Exhibit No.:	________________
Issues:	**Pensions & Retiree Medical (OPEB)**
Witness/Type of Exhibit:	**Pitts/Rebuttal**
Sponsoring Party:	**Office of Public Counsel**
File Nos.:	**GR-2017-0215 and GR-2017-0216**

REBUTTAL

TESTIMONY OF

DAVID G. PITTS

Submitted on Behalf of the Office of the Public Counsel

MISSOURI GAS ENERGY

LACLEDE GAS COMPANY

FILE NOS. GR-2017-0215 AND GR-2017-0216

October 17, 2016

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Laclede Gas Company's Request to Increase its Revenues for Gas Service	)))	**Case No. GR-2017-0215**
In the Matter of Laclede Gas Company d/b/a Missouri Gas Energy's Request to Increase its Revenues for Gas Service	)))	**Case No. GR-2017-0216**

AFFIDAVIT OF DAVID G. PITTS

STATE OF PENNSYLVANIA)
) ss
COUNTY OF ALLEGHENY)

David G. Pitts, of lawful age and being first duly sworn, deposes and states:

1. My name is David G. Pitts. I am the owner of Independent Actuarial Services, having its principal place of business at 33 Amesbury Circle, Crossville TN 38558. I have been retained by the Office of the Public Counsel in this proceeding on their behalf.

2. Attached hereto and made a part hereof for all purposes is my rebuttal testimony.

3. I hereby swear and affirm that my statements contained in the attached rebuttal testimony are true and correct to the best of my knowledge and belief.

Commonwealth of
Pennsylvania
County of
Allegheny

David G. Pitts

Subscribed and sworn to me this 17th day of October 2017.

Notary Public

COMMONWEALTH OF PENNSYLVANIA
NOTARIAL SEAL
KaVon Smith, Notary Public
City of Pittsburgh, Allegheny County
My Commission Expires Dec. 11, 2019
MEMBER, PENNSYLVANIA ASSOCIATION OF NOTARIES

Table of Contents

REBUTTAL TESTIMONY

OF

DAVID G. PITTS
LACLEDE GAS COMPANY

MISSOURI GAS ENERGY

CASE NO. GR-2017-0215

CASE NO. GR-2017-0216

I. INTRODUCTION

Q: PLEASE STATE YOUR NAME AND YOUR BUSINESS ADDRESS.

A: My name is David G. Pitts, and my business address is 33 Amesbury Circle, Crossville TN, 38558.

Q: ARE YOU THE SAME DAVID G. PITTS WHO FILED DIRECT TESTIMONY ON BEHALF OF THE OFFICE OF PUBLIC COUNSEL ON SEPTEMBER 8, 2017?

A: Yes.

Q: WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A: I review the Pension and Other Post-Employment Benefit (OPEB) related testimony included in the Staff Report on Cost of Service (submitted on September 8) for case numbers GR-2017-0215 and GR-2017-0216. I provide both technical and strategic review and commentary.

II. PENSIONS

Q: PLEASE SUMMARIZE STAFF'S TESTIMONY ON PENSIONS

A: Staff recommends continuing the ratemaking methodology agreed to and stipulated from MGE's most recent rate case, GR-2014-0007. More specifically, Staff recommends the following (Staff Report, p. 69):

- Continuation of a pension tracker, in which differences between actual cash expenditures and amounts collected in rates are included in rate base as either a regulatory asset or liability;
- Pension liability of $26,865,607 for MGE, and pension asset of $119,338,683 for LAC, as of June 30, 2017 (Staff Report, Accounting Schedule 2);
- Eight-year amortization of such amounts to be included in Cost of Service determination;
- Current pension cost of $0 for MGE and $29 million for LAC also to be included in Cost of Service determination; and
- Contributions to respective MGE and LAC pension trusts "as required under minimum ERISA funding or other minimum statutory funding."

Q: DO YOU HAVE ANY COMMENTS ON STAFF'S ANALYSIS?

A: Yes. I have several comments related to the testimony that Staff prepared.

