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Issues:	FAS 87, FAS 106 and Funding of Pension Plans
Witness:	Michael D. McGilligan
Sponsoring Party:	Union Electric
Type of Exhibit:	Rebuttal Testimony
Case No.:	EC-2002-1
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MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. EC-2002-1

REBUTTAL TESTIMONY

OF

MICHAEL D. MCGILLIGAN

ON

BEHALF OF

UNION ELECTRIC COMPANY
d/b/a AmerenUE

Exhibit No. 153
Date 7/10/02 Case No. EC-2002-1
Reporter KEM

St. Louis, Missouri
May, 2002

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REBUTTAL TESTIMONY

OF

MICHAEL D. MCGILLIGAN

CASE NO. EC-2002-1

I. Opening and Purpose

Q. Please state your name and business address.

A. My name is Michael D. McGilligan. My business address is 101 South Hanley, Suite 900, St. Louis, Missouri 63105.

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

A. I am a Principal with Towers Perrin. I serve as an actuary and employee benefits consultant to a number of clients in the firm's St. Louis office.

Q. Please describe Towers Perrin.

A. Towers Perrin is an international management and actuarial consulting firm with offices in 74 locations throughout the world. We serve approximately 7,000 clients worldwide in virtually every industry as well as in the government, education, and not-for-profit sectors.

Q. Please describe your education.

A. I received a Bachelor of Arts degree in mathematics from Knox College in 1972. I completed the examination requirements for designation as a Fellow of the Society of Actuaries and received such designation in May 1977. I completed both the examination and experience requirements for designation as an Enrolled Actuary under the Employee Retirement Income Security Act of 1974 (ERISA) and received such designation in 1979.

Q. Please describe your qualifications.

A. I have been employed with Towers Perrin as a consulting actuary since 1978. From 1972 to 1978, I was employed by the Equitable of New York in various actuarial capacities. I have substantial technical and consulting experience with regard to employee benefit plans — including the design, funding, accounting, and communication of pension and postretirement welfare programs.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to rebut the testimony of the Staff's witness, Greg R. Meyer—which recommends a reduction in pension and other postretirement (OPEB) expense of approximately $7 million. Because of acknowledged errors in Mr. Meyer's work papers, an exact calculation of the impact on expense cannot be determined at this time. I will also show that the Staff's method is an inappropriate approach to recognizing pension and OPEB expense, although Mr. Meyer's lack of familiarity with these subject areas, exhibited in depositions, handicaps our ability to do this. As part of my testimony, I have prepared an **Executive Summary** attached as Appendix A.

II. <u>Rules For Recognition of Expense</u>

Q. What are the regulations governing corporate recognition of expense as it relates to pension and other postretirement benefit plans?

A. The Financial Accounting Standards Board ("FASB") has issued Statement of Financial Accounting Standards No. 87 ("FAS 87") for pension and No. 106 ("FAS 106") for other postretirement benefit plans. These statements are part of the

Generally Accepted Accounting Principles ("GAAP") to which U.S. corporations must adhere.

Q. What is FAS 87?

A. FAS 87 is an accounting standard issued in December 1985 relating to employers' accounting for pensions. FAS 87 requires employers to recognize the cost of providing pensions on an accrual basis. It requires pension cost to be recognized over the period during which benefits are earned, i.e., during the working years of the employees. The standard also contains the detailed rules and other guidance that govern the determination of the accrual costs.

Q. What is FAS 106?

A. FAS 106 is an accounting standard issued in December 1990 relating to employers' accounting for postretirement benefits other than pensions. FAS 106 requires employers to recognize the cost of providing postretirement benefits on an accrual basis. It requires the cost to be recognized over the period during which benefits are earned, i.e., during the working years of the employees to full eligibility date. The standard also contains the detailed rules and other guidance that govern the determination of the accrual costs.

Q. What are FAS 87 and FAS 106 intended to do?

A. They are intended to provide a procedure for systematically accruing costs during the expected period of active service of the covered employees. They are also intended to provide comparability from one company to another and from period to period for the same company.

Q. What is the process for determining the accrual costs under FAS 87 and FAS 106?

A. The accrual cost is determined as the total of the following items:

• Service cost	The value of benefits assigned to the current year under the benefit formula.
• Interest cost	Interest on the liability earned to date.
• Return on assets	The expected return on **market-related value of assets** for the year, and a reduction to expense. Amounts different from expected during the year are deferred and spread over future years.
• Amortization	1. Changes in liabilities due to plan changes, **assumption changes, and experience gains or losses are subject to amortization.** 2. Employers may elect to amortize only the portion of those gains or losses in excess of 10% of the greater the liability or assets used in determining annual expense **(Corridor approach).** 3. The amount to be amortized is spread over an **amortization period** not to exceed the average future service of active employees.

Therefore, FAS 87 and FAS 106 expense can be described as:

- A normal accrual reflecting the value of benefits earned during the year (i.e., service cost); plus
- A charge or credit depending on the funded status of the plan (interest cost less return on assets); plus
- A charge or credit to recognize a portion of asset and liability shortfalls or surplus.

