ORDER NO. 15 226

ENTERED AUG 03 2015

BEFORE THE PUBLIC UTILITY COMMISSION

OF OREGON

UM 1633

In the Matter of PUBLIC UTILITY COMMISSION OF OREGON, Investigation into Treatment of Pension Costs in Utility Rates.	ORDER

DISPOSITION: USE OF FAS 87 RECOVERY AFFIRMED; PROPOSAL TO PLACE ACTUARIAL ACCOUNTS IN RATE BASE REJECTED

We affirm our policy of allowing a utility to recover its pension contributions through Financial Accounting Standard 87 (FAS 87) expense and reject the Joint Utilities' proposal to include their prepaid pension assets and accrued pension liabilities in rate base.

I. INTRODUCTION

We opened this docket to investigate the ratemaking treatment of pension-related costs and to determine policy for how utilities should recover these costs on a going forward basis. We did so after utilities in various proceedings requested that we expand our approach to pension cost recovery to include costs that our current policy does not address. Specifically, the utilities noted that our current recovery policy—based on the expense determined under FAS 87—does not provide recovery for any costs incurred by the utilities to finance the required contributions to their pension plans.

We divide our order into three parts. First, to provide a proper context for this investigation, we begin with a discussion of pension plans and how they are regulated. We describe the accounting and funding requirements that govern pension plans, how employers calculate FAS 87 expense, and how we have treated pension costs in utility ratemaking.

Second, we summarize the recommendations of the parties. A group of utilities propose changes to our current pension policy to allow the recovery of financing costs. These utilities, which we will collectively refer to as the Joint Utilities, are PacifiCorp, dba Pacific Power; Portland General Electric Company; Northwest Natural Gas Company, dba NW Natural; Avista Corporation, dba Avista Utilities; and Cascade Natural Gas Corporation. All other parties recommend no changes to our method of pension cost recovery or recommend significant changes to the Joint Utilities' proposal. These parties include Commission Staff, Idaho Power Company, the Citizens' Utility Board of Oregon (CUB), the Industrial Customers of Northwest Utilities (ICNU), and the Northwest Industrial Gas Users (NWIGU).

Finally, we provide our resolution and reasoning to reject the Joint Utilities' proposal and affirm the use of FAS 87-based recovery.

II. BACKGROUND

A "defined benefit" pension is an employer-sponsored retirement plan through which employees accrue benefits and receive specified payments after they retire. The payments made under pension plans are guaranteed and an employer must keep the plan funded at a level to meet this obligation.

Pension plans are highly regulated. The Employment Retirement Income Security Act of 1974 (ERISA) and the Pension Protection Act of 2006 (PPA) establish funding requirements to provide benefit security for retirees by protecting the assets of pension plans to guarantee payment of benefits.

Employers fund a pension trust with cash contributions or investments. A custodian is tasked with managing the funds' assets solely in the interests of participants and beneficiaries. The returns on fund investments increase the pool of assets, which is used to pay retirees.

A. Accounting Requirements

Since 1987, employers are required to use FAS 87 accounting standards for financial reporting of pension costs. FAS 87 requires employers to recognize the cost of their pension plans on an accrual rather than a cash basis. In other words, pension cost is recognized over the period during which benefits are earned, or "accrued"—that is, during the working years of the employees that will receive the pension benefits during retirement.

Because FAS 87 expense is based on an accrual, not cash basis, the amount of pension costs recorded is generally different than the actual amount of annual contributions made. Over the life of the plan, however, total contributions are expected to equal total FAS 87 expense (as well as FAS 88 expense related to pension plan termination).

The FAS 87 expense, which can be positive or negative, is calculated based on four components:

- Service cost – The value of the benefits earned, or accrued during the current year based on the applicable benefit formula for each participant.
- Interest cost – The interest on the pension plan liability (projected benefit obligation) for the year. This amount increases pension cost and represents the time value of money on the benefit obligation.

