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| *Exhibit No.:* | |
| *Issue:* | *Pension Expense, OPEB Expense* |
| *Witness:* | *Steve M. Traxler* |
| *Sponsoring Party:* | *MoPSC Staff* |
| *Type of Exhibit:* | *Surrebuttal Testimony* |
| *Case Nos.:* | *TC-93-224 & TO-93-192* |

# MISSOURI PUBLIC SERVICE COMMISSION

# UTILITY SERVICES DIVISION

# SURREBUTTAL TESTIMONY

# OF

# STEVE M. TRAXLER

# SOUTHWESTERN BELL TELEPHONE COMPANY

# CASE NOS. TC-93-224 & TO-93-192

***Jefferson City, Missouri***
***June, 1993***

# SURREBUTTAL TESTIMONY

# OF

# STEVE M. TRAXLER

# SOUTHWESTERN BELL TELEPHONE COMPANY

# CASE NOS. TC-93-224 & TO-93-192

Q. Please state your name and business address.

A. Steve M. Traxler, 615 East Thirteenth Street, Suite 510, Kansas City, Missouri 64106.

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

A. I am a Regulatory Auditor for the Missouri Public Service Commission (Commission).

Q. Are you the same Steve M. Traxler who has previously filed direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your surrebuttal testimony?

A. My surrebuttal testimony will address the rebuttal testimony of Southwestern Bell Telephone Company (SWBT or Company) witnesses David W. Toti, David C. Foster, James K. Zishka and Joseph M. Vogl on the issues of pension expense and post-employment benefit costs (OPEBs).

## PENSION EXPENSE

Q. Do you agree with SWBT's position that the ratemaking treatment used for pension expense and OPEB costs should be consistent?

A. Yes. Pension costs and OPEB costs are similar in that both represent benefits to be paid to employees after retirement. If the Commission decides that FAS 106 accounting treatment for employee benefit costs is appropriate for ratemaking purposes, then FAS 87 accounting treatment should be adopted for pension cost for ratemaking purposes. This will better reflect the actual revenue the Company needs from ratepayers to meet its obligations.

If the Commission decides that OPEB costs should continue to be determined for ratemaking purposes as incurred; " i.e., the pay-as-you-go" method, then pension cost should be based upon the level of cash required to <u>adequately</u> <u>fund</u> its pension obligation.

Q. If pension expense for ratemaking purposes is based upon the level required to <u>adequately</u> <u>fund</u> the pension obligation, how should it be calculated?

A. The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to insure that employers' pension obligations be adequately funded. A minimum contribution requirement is one of the provisions of this legislation. By basing pension expense for ratemaking purposes on the ERISA minimum contribution, the Commission will be providing the utility with an <u>adequate</u> pension cost amount based upon safeguards included in the ERISA regulations.

Q. What ratemaking treatment is being proposed by SWBT for pension expense for this case?

A. SWBT is proposing that pension expense and OPEB expense be given ratemaking treatment consistent with GAAP treatment required for financial reporting purposes.

SWBT is recommending that pension expense and OPEB expense be included in cost of service in this proceeding based upon Financial Accounting Standard (FAS) 87, Employers' Accounting for Pensions, and FAS 106, Employers' Accounting for Post-Retirement Benefits Other Than Pensions, respectively.

Q. What reasons have been given by SWBT in support of their position that pension expense should be included in cost of service based upon FAS 87?

A. SWBT witness Toti lists the following reasons in support of using FAS 87 for pension expense cost determination in this proceeding:

1. FAS 87 results in a better match of the cost of providing utility service with the time period when that service was provided by employees than does the fund contribution required under ERISA regulations.

2. The ERISA minimum contribution is not necessarily based entirely on cost of service.

3. If FAS 87 is not adopted for ratemaking purposes in this proceeding, it will require the write-off (charge against earnings) of

$38.5 million for the prepaid pension asset established for financial reporting purposes under FAS 87.

4. In adopting the Uniform System of Accounts, Part 32 in Case No. TC-89-14, the Missouri Commission adopted generally accepted accounting principles (GAAP) for ratemaking purposes.

5. The rates of SWBT-MO customers have been reduced approximately $18 million annually since July 1, 1989, the effective date of SWBT-MO's last rate order in Case No. TC-89-14.

Q. Do you agree with Mr. Toti's first assertion that FAS 87 results in a better match of the cost of providing utility service with the time period when service was provided by employees?

A. No. The actuarial calculation of SWBT-MO's future pension obligation under FAS 87 for financial reporting purposes and under ERISA regulations for funding purposes are both intended to determine SWBT-MO's future pension obligation.

Q. If the pension obligation is the same for FAS 87 for financial reporting purposes and ERISA funding requirements, what accounts for the difference between annual expense amounts determined under FAS 87 and cash contribution required under ERISA funding regulations?

A. A difference occurs between the pension cost determined for <u>financial reporting</u> purposes under FAS 87 and the pension cost used in <u>funding</u> calculations in accordance with Internal Revenue Service (IRS) and ERISA regulations. This difference results from using a different actuarial method and/or assumptions. The net result is that pension cost reflected in the financial records of the Company under FAS 87 is not the same amount that is deposited in the pension fund to meeting funding requirements. FAS 87 accounts for the difference between pension expense recorded for financial reporting and the amount actually funded as a prepaid pension asset or as a liability. A prepaid asset is recognized when the amount of cash contribution to the pension fund exceeds the pension expense recorded for financial recording purposes.