III. Comparison of Methods

Q. What underlying principles were used to determine Ameren's current expense recognition methods related to pension and other postretirement benefits?

A. Our goal was a reasonable and representative method that controls year-to-year volatility and follows GAAP. We feel the methods currently used allow Ameren to report accurate and realistic earnings (even more important today, in light of increased accounting scrutiny) and limit the need for frequent, sizeable true-ups to avoid inter-generational subsidies.

Q. Please provide a description of the Staff's proposed method changes.

A. The Staff is proposing to change the market-related value of assets, the amortization period used to recognize gains/losses, and the method used to determine the gain/loss subject to amortization. A description of each follows:

Market-Related Value of Assets

- FAS 87 Standard — Either fair value of assets, or a smoothed value that recognizes changes in fair value in a systematic and rational manner over not more than five years.
- Ameren's Method — A smoothed value that recognizes changes in fair value in a systematic and rational manner over four years.
- Staff's Method — The fair value of assets.

Amortization of Gains/Losses

Method	Amount Subject to Amortization (Before Corridor)	Corridor	Amortization Period
FAS 87 Standard	Unrecognized net gain or loss, excluding asset gains and losses not yet reflected in market-related value of assets	No more than 10% of greater of liabilities or assets used in determining annual expense	No more than the average remaining service of actives (15 years for Ameren)
Ameren	Same as FAS 87 Standard	None	10 years (as required by prior rate case agreement)
Staff	Average of the prior five year's unrecognized gains or losses	None	5 years

Ameren's method uses the FAS 87 Standard for determining the amount subject to amortization, the Staff's method for setting the Corridor and an amortization period between the two approaches. Compared to non-Missouri utilities, the Ameren method provides a reasonable balance between recognizing actual plan experience and controlling volatility.

IV. Appropriateness and Justification of Staff's Method

Q. Is the Staff's overall method appropriate for expense recognition?

A. No, it is inappropriate for the following reasons:

1. The primary reason is that the Staff's method results in unacceptable year-to-year volatility in total expense as illustrated for the Ameren Retirement Plan in the table below. Please note the expense figures using the FAS Standard and Staff methodologies assume 2000 was the first year these methods were used.

Total Company Pension Expense
(in millions)

	2000	2001	2002*
FAS Standard	$17	$18	$27
Ameren	1	2	16
Staff	(19)	(11)	12

*estimated based on actual 1/1/2002 assets, but estimated liabilities

The increase in expense over the two-year period is $31 million under the Staff's method which is two times greater than the $15 million increase under Ameren's method and three times greater than the FAS 87 Standard. Indeed, Mr. Meyer conceded that if the Staff's method would result in significant volatility then the Staff would abandon its method (See April 24, 2002 Meyer Deposition, page 37, line 25 through page 38, line 3).

2. The Staff's method—while initially generating a lower level of expense than Ameren's method—does not eliminate expense but defers recognition of expense to a future period. The Staff's method will ultimately produce expense levels greater than Ameren's method. In essence, the Staff's method will contribute to inter-generational inequity by improperly placing more of the burden of funding today's pension expenses on future customers.

3. The Staff's method has a much greater tendency to increase expense (and therefore rates) in poor economic environments – which would seem to be at odds with good ratemaking policy.

4. The Staff's method of recognizing gains and losses does not comply with FAS 87 or FAS 106. In addition, because it would be administratively impossible to apply the Staff's method to Missouri Regulatory jurisdictions only, the company would be required to use the Staff's method for financial reporting purposes. This will introduce excess volatility to Ameren's earnings and also reduce the ability of shareholders/investors to compare Ameren to other companies.

Q. Has Mr. Meyer, in his testimony, provided valid justification for changing to the Staff's proposed method?

A. No. There are three primary reasons why Mr. Meyer's justification is in error:

1. Many of his arguments are qualitative, not measurable or verifiable, and often are simply Staff's opinion of what is reasonable.

For example, Mr. Meyer cites two reasons for changing the market-related value of assets to fair value. His second reason states, in its entirety, on page 21, lines 4-6 of his current testimony, "2) Recognition of the gain and loss in calculating FAS 87 and FAS 106 is that gains and losses need to be reflected on a timely basis in order to accurately reflect a utility's pension and OPEBs cost."

Please note that nowhere in Mr. Meyer's testimony has he:

- Defined what a timely basis is.
- Provided evidence that Ameren's method is not already accurately reflecting pension and OPEB costs on a timely basis.

In his April 2002 deposition, Mr. Meyer was not able to cite the criteria used by the Staff to determine the appropriate balance between timely recognition and volatility of expense (See April 24, 2002 Meyer Deposition, page 50, lines 9 – 20).

2. When Mr. Meyer provides evidence that is measurable or verifiable, his statements are either not correct or would no longer be correct if the statement was made using the most recent economic information available.

In fact in his most recent testimony, Mr. Meyer has deleted the first reason (all large utilities have well funded pension plans and annual gains are a rule rather than an exception) from his original testimony that had been given for opposing the use of a market-related value of assets.