- Expected return on assets – The expected return on assets for the year, which if positive will reduce pension cost. The difference between the actual return on assets and the expected return on assets represents an actuarial gain or loss that will be recognized in future pension cost.
- Amortizations of unrecognized costs – The change in liability due to plan changes, changes in actuarial assumptions used to value plan liabilities, differences between past differences between expected and actual asset returns, and other unrecognized gains and losses.

When the pension fund trust is producing significant investment gains, the FAS 87 expense can be negative, signaling that the trust is in good financial health. When the pension fund investments lose value, the FAS 87 turns positive, signaling a need for increased contributions.

B. Funding Requirements

Employers use actuaries to determine the amounts to contribute to the plans. Contribution levels are designed to meet specified targets, which are typically guided by federal minimum funding requirements based on the value of plan assets and the projected future obligation.

Employers are generally required to annually fund the amount of benefits being earned for the year plus a portion of any unfunded liability. Traditionally, ERISA required employers to amortize any unfunded liability over a 10 to 15 year period. The PPA included additional requirements to ensure that a plan is fully funded. Among other changes, the PPA decreased the period for amortizing the unfunded liability to 7 years, which has accelerated and front-loaded required employer contributions.

Due to these funding obligations, employers are required to make contributions to their pension plans that are often significantly different than their recorded FAS 87 expense in any given year. If cumulative contributions exceed recorded FAS 87 expense, the difference is recognized as a *prepaid pension asset*. If cumulative contributions are less than the recorded expense, the difference is recognized as an *accrued pension liability*.

A prepaid pension asset represents only the financial accounting difference between actual contributions and the FAS 87 determined accruals. For this reason, a prepaid pension asset balance does not necessarily represent the cumulative contributions to a pension fund. A decrease in FAS 87 expense due to excess returns earned on the pension fund will increase the prepaid pension asset balance—regardless of whether the employer made any cash contributions.

Employers may make contributions above minimum funding obligations; however, the Internal Revenue Code contains provisions limiting the maximum tax deduction for pension fund contributions. Contributions above the minimum funding obligation and up to the maximum tax deductible amount for the year are often referred to as discretionary contributions.

C. Rate Recovery

All the utilities have defined benefit pension plans. With the exception of Idaho Power and Avista,[1] all the defined benefits plans are closed and are not being offered to new employees.

Prior to the adoption of FAS 87 in the late 1980s, most regulatory commissions allowed utilities to recover, as an operating expense, their annual cash contributions to the pension plans. Some jurisdictions, including the Idaho Public Utilities Commission, still use cash contributions for purposes of setting rates.

Since its inception, however, FAS 87 expense has been used by a majority of commissions, including Oregon, as a proxy for cash contributions when setting rates. The use of FAS 87 to determine utility operating expense has been favored because it spreads the cost of the plan over a reasonable period of time and is less volatile than actual cash contributions.

In Oregon, NW Natural was the first utility to seek a switch to FAS 87-based rate recovery in 1986. The other utilities followed suit until the Commission had approved, by 1998, requests by all the Joint Utilities and Idaho Power to recover pension costs through FAS 87 expense. Under this approach, utilities recover their pension contributions through an annual FAS expense forecast in a test year period. At the time of transition to FAS 87-based recovery, no utility sought recovery of financing costs to address the issue of the potential timing differences between the build-up of a prepaid pension asset and its amortization through FAS 87 expense.

As expected, the utilities' pension contributions have not matched the forecast FAS 87 expense, and the utilities have had, at any given time, either a prepaid pension asset or an accrued pension liability. Since use of FAS 87 was implemented, all but one utility has had an accrued pension liability. For example, PacifiCorp, shortly after it switched to FAS 87-based recovery, twice had an accrued pension liability balance that exceeded $100 million. Currently, however, all but one energy utility has a prepaid pension asset:

Utility	Prepaid Pension Asset (Accrued Pension Liability)[2]
Avista	$80.7M
Cascade	$17.7M
Idaho Power	($28.8M)
NW Natural	$25.2M
PacifiCorp	$310M
PGE	$76.6M

[1] Avista's defined benefit plan is still open to union employees, but only in Idaho and Washington.
[2] Idaho Power's balance is from December 31, 2012; all others are from December 31, 2013.