Q. Does the difference between pension expense under FAS 87 and the actual cash contribution to the fund represent a permanent difference?

A. No. A prepaid asset or accrued liability recognizing the annual difference between FAS 87 and the actual cash contribution to the pension fund is nothing more than an accounting entry to recognize a "timing" difference for pension cost recognition under the two methods. Both pension expense under FAS 87 and ERISA funding calculation will recognize the total pension obligation. The pension expense recognized annually under FAS 87 and the actual cash contribution to the pension fund under ERISA regulations will differ in any given year due to the use of different actuarial methods and assumptions which allocate the total obligation differently over the number of years assumed in the calculation.

Q. With regard to SWBT, why has pension expense under FAS 87 been less than the amount calculated for funding calculations under ERISA resulting in the recognition of a prepaid pension asset in the financial records?

A. Calculating the pension cost required under ERISA regulations and the maximum tax deductible amount under IRS regulations will always be zero or greater. However, a negative pension expense can result for financial reporting purposes under FAS 87, and can be expected when a company's pension fund is over-funded.

Q. Please explain how pension expense calculated under FAS 87 can result in a negative amount.

A. The pension expense calculation under FAS 87 includes an amount for the expected income to be earned on the pension fund assets. The returns earned on pension fund assets reduces the Company's overall pension cost because the returns can be utilized by the Company to pay its pension obligation. A negative pension expense results for SWBT because the expected earned return on the pension fund assets and the transition asset amortization is greater than the other pension cost amounts for service cost and interest.

Q. Do you agree with Mr. Toti's assertion that the minimum contribution required under ERISA regulations is not suitable for determining cost of service?

A. No. As previously stated, the ERISA minimum contribution is intended to provide adequate funding for the company's pension plan obligation to its employees. The company's actuary must measure the same pension obligations under FAS 87 for financial reporting and ERISA funding requirements.

Q. Why is the Staff recommending the usage of the ERISA minimum contribution instead of FAS 87 for ratemaking purposes?

A. FAS 87 and the ERISA minimum contribution both have certain advantages:

1) The main advantage of the ERISA minimum contribution is that pension cost collected through rates matches the annual <u>cash</u> requirement of the utility to fund its pension obligation. FAS 87 will often result in a <u>negative</u> pension expense when the pension fund is well funded. This will reduce a utility's cash flow collected through rates even though a minimum cash contribution may be required under ERISA regulations. This is especially true for companies with more than one pension fund.

2) FAS 87 will result in a lower revenue requirement when the plan is overfunded.

3) The ERISA minimum contribution is more timely in reflecting differences between expected assumptions and actual costs.

The Staff believes that, on balance, use of the ERISA minimum contribution is the preferable ratemaking treatment.

Q. Do you agree with Mr. Toti that the failure of the Missouri Commission to adopt FAS 87 in this proceeding will result in a financial statement write-off of $38.5 million representing the accumulated prepaid asset balance recorded in accordance with FAS 87 for financial reporting purposes?

A. No, I do not.

Q. What is the basis for Mr. Toti's position that SWBT will be required to write-off the accumulated FAS 87 prepaid pension asset in the event that the

Commission does not adopt FAS 87 for cost of service determination in this proceeding?

A. Mr. Toti's position that a pension asset write-off will be required if FAS 87 is not adopted by the Commission in this proceeding is based upon the following arguments:

(1) The Missouri Commission adopted FAS 87 in Case Nos. TC-89-14, et. al., (TC-89-14). Mr. Toti believes that 100% of the pension credits recorded on the books of SWBT since 1988 have been flowed back to customers through lower rates.

(2) Discontinuance of FAS 87 for ratemaking purposes will not allow SWBT-MO to recover the pension credits flowed back to customers when, in the future, FAS 87 expense exceeds contributions to the fund.

Q. Do you agree with Mr. Toti that rates established in Case No. TC-89-14 have resulted in a benefit to ratepayers due to a reduction in rates for all of the FAS 87 pension credits recorded from 1988 through 1991?

A. No, I do not. I will agree that SWBT-MO did in fact record a FAS 87 pension credit in its financial records in every year from 1988 through 1991. However, the rates established in Case No. TC-89-14 have not been in effect long enough for SWBT-MO customers to receive the benefit of the entire pension credit recorded from 1988 through 1991.

Q. Please explain your assertion that rates established in Case No. TC-89-14 have not resulted in a reduction in rates for the full impact of FAS pension credits recorded by SWBT-MO from 1988 through 1991.

A. Rates established in Case No. TC-89-14 became effective on July 1, 1989. Pension credits were recorded on the books of SWBT-MO for the years 1988 through 1991. The incentive regulation plan approved in Case No. TC-89-14 has resulted in SWBT-MO customers receiving the benefit of pension credits recorded for the time frame from July 1, 1989 through December, 1991. Since rates established in Case No. TC-89-14 were not effective until July 1, 1989, SWBT-MO customers could not have benefitted from pension credits recorded by the Company from January 1, 1988 through June 30, 1989. Mr. Toti is incorrect in asserting that SWBT-MO customers have received the benefit, through lower rates, of all pension credits recorded on the books of SWBT-MO since 1988.

Q. You previously mentioned that Mr. Toti's second reason for asserting that a pension asset write-off will occur if FAS 87 is not adopted in this proceeding is that the change from FAS 87 to a contribution method in this proceeding will preclude SWBT-MO from recovering the prepaid asset in the future when FAS 87 expense exceeds pension fund contributions. Do you believe that SWBT-MO will in fact be required to write-off a prepaid asset balance if FAS 87 is not adopted for ratemaking purposes in this proceeding?