As another example, on page 17 of his March 2002 testimony, lines 11-13, Mr. Meyer states, "An examination of the unrecognized net gain/loss balance for AmerenUE and most of the large utilities in Missouri show that the unrecognized balance is a net gain."

Using the qualified pension plan financial disclosure information as of December 31, 2001, Ameren's unrecognized gain/loss account shows a loss of $26.5 million (See Schedule 1)

3. Based on the depositions of Mr. Meyer, it is clear that Mr. Meyer did not understand the method that the Staff is proposing or its impact on the recognition of expense.

Mr. Meyer concedes that he consulted no treatise, article, or journal that supports the adjustments he proposes (April 24, 2002 Meyer Deposition at page 34, lines 6-19). He admits that this testimony is his first in at least eight years on pension and OPEB (November 29, 2001 Meyer Deposition, page 87, lines 11-16) and that he was chosen so that he could get experience in this area. He admitted in November (See Meyer Deposition, page 96, lines 9-12) that he "had to rely on the expertise of co-workers," and that someone else had drafted the testimony (See Meyer Deposition, page 85, lines 15-17). He was also unable to answer many of the deposition questions specifically related to his testimony, and cited his own lack of experience for not providing answers (See November 29, 2001 Meyer Deposition, page 114, line 24 through page 115, line 1; page 116, lines 5-

6; page 128, lines 7-11). He gave conclusory answers to questions concerning whether and why the Company's method could be considered unreasonable (See November 29, 2001 Meyer Deposition, pages 92-94).

In addition, in the April 2002 deposition, Mr. Meyer demonstrated that he did not understand that the Staff's method has the effect of smoothing asset gains and losses over five years in the unrecognized gain/loss account (See Meyer Deposition, page 41, line 20 through page 42, line 13). He also believes that any year's gain or loss is fully amortized after five years under the Staff's approach when, in fact, that is not the case (See Meyer Deposition, page 55, line 16 through page 56, line 12). Mr. Meyer clearly lacks the training, knowledge, and experience necessary to address this subject.

Mr. Meyer's main objection to Ameren's method is that the market-related value defers recognition of gains/losses up to four years. This position is irrational since the Staff's method defers recognition of gains/losses up to five years. If Ameren's method is not preferable to Mr. Meyer because it defers the recognition of gains and losses over four years, then he should withdraw the Staff's method since it defers the recognition over five years.

V. Market-Related Value of Assets

Q. The Staff is proposing the use of fair value of assets instead of a market-related value of assets. What is your opinion of this request?

A. Of the proposed changes, I believe this change may have the most adverse effect on Ameren's ability to manage its business. The market-related value of assets is needed to control year-to-year volatility of expense and does not materially impact the long-term recognition of cost.

Q. Why do you say that the market-related value of assets is needed to control year-to-year volatility?

A. Given the $1.5 billion in combined pension and postretirement welfare trust assets, we would expect a gain or loss in excess of $100 million roughly 5 out of every 10 years.

Remember that pension and OPEB expenses are each a combination of several items, including the expected return on assets. Assuming a $100 million asset gain in the current year, the return on asset component of expense will increase by $2.1 million ($100 million / 4 * .085) under Ameren's method and $8.5 million ($100 million * .085) under the Staff's method for the following year. This illustrates that the return on asset component of expense is four times more volatile under the Staff's method than under Ameren's. Note that the actual return on assets for both the pension and postretirement welfare trusts during 2001 was a loss of $202 million.

Q. Why do you say that the market-related value of assets is needed yet does not impact the long-term recognition of cost?

A. As seen earlier and also illustrated in Schedule 2, the Staff's method in total is two to three times more volatile than Ameren's current method. This extra volatility is truly a "surprise" in that it can be caused by events late in the year such as significant changes in the market's performance during the fourth quarter, which prohibits an organization from building reliable budgets for the next year.

Using a market-related value of assets spreads the impact of asset gains and losses—over four years in Ameren's case—which has the following advantages:

- It minimizes the change in expense from the prior year, which improves an organization's ability to budget for next year.
- It reflects the impact of the asset gain/loss over four years, which allows an organization to plan and prepare for potential changing expense levels.

It is important to reiterate that the market-related value does not materially impact the long-term cost recognition of the plan. This can be seen in the table below which reflects:

- A ten-year forecast of pension expense (fiscal 2002–2011) under the current Ameren method and the Staff's method
- Asset returns for the next ten years equal to Ameren's expected return on assets of 8.5% (constant returns), or asset returns alternating annually between 16.0% and 0.0% (volatile returns)

Comparison of Average Expense and Volatility over Ten-Year Forecast

(millions)

	Average Expense	**Average Volatility***
Constant returns		
– Ameren	$51	$5
– Staff	53	7
Volatile returns		
– Ameren	50	6
– Staff	52	14

*Average Volatility is the average of the absolute value of the change in expense from year to year

The variation in total expense recognition between Ameren's current method and the Staff's method is similar over the ten-year period. Under the volatile return scenario, the Staff's method is more than twice as volatile as Ameren's method. Ultimately, because the FAS 87 expense represents the benefits paid, the expense recognized will be the same under either method, but Ameren's method provides much lower volatility.

