19 of this docket to respond to the primary objections that have been made to the
20 Commission already.

21 **Q. What are the primary arguments made by other parties against allowing utilities to**
22 **recover their costs to finance their prepaid pension assets?**

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1 The primary arguments are as follows: (1) The proposal constitutes retroactive
2 ratemaking because it seeks to recover the costs associated with contributions that were
3 made in the past; (2) Recovery is inappropriate because the prepaid asset was built up
4 in the past when rates were considered "fair and reasonable"; and (3) FAS 87 expense
5 is no longer a reasonable basis for recovering pension costs and recovery should be
6 based only on cash contributions.

7 **Q. What is your response to the argument that your proposal constitutes retroactive**
8 **ratemaking?**

9 A. The rule against retroactive ratemaking prohibits the Commission from setting future
10 rates based on a utility's past revenues and expenses. The Joint Utilities are not
11 seeking to recover past FAS 87 expense or past financing costs. Instead they are
12 seeking approval of a methodology that allows them to recover the costs they incur in
13 the future to finance pension contributions until FAS 87 expense allows "recovery of"
14 their required contributions. The rule against retroactive ratemaking is not implicated by
15 a request to recover future financing costs.

16 **Q. What is your response to the argument that your proposal inappropriately**
17 **requires adjustment of past rates that were just and reasonable?**

18 Parties have taken the position that the Joint Utilities should not be allowed to recover
19 financing costs on the prepaid asset in the future, because the prepaid asset itself was
20 built up during past periods. This argument seems to be connected to their positions
21 about "retroactive ratemaking," but the argument also seems to encompass a position
22 that if the utilities' rates were considered "fair and reasonable" during the period in which

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1 the prepaid asset built up, allowing the utility to recover future financing costs would lead
2 to an over-recovery.

3 This argument also relies on a confusion of the Joint Utilities' proposal. Again,
4 we are not proposing to recover past expenses, or past financing costs. And, the Joint
5 Utilities are not relying on a demonstration that past rates were somehow not just and
6 reasonable in order to support their request in this case. Instead, our proposal is
7 founded on a demonstration that the current method of recovering pensions costs will
8 not allow for recovery of significant pension costs in the future.

9 **Q. What is your response to the argument that FAS 87 is no longer a reasonable**
10 **basis for recovering pension costs and recovery should be based only on cash**
11 **contributions?**

12 A. As stated above, the Joint Utilities believe that FAS 87 expense is one important
13 component of the recovery of pension costs because it represents the utilities' actual
14 expenses under financial accounting standards. However, FAS 87 expense does not
15 provide for the financing costs of the pension plan. Including the prepaid pension asset
16 in rate base in addition to recovery of FAS 87 expense would provide for the recovery of
17 the financing costs.

18 Transitioning to a cash contribution basis of recovery would be fair and just only if
19 the prepaid pension asset balance at the time of transition is amortized into rates over a
20 specified period while earning a return. Otherwise, a disallowance would be triggered,
21 leading to a write-off of the prepaid pension asset. As a prepaid pension asset balance
22 represents contributions in excess of expense at a point in time, it also means that
23 expenses will exceed contributions over the remaining life of the pension plan (i.e., over

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1 time, contributions and expense will equal). The following table illustrates this point,
2 assuming an eight year pension plan life with recovery based on FAS 87 expense for the
3 first four years and recovery based on cash contribution for the remaining four years.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Total
FAS 87 expense	10	10	10	10	10	10	10	10	**80**
Cash contribution	12	12	12	12	12	12	8	-	**80**
Cum. prepaid balance	2	4	6	**8**	10	12	10	-	
Recovery in rates	10	10	10	10	12	12	8	-	**72**
Total expense and contribution	80								
Total recovery	72								
Under recovery	(8)								
Prepaid at time of conversion (year 4)	8								

4 It would be similarly inappropriate for a utility to order mid-year that all customers would
5 be transferred to equal pay prospectively without considering whether and how to
6 reconcile the fact that some customers already paid monthly bills for the coldest part of
7 the year.

8 ## VI. CONCLUSION

9 **Q. Please summarize your testimony provided above.**

10 A. The Joint Utilities believe that the current approach to pension cost recovery should be
11 modified because it does not provide for the recovery of significant financing costs. We
12 propose that the Commission continue to provide for the recovery of FAS 87 expense,
13 while also allowing utilities to recover a return on their prepaid pension asset
14 prospectively. Doing so will allow for an appropriate recovery of pension costs in rates.

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

16 A. Yes.

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BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY RATES

UM 1633

Joint Direct Testimony of

Portland General Electric,
PacifCorp,
Avista Utilities,
Cascade Natural Gas,
NW Natural Gas

EXHIBITS 101-105

September 30, 2013

1 **QUALIFICATIONS DOCUMENT OF DOUGLAS K. STUVER**

2 **Q. Please state your name, business address, and present position with**
3 **PacifiCorp d/b/a Pacific Power (PacifiCorp or Company).**

4 A. My name is Douglas K. Stuver and my business address is 825 NE Multnomah
5 Street, Suite 1900, Portland, Oregon, 97232. My present position is Senior Vice
6 President and Chief Financial Officer.