A. No, I do not.

Q. Please state your reasons.

A. The prepaid pension asset on the books of SWBT-MO is reversed (turns around) when pension expense under FAS 87 exceeds the actual cash contribution to the pension fund. The reversal of the prepaid pension asset began in 1992 because the pension expense recorded on the financial records in 1992 under FAS 87 was a positive amount while the cash contribution to the fund was zero for 1992.

According to information obtained in response to Staff Data Request No. 10, SWBT projects that the prepaid asset balance will reverse by January 1, 1994, the date that new rates established in this proceeding will likely take effect.

Q. What information contained in SWBT-MO's response to Staff Data Request No. 10 led you to the conclusion that the prepaid pension asset balance on the books of SWBT will reverse prior to the effective date of new rates established in this proceeding?

A. SWBT-MO provided the actuarial report for the Southwestern Bell Corporation Pension Benefit Plan (SBCPBP) and the Southwestern Bell Corporation Pension Plan (SBCPP) for the year 1992. The following reference on page I-1 of the 1992 actuarial report addresses the projected reversal of the FAS 87 prepaid pension asset:

*(Dollars in Millions)*

> **401(h) Transfer.** Forecasts in this report anticipate that pension plan cash in excess of $100 per year will be used to pay post-retirement medical benefits in 1992-95, through transfers to a "401 (h) account" in the pension plans. Together with future updates and plan changes, these negative cash pension costs should rapidly reduce

the prepaid pension asset on SBC's balance sheet. (Figures 9 and 10)

Schedule 1 attached to this surrebuttal testimony reflects the actual and projected prepaid asset balances for both of the SBC pension plans for the years 1985 through 1995. The data on the graph, labeled Prepaid Pension Expense, reflects that the prepaid pension asset began reversing in 1992 and is projected to reverse completely by 1994.

Since the current incentive regulation plan will be in effect until January 1, 1994, SWBT-MO will have recovered the increase in FAS 87 pension expense occurring in 1992 and 1993.

The projected reversal in 1992 and 1993 will eliminate any possibility of a pension asset write-off as a result of a decision by the Commission to determine pension cost in this proceeding on a contribution basis instead of on FAS 87.

Q. What point in time has the Staff used for rate base determination in this proceeding?

A. The Staff has determined rate base based upon investment levels as of September 30, 1992.

Q. Given the facts that the Staff's rate base is stated at the September 30, 1992 level and that as of September 30, 1992, SWBT-MO does have FAS 87 prepaid pension asset balance, how do you justify not including the prepaid pension balance at September 30, 1992, in the Staff's rate base determination in this case?

A. The Staff's revenue requirement calculation establishes SWBT-MO's net plant investment (rate base), major components of annual operating expense and capital costs as of September 30, 1992. The rate base amount used in the revenue requirement calculation should include a representative level of all the asset investments required by SWBT-MO to provide service to its customers. By representative, we mean that the rate base amount includes the kind of assets that will be used by SWBT-MO to provide service to its customers during the period that rates will be in effect. For example, SWBT-MO's investment in digital switches and telephone poles are assets which will also be used in providing service during the period that rates established in this case are in effect.

Because SWBT-MO projects that it will not have a prepaid pension asset in 1994 and 1995 when rates set in this proceeding are in effect, the inclusion of this prepaid asset in rate base will result in an overstatement of revenue requirement for this case.

In fact, the prepaid pension expense graph on Schedule 1, reflects that SBC is projecting that it will be recognizing a FAS 87 accrued liability instead of a prepaid pension asset beginning in 1994.

Inclusion of an FAS 87 accrued pension liability in rate base would reduce rate base and revenue requirement, the exact opposite impact of a FAS 87 prepaid pension asset.

Q. Isn't it true that the Staff has included other prepaid expenses in the rate base and revenue requirement calculation in this case?

A. Yes. However, these prepaid expense amounts represent investments by SWBT-MO which are required on an "ongoing" basis to provide service to customers. Prepaid insurance expense is a good example.

As I have previously explained, the FAS 87 prepaid asset is projected to reverse by the time rates in this case become effective in 1994. The FAS 87 prepaid pension asset is actually projected to become a FAS 87 accrued liability which would actually reduce SWBT-MO's revenue requirement if reflected in rates.

In summary, Mr. Toti's assertions that SWBT will be required to write-off a prepaid pension asset if FAS 87 is not adopted in this case and that the prepaid pension asset as of September 30, 1993 should be included in rate base are not justified for the following reasons:

1. The prepaid pension asset at September 30, 1992 does not represent an "ongoing" asset investment for SWBT-MO. Schedule 1, from the SBC 1992 actuarial report projects that the prepaid asset will completely reverse by early 1994.
2. Because the current incentive regulation plan will be in place until January 1, 1994, SWBT-MO will recover the increase in FAS 87 expense causing the reversal of the prepaid pension asset.
3. Even if rate base treatment were justified, the entire balance as of September 30, 1992 should not be included in rate base because FAS 87 pension credits recorded from January 1, 1988

through July 1, 1989 were never flowed back to customers. Rates established in Case No. TC-89-14, the first year that FAS 87 was adopted for ratemaking purposes, were effective July 1, 1989.

## OTHER POST-EMPLOYMENT BENEFITS EXPENSE (OPEB)

Q. Have you read the rebuttal testimony of SWBT witnesses David W. Toti, David C. Foster, James K. Zishka and Joseph M. Vogl on the issue of OPEB's expense?