III. POSITIONS OF THE PARTIES

All parties favor the continued use of FAS 87 expense for ratemaking purposes for the return of the utilities' pension plan contributions. They generally agree that FAS 87 is a reasonable proxy for cash contributions when determining utility operating expense, and oppose reverting back to the recovery of actual cash contributions due to the volatility of short-term funding requirements.[3]

The parties disagree, however, as to whether our current pension cost recovery policy should be revised to allow the utilities the opportunity to recover financing costs associated with prepaid pension assets. We summarize their arguments below.

A. Joint Utilities

The Joint Utilities contend that the passage of the PPA, coupled with financial market downturns, have significantly increased the Joint Utilities' required contributions to their pension plan funds and have accelerated the timing of such required payments. Moreover, the Joint Utilities contend that these prepaid pension assets will persist for many years, particularly because the increased cash contributions also serve to immediately decrease FAS 87 expense to be recovered in rates. For this reason, and given the growth of their prepaid pension asset balances, the Joint Utilities contend that recovery of FAS 87 expense only—with no recovery of the financing costs—has resulted in pension cost recovery that is no longer fair or reasonable.

In addition to the *return of* pension costs through FAS 87, the Joint Utilities now seek a *return on* the cash contributions to cover the financing costs associated with prepaid pension assets. To accomplish this, the Joint Utilities request that prepaid pension assets be added to rate base, where they will earn a return at their respective cost of capital. The utilities contend this will provide them an opportunity to recover the financing costs associated with the cash outlay in excess of the cumulative accrual expense until the cash costs have been recovered in rates. The Joint Utilities state this proposal is consistent with the Commission's practices for other investments, where it allows a return of the investment (through the recovery of depreciation expense) and a return on the investment (representing the utility's financing costs).

The Joint Utilities emphasize that they are only seeking to recover future—not past—financing costs. They seek approval of a methodology that allows them to recover only the costs they incur in the future to finance pension contributions until FAS 87 expense allows the return of the contributions.

[3] Although Idaho Power currently recovers its pension costs in its Idaho jurisdiction on a cash basis, the company does not request a transition in Oregon from FAS 87-based rate recovery to cash-based rate recovery.

The Joint Utilities also clarify that they propose both actuarial balances—prepaid pension assets and accrued pension liabilities—be included in rate base to ensure symmetrical ratemaking treatment. The inclusion of an accrued pension liability would reduce rate base, effectively lowering customer rates.

B. Idaho Power

Idaho Power requests no change to its method of pension cost recovery. As noted above, unlike the Joint Utilities, Idaho Power currently has an accrued pension liability, not a prepaid pension asset. Because the company is not currently incurring any financing costs related to a prepaid pension asset, Idaho Power states that the rate recovery of FAS 87 expense provides the company with a reasonable opportunity to recover its prudently incurred pension costs.

C. Staff

Staff supports the Joint Utilities' proposal in part. Staff recognizes 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" that should be recovered in rates.[4] Staff opposes, however, recovery of any financing costs on past pension contributions. Because pension costs were examined in prior rate cases, Staff does not believe that utilities should now be able to seek a return on amounts that accrued during periods when overall just and reasonable rates were set. Staff contends that allowing recovery of financing costs associated with past contributions would constitute single-issue ratemaking and violate the prohibition on retroactive ratemaking.