7 **Q. Briefly describe your education and professional experience.**

8 A. I have a Bachelor of Arts degree in business administration from the University of
9 Pittsburgh and am a Certified Public Accountant licensed in Pennsylvania.
10 I worked for Ernst & Young for eight years in auditing and have since worked for
11 Enserch Energy Services, CNG Energy Services, and Duke Energy Corporation
12 in various accounting and risk management capacities. I joined PacifiCorp in
13 2004 as the controller for the commercial and trading division and moved into my
14 current role as Senior Vice President and Chief Financial Officer in March 2008.

15 **Q. What are your responsibilities as Senior Vice President and Chief Financial**
16 **Officer?**

17 A. My primary responsibilities include the accounting, treasury, tax, financial
18 planning and analysis, external financial reporting, commodity risk management,
19 and internal audit functions for PacifiCorp.

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1 **QUALIFICATIONS DOCUMENT OF BRODY J. WILSON**

2 **Q. Please state your name, business address, and present position with**
3 **Northwest Natural Gas Company (NW Natural or Company).**
4 A. My name is Brody J. Wilson and my business address is 220 NW Second
5 Avenue, Portland, Oregon 97209. My present position is Controller and Chief
6 Accounting Officer.
7 **Q. Briefly describe your education and professional experience.**
8 A. I have a Bachelor of Science in Business Administration in Accounting, George
9 Fox University and am a Certified Public Accountant licensed in the State of
10 Oregon. I worked at PricewaterhouseCoopers, LLP for 11 years in their Power
11 and Utilities Assurance practice and have since worked at NW Natural. I joined
12 NW Natural in September 2012 as the Assistant Controller and moved into the
13 Acting Controller role in February 2013 and finally the Controller and Chief
14 Accounting Officer role in September 2013.
15 **Q. What are your responsibilities as Controller and Chief Accounting Officer?**
16 A. My primary responsibilities include general and gas accounting, financial
17 reporting, tax and accounts payable functions at NW Natural.

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1 **QUALIFICATIONS DOCUMENT OF PATRICK HAGER**

2 **Q. Mr. Hager, please state your educational background and experience.**

3 A. I received a Bachelor of Science degree in Economics from Santa Clara
4 University in 1975 and a Master of Arts degree in Economics from the University
5 of California at Davis in 1978. In 1995, I passed the examination for the Certified
6 Rate of Return Analyst (CRRA). In 2000, I obtained the Chartered Financial
7 Analyst (CFA) designation.

8 I have taught several introductory and intermediate classes in economics
9 at the University of California at Davis and at California State University
10 Sacramento. In addition, I taught intermediate finance classes at Portland State
11 University. Between 1996 and 2004, I served on the Board of Directors for the
12 Society of Utility and Regulatory Financial Analysts. Locally, I have been on the
13 Board of Directors for Advantis Credit Union since 2007, serving previously on
14 the Audit Committee.

15 I have been employed at PGE since 1984, beginning as a business
16 analyst. I have worked in a variety of positions at PGE since 1984, including
17 power supply. My current position is Manager, Regulatory Affairs.

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1 **QUALIFICATIONS DOCUMENT OF RYAN L. KRASSELT**

2 **Q. Please state your name, business address, and present position with**
3 **Avista Corp.**
4 A. My name is Ryan L. Krasselt. My business address is 1411 East Mission
5 Avenue, Spokane, Washington. I am employed by Avista Corporation as Director
6 of Finance and Assistant Treasurer.
7 **Q. Would you please describe your education and business experience?**
8 A. I received a Bachelor of Science degree in 1994, with majors in Accounting and
9 Finance from the University of Idaho in Moscow, Idaho and became a Certified
10 Public Accountant in 1995. I have extensive experience in finance and
11 accounting within the utility sector. I joined Avista in July 2001 as a Financial
12 Business Partner in accounting. Prior to joining Avista, I was a senior manager
13 in auditing for PricewaterhouseCoopers.

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1 **QUALIFICATIONS DOCUMENT OF MICHAEL P. PARVINEN**

2 **Q. Please state your name and business address.**

3 A. My name is Michael P. Parvinen. My business address is 8113 W. Grandridge
4 Blvd., Kennewick, Washington 99336-7166. My e-mail address is
5 michael.parvinen@cngc.com.

6 **Q. By whom are you employed and in what capacity?**

7 A. I am employed by Cascade Natural Gas Corporation (Cascade) as the Director
8 of Regulatory Affairs. In this capacity, I am responsible for the management of
9 all state regulatory functions at Cascade excluding pipeline safety.

10 **Q. What is your educational and professional background?**

11 A. I graduated from Montana College of Mineral Science and Technology in May of
12 1986, and received a Bachelor of Science degree in Business Administration with
13 an emphasis in accounting. I have been employed by Cascade since September
14 2011. Prior to joining Cascade I was employed by the Washington Utilities and
15 Transportation Commission (Washington Commission) for nearly 25 years. I was
16 employed as a Regulatory Analyst, later as a Deputy Assistant Director, and
17 lastly as the Assistant Director of the Energy Section.

BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY RATES

UM 1633

Direct Testimony of

C. Kenneth Vogl

EXHIBIT 200

September 30, 2013

EXHIBIT 200 – DIRECT TESTIMONY – PENSIONS

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I. INTRODUCTION

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

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

5 **Q. On whose behalf are you testifying?**

6 A. I am testifying on behalf of PGE, PacifiCorp, Avista Utilities, Cascade Natural Gas, and
7 NW Natural; collectively known as the "Joint Utilities."

8 **Q. Please describe your professional experience.**

9 A. I have been employed with Towers Watson or one of its predecessor companies in St.
10 Louis since 1995. I was employed with Towers Perrin from 1995 to 2007 and Watson
11 Wyatt Worldwide from 2007 to 2009. In January 2010, Towers Perrin and Watson Wyatt
12 Worldwide merged to form Towers Watson. I was also employed with William Mercer in
13 St. Louis from 1994 to 1995.

14 **Q. Please describe your educational background.**

15 A. I received a Bachelor of Science degree in mathematics from the University of Missouri,
16 Columbia in 1988 and a Doctorate of Philosophy in mathematics from Washington
17 University in 1994. I completed the examination requirements for designation as a
18 Fellow of the Society of Actuaries and received such designation in August 2000. I
19 completed both the examination and experience requirements for designation as an
20 Enrolled Actuary under the Employee Retirement Income Security Act of 1974 ("ERISA")
21 and received such designation in 1998.

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1 **Q. What are your duties in your current position?**

2 A. I have substantial technical and consulting experience relative to employee benefit plans
3 – including the design, funding, accounting, and communication of pension and post-
4 retirement welfare ("OPEB") programs. In addition, I have assisted many regulated
5 utilities throughout the country on pension and OPEB program issues that have needed
6 to be addressed through rate cases or other discussions with regulatory staff.

7 **Q. Have you previously testified before other regulatory agencies and courts on**
8 **utility-related matters?**

9 A. I have provided written and/or oral testimony to state regulatory agencies in Illinois,
10 Kansas, Minnesota, Missouri and New Mexico.

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

12 A. The purpose of my testimony is to provide an overview of how the costs of pension
13 benefits are determined for both accounting purposes and cash funding purposes. I'll
14 also describe how recent changes are affecting the relationship between these costs.
15 There are specific rules and regulations that govern how these costs are to be
16 determined, so I will briefly describe these and discuss how the costs differ and interact
17 with each other. In addition, I'll illustrate how these costs are expected to behave in the
18 future.

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II. PENSION PLAN COSTS

1 **Q. In your opinion, is there a "best" way of determining the cost of a pension plan?**
2 A. No, not necessarily. The actual cost of any pension plan will not be known until the last
3 benefit is paid to the last plan participant. Because the benefits are expected to be paid
4 many years into the future, reasonable cost methods generally reflect the cost of the
5 pension benefit in the period of time the benefit is earned. Depending on the objectives,
6 one cost method may be more desirable than another. For example, as I will discuss in
7 more detail later, from a funding perspective the primary objective of Pension Protection
8 Act of 2006 ("PPA") was to improve the benefit security provided by pension plans. PPA
9 was well designed to meet this objective. From an accounting perspective, the primary
10 objectives are consistency and comparability of costs from year to year and from one
11 organization to another. I believe pension cost as determined by the accounting
12 standards meets these objectives and will discuss this later as well.
13 **Q. Please provide a brief overview of how pension costs are determined for**
14 **accounting purposes.**
15 A. Pension costs are typically calculated in accordance with the Statement of Financial
16 Accounting Standards No. 87 ("FAS 87"). FAS 87 is an accounting standard issued by
17 the Financial Accounting Standards Board ("FASB") in December 1985 relating to
18 employers' accounting for pensions. Costs also include amounts calculated in
19 accordance with the Statement of Financial Accounting Standards No. 88 ("FAS 88"), an
20 accounting standard dealing with settlements and curtailments of pension plans. FAS
21 87 and FAS 88 have recently been codified by FASB Accounting Standards Codification

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1 Topic 715 ("ASC 715"), but will still be referred to throughout this testimony as FAS 87
2 and FAS 88 for ease of understanding. FAS 87 requires employers to recognize the
3 cost of their pension plan(s) on an accrual basis rather than a cash basis. In other
4 words, pension cost is recognized over the period during which benefits are earned (or
5 "accrued"), *i.e.*, during the working years of the employees who will receive the pension
6 benefit upon retirement.

7 The FAS 87 pension cost is equal to the sum of the following components:

8 - Service cost – The value of the benefits earned, or accrued, during the current
9 year based on the applicable benefit formula for each participant.
10 - Interest cost – The interest on the pension plan liability (*i.e.,* Projected Benefit
11 Obligation, or PBO) for the year. This amount increases pension cost and
12 reflects the passage of time or the time value of money on the PBO.
13 - Expected return on assets – The expected return on assets for the year. This
14 amount reduces pension cost. Note that the difference between the actual return
15 on assets and the expected return on assets represents an actuarial gain or loss
16 that will be recognized in future pension cost.
17 - Amortizations of unrecognized costs – The change in liability due to plan
18 changes, changes in actuarial assumptions used to value plan liabilities,
19 differences between expected and actual asset returns, and/or experienced
20 gains or losses will be recognized over time and are subject to amortization. The
21 amortization period is not to exceed the average future lifetime of plan
22 participants. In amortizing unrecognized gains or losses, a 10% corridor is