A. Yes, I have.

Q. What ratemaking treatment is being proposed by SWBT-MO for OPEBs?

A. SWBT-MO is proposing that OPEBs be calculated based upon Statement of Financial Accounting Standards (FAS) 106, Employers' Accounting for Post-Retirement Benefits other than Pensions.

Q. How have OPEB costs been treated for financial reporting and ratemaking purposes in the past?

A. OPEB costs have been determined for financial reporting and ratemaking purposes based upon the actual amount of benefits requiring payment in the current year. This method is commonly referred to as the "pay-as-you-go" method.

Q. How are OPEB costs measured under FAS 106?

A. FAS 106 attempts to measure the total cost of an employee's post-employment benefits other than pensions, and then accrues this cost to expense over the employee's years of service. The estimate of the OPEB obligation is similar to pension cost estimation under FAS 87, Employers' Accounting for Pensions, in that actuarial assumptions are used to make the estimate.

Q. Are the same actuarial assumptions used for pension expense determination under FAS 87 and OPEB expense under FAS 106?

A. Some actuarial assumptions that are used for both pension expense and OPEB expense estimates include:

Employee Mortality

Employee Turnover

Retirement Age

Income Earned on Plan Assets

Time Value of Money (Discount Rate)

Future Salary Increases

Q. What additional actuarial assumptions are necessary in estimating OPEB costs?

A. Measurement of an employer's OPEB obligation requires the use of several assumptions unique to the field of study relating to health care benefits. These include:

Per Capita Claims Cost by Age

Health Care Cost Trend Rates

Medical Coverage to be Paid by Medicare

Q. What arguments have been made by SWBT-MO in support of their position that FAS 106 should be adopted for ratemaking purposes in this case?

A. SWBT-MO supports its position for adoption of FAS 106 based upon the following arguments:

1. FAS 106 is appropriate for ratemaking purposes because it provides a more accurate measure of periodic OPEB expense.
2. FAS 106 represents accrual accounting. Since accrual accounting is required by GAAP, FAS 106 should be adopted for ratemaking purposes.
3. FAS 106 provides intergenerational equity for ratepayers.
4. Failure to adopt FAS 106 for ratemaking purposes will have a negative impact on SWBT's financial condition and capital costs.

Q. What are the reasons supporting the Staff's position that OPEB costs should continue to be recovered for ratemaking purposes as incurred (pay-as-you-go)?

A. The Staff's recommendation to continue use of the pay-as-you-go method for determining OPEB expense for ratemaking purposes is based upon the following arguments:

1. The difficulty in estimating an OPEB benefit obligation 30 years from now is recognized by the Financial Accounting Standards Board (FASB) and the actuarial profession. A question therefore arises as to whether this estimate meets the known and measurable requirement which is based on many years of Commission precedent.

2. Unlike pensions and nuclear decommissioning costs, there is *no* federal legislation which requires advance collection of OPEB costs.

3. The Internal Revenue Service (IRS) allows a current tax deduction for advance funding amounts for pensions and nuclear decommissioning costs. However, current IRS regulations do not permit a current tax deduction for all of the OPEB costs calculated under FAS 106.

4. Compliance with GAAP has never been a universal requirement for setting rates for a regulated utility. Deviation from GAAP accounting for ratemaking purposes has been recognized by the accounting profession and state regulatory commissions for many years when strict adherence to GAAP accounting for

ratemaking purposes was judged to result in unfair and/or excessive rates. In addition, the Federal Communications Commission Uniform System of Accounts (Part 32) adopted by the Commission for financial accounting purposes does not preclude the Commission from using actual costs for cost of service determination when an "accrued" expense is considered to be inaccurate. In its order in Case TC-89-14 the Commission stated that, "The Commission, as stated earlier, has the authority to establish separate ratemaking treatment for costs than those required by Part 32."

5. Intergenerational equity between generations of customers will not result from use of either FAS 106 or pay-as-you-go.

Q. Has the accounting profession and actuarial profession recognized the difficulty in estimating OPEB costs under FAS 106?

A. Yes. In paragraphs 194 and 195 of FAS 106, FASB recognized that the calculation of the OPEB obligation under FAS 106 is more ***sensitive*** to ***changes*** in actuarial assumptions than pension cost determination under FAS 87:

> the turnover assumption may have a more significant effect for post-retirement benefits. . .
>
> the dependency status assumption also may have a more significant effect on post-retirement benefit measurements. . .

> post-retirement benefit measurements are more sensitive to assumptions about retirement ages. . .
>
> similarly post-retirement benefit measurements are more sensitive to the life expectancy assumption.

Q. Due to the ***subjectivity*** of the health care cost trend rate, isn't it true that FAS 106 ***requires*** financial statement disclosure for the impact of a 1% change in the health care trend rate?

A. Yes. Paragraph 353 of FAS 106 requires financial statement disclosure for the impact of a 1% change in the health care trend rate.

Q. Isn't it true that budgeted costs are allowed for ratemaking purposes for pension costs and nuclear decommissioning costs?

A. Yes. However, the inclusion of budgeted costs for pension and nuclear decommissioning is consistent with the funding required by Federal law. An employer's pension obligation is a ***legal*** obligation to the employee. The ERISA Act of 1974 was enacted to insure that employers meet their pension obligations. Advance funding for pension costs and nuclear decommissioning costs are required by law because of the public health or other public interests involved.