Staff proposes that the utilities be allowed to collect financing costs *only* on a prospective basis. To ensure that utilities earn a return on prospective pension expense and contributions, Staff recommends the prepaid pension assets be placed in rate base beginning with a zero balance, with certain modifications. At the outset, Staff states that the prospective balance should be adjusted to (1) offset the associated deferred tax asset or liability created by the difference between an employer's cash expense and accrual expense[5]; and (2) exclude amounts accumulated due to excess investment returns on pension funds. Staff notes, however, that quantifying the effects of excess investment earnings might not be possible. In addition, Staff contends the prospective account balances should receive a lower rate of return. Staff does not believe that the account balances should be treated like a capital investment in rate base and receive a return equal to the authorized rate of return. Instead, Staff believes a lower rate, more commensurate with that of a balancing account, should be used.

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[4] Staff/100, Bahr/20.

[5] CUB also requests that customers receive the benefit of deferred tax benefits, but believes such treatment is mandatory under ORS 757.269—and should not be adopted as a conditional provision to granting the Joint Utilities' proposal.

Alternatively, Staff would support the Joint Utilities' request to recover a return on the portion of the account balances accumulated since 2008, the year of the PPA and the economic recession, but with the balance adjusted consistent with its recommended modifications above *plus* one more adjustment. Under its alternative recommendation, Staff recommends that the account balances be further adjusted to exclude the difference between pension costs recovered from customers in rates and actual FAS 87 expense paid by the utility. Staff adds that pension costs placed in rates might have to be estimated due to the "black box" nature of prior rate case settlements.

D. CUB and ICNU/NWIGU

CUB and ICNU/NWIGU oppose the Joint Utilities' request to recover financing costs on prepaid pension assets on numerous policy and legal grounds. First, they contend the utilities' proposal is imbalanced given the past history of pension costs. They point out that, while many utilities now have a prepaid pension asset on which they seek a return, they previously had accrued pension liabilities that were never used to benefit customers. CUB notes that PacifiCorp, for example, had an average accrued pension liability of $63 million per year between 1998 and 2005. They also question the Joint Utilities' assertion that the new federal funding requirements under the PPA, coupled with the 2008 economic recession, warrant a change in policy. They note that the current prepaid pension asset balances for both PGE and NW Natural are roughly equivalent to, or even less than, the balances that existed prior to 2008.

Second, CUB and ICNU/NWIGU argue that the Joint Utilities seek a return on amounts that may not represent an investment by utility shareholders. They explain that, because the prepaid pension asset is the cumulative difference between FAS 87 expense accrued by utilities and amount of contributions to the pension trust fund, this cumulative "difference" is affected by both cash contributions and negative FAS 87 expense. CUB asserts that significant portions of the prepaid pension asset balances come from periods of high economic growth during the late 1990s that created negative FAS 87. As an example, CUB notes that PGE's prepaid pension asset grew significantly between 1995 and 2004 without a single contribution by the utility. CUB and ICNU/NWIGU question why the utilities should be permitted to recover financing costs on monies that they did not, in fact, finance.

Third, the customer groups also contend that the characteristics of prepaid pension assets make them inappropriate for inclusion in rate base. ICNU/NWIGU contend that pension assets are not tangible assets like a utility plant that is providing utility service, and unlike other non-tangible assets that have received rate base treatment (like prepaid insurance), they might not represent actual shareholder investment. CUB and ICNU/NWIGU also emphasize that prepaid pension assets do not necessarily depreciate over a set period of time and, under certain conditions, could increase. CUB explains that pension contributions not only work to increase the prepaid pension asset balance, but to also reduce future FAS 87 expense and delay recovery of the contributions. CUB views the Joint Utilities' proposal as a potential perpetual revenue mechanism that may tempt utilities to make additional contributions even if their pension plans are full or over-funded.

Moreover, CUB and ICNU/NWIGU contend that the Joint Utilities' proposal would be difficult to implement. They explain that providing a return on prepaid pension assets will require a retrospective examination of how those assets developed. Determining the prudency of past pension plans investments will be difficult, if not impossible, due to a variety of reasons. CUB states that the relevant data might simply not exist, noting that PacifiCorp has no pension data prior to 1998. Other factors, such as corporate acquisitions and black-box rate case settlements, would, according to the customer groups, make a retrospective prudency review extremely costly and time consuming.