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1 allowed to be used in which only those gains or losses in excess of the greater of
2 10% of the PBO or the market-related value of assets are subject to amortization.
3 The simplified example below shows how the FAS 87 pension cost would be
4 determined for a sample plan sponsor. For this example, we have assumed the
5 following:

Table 1

Projected Benefit Obligation	$	800	million	Discount Rate	4%
Fair Value of Assets	$	650	million	Expected Return on Assets	8%
Unrecognized Losses	$	270	million	Amortization Corridor	10%
Annual Benefits Earned	$	20	million	Average Future Service (AFS)	12

6 Using the assumptions listed above, the FAS 87 pension cost would be calculated as
7 follows:

Table 2

Service Cost	$	20	*Annual benefits earned for the year*
Interest Cost		32	*$800m liability x 4% interest*
Expected Return on Assets		(52)	*$650m assets x 8% expected return*
Amortization		16	*($270m unrec - $80m corridor) / AFS of 12*
Total FAS 87 Pension Cost	$	16	

8 **Q. What are FAS 88 costs and how do they factor into the pension cost calculation?**
9 A. FAS 88 requires an immediate recognition of unrecognized costs whenever certain
10 triggering events occur. The immediate recognition is typically just an acceleration of
11 costs that would have been recognized in the future. Two events that create a FAS 88
12 acceleration of costs are:

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1 **A curtailment** is an event that (a) significantly reduces the expected years of
2 future service of present employees or (b) eliminates for a significant number of
3 employees the accrual of defined benefits for some or all of their future services
4 (e.g., a plan freeze). A curtailment can generate an immediate income statement
5 impact by (1) recognizing all or a portion of the unrecognized costs (or credits)
6 due to previous plan changes, and (2) recognizing all or a portion of the decrease
7 (or increase) in PBO if the plan is in an unrecognized gain (or loss) position.
8 **A settlement** is an event that (a) is an irrevocable action, (b) relieves the
9 employer (or the plan) of primary responsibility for a pension benefit obligation,
10 and (c) eliminates significant risks related to the obligation and the assets used to
11 effect the settlement (e.g., an annuity purchase). A settlement can generate an
12 immediate income statement impact by recognizing all or a portion of the
13 unrecognized costs (or credits).
14 To summarize, FAS 88 requires an acceleration of deferred costs whenever 1)
15 there are fewer participants working or accruing a benefit as in the case of a curtailment,
16 or 2) the plan is smaller relative to its historical experience as in the case of a settlement.
17 While my testimony will mainly focus on the calculation of the recurring FAS 87
18 component of pension costs, I will also describe events that could trigger a FAS 88 cost
19 and how the FAS 88 cost would be calculated.
20 **Q. Please provide a brief overview of how pension costs are determined for cash**
21 **funding purposes.**
22 A. PPA redefined minimum required cash funding requirements for nearly all pension plans
23 in 2008 and beyond. Prior to 2008, the minimum required funding requirements were

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1 specified in ERISA. In general, PPA requires a pension plan sponsor to annually
2 contribute an amount equal to: (1) the benefits being earned for the year, plus (2) a
3 seven year amortization of the amount the plan is underfunded. A seven year
4 amortization base is established each year based on the difference between the funded
5 status of the plan and the value of the previous seven-year amortization bases that still
6 exist. Once the plan becomes fully funded, all amortization bases are wiped out and the
7 required contribution simply becomes the benefits being earned for the year (also
8 referred to as "normal cost"), or less to the extent the plan is overfunded (no contribution
9 required if the plan is overfunded by more than the benefits being earned for the year).
10 Contributions are typically required on a quarterly basis with a final contribution allowed
11 to be made up to 8½ months after the end of the plan year.

12 Note additional rules apply to plans that are severely underfunded (referred to as
13 "at-risk") that will increase the contribution requirement over what is described above,
14 but this testimony will ignore those rules for simplicity. In addition, PPA introduced
15 "benefit restrictions" whenever a plan's funded status falls below certain thresholds, thus
16 requiring a plan sponsor to keep their plan well-funded in order to pay or provide benefits
17 as promised to participants. For example, plan sponsors must keep their plan at least
18 80% funded in order to pay lump sum distributions or to amend the plan for benefit
19 improvements. Satisfying this benefit restriction threshold has been a significant
20 challenge for many plan sponsors in the recent decreasing interest rate environment.

21 The simplified example below shows how the PPA minimum required
22 contribution would be determined for a sample plan sponsor. For this example, we have
23 assumed the following:

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Table 3

PPA Funding Liability	$	760	million	Discount Rate	4%
Market Value of Assets	$	650	million		
Annual Benefits Earned	$	22	million		

1 Using the assumptions listed above, the PPA required contribution would be calculated
2 as follows:

Table 4

Normal Cost	$	22	*Annual benefits earned for the year*
Amortization		18	*Amortization of $110m unfunded over 7 years*
Total Required Contribution	$	40	

III. RECENT CHANGES

3 **Q. How have funding requirements changed since the passage of PPA?**

4 A. In comparing the PPA requirements to the previous funding requirements, plans are still
5 generally required to annually fund the amount of benefits being earned for the year plus a
6 portion of the unfunded liability. However, the portion of unfunded liability that is required to be
7 funded has been changed by PPA. Historically, the unfunded liability would generally be
8 amortized over a 10-15 year period, meaning that a typical plan would be fully funded after
9 10-15 years on an expected basis (i.e., assuming no change to interest rates, reasonable
10 investment return, logical demographic experience, etc.). PPA decreased the period for
11 amortizing the unfunded liability to seven years, which has significantly accelerated and front-
12 loaded required contributions in order to satisfy the funding rules. The resulting impact on
13 companies subject to PPA is that more cash has been and will be required to fund the plan
14 sooner than under previous funding rules.