Q. Do employers have a ***legal*** obligation to provide OPEB benefits to their employees?

A. No. The absence of a legal obligation was recognized by the FASB in paragraph 346 of FAS 106. "Employers indicated that they currently do not have a statutory requirement to provide those promised benefits, unlike their legal obligation to provide certain vested pension benefits."

Q. In your opinion, would it be more likely that the OPEB obligation would be overstated as a result of the assumptions being different than actual results?

A. It is my opinion that the OPEB obligation estimate under FAS 106 would more likely be overstated than understated for the following reasons:

1. A significant increase in cash flow will result for Missouri utility companies because OPEB costs are being collected an average of 30 years in advance, if external funding is not required. An overstatement in the OPEB obligation would result in increased cash flow to the utility company.

2. Many of the same actuarial assumptions used for estimating OPEB expense are used in pension expense calculations. Every pension fund for every major utility that I am familiar with in Missouri is over-funded at the current time. Many are so over-funded that the IRS will ***not allow*** a tax deductible pension contribution to be made. This supports my belief that if an actuaries are going to err, it is much more likely that they will overstate the expense and liability.

Q. One of the reasons provided by SWBT-MO in support of adopting FAS 106 for ratemaking purposes is that it provides equity among different generations of customers. Do you agree with this assertion?

A. As previously discussed, actuarial experts and those responsible for drafting FAS 106 admit the unpredictable nature of future medical costs.

Secondly, the accrual for OPEB costs under FAS 106 does not include any consideration for changes resulting from a national health care system, an issue that the Clinton administration has vowed to pursue.

In addition, the expense accrual under FAS 106 includes the amortization of Transition Benefit Obligation (TBO). The TBO costs represents the projected cost of providing benefits related to service performed ***prior*** to the implementation date of FAS 106. SWBT-MO is recommending that this prior service cost be amortized for ratemaking purposes over a 16 year period. The TBO amortization represents over 37 percent of the FAS 106 expense proposed to be collected from customers over the next 20 years. Requiring today's customers to pay for the cost of OPEB benefits earned in the past does not result in intergenerational equity between different generations of customers.

Although the actual claims paid in the current year (pay-as-you-go) may not represent the cost of future OPEB benefits for service provided by employees today, it has certain advantages over FAS 106 which result in more equitable treatment between different generations of customers.

(1) Actual claims paid are known amounts

(2) The difference between OPEB expense under FAS 106 and the actual cost incurred is nothing more than an estimated timing difference. Setting rates

on a pay-as-you-go basis will allow SWBT-MO to recover its full cost for OPEB benefits as it has in the past.

Q. One additional argument made by SWBT supporting their position that FAS 106 results in equitable treatment for different generations of ratepayers is that FAS 106 provides a "correction" mechanism for reflecting the difference between expected and actual results. Does this correction mechanism promote intergenerational equity for ratepayers?

A. No, it does not. Differences between expected results and actual results are accounted for in a net gain/loss balance under FAS 87 and FAS 106.

This net gain/loss balance is amortized (reflected in the annual calculation of FAS 87 and FAS 106 expense) over a period of years elected by SWBT. SWBT has chosen to amortize the difference between <u>actual</u> and expected results over the average remaining service life of employees, 16 years. This period represents the <u>maximum</u> length of time allowed under FAS 87 and FAS 106. Election of the maximum length of time to reflect the actual results for example income earned on funded assets does not promote intergenerational equity because ratepayers have to wait 16 years before their rates reflect the <u>actual</u> income or loss on funds assets to be fully reflected in rates. Selection of the maximum deferral period for reflecting differences between actual and expected results is in direct conflict with SWBT's argument that intergenerational equity results from the adoption of FAS 87 and FAS 106.

Q. In your opinion, has SWBT-MO overstated its recommended level of FAS 106 OPEB expense?

A. Yes. The level of OPEB expense calculated under FAS 106 being recommended by SWBT-MO is overstated for the following reasons:

(1) On March 31, 1993, SBC contributed $132.3 million into a Section 501(c) VEBA trust fund established for funding OPEB benefits for bargaining employees. The workpapers provided to me supporting SWBT-MO's recommended OPEB expense amount under FAS 106 do not reflect the reduction in the FAS 106 expense resulting from the expected investment earnings on the $132.3 million in trust fund assets.

(2) SWBT-MO has failed to recognize a rate base offset for the advance collection of OPEB expense from customers resulting from the adoption of FAS 106 for ratemaking purposes.

(3) SWBT-MO witness James E. Zishka provides historical medical cost information which indicates that the rate of growth related to the cost of providing health care to retirees of SWBT has declined substantially in 1992. The rate of growth in the cost of providing health care to retirees in 1992 is substantially below the health trend rate assumptions used in calculating OPEB expense under FAS 106.

Q. Why is it appropriate for SWBT-MO to reflect the expected investment return on the assets in the VEBA trust fund in calculating OPEB expense under FAS 106?

A. The difference between OPEB expense under FAS 106 and the actual benefits paid in a given year represent an <u>advance</u> collection of a future expense from today's ratepayers. Ratepayers should be compensated for the funds they provide in advance in one of two ways.

(1) If the amounts collected in advance have been deposited in a separate trust fund, the income earned on those funds should be used as a reduction in the FAS 106 expense accrual because the investment income can be used to pay OPEB benefits to the retirees of SWBT-MO. Both FAS 87 for pension costs and FAS 106 for OPEB costs provide for the consideration of investment income earned on funded assets in calculating the FAS 87 pension and FAS 106 OPEB expense amounts.