1. Staff provided very thorough analysis supporting its Pension Cost of Service recommendation, with appropriate calculations and citations to previous Stipulations and Orders, etc. Staff's summary greatly simplifies current and future rate analysis regarding pension treatment, and should be memorialized in future proceedings.
2. Staff correctly pointed out that the LAC Stipulation included the establishment of a regulatory asset equal to the cumulative difference between cash expenditures and FAS87 expense (Staff Report, p. 66). As this account does not directly impact Cost of Service, I

recommend maintaining such account going forward.[1] Moreover, discontinuing the usage of this account might be considered a change in accounting methodology which would need to be addressed further.

3. Staff also points out that rate base treatment for the LAC pension asset only includes "…the amount funded by Laclede in accordance with the ERISA minimums." (Staff Report, p. 66). However, Staff did <u>not</u> adjust the LAC pension asset or excess contributions, which are estimated at $60 million (assuming 2016 actuarial results are similar to prior years). See below:

[1] Staff did not explicitly address the continuation of this account in its testimony, correctly observing that the cost of service calculations don't rely directly on the value of this account. This type of tracker mitigates the shareholder impact of differences between the expected vs actual pension expense experienced through the rate-cycle. Without such a tracker / accounting treatment, earnings would fluctuate based on these differences.

Plan Year	LAC Contrib	ERISA min	Excess
2010 / 2011	16,815,000	15,000,000	1,815,000
2011 / 2012	33,310,000	15,000,000	18,310,000
2012 / 2013	23,400,000	8,715,537	14,684,463
2013 / 2014	16,165,000	16,912,859	-
2014 / 2015	27,450,000	15,824,478	11,625,522
2015 / 2016	26,020,000	18,392,819	7,627,181
2016 / 2017	22,500,000	not provided	
			54,062,166
Notes	LAC Contrib from Staff Direct, p. 68		
	2010 and 2011 ERISA min assumed at $15 million		

It is possible some of the excess calculations for individual plan years shown above are overstated, since excess contributions used to eliminate benefit restrictions or PBGC variable premiums are permissible in the LAC Stipulation, however this information could not be gleaned from the available actuarial reports. I am willing to revisit this recommended adjustment to the LAC pension asset if the Company can provide supporting documentation.

4. Finally, Staff recommends current year pension costs of $0 and $29 respectively, for MGE's and LAC's pension plans. This is consistent with Staff's recommendation that "…LAC and MGE contribute to their respective pension trusts as required under minimum ERISA funding or other minimum statutory funding." (Staff Report, p. 69).

Q: DO YOU AGREE WITH STAFF'S RECOMMENDATION ON PENSIONS?

A: I agree with Staff's development of prepaid pension assets and liabilities, subject to the $60 million adjustment I identified earlier for excess LAC contributions. I disagree with Staff in the following areas:

- Continued use of WACC on pension asset/liability rate base return;
- Continued use of ERISA minimums in setting Pension Cost of Service; and
- Contribution strategy based on ERISA / statutory minimums.

Q: HOW DOES YOUR RECOMMENDED RATE BASE TREATMENT DIFFER FROM STAFF'S?

A: I recommend setting rate base return for pension assets and liabilities using the Company's pre-tax cost of debt. As I describe more fully in my testimony (Pitts Direct, pp. 14 – 15), subjecting ratepayers to "finance charges" based on WACC for pensioner debt that accrues at risk-free rates is excessive.[2] Shareholders should not earn risk-free profits from financing arrangements unilaterally imposed on ratepayers (captive borrowers) for legacy pension obligations.

Q: HOW DOES YOUR RECOMMENDED COST OF SERVICE METHODOLOGY DIFFER FROM STAFF'S?

A: Staff uses the "minimum required contribution" as current pension expense in its development of Cost of Service. Staff observes "…the trust fund for MGE contains sufficient

[2] Pension debt "owned" by the pensioner can be considered "guaranteed", and thus consistent with a risk-free discount/accrual rate. The payments are considered guaranteed because obligations are contractually mandated, collateralized, super senior debt, etc.

assets to provide for MGE's pension liability, which leads to an estimated future funding of $0;" (Staff Report, p. 69).

Although the minimum required contribution for MGE during 2017 is $0, the plan is not actually fully funded.[3] A more accurate representation of the plan's funded status can be observed in the Company's annual report, which discloses assets and liabilities using fair market values. As of 9/30/2016, the Company disclosed that the MGE pensions were only 78% funded, with assets of $149 million and liabilities of $192 million. Given the fact that the actual market value of MGE's pension is likely 10-15% higher than the disclosed (assumed) value,[4] a strategy of setting Cost of Service at ERISA minimums understates the actual costs incurred by today's ratepayers, and shifts costs to the future, an inequity to future ratepayers.