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1 **Q. Have there been other recent changes to the pension environment?**

2 A. From an economic perspective, there have been two significant issues affecting the
3 pension environment over the past five years or so. The first was the stock market crash
4 of 2008. Prior to that market crash, many pension plans were at or above 100% funded
5 and experiencing fairly small accounting and cash costs. With the market crash
6 occurring in the same year PPA funding rules were effective, plan sponsors were
7 immediately faced with underfunded plans and large required pension contributions due
8 to the accelerated recognition of the investment losses under PPA. The other issue that
9 has affected the pension environment is the decline in interest rates. The Citigroup
10 Pension Liability Index is generally considered a reasonable proxy for pension discount
11 rates, and it decreased nearly 250 basis points from the end of 2007 to the end of 2012.
12 Decreasing interest rates will increase the plan's obligation, thereby increasing the
13 unfunded liability and ultimately increasing the accounting and cash cost. See the table
14 below for a summary of the Citigroup Pension Liability Index at the end of each year
15 since 2007.

Table 5

Citigroup Pension Liability Index	
12/31/2007	6.48%
12/31/2008	5.87%
12/31/2009	5.98%
12/31/2010	5.54%
12/31/2011	4.40%
12/31/2012	4.05%

16 To illustrate how pension plan funded status has behaved over the past decade, we
17 have gathered pension financial information from the annual reports of 21 large utilities

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1 that existed in 2002, 2007, and 2012. The 21 utilities are all members of the 2012
2 Fortune 1000 and were selected to provide a reasonable representation of the utility
3 industry. See Exhibit 201 for a more detailed summary of these utilities. On average,
4 the utility group had a funded percentage of 84% in 2002, 101% in 2007, and 78% in
5 2012. This shows that plans have been significantly affected by the combination of new
6 funding regulations, a market crash and decreasing interest rates. Also note that the
7 decrease in funded status from 2007 to 2012 is after reflecting the significant cash
8 contributions that plan sponsors made during this period, which will be discussed later in
9 the testimony.

10 In addition to the changes described above, there has been some recent
11 legislation passed that has provided temporary funding relief to plan sponsors. The
12 Moving Ahead for Progress in the 21st Century Act ("MAP-21") was signed in 2012 and
13 has allowed plans to use a higher interest rate in the short term when measuring the
14 liability for PPA funding purposes. This temporarily improves a plan's funded status and
15 decreases the amount of contributions required. The impact of the MAP-21 interest rate
16 relief is expected to phase out over the next few years, and makes no changes to the
17 long-term cost of a pension plan.

18 **Q. Please describe the difference between accounting costs and cash costs under**
19 **PPA.**

20 A. From a high level, both are designed to reflect the cost of the plan over the life of the
21 plan. As described above, both include the benefits being earned for the year as a key
22 component of their respective cost. However, the primary difference between the two
23 methods is the time period over which the unfunded liability is recognized. PPA

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1 front-loads the recognition by spreading changes in the funded status over seven years.
2 While FAS 87 isn't as explicit and can vary slightly from plan to plan, it generally will
3 spread the bulk of funded status changes over a period of 15-20 years. The example
4 below illustrates how a $100 loss in a given year would be reflected differently over the
5 next 15 years for FAS 87 and PPA purposes using the sample plan assumptions
6 previously described.

Table 6

	Yr 1	Yr 2	Yr 3	Yr 4	Yr 5	Yr 6	Yr 7	Yr 8	Yr 9	Yr 10	Yr 11	Yr 12	Yr 13	Yr 14	Yr 15	Total
FAS 87	8.3	7.6	7.0	6.4	5.9	5.4	4.9	4.5	4.2	3.8	3.5	3.2	2.9	2.7	2.5	72.8
PPA	16.0	16.0	16.0	16.0	16.0	16.0	16.0	-	-	-	-	-	-	-	-	112.0

7 Notice the $100 loss has been fully reflected in level amounts after seven years under
8 PPA (note PPA requires both principal and interest for amortization of the $100), while it
9 is spread out over many more years under FAS 87 and the annual amount is gradually
10 decreasing. This is due to the difference in amortization length and methodology
11 between the two. One can see from the table above how PPA would be more desirable
12 if the objective was to secure the benefits by quickly improving the funded status of the
13 plan. One can also see that FAS 87 would be more desirable if the objectives were to
14 minimize year-to-year volatility (Year 1 recognition under PPA is 1.9 times greater than
15 year 1 recognition under FAS 87) and spread the cost of unexpected experience over
16 longer periods of time.