(2) If the amounts collected in advance from ratepayers have not been put in a separate trust fund, then the accumulated balance of funds collected in advance should be deducted from rate base. This treatment allows the ratepayer to earn the same overall rate of return allowed by the Commission for the Company's investors.

Q. How did you conclude that the assets contributed to the VEBA trust have been provided by ratepayers and therefore should be considered in determining the OPEB expense level under FAS 106?

A. In response to Staff Data Request No. 500, SWBT indicated that SBC had transferred <u>excess</u> pension assets from its pension funds under the Internal Revenue Service regulations for a 401(h) transfer. The pension asset transfer took place in December, 1992. The benefit of any transfer of assets from a pension fund for a regulated utility should flow directly to ratepayers because they have provided 100% of the contributions made to the pension fund.

Although SBC did not deposit any funds in the 501(c) VEBA trust for OPEB benefits until March, 1993, the source for most of the contribution is the excess pension asset transfer made in December of 1992.

Q. You mentioned previously that SWBT-MO failed to recognize a rate base offset for the advance collection of OPEB expense from ratepayers in its recommendation to adopt FAS 106 in this case. Why is a rate base offset for the advance collection of OPEB benefits appropriate if the Commission adopts FAS 106 in this proceeding?

A. SWBT-MO's recommended FAS 106 OPEB expense amount will result in the advance collection of OPEB costs in the amount of $28 million annually (Missouri Jurisdiction) if FAS 106 is adopted in this case. Assuming rates established in this proceeding are in effect for only two years, SWBT-MO will receive $56 million in OPEB costs, most of which will not be used to pay OPEB benefits for 20-30 years in the future. Fairness dictates that the ratepayers be compensated for the advance payment of OPEB costs under FAS 106 due to the significant magnitude of the annual amounts involved.

Q. Isn't it true that SWBT-MO will not in fact collect any additional OPEB costs related to FAS 106 until after the effective date of rates established in this proceeding?

A. Yes.

Q. If SWBT-MO has not in fact received any advance collection of OPEB costs to date then how do you justify a rate base offset representing the advance collection of FAS 106 OPEB costs?

A. From a traditional test year approach, a rate base offset would not be justified because SWBT-MO will not begin advance collecting OPEB costs under FAS 106 until the effective date of rates in this proceeding. However, the adoption of FAS 106 in this case represents a <u>new</u> and <u>substantial</u> change in cost of service. Due to the magnitude of the costs collected in advance from ratepayers under FAS 106, fairness dictates the recognition of at least <u>some</u> of the FAS 106 costs collected in advance by way of a rate base offset. This approach will give some compensation to ratepayers for the substantial amount of OPEB costs collected in advance during the period that rates set in this proceeding will be in effect.

Q. What level of rate base offset do you consider fair to the Company and its customers for recognition of the advance collection of OPEB costs if FAS 106 is adopted in this case?

A. I believe the rate base used in determining cost of service in this case should reflect 50% of the FAS 106 costs collected in advance for a two year time frame. This amount should be reduced to reflect the assets contributed to the SWBT 501(c) VEBA trust as long as a return on these assets has been used in determining the FAS 106 expense amount. The rate base offset as described is calculated below:

| | | Missouri (Millions) |
|---|---|---|
| (1) | OPEB Costs Collected in Advance - Year 1 | 37.7[1] |
| (2) | OPEB Costs Collected in Advance - Year 2 | 37.7 |
| (3) | Total Collected if Rates are in Effect for 2 Years | 75.4 |
| (4) | Divided by 2 to obtain the average balance for the 2 year time frame: | ÷ 2<br>37.7 |
| (5) | Less the existing assets in the 501(c) VEBA trust which have already been recognized in calculating the FAS 106 expense: | (21.3)[2] |
| (6) | Rate Base Offset: | 16.4 |
| (7) | Jurisdictional Separation Factor | 75.54% |
| (8) | Rate Base Offset - FAS 106 Expense - Missouri Jurisdiction | 12.2 |
| (9) | Less: Negative Deferred Income Tax | (4.4) |
| (10) | Net Rate Base Offset - Missouri Jurisdiction | 7.8 |

Source: [1] SWBT-MO Schedule 22
[2] Response to Staff Data Request No. 169

Q. The last reason you mentioned in support of your position that SWBT-MO has overstated its recommended level of OPEB expense under FAS 106 in this case was that the health care trend rate assumptions used in calculating the FAS 106 expense amounts are significantly higher than the actual growth rate incurred by SWBT-MO for 1992. Please compare SWBT-MO's actual health cost growth rate in 1992 with the health care trend rate used in determining SWBT-MO's recommended level of OPEB expense calculated under FAS 106.

A. Schedule 2 attached to the rebuttal testimony of SWBT witness James E. Zishka indicates that the average cost to provide medical benefits to SWBT retires rose only 4.77% in 1992.

The health care trend rate used in calculating the FAS 106 expense amount being recommended for cost of service consideration by SWBT was shown in the April 1993 actuarial report from Towers Perrin to be 11.0% for post-age 65 claims and 12.0% for pre-age 65 claims. (Towers Perrin is the Company's actuary.) Both of these assumed growth rates for health care costs are substantially above the actual rate of growth experienced in 1992.

Q. Did Mr. Zishka discuss changes in the SWBT health care plans which occurred in 1992 and therefore would have some impact on the reduced growth rate for the cost of health care for SWBT retirees?