Q. You have already commented on the two reasons given by Mr. Meyer to oppose the use of a market-related value of assets. Will you briefly restate your comments?

A. Yes. Let me point out that the first reason included in his original testimony for eliminating the market-related value has been withdrawn. The first reason included in his most recent testimony for opposing the use of a market-related value of assets is that gains and losses are not fully subject to amortization for four years. It is difficult to see why this is not acceptable since asset gains and losses under the Staff's method are not fully subject to amortization for five years.

His second argument states that recognition of the gain and loss in calculating FAS 87 and FAS 106 expense should be reflected on a timely basis in order to accurately reflect a utility's pension and OPEB cost. I agree with this statement, but I do not see how using a market-related value of assets is contrary to reflecting expense on a timely basis, nor does Mr. Meyer illustrate his claim. As I have already shown, Ameren's method recognizes expense in a reasonable and timely manner as compared to the FAS 87 Standard, whereas the Staff's method introduces unneeded and unacceptable volatility.

VI. Gain/Loss Amortization Approach

Q. What changes are the Staff proposing to the Gain/Loss Amortization Method?

A. The Staff is proposing to:

- Change the amount of unrecognized gains and losses subject to amortization from the FAS 87 Standard amount to a five-year average of unrecognized gains and losses.
- Change the period over which these gains and losses are amortized from 10 years to 5 years.

Q. Please comment on the Staff's proposed amortization approach of using a 5-year average of unrecognized gains and losses.

A. While Mr. Meyer stated in his recent deposition that the Staff's approach is in compliance with FAS 87 and FAS 106 (See April 24, 2002 Meyer Deposition, page 45, line 18 through page 46, line 15 and page 51, line 6 through page 52, line 8), in fact, the Staff's amortization method is not in compliance with FAS 87 or FAS 106 and therefore does not satisfy GAAP for pension and other postretirement benefits. As I have mentioned, FAS 87 and FAS 106 provide for a minimum amortization determined by dividing (a) by (b), with (a) being the excess of the recognized gain/loss account above 10% (the corridor) of the greater of the assets and liabilities, and (b) being the average future service. Faster amortization is allowed. For example, you can amortize amounts within the corridor (as Ameren does) or you could use a shorter amortization period (as Ameren does). However, there is no provision allowing a five-year smoothing of the gain/loss account. This smoothing does not comply with FAS 87 or FAS 106 because it does not reflect the current status of the gain/loss account and would allow expense to be reduced when FAS 87 and FAS 106 would require an increase, and vice versa. Outside of the PSC Staff jurisdiction, I am not aware of any other organization that uses the Staff's method. In his November deposition, Mr. Meyer was also unable to name even one organization outside the jurisdiction of the Missouri PSC that used this approach (See Meyer Deposition, page 110, line 25 through page 111, line 3). Whether this is because of the conflict with FAS 87 and FAS 106, or because of the excessive volatility it causes, the approach suggested by Meyer is not used anywhere else in the country.

An example of the non-compliance resulting from Mr. Meyer's approach is illustrated by the Ameren Retirement Plan's gain/loss account status as of January 1, 2002. At that time, the gain/loss account was in a loss position of $26.5 million because of poor returns in 2000 and 2001. Under FAS 87, no recognition of this loss is required, but a company could choose to recognize a portion of it. However, the Staff's method would recognize a $32 million *gain* — resulting in an overall expense that is $32 million less than the FAS 87 minimum. (see Schedule 1 for more details.)

Q. Please comment on the Staff's position that the 5-year average balance of unrecognized gains/losses reduces volatility.

A. I agree that the Staff's 5-Year Average Balance, although not in compliance with FAS 87, is less volatile than an approach that does not use averaging or smoothing. However, it is still more volatile than Ameren's method. Furthermore, it is *the volatility of the total annual expense* that is critically important because that is the number reflected in rates. The Staff's method does not control the annual volatility of total expense very well. Schedule 2 illustrates the range of pension expense from Ameren's method, the Staff's method, and the FAS 87 Standard, based on a reasonable range of annual investment returns (from the 10^{th} to 90^{th} percentiles shown in Schedule 3).

Schedule 2 shows that for the Ameren Retirement Plan, the Staff's method is:

- 2.7 times more volatile than Ameren's current method
- 5.8 times more volatile than the FAS 87 Standard.

Q. Greg Meyer has stated in his testimony that using a 5-year amortization period is consistent with Missouri PSC precedent for treating abnormal, significant gains/losses. Please comment on this statement relative to pension accounting.

A. The Staff's application of this line of precedent to pension accounting is inappropriate. First, unrecognized gains/losses arising from assumption changes or plan experience are not abnormal. On the contrary, FAS 87 and FAS 106 require most assumptions (including the expected rate of return on plan assets and demographic assumptions) to be set using a long-term view of the plan, and therefore gains/losses are expected to arise on an annual basis. FAS 87 and FAS 106 have a well-defined process to recognize these gains/losses, and that process includes recognition over the average future service of active employees. In fact, because of the volatile nature of the gain/loss account, FAS 87 and FAS 106 do not require recognition of gains/losses that are less than 10% of the greater of assets and liabilities (the corridor approach). Most large companies with pension plans take advantage of this corridor.