17 **Q. Will the accounting cost and the cash cost be equal to each other over the life of**
18 **the plan?**

19 A. Yes, a fundamental characteristic of the accounting cost is that the accumulated
20 contributions will equal the accumulated pension costs over the life of the plan. The

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1 accounting cost includes the annual FAS 87 costs plus, if any, the FAS 88 costs
2 triggered by special events.

3 **Q. Is the difference between accounting cost and cash cost tracked by plan**
4 **sponsors?**

5 A. Yes. At any point in time, the prepaid pension asset is defined as the difference
6 between the cumulative contributions and the cumulative accounting costs incurred (i.e.,
7 recognized as FAS 87 expense).

8 **Q. Is the prepaid pension asset disclosed by plan sponsors?**

9 A. Prior to the Statement of Financial Accounting Standards No. 158 (FAS 158), which was
10 issued in 2006, the prepaid pension asset (or Accrued Pension Cost if cumulative
11 accounting cost has exceeded cumulative cash cost) was required to be disclosed
12 directly on the pension footnote of the annual GAAP financial report. After FAS 158, the
13 prepaid pension asset amount can now be determined by adding the funded status of
14 the plan to the total unrecognized costs for FAS 87 purposes. These individual pieces
15 are disclosed directly on the pension footnote of the annual report (or can be found in a
16 typical actuarial valuation report). For example, using the same assumptions as were
17 used in the previous FAS 87 pension cost example, a plan with $800 million of
18 obligation, $650 million of assets and $270 million of unrecognized costs would have a
19 $120 million prepaid pension asset (-$150 million funded status + $270 million
20 unrecognized costs = $120 million prepaid pension asset).

21 **Q. How has the prepaid pension asset changed as a result of PPA?**

22 A. As described above, PPA has resulted in more cash being required sooner than was the
23 case under previous funding rules. Since no similar changes have taken place relative

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1 to accounting for the cost of the plan, the magnitude of required cash contributions
2 relative to FAS 87 expense has led to increased prepaid pension assets. The prepaid
3 pension asset also increases as a result of the higher expected asset returns generated
4 by the accelerated funding, which lowers the FAS 87 expense. Thus, growth of the
5 prepaid pension asset resulting from cash contributions in excess of FAS 87 expense is
6 compounded by the decrease in FAS 87 expense resulting from the benefit of higher
7 expected asset returns.

8 To support this claim, we collected the accrued pension cost and prepaid pension asset
9 for each of the 21 large utilities referenced above as of 2002, 2007 and 2012. On
10 average, the utility group had a prepaid pension asset of roughly $250 million, $490
11 million and $890 million in 2002, 2007 and 2012, respectively. As you can see, the
12 prepaid pension asset increased substantially over the past five years. While there are
13 some utilities that still have an accrued pension Cost and/or had accounting cost greater
14 than cash cost over the period, the vast majority had higher cash cost and increased
15 their prepaid pension asset.

16 **Q. How is the prepaid pension asset expected to behave in the future?**

17 A. While we can't predict how economic conditions will behave in the future, we know that
18 the majority of pension plans are currently underfunded and will need to make up that
19 unfunded liability in the future. Due to the difference in how the unfunded liability is
20 recognized in determining required contributions and the phasing out of MAP-21 interest
21 rate relief, it is expected that cash costs will continue to exceed accounting costs over
22 the next several years. The example below shows how the accounting costs and cash
23 costs would compare over the next ten years for a sample plan sponsor. For this

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1 example we will use the following assumptions (note these are the same as shown in the
2 previous pension cost examples with added assumptions for projection purposes):

Table 7

FAS 87 assumptions					
Projected Benefit Obligation	$	800	million	Discount Rate	4%
Fair Value of Assets	$	650	million	Expected Return on Assets	8%
Unrecognized Losses	$	270	million	Amortization Corridor	10%
Annual Benefits Earned	$	20	million	Average Future Service	12
Annual Benefit Payments	$	40	million	Asset Smoothing	None
PPA assumptions					
PPA Funding Liability	$	760	million	Discount Rate	4%
Market Value of Assets	$	650	million	Expected Return on Assets	8%
Annual Benefits Earned	$	22	million	Asset Smoothing	None
Annual Benefit Payments	$	40	million		

3 Using the assumptions listed above, the expected accounting and cash costs
4 over the next ten years would be as follows:

Table 8

(in millions)	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total
Accounting Cost	16	12	8	5	2	-	(1)	(2)	(4)	(5)	31
Cash Cost	40	36	32	18	-	-	-	-	-	-	126
Prepaid Pension Asset Growth	24	24	24	13	(2)	-	1	2	4	5	95

5 As you can see, the cash cost is expected to greatly exceed the accounting costs
6 over the ten years shown. The quicker recognition of the unfunded liability for cash
7 purposes causes large contributions in the early years, which in turn immediately
8 reduces the accounting cost causing the prepaid pension asset to continue to grow.
9 Prior to PPA, the cash cost would have been spread over more years causing less of a
10 difference when compared to the accounting cost. Note the cash cost is eliminated after
11 four years in this example (as opposed to the seven years over which the unfunded

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1 liability is recognized) due to the asset returns each year also helping to shrink the
2 unfunded liability. Also note that because of the significant mismatch between cash
3 funding and accounting cost, the prepaid pension asset is not expected to reverse itself
4 in the near future.