A. Yes, Mr. Zishka mentioned numerous changes resulting from bargaining agreements with the CWA union in 1992. In addition Mr. Zishka discussed additional changes in 1993 that should also result in slowing the growth rate for health care. The impact of these changes were not even reflected in the 4.77% growth rate experienced for 1992, which adds additional validity to that growth rate.

Q. In calculating its OPEB liability under FAS 106 did SWBT use a health care trend rate in any year which was as low as the actual rate of growth experienced in 1992?

A. No. SWBT utilized health care trend rates for the first five years of the FAS 106 calculation which were more than <u>double</u> the actual rate of growth experienced in 1992 of 4.77%. In no year in the next 20 years has SWBT assumed that the growth rate for health care costs would be as low as the 4.77% growth rate actually experienced in 1992.

The fact that significant plan changes have taken place in 1992 and 1993 and that SWBT's actual growth rate was only 4.77% in 1992 makes the assumed health care trend ratio used in the 1993 FAS 106 calculation questionable. It is also difficult to accept the fact that SWBT does not expect to hold the growth in health care cost to 4.77% in any year for the next 20 years, especially when one considers that:

(1) a benefit cap on health care benefits effective in 1993 for retirees retiring on or after September 1, 1992 was not in place in 1992, the year that the growth rate was only 4.77%.

(2) Mr. Zishka discussed additional cost reduction changes to occur in 1993 which were not even reflected in the 1992 growth rate of 4.77%.

Q. Have SWBT witnesses indicated that SWBT will incur adverse financial impacts if FAS 106 is not adopted for ratemaking purposes?

A. Yes. SWBT witness William E. Avera quotes from a discussion by Standard and Poors in Credit Week "Utilities and FAS 106" (June 15, 1992). The quote reflected on page 39 of Mr. Avera's rebuttal testimony includes the following statement:

> "Under a worst case scenario, unresponsive regulatory treatment which leads to a reduction in cash flow may result in immediate, negative ratings actions." (emphasis added)

Q. Does Staff's recommended treatment for OPEB costs result in a <u>reduction</u> in cash flow for SWBT-MO?

A. No. Staff's recommended use of actual incurred OPEB costs for ratemaking purposes does not result in a <u>reduction</u> in cash flow. Continuation of pay-as-you-go for ratemaking purposes <u>maintains</u> the current cash recovery mechanism for OPEB benefit costs.

Q. Can the difference between accrued expense under FAS 106 and the actual OPEB costs incurred in a given year be described as a "timing difference"?

A. Yes. If FAS 106 could be calculated <u>accurately</u>, then the difference between expense amounts under FAS 106 and pay-as-you-go amounts would be nothing more than timing differences. Both methods would reflect the total cost of providing OPEB benefits to employees.

Q. Has any SWBT corporate officer made statements supporting your previous statements that the difference between FAS 106 and pay as you go amounts represent timing differences and not a <u>real</u> increase in OPEB benefits costs?

A. Yes. The following quotes are taken from a 1992 shareholders meeting held on April 24, 1992 and were made by Mr. Edward Whitacre, Southwestern Bell Corporation (SBC) Chairman of the Board and Chief Executive Officer.

> ...106 refers to FASB 106 which is an accounting ruling and all companies in the United States have to implement this accounting change. It has <u>no impact</u> on cash flows. It is strictly a <u>paper entry</u> on our books and all companies must do it. (emphasis added) "It is a <u>bookkeeping entry</u> and all companies in the United States must do the same thing." (emphasis added)

It is interesting to note that no high ranking officer of SWBT and/or SBC testifies on this issue.

Q. You mentioned previously in your testimony that the Transition Benefit Obligation (TBO) represents the projected cost of providing benefits related to service performed prior to the implementation date of FAS 106. What options did SWBT have in recognizing the TBO for financial reporting purposes under FAS 106?

A. FAS 106 provides for two options for financial statement recognition of the TBO:

1. Charge the entire TBO balance against income in the year of adoption, 1993; or
2. Amortize the TBO balance over a period not to exceed 20 years.

Q. What option was chosen for financial statement recognition of the TBO?

A. SBC/SWBT chose to write the entire TBO balance off against earnings in 1993. SBC wrote off 2.8 billion dollars against 1993 earnings in the first quarter of 1993.

Q. Did the 2.8 billion dollar write-off of the TBO in the first quarter of 1993 have any detrimental impact on the stock price of SBC in 1993 to date?

A. No. SBC's thirty day average stock price (adjusted for the stock split in May, 1993) is reflected below for the same day in the first six months of 1993.

| | 30 Day Average |
|---|---|
| January 8, 1993 | 35.998 |
| February 8, 1993 | 36.250 |
| March 8, 1993 | 36.029 |
| April 8, 1993 | 37.359 |
| May 7, 1993 | 38.786 |
| June 8, 1993 | 38.081 |

Q. You mentioned earlier in your testimony that the TBO represented over 37 percent of the total projected FAS 106 expense for SWBT for the next 20 years.

A. Yes. The April 1993 actuarial report from Towers Perrin, the Company's actuarial firm, reflects that the TBO represents 37.8% of the FAS 106 expense for the next 20 years for SWBT.

Q. Since SBC/SWBT chose to write off the entire TBO in 1993 against earnings, isn't it true that none of the financial statements provided to rating agencies and stockholders after 1993 will reflect any FAS 106 expense amount related to the TBO?