Ameren has chosen not to apply this corridor and therefore to recognize gains/losses more rapidly than required under FAS 87. However, this choice was made only because asset gains and losses are smoothed under the current Ameren method. A Company concerned about volatility of expense has to employ either asset smoothing or the corridor approach. To reject both, as the Staff is recommending, exposes such a company to unacceptable amounts of volatility.

Secondly, investment returns greater than expected are the primary sources of gains, and less than expected are the primary sources of losses. Schedule 3 shows the expected range of one-year and five-year compound period returns for Ameren's asset mix under Towers Perrin's capital market assumptions for 2001.

As shown in the table, there is a 50% chance (hardly abnormal) that actual returns will be either greater than 12.9% (75th percentile) or less than –.6% (25th percentile). Since Ameren's assumed rate of return is 8.5%, actual returns greater than 8.5% create gains while actual returns less than 8.5% create losses. This means that, on pension assets of $1.3 billion, there is a 25% chance of getting an annual investment gain greater than $58 million and a 25% chance of an investment loss greater than $124 million.

The wide variance in normal pension investment returns has the potential of generating large changes in the gain/loss account. Amortizing these changes over five years creates excessive volatility in the amortization amount from year to year, and more importantly, excessive volatility in total expense.

Finally, Ameren's Pension Plan has experienced returns over the past ten years consistent with the ranges illustrated above. The following table documents the actual return on assets for this period.

Fiscal Year	Actual Return
1992	8.4%
1993	13.6%
1994	-1.1%
1995	24.1%
1996	12.9%
1997	16.7%
1998	12.6%
1999	11.0%
2000	1.5%
2001	-3.5%

The ten-year compound return is 9.3%, compared to the assumed rate of return on plan assets of 8.5%. Note that this includes the period from 1995 through 1999, in which a typical asset mix (60% stock, 40% bonds) realized the second highest five-year return in 50 years. Also note that over the past ten years 50% of the actual returns have fallen within –1% to 13% and the other 50% have fallen outside that range.

Q. In Mr. Meyer's testimony, he stated the 5-year amortization period is consistent with ERISA/IRS requirements. Is this statement true?

A. No, there are four primary reasons why Mr. Meyer's statement is not accurate:

- Once again, a focus on the total method is critically important. ERISA/IRS allows asset gains/losses to be based on smoothing of up to five years before being subject to a five-year amortization. Since the Staff's method does not allow a smoothing of assets, it is inappropriate to consider the Staff's use of a five-year amortization period consistent with the ERISA/IRS treatment.

- The ERISA/IRS Regulations require assumption changes to be amortized over ten years, not five years as Mr. Meyer implies on page 18 lines 19-26 of his testimony. (See Internal Revenue Code §412(b)(2)(B)(v)). The Staff's method (which would amortize assumption changes over five years) is **inconsistent** with ERISA/IRS requirements.
- Also, ERISA/IRS allows the use of alternate funding methods (such as the aggregate funding method), which FAS 87 does not allow. The aggregate funding method recognizes assumption changes and gains/losses over the average future service of active employees, not over five years.
- Finally, ERISA/IRS allows any volatility created by the amortizations to be smoothed if prior contributions were larger than required. FAS 87 has no such provision.

The following table illustrates the incidence and amount of cost recognition under the various methods being compared.

Illustration of $1,000 Asset Gain/Loss
Effect on Expense

Year	Ameren's Method	IRS Minimum with Asset Smoothing	Staff's Method
1	$ 46	$ 51	$125
2	92	106	160
3	137	166	189
4	182	230	210

5	164	301	222
6	148	250	186
7	133	195	147
8	120	135	109
9	108	70	74
10	97	0	45

Note that in the first year, both the IRS method and Ameren's method reflect about 5% of the change while the Staff's method reflects 12.5%. Over the ten-year period, Ameren's method rises slower and declines slower than the other methods - which reduces volatility. In all cases, contributions are assumed to equal the amount of expense recognized.

VII. Prevalence of Accounting Methods

Q. What accounting methods are other plan sponsors using?

A. From a recent Towers Perrin survey of non-Missouri utility clients from across the country (please see Schedule 4 for more detail):

- 20 of 20 (100%) use either a market-related value of assets, a 10% corridor, or both to defer recognition of gains/losses to control the volatility of pension expense.
  - 13 of 20 (65%) used a smoothed market-related value of assets
  - 18 of 20 (90%) used a corridor to defer recognition of a portion of their gains/losses (10% corridor)
- 18 of 20 (90%) amortized gains/losses over the average future service of employees
- No organization used the Staff's method of amortization.

VII. Summary and Closing

Q. Please summarize your testimony.

A. Ameren's current approach offers a reasonable balance between stable year-to-year expense and timely recognition of gains/losses. Ameren currently amortizes gains/losses faster than the typical utility (or non-utility for that matter).