---

[3] The plan is deemed fully funded from an ERISA perspective, which means that no current contributions are due. While the ERISA funded ratio drives tax policy, it does not represent the fair market value condition of the plan. Nor is a fully funded ERISA measure consistent with the PBGC's funded status measure, which currently results in excess PBGC variable premiums for both MGE and LAC. For more information, see footnote 3 and pages 12-14 in Pitts Direct.

[4] See pages 8 and 9 of Pitts Direct. Note that the liability might be even higher than the 10-15% adjustment if the Company were to explicitly value guaranteed return features. See Embedded Options in Pension Plans / Valuation of Guarantees in Cash Balance Plans Report (Society of Actuaries Pension Section, 2014) for additional information.

Instead, I recommend using FAS87 as the current Cost of Service, with an explicit 20-year amortization of prepaid pension assets/liabilities, using cost-of-debt as the interest accrual (rate base return).[5]

Q: HOW DOES YOUR RECOMMENDED CONTRIBUTION STRATEGY DIFFER FROM STAFF'S?

A: A contribution strategy that follows the ERISA / statutory minimum exposes ratepayers to both excessive fees[6] and excessive risks.[7] Instead, I recommend the Company undertake a strategic pension financing review, including for example, the impact on ratepayer pension cost (and risk) of borrow-to-fund strategies. (Pitts Direct, p. 17)

Q: PLEASE SUMMARIZE YOUR RECOMMENDATION ON PENSION RATEMAKING METHODOLOGY IN THIS CASE

---

[5] See page 16 and 17 of Pitts Direct for the rationale behind this recommendation. Also note that such treatment would require a separate special amortization account, and FAS87 development would also need to consider the accelerated amortizations in its development.

[6] Underfunded pension plans generate additional PBGC variable premiums, as there is a direct correlation between a plan's funded status and the PBGC's risk exposure, which determines actual PBGC premiums. Since 2015, the LAC and MGE plans have been assessed additional PBGC premiums of $2.4 million. The $2.4 million in variable premiums can be thought of as a penalty, since the money goes to the PBGC and not the plan.

[7] By maintaining an underfunded pension plan, the Company's investment policy continues to take on a substantial amount of equity risk. Only when the plan reaches full funding does the investment policy de-risk the investments by increasing its allocation to fixed income investments. While taking such risks may indeed pay off, thereby lowering the cash out-of-pocket costs, they may also result in significant losses. Importantly, the risk is borne by future ratepayers – an intergenerational inequity.

A: As developed more thoroughly in Pitts Direct, I recommend the following methodology:

- 20-year amortization of prepaid pension asset / liability, with return set at cost-of-debt;
- FAS87 expense for current year pension costs;
- Changed funding policy to minimize the frictional costs of PBGC variable premiums; and
- Strategic pension financing review

Q: WHY SHOULD THE COMMISSION CONSIDER CHANGING THE METHODOLOGY STIPULATED AND AGREED TO IN PRIOR ORDERS?

A: There are numerous changed conditions in the last several years that have not been addressed in the recommendations set forth by Company and Staff. These changes include:

- Historically low interest rates, leading to lower borrowing costs;[8]
- Increased funding requirements / underfunding penalties set forth in the MAP-21 legislation passed in 2012, and since updated in 2014 and 2015;

[8] Companies routinely restructure their debt offerings when market conditions change. Homeowners do as well, as the cost of debt falls. Ratepayers should be afforded the same opportunities to lower their cost of debt (owed to pensioners), since the current rate base financing approach is akin to paying for a mortgage payment with a credit card. See Attachment J of Pitts Direct for a discussion of current pension funding strategies in the retirement sector.

- Changes in pension accounting standards that clarify the distinction between operational, financing and investing costs, and costs eligible for capitalization, effective March 10, 2017;
- Changes in investment strategies, which seek to de-risk pensions as funding levels improve; and
- An evolving regulatory environment, in which prepaid pension assets are more closely monitored and managed.