5 **Q. How would the example change if the plan were to freeze benefits for all**
6 **employees?**

7 A. As discussed earlier, freezing the pension plan would be considered a curtailment event.
8 Freezing the plan would decrease both cash and accounting cost as follows:

9 **For cash funding purposes**, since no benefits are earned during the year, the
10 cash cost would simply decrease by $22 million resulting in a cash cost of
11 $18 million which is the amortization of the unfunded liability.

12 **For accounting purposes**, there would be much more complex changes.
13 Assuming the PBO would be reduced by $40 million as a result of the freeze, the
14 accounting cost would decrease by $25 million as follows:

15 • $20 million reduction in Service Cost due to benefits no longer being earned
16 • $1.6 million reduction in Interest Cost (4% discount rate * $40 million
17 reduction in PBO)
18 • $3.3 million reduction in Amortization ($40 million reduction in unrecognized
19 cost / 12 average future service)
20 • Note that no one-time FAS 88 charge would be triggered in this example
21 since 1) we're assuming the plan had no unrecognized cost (or credit) due to
22 previous plan changes and 2) the gain due to the decrease in PBO was
23 required to offset the existing unrecognized costs.

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1 See the table below for a longer-term illustration of the impact of a plan freeze on our
2 sample plan.

Table 9

(in millions)	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	Total
Accounting Cost	(9)	(12)	(15)	(18)	(21)	(23)	(26)	(28)	(31)	(33)	(216)
Cash Cost	18	14	9	-	-	-	-	-	-	-	41
Prepaid Pension Asset Growth	27	26	24	18	21	23	26	28	31	33	257

3 **Q. How would the example change if the plan were to terminate and purchase**
4 **annuities for all participants?**

5 A. A plan termination would technically trigger both a curtailment and a settlement. For
6 simplicity I will illustrate the cash funding and accounting impact of the combined events.
7 To illustrate the financial impact, we will need to estimate the plan termination liability, or
8 in other words, the amount necessary to cover the cost of purchasing annuities for all
9 plan participants. This amount will vary based on the specific characteristics of the plan
10 and annuity provider, but is generally thought of as 100%-120% of the PBO. Using our
11 sample plan, if we assume the plan termination liability is $880 million, this would
12 represent an additional $80 million actuarial loss above the $800 million PBO. The final
13 costs would then be:

14 - Cash cost of $230 million ($880 million minus $650 million asset value)
15 - Accounting cost of $350 million (acceleration of the $270 million in
16 unrecognized costs plus the additional $80 million actuarial loss due to
17 termination)

18 Note that since the plan was in a prepaid pension asset position of $120 million, the
19 plan's total cash cost and total accounting cost would be equal upon termination.

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1 **Q. In light of the recent changes to the pension environment, what considerations**
2 **should be made from a pension cost ratemaking perspective?**
3 A. For plan sponsors who receive rate reimbursement based on accounting costs, the
4 greatest potential concern is treatment of the prepaid pension asset. As shown above,
5 the prepaid pension asset has grown significantly over the past several years and is
6 expected to continue to grow in the near future. This means plan sponsors are being
7 required to fund their plans with cash that has not yet been recovered in rates and could
8 have potentially been used for other business reasons. In addition, since the increased
9 short-term cash requirements also serve to immediately decrease the accounting costs,
10 it is likely that it will take many years to fully recover these amounts in rates. With that in
11 mind, including the prepaid pension asset in rate base and allowing it to earn a return
12 until the cash costs have been recovered in rates is a fair and reasonable way to ensure
13 plan sponsors are not negatively affected by the recent changes to the pension
14 environment.
15 **Q. What type of pension cost should be used for rate reimbursement?**
16 A. While both cash cost and accounting cost are used throughout the country, it has been
17 my experience that using accounting cost is far more prevalent than any other approach.
18 In my opinion, using accounting cost (FAS 87 and FAS 88) is logical and preferable for
19 several reasons:
20 (1) It spreads the cost of the plan over a reasonable period of time and generally
21 ensures that one generation of ratepayers does not have to compensate for costs from a
22 previous generation of ratepayers.

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1 (2) It is not as volatile as cash cost and does not front-load the recognition of gains and
2 losses as is done when determining the minimum funding requirements. Doing so could
3 create some of the generational concerns mentioned above by having a short-term spike
4 in cost only to decrease sharply right away.
5 (3) It has special conditions built-in for reflecting significant plan events such as a plan
6 freeze or termination (i.e., FAS 88 costs or credits) in a reasonable manner. Including
7 FAS 88 costs or credits is necessary in order to ensure that cumulative contributions will
8 equal cumulative accounting costs over the life of the plan.

9 **IV. SUMMARY**

10 **Q. Please summarize your testimony.**

11 A. As discussed above, there are specific rules and regulations that govern how accounting
12 costs and minimum cash requirements are determined for pension plans. Recent
13 changes in the pension environment have increased the importance in understanding
14 the relationship between cash cost and accounting cost for plan sponsors. While
15 historically these costs behaved somewhat similarly, the passage of the PPA is now
16 making it much more likely that cash costs have exceeded accounting costs and are
17 going to continue to do so in the near future. Since regulated utilities typically recover
18 accounting costs for their pension plan in rates, understanding the reasons driving the
19 growth of the prepaid pension asset is important, and receiving a return on this amount
20 is essential to ensure the recent changes do not negatively affect the fair reimbursement
21 of pension costs for plan sponsors.