The Staff's proposed method is inappropriate because:

- Year-to-year volatility of pension expense under the Staff's method is two to three times greater than under Ameren's current method.
- It understates the current cost of the pension and OPEB plans, resulting in increasing levels of expense to be paid by future rate payers.
- It does not reflect the current financial conditions of the plan, and acts to significantly increase expense in poor economic environments (and vice versa), which seems to be at odds with good ratemaking policy.
- It is not used by utilities outside the state of Missouri, which ultimately affects the comparability between companies.
- It does not comply with FAS 87 or FAS 106.

The Staff's reasons for proposing the method are not accurate because:

- Ameren's return on asset assumption of 8.5% is in a reasonable range of expected long-term returns.
- Gains/losses arising within the operation of a pension plan are not abnormal.

- Amortizing gains/losses over a five-year period is not necessarily consistent with the ERISA/IRS approach for funding pension plans.
- The Staff's witness lacks experience in these areas, lacks knowledge of FAS 87, FAS 106 and ERISA, and was unable to justify the pension and OPEB expense calculation method changes proposed in his testimony and deposition (See, e.g. November 29, 2001 Meyer Deposition, page 114, line 19 through page 115, line 1; page 116, lines 5-9; April 24, 2002 Meyer Deposition, page 58, lines 9-20).
- The primary reason offered in Mr. Meyer's original testimony that investment "gains are the rule not the exception" is not true and has been omitted from his most recent testimony.

Q. What impact, if any, do you think the chosen test year has on the results you have discussed?

A. Because of the poor asset return performance during 2000 and 2001, the pension expense over the next five years is expected to be significantly higher than the test year under either Ameren's method or the Staff's proposed method. The average expected pension expense for AmerenUE over the next five years will be more than $25 million greater than the test year amount under the Staff's method. Thus, the $7 million reduction in pension and OPEB expense recommended by the Staff is particularly inappropriate when these expenses will in fact be increasing based on known and measurable asset returns.

Q. Does this conclude your rebuttal testimony?

A. Yes it does.

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

The Staff of the Missouri Public Service Commission, Complainant,	)	
vs.	)	Case No. EC-2002-1
Union Electric Company, d/b/a AmerenUE, Respondent.	)	

AFFIDAVIT OF MICHAEL D. MCGILLIGAN

STATE OF MISSOURI)
) **ss**
CITY OF ST. LOUIS)

Michael D. McGilligan, being first duly sworn on his oath, states:

1. My name is Michael D. McGilligan. I work in St. Louis, Missouri and I am a Principal with Towers Perrin and serve as an actuary and employee benefits consultant.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Union Electric Company d/b/a AmerenUE consisting of 22 pages, Appendix A, Exhibits 0 through 0 and Schedules 1 through 4, all of which have been prepared in written form for introduction into evidence in the above-referenced docket.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Michael D. McGilligan
Michael D. McGilligan

Subscribed and sworn to before me this 1st day of May, 2002.

Kay Vosholler
Notary Public

My commission expires: November 27, 2004

KAY VOSHOLLER
Notary Public – Notary Seal
STATE OF MISSOURI
St. Louis County
My Commission Expires: Nov. 27, 2004

EXECUTIVE SUMMARY

Michael D. McGilligan

Actuary and employee benefits consultant and Principal with Towers Perrin

* * * * * * * * * *

The Staff's methodology for recognizing pension and other post retirement benefits (OPEB) expense, as outlined in Staff witness Greg R. Meyer's testimony, is inappropriate. The Staff's methodology—which reduces AmerenUE's current expenses by approximately $7 million—does not eliminate the expense but, rather, defers it to be paid by future ratepayers. In addition, the Staff's methodology increases the volatility of expense; results in a lack of comparability both between periods and with other companies; does not represent sound ratemaking policy; and is not in compliance with generally accepted accounting principles.

The primary reason why the Staff's method is inappropriate is because it produces excessive levels of year-to-year volatility in total expense, as demonstrated in the chart below.

Investment Return for 2002	**FAS 87 Expense for Fiscal Year 2003** (millions)	
	Ameren's Method	**Staff's Method**
-6.2% (10th Percentile)	$40	$45
8.50% (Average)	32	22
24.7% (90th Percentile)	23	(1)
Range of Expense	**17**	**46**

This volatility can be a "surprise" caused by events late in the year, such as significant changes in the market's performance.

Because of immediate recognition of market changes in the expected "return on assets" component of pension and OPEB expense, the Staff's methodology has a much greater tendency to increase expense (and therefore rates) in poor economic environments—which would seem to be at odds with good ratemaking policy. Further, the significant volatility in expense introduced by the Staff method raises the prospect that those costs reflected in UE's financial statements will not adequately match those costs embedded in the rate structure. This result is inconsistent with sound ratemaking policy.

On the other hand, if the Staff method is adopted, Ameren might be required to implement it company-wide for financial reporting purposes due to administrative constraints. This would result in excess volatility being introduced into Ameren's earnings, and a reduced ability for shareholders/investors to compare Ameren to other companies--because the Staff's methodology is not in use for any other utilities outside of the Missouri Public Service Commission's jurisdiction.