In addition to these changes, which support a review of regulatory guidance on pensions, there is an overall fairness principle that is being violated. The current financing methodology is not fair to current and future ratepayers, as they are captive borrowers and are being charged penalty rates relative to their credit-worthiness.

Q: ARE THERE OTHER JURISDICTIONS THAT FOLLOW A SIMILAR RATEMAKING METHODOLOGY FOR PENSIONS?

A: Yes. Decision No. C16-0123 (proceeding No. 15AL-0135G) directs Public Service Company of Colorado (Gas) to create a special amortization equal to legacy prepaid pension assets, and to amortize such amount over a 15-year period, with interest accrued at cost-of-debt.

Q: DOES THIS CONCLUDE YOUR PENSION RELATED TESTIMONY?

A: Yes.

III. OPEBS

Q: PLEASE SUMMARIZE STAFF'S RECOMMENDATION ON OTHER POST EMPLOYMENT BENEFITS (OPEBS)

A: Staff recommends continuing the ratemaking methodology agreed to and stipulated from the most recent MGE and LAC rate cases, GR-2014-0007 and GR-2013-0171. More specifically (Staff Report, p. 69):

- Continuation of an OPEB tracker, in which differences between actual cash expenditures and amounts collected in rates are included in rate base as either a regulatory asset or liability;
- OPEB liability of $1,958,522 for MGE, and $37,036,298 for LAC, as of June 30, 2017 (Staff Report, Accounting Schedule 2);
- Eight-year amortization of such amounts to be included in Cost of Service determination; and
- Current OPEB costs equal to annualized LAC and MGE forecasted cash contributions for fiscal year 2018.

Q: DO YOU HAVE ANY COMMENTS ON STAFF'S ANALYSIS?

A: As with Staff's pension testimony, they did a thorough job documenting existing methodology as well as adjustments made to prepaid OPEB asset accounts (for example, for shared service employees.)

Q: DO YOU AGREE WITH STAFF'S RECOMMENDATION?

A: Yes and no:

- I agree with continued use of OPEB trackers;[9]
- Although I haven't directly reviewed Staff's development of the prepaid OPEB asset values, the adjustments that Staff made for shared services employees appears appropriate;
- As with the prepaid pension asset, I recommend amortizing the prepaid OPEB asset over a 20-year period, with interest accrual (rate base return) at cost-of-debt; and
- Current OPEB costs should be set at FAS106 levels instead of cash.

[9] As with LAC pension tracker, an additional OPEB regulatory tracker capturing the differences between FAS106 and rates could be used

Q: DO YOU HAVE ANY OTHER RECOMMENDATIONS?

A: Yes. I recommend an independent OPEB benefit review, considering the richness of LAC's OPEB program. To illustrate this point, consider the "Service Cost" row shown below in Table DGP-1 (replicated from Pitts Direct). Service Cost represents the cost of benefits earned over the course of the year – an operational cost.

TABLE DGP-1						
	Pensions			OPEBs		
	LAC	MGE	Total	LAC [1]	MGE	Total
2016 Net Periodic Expense						
Service Cost	7.7	2.1	9.8	10.3	0.2	10.5
Interest Cost	13.9	7.5	21.4	7.1	1.0	8.1
Expected ROA	(16.6)	(10.1)	(26.7)	(7.3)	(1.2)	(8.5)
Amort PSC	0.4	-	0.4	0.8	(0.5)	0.3
Amort Loss	6.3	1.4	7.7	3.5	0.3	3.8
Net Periodic Expense	11.7	0.9	12.6	14.5	(0.3)	14.2
Discount Rate	4.40%	4.50%		4.00%	4.30%	
Compensation Increase	3.00%	3.00%		3.00%	N/A	
Expected Return on Assets	7.75%	7.75%		6.00%	4.75%	
				[1] Medical, Life, Group, Senior Officers Life		

MGE's operational OPEB costs are 10% of its pension costs, a relative difference not uncommon in compensation packages in general.

LAC's operational OPEB costs are 133% of its pension costs, however, which is highly unusual. Therefore, I recommend an independent OPEB benefit review be performed to ensure LAC's program is fair and reasonable.

Q: **DOES THIS CONCLUDE YOUR TESTIMONY?**

A: Yes.