In addition to these policy arguments, CUB and ICNU/NWIGU also raise legal objections to the Joint Utilities' proposal. CUB contends that asking for a return on prepaid pension assets violates the rule against retroactive ratemaking because the prepaid pension asset reflects the sum of prior decisions related to pensions that have flowed through several rate cases. In addition, CUB and ICNU/NWIGU argue that the Joint Utilities' proposal violates the principle of single issue ratemaking. ICNU/NWIGU explain that the Joint Utilities have asked the Commission to find that including the prepaid pension asset in rate base is necessary to establish "fair and reasonable rates" without examining the full picture of Joint Utilities' costs and revenues.

IV. RESOLUTION

We affirm our long-standing policy of allowing a utility to recover its pension contributions through FAS 87 expense and reject the Joint Utilities' proposal to include their current prepaid pension assets in rate base.[6] We find no systemic change to the dynamics of FAS 87 expense that justifies a change to our current pension cost policy. Moreover, the Joint Utilities' proposal is inequitable and would be problematic to implement.

We are not persuaded that the new federal funding requirements under the PPA, coupled with the 2008 economic recession, constitute sufficiently changed circumstances to warrant modifications to our FAS 87-based recovery. The evidence shows that these events did not disproportionally and systematically affect the utilities' prepaid pension assets. In fact, two of the Joint Utilities' prepaid pension asset balances peaked in 2005, before the PPA and 2008 financial crisis. The record also fails to support the Joint Utilities' claim that these events will lead to large prepaid pension assets that will persist for the foreseeable future. Idaho Power has maintained an accrued pension liability balance since the passage of the PPA. Moreover, while one utility maintains a large balance, other prepaid pension assets are declining significantly as the economy recovers and grows. For example, PGE's prepaid pension asset, which had a balance of

[6] Because the prepaid pension asset or accrued pension liability will not be included in rate base, we conclude that the associated deferred tax asset or liability should also not be included in rate base.

$108 million in 2008, is projected to be just $18 million at the end of 2015.[7] Thus, based on this record, we conclude that any impact of the new federal funding obligations are temporary and will continue to be mitigated over time.

We also share three primary concerns raised by Staff and the intervenors about the Joint Parties' proposal to place their prepaid pension assets in rate base. At the outset, the timing of the requested policy change appears opportunistic and does not fairly reflect the history of pension recovery under FAS 87. Prepaid pension assets and accrued pension liabilities fluctuate and are cyclical by nature. Although the Joint Utilities currently have prepaid pension assets, all but one previously maintained accrued pension liabilities—including PacifiCorp with accrued pension liability balances that exceeded $100 million. During those periods the utilities benefitted under our current policy, as the accrued pension liabilities were not used to offset their rate base, which would have reduced customer rates. Like Idaho Power is today, the utilities then were satisfied with our current FAS 87 recovery. Seeking to include the actuarial balances in rate base now while the Joint Utilities have prepaid pension assets is arbitrary and would produce an unbalanced result.

Second, prepaid pension assets are not traditional rate base items.[8] Contrary to the arguments made by the Joint Utilities, shareholder contributions do not solely drive prepaid pension asset balances. When FAS 87 expense is negative, such as periods of high economic growth, a prepaid pension asset balance will increase even with no shareholder contributions. This in fact happened beginning in 1995, when some of the utilities' prepaid pension assets grew significantly without a single shareholder contribution. In some years, the balance grew by as much as $14 million annually with no investment.[9] Thus, placing the current prepaid pension asset balances in rate base would allow them to earn a return on amounts that do not necessarily represent shareholder investments.