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

23 A. Yes.

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BEFORE THE

PUBLIC UTILITY COMMISSION OF OREGON

INVESTIGATION INTO TREATMENT OF PENSION COSTS IN UTILITY RATES

UM 1633

Direct Testimony of

C. Kenneth Vogl

EXHIBIT 201

September 30, 2013

(in millions)	2002 Annual Report			
	Projected Benefit Obligation	Fair Value of Assets	Funded Percentage	(Accrued Cost)/ Prepaid Asset
Alliant Energy Corporation	609	467	77%	49
Ameren Corporation	1,587	1,059	67%	(139)
American Electric Power Company, Inc.	3,583	2,795	78%	212
Atmos Energy Corporation	285	210	74%	10
Consolidated Edison, Inc.	6,434	5,760	90%	956
Dominion Resources, Inc.	2,801	3,074	110%	1,660
Duke Energy Corporation	3,005	2,375	79%	313
Edison International	2,760	2,365	86%	176
Exelon	7,854	5,395	69%	(144)
NiSource Inc.	1,948	1,651	85%	257
PEPCO Holdings, Inc.	1,399	1,241	89%	125
Pinnacle West Capital Corporation	1,070	721	67%	(43)
PPL Corporation	3,684	3,133	85%	9
Public Service Enterprise Group Incorporated	2,968	2,131	72%	275
Puget Energy Inc.	370	344	93%	57
Southern Company	4,094	4,600	112%	686
Teco Energy, Inc.	455	372	82%	(4)
UGI Corporation	191	166	87%	25
Westar Energy, Inc.	478	382	80%	(2)
Wisconsin Energy Corporation	1,079	861	80%	203
Xcel Energy Inc.	2,506	2,640	105%	540
Average	2,341	1,988	84%	249

(in millions)	2007 Annual Report				
	Projected Benefit Obligation	Fair Value of Assets	Funded Percentage	Unrecognized Costs	(Accrued Cost)/ Prepaid Asset
Alliant Energy Corporation	879	890	101%	154	165
Ameren Corporation	3,076	2,698	88%	(24)	(402)
American Electric Power Company, Inc.	4,109	4,504	110%	548	943
Atmos Energy Corporation	428	389	91%	49	11
Consolidated Edison, Inc.	8,696	8,400	97%	1,692	1,396
Dominion Resources, Inc.	3,693	5,098	138%	388	1,793
Duke Energy Corporation	4,473	4,321	97%	72	(80)
Edison International	3,355	3,597	107%	40	282
Exelon	10,427	9,634	92%	2,968	2,175
NiSource Inc.	2,159	2,238	104%	128	207
PEPCO Holdings, Inc.	1,701	1,631	96%	215	146
Pinnacle West Capital Corporation	1,721	1,319	77%	281	(121)
PPL Corporation	5,484	5,600	102%	335	451
Public Service Enterprise Group Incorporated	3,601	3,390	94%	530	319
Puget Energy Inc.	463	559	121%	(1)	94
Southern Company	5,660	7,624	135%	(26)	1,938
Teco Energy, Inc.	557	493	89%	22	(43)
UGI Corporation	310	294	95%	12	(5)
Westar Energy, Inc.	578	468	81%	126	16
Wisconsin Energy Corporation	1,161	1,007	87%	299	145
Xcel Energy Inc.	2,663	3,186	120%	340	864
Average	3,104	3,207	101%	388	490

(in millions)	2012 Annual Report				
	Projected Benefit Obligation	Fair Value of Assets	Funded Percentage	Unrecognized Costs	(Accrued Cost)/ Prepaid Asset
Alliant Energy Corporation	1,208	966	80%	526	284
Ameren Corporation	4,151	3,193	77%	765	(193)
American Electric Power Company, Inc.	5,205	4,696	90%	2,122	1,613
Atmos Energy Corporation	610	343	56%	231	(36)
Consolidated Edison, Inc.	13,406	9,135	68%	5,617	1,346
Dominion Resources, Inc.	6,125	5,553	91%	2,876	2,304
Duke Energy Corporation	8,365	7,754	93%	2,605	1,994
Edison International	4,948	3,542	72%	1,156	(250)
Exelon	16,800	13,357	80%	8,007	4,564
NiSource Inc.	2,792	2,161	77%	1,200	569
PEPCO Holdings, Inc.	2,494	2,039	82%	988	533
Pinnacle West Capital Corporation	2,851	2,079	73%	647	(124)
PPL Corporation	12,934	10,850	84%	3,517	1,433
Public Service Enterprise Group Incorporated	5,235	4,357	83%	2,035	1,157
Puget Energy Inc.	668	531	79%	44	(93)
Southern Company	9,302	7,953	85%	3,138	1,789
Teco Energy, Inc.	715	529	74%	270	84
UGI Corporation	573	370	65%	211	8
Westar Energy, Inc.	929	548	59%	387	7
Wisconsin Energy Corporation	1,509	1,385	92%	731	608
Xcel Energy Inc.	3,640	2,944	81%	1,798	1,102
Average	4,974	4,014	78%	1,851	890