Finally, the Staff method is inappropriate because the method of recognizing gains and losses is not in compliance with Statement of Financial Accounting Standards (FAS) Nos. 87 or 106, which is the guidance within generally accepted accounting principles for the accounting for pension and OPEB benefits. FAS 87 relates to the accounting for pensions, while FAS 106 addresses issues related to the accounting for OPEBs. Specifically, implementation of the Staff's method can lead to the recording of gains from investment plan assets in periods when losses have actually occurred and vice versa.

The Staff's justification for proposing a new method is erroneous. Many of the arguments presented are qualitative, not measurable or verifiable and often are simply Staff's opinion of what is reasonable. When Staff attempts to present evidence that can be measured or verified, their information is either incorrect or outdated. Finally, it was evident in the depositions of Staff witness Meyer that he did not fully understand the method that the Staff is proposing nor its impact on the recognition of pension and OPEB expense. He admitted in deposition that his testimony had been drafted by another Staff member and thus he was unable to answer many of the deposition questions specifically related to his testimony.

Because of the poor asset return performance during 2000 and 2001, the average pension expense over the next five years for AmerenUE will be more than $25 million greater than the test year under the Staff's proposed method. Thus, the $7 million reduction in pension and OPEB expense recommended by the Staff is particularly inappropriate, when these expenses will in fact be increasing due to known and measurable asset returns.

Finally, the increase in expense over the next ten years using the Staff's proposed method is significantly higher than using Ameren's method, resulting from the deferral of expense from the current period into future periods.

Rebuttal Testimony of Michael D. McGilligan
AmerenUE
Case No. EC-2002-1
Schedule 1 – Illustration that Staff's Method Does Not Comply With FAS 87

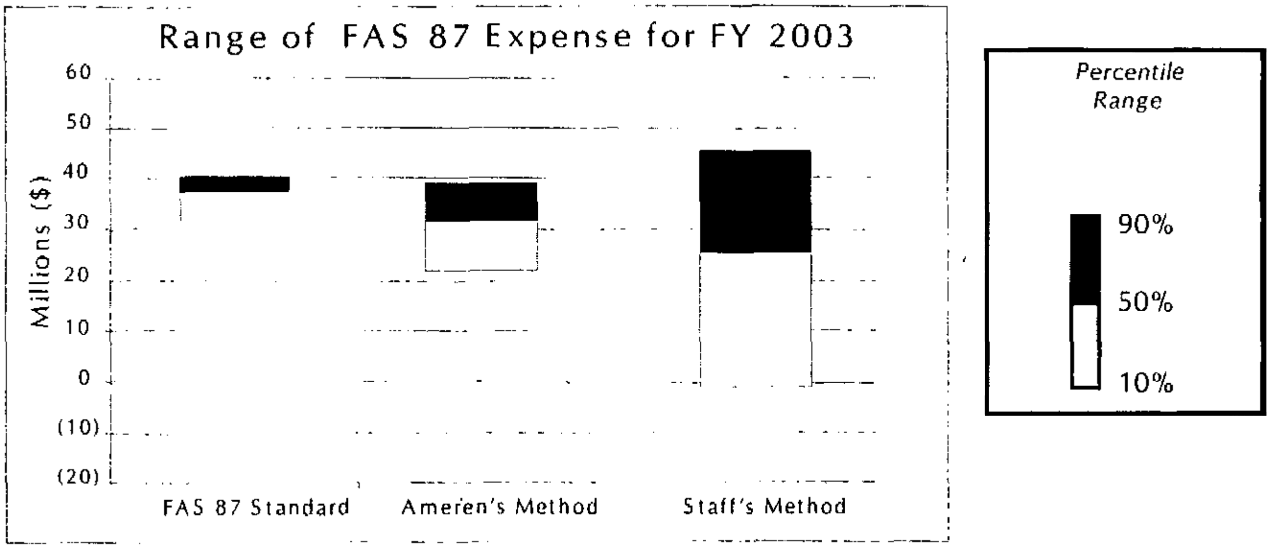
	Staff's Method 01/01/2002	FAS 87 Minimum Assuming (MRV=FV)
Expense		
Service cost	$ 33.4	$ 33.4
Interest cost	101.3	101.3
Expected Return on Assets	(100.8)	(100.8)
Amortization:		
Transition Obligation	(1.3)	(1.3)
Prior Service Cost	9.1	9.1
Net Loss/(Gain)	(31.9) ←	→ -
Pension Cost	9.8	41.7

Note: This schedule illustrates that the Staff's method will not comply with FAS 87. Since the plan is estimated to have an unrecognized loss of $26.5 million (see below) on 1/1/2002, the minimum amortization of the loss is zero. The Staff's method would recognize a $31.9 million gain. As a result, the Staff's method would produce an expense $31.9 million less than the minimum amount required under FAS 87.