Third, any effort to determine what amounts actually represent shareholder investments would be severely compromised by the fact that the prepaid pension assets represent the culmination of decades of actions related to the pension plans. To isolate actual investments, we would be required to perform a complicated retrospective examination of each pension plan to determine what contributions were made, whether they were made prudently in light of the then existing circumstances, and to what extent they were addressed in prior rate proceedings. The difficulty of such an exercise would be further exacerbated in light of questions about the availability of past records, as well as the inability to identify what amount of pension expense was included in prior rate cases that

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[7] Under OAR 860-001-0460(1)(d), we take official notice of PGE/500, Barnett-Jaramillo/34, filed *In the Matter of Portland General Electric Company, Request for a General Rate Revision,* Docket No. UE 294. Within 15 days, any party may explain or rebut the noticed fact. OAR 860-001-0340(2).

[8] For this discussion, we assume, without deciding, that pension contributions should be treated as investments rather than expenses. *See,* e.g., *In the Matter of Northwest Natural Gas Company, dba NW Natural, Request for a General Rate Revision,* Docket No. UG 221, Order No. 12-437 at 21 (Nov 16, 2012).

[9] CUB/100, Jenks-McGovern/13-14.

were resolved via settlement.[10] Although we are not required to make such determinations at this time, these concerns are relevant to our consideration as to the feasibility of the Joint Utilities' proposal.

Based on the totality of the circumstances, we conclude that the Joint Utilities have failed to establish that a change in our current FAS 87-based recovery is necessary. Although this methodology does not provide for the recovery of financing costs when prepaid pension assets increase and pension contributions are collected over time, FAS 87 has been used successfully for almost 30 years as part of this Commission's overall ratemaking formula to appropriately balance the interests of the utilities and customers and establish overall rates that were just and reasonable.

Given our resolution, we need not address the legal arguments raised by Staff and the intervenors about whether the Joint Utilities' proposal constitutes retroactive ratemaking or single issue ratemaking.

Finally, we recognize that NW Natural previously sought and obtained approval for the use of a balancing account to track the difference between the actual pension expense experienced by the company and the amount covered in rates.[11] Although we reject the Joint Utilities' proposal here, the utilities may seek similar, utility specific relief as they find necessary to ensure rates are just and reasonable.[12]

V. ORDER

IT IS ORDERED that:

1. The policy of allowing utilities to recover pension costs through FAS 87 expense is affirmed; and

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[10] Although Staff's proposal to reset the actuarial accounts and place them in rate base prospectively would eliminate these challenges, its proposal, like the Joint Parties' request, is arbitrary and would similarly produce an unbalanced result. Because the cumulative pension contributions will generally equal the cumulative FAS 87 expense over the life of a pension plan, and because the Joint Utilities currently have prepaid pension assets, the cumulative FAS 87 expense will exceed the cumulative cash contributions on a prospective basis. Thus, going forward the Joint Utilities will have, on average, greater accrued pension liabilities than prepaid pension assets.

[11] *See In the Matter of Northwest Natural Gas Company, dba NW Natural, Application to Defer Pension Costs* Docket No. UM 1475, Order No. 11-051 (Feb 10, 2011).

[12] We note that NW Natural, PGE, and PacifiCorp also sought to defer certain costs related to their pension plans. Although PacifiCorp later withdrew its application, the applications filed by NW Natural (UM 1619 and UM 1630) and PGE (UM 1623) have been held in abeyance pending the resolution of this docket. We direct the Administrative Hearings Division to activate these dockets and establish proceedings to determine the appropriate treatment of these applications in light of our decisions here.

2. The Joint Utilities' proposal to include prepaid pension assets in rate base is rejected.

Made, entered, and effective AUG 0 3 2015.

Susan K. Ackerman
Chair

John Savage
Commissioner

Stephen M. Bloom
Commissioner

A party may request rehearing or reconsideration of this order under ORS 756.561. A request for rehearing or reconsideration must be filed with the Commission within 60 days of the date of service of this order. The request must comply with the requirements in OAR 860-001-0720. A copy of the request must also be served on each party to the proceedings as provided in OAR 860-001-0180(2). A party may appeal this order by filing a petition for review with the Court of Appeals in compliance with ORS 183.480 through 183.484.