Funded Status	
Projected Benefit Obligation	$(1,402.9)
Fair Value of Assets (FV)	1,225.3
Unrecognized Transition Obligation	(4.7)
Unrecognized Prior Service Cost	80.8
Unrecognized Loss/(Gain)	**26.5**
(Accrued)/Prepaid Cost	(75.0)
Other Elements	
Market-Related Value of Assets (MRV)	$ 1,225.3
Assumptions	
Discount Rate	7.25%
Expected Return on Assets	8.50%
Salary Increase	4.25%
Actual Investment Return	-3.5%

Note: Amounts reflect Ameren Corporation's qualified pension plan before application of the allocation factors for the Missouri Component of AmerenUE.

Rebuttal Testimony of Michael D. McGilligan
AmerenUE
Case No. EC-2002-1
Schedule 2 – Illustration of Volatility Under Staff's Method



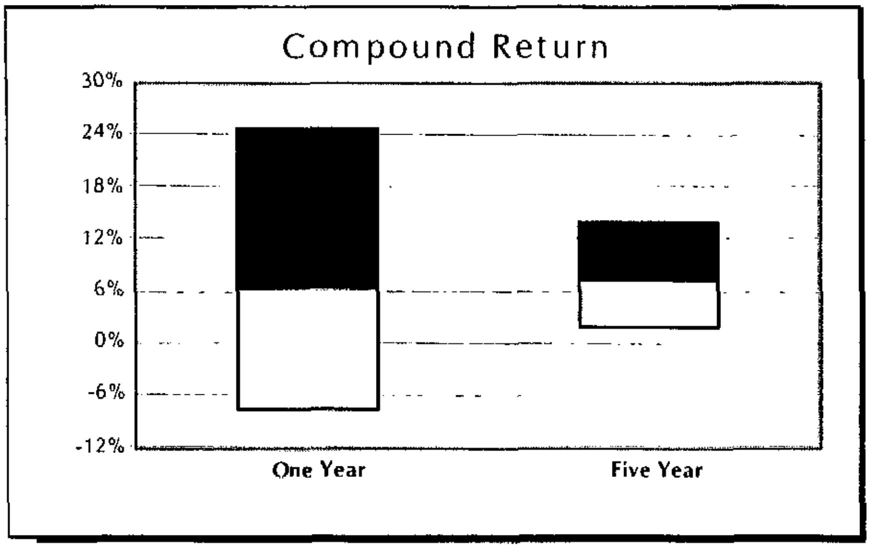
Investment Return For 2002		Fiscal 2003 Expense in Millions: FAS 87 Standard	Ameren's Method	Staff's Method
-6.2%	(10th percentile)	$40	$40	$45
8.5%		37	32	22
24.7%	(90th percentile)	32	23	(1)
Range of Expense		8	17	46

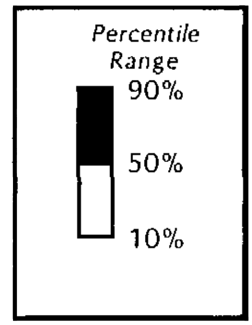
This chart illustrates that the Staff's method is significantly more volatile than Ameren's current method. It is 2.7 times more volatile than Ameren's method and 5.8 times more volatile than the FAS 87 Standard.

Ameren's method provides for increased recognition of gains and losses relative to the FAS 87 Standard, but without significantly increasing volatility.

Note: Amounts reflect Ameren Corporation's qualified pension plan before application of the allocation factors for the Missouri Component of AmerenUE.

Rebuttal Testimony of Michael D. McGilligan
AmerenUE
Case No. EC-2002-1
Schedule 3 – Illustration of Range of Returns Expected Under Ameren Retirement Plan





Percentile	1-Year Return	5-Year Return
10	-6.2%	2.5%
20	-1.1%	4.6%
25	**-0.6%**	**5.1%**
30	1.6%	5.7%
40	4.8%	6.8%
50	**6.9%**	**7.8%**
60	9.6%	9.1%
70	11.6%	9.7%
75	**12.9%**	**10.1%**
80	16.1%	11.5%
90	24.7%	13.9%
Average	7.5%	7.8%

This chart illustrates that annual returns significantly different than the assumed long rate of return are common and support the need for smoothing the market value of assets.

Note: Ameren's long term assumption for return on plan assets (8.5%) is greater than the expected compound return over the next five years.

Note: Amounts reflect Ameren Corporation's qualified pension plan before application of the allocation factors for the Missouri Component of AmerenUE.

Rebuttal Testimony of Michael D. McGilligan
AmerenUE
Case No. EC-2002-1
Schedule 4 – Comparison of Expense Smoothing Approaches Used by Other Utilities

Method Used	Number of Utilities	Percentage
Smoothed value of assets	13	65%
Amortizes gains/losses over average future service	18	90%
10% corridor when amortizing gains/losses	18	90%
None of the above (Staff's method)	0	0%
At least one (Ameren's method)	20	100%
At least two	18	90%
All three	11	55%

The survey was comprised of 20 non-Missouri utilities.

This schedule illustrates that most utilities use features allowed under FAS 87 that help control volatility of expense.

All of the utilities use either a smoothed value of assets or the 10% corridor.