A. Yes, that is correct. SBC and none of its regulated or <u>unregulated</u> subsidiaries will have any charges against earnings after 1993 for the FAS 106 TBO which represents over 37 percent of the total FAS 106 expense to be charged against the earnings of SBC over the next 20 years. In addition the TBO write off in 1993 has not resulted in a decline in the stock price of SBC as of June 8, 1993, as previously discussed.

Q. To your knowledge, have any other state Commissions decided not to adopt FAS 106 for the purpose of setting rates?

A. Yes. The South Dakota Commission ordered the continued use of pay as you go for ratemaking treatment of OPEB costs in case No. EC-92-106. Some of the reasons cited by that Commission in support of their decision are listed below:

> It is impossible to estimate accrued PBOP expenses when a utilities benefit plan is always subject to modification.
>
> Health care costs depend on a great number of variables such as: technology; infrastructure of the industry; government regulation; efforts to contain health care costs; preventative care; cost of drugs; inflation; government provided benefits and required employee copayments. With all these variables, it is impossible to project future health care cost trends with any degree of confidence.
>
> Health care has been very high on the national agenda for reform. As the result of threatened legislative action, reform is currently being pursued by the health care industry, the business community, states and the Federal government. Because of this call for change, it is impossible for anyone to accurately estimate PBOP costs into the future.
>
> The Commission has historically supported the use of accrual accounting when such a method more closely matches the costs of utility service with service benefits. Accrual accounting places the costs incurred in the proper time period for recovery in rates. However, PBOP costs accrued pursuant to FAS 106, especially future medical costs projected over long periods of time, are too speculative to be used for ratemaking purposes.
>
> <u>The PAYGO method of accounting for PBOPs fully compensates utilities for such expenses and the compensation paid coincides with a utility's cash disbursements.</u> (Emphasis added)

The Arizona Commission has also issued an Order in Docket 57745 requiring the continuation of "pay-as-you-go" to be used for the recovery of OPEB costs in rates.

Q. In the event the Commission decides against the Staff on this issue, what conditions should the Commission require before adopting FAS 106 for ratemaking purposes?

A. The following conditions should be required before adopting FAS 106 for ratemaking purposes:

1. Only amounts which can be economically funded externally should be allowed recovery in rates. Any expense amounts exceeding the amount to be externally funded should not be allowed in rates.

2. Due to the significant variation in the cost of OPEB costs among Missouri utility companies, the Commission should be required to justify the prudency of the OPEB benefit plans being offered. Any OPEB benefits judged to be unreasonable in comparison to other regulated utilities in the state should not be included in cost of service.

3. An outside actuary should be employed by the Commission to examine the assumptions and calculation of the initial projection of the OPEB obligation under FAS 106. This outside review should also be required in future rate cases for all major utility companies.

4. Federal legislation enacted in 1990 permits the transfer of excess pension fund assets for the purpose of paying OPEB costs incurred in the year of transfer. SWBT made such a transfer in 1992. All Missouri utility

companies should be required to pursue this option, and, if rejected, should provide a complete analysis as to why they have chosen not to use this option for reducing the impact of adopting FAS 106 for ratemaking purposes.

Q. What are your reasons of recommending that the Commission allow only amounts which can be economically funded for ratemaking purposes if estimated OPEB costs under FAS 106 are allowed for ratemaking purposes?

A. My recommendation of limiting the recovery of estimated OPEB costs to the amounts that the utility can economically fund is based upon the following reasons:

1. If adopted for ratemaking purposes, the OPEB obligation calculated under FAS 106 would be recovered through rates 30 or more years in advance. This will result in a significant increase in cash flow for a regulated utility. If the liability calculated under FAS 106 is overstated, the cash flow to the utility increases. As I have pointed out previously, the potential for actuarial assumptions to overstate a liability is real when one examines the over-funded status of the pension funds of major utility companies in this state.

If revenue collected for OPEB costs is not funded, there is more incentive for overstatement of the liability because the utility benefits from the use of the additional funds. Requiring the OPEB costs collected through rates be put in a separate trust fund mitigates any incentive to overstate the OPEB liability.

2. A non-funding strategy for OPEB costs would be considered a "credit risk" by rating agencies. Standard and Poor made the following statement in the June 15, 1992 issue of <u>CREDITWEEK</u>:

> If not mandated to create an account for the non-qualified portion, utilities might channel the cash from accrual recovery to <u>general corporate purposes or dividends to shareholders</u>. S & P would view a nonfunding strategy as a <u>credit risk</u> since the utility would have to come up with the cash in the future when retiree claims are filed. (Emphasis added)

3. Requiring that estimated OPEB costs collected through rates be held in a separate trust fund eliminates the possibility that the utility uses the funds for purposes for which they were not intended, such as paying dividends to stockholders, or investing the funds in non-regulated ventures.

Q. It is possible to <u>economically fund</u> the total OPEB cost calculated under FAS 106?

A. Economic funding can be accomplished for the OPEB obligation related to "bargaining employees"; however, IRS restrictions on funding all of the costs related to the OPEB obligation related to "non-bargaining" employees and retirees do not allow for economic funding in all instances.

Q. What are some of the IRS restrictions on the tax deductibility of estimated OPEB benefits calculated under FAS 106?

A. Tax deductible contributions can be made for the OPEB liability related to "bargaining" employees. With a few possible exceptions, tax deductible contributions related to "non-bargaining employees" have the following restrictions and limitations:

1. In calculating the OPEB obligation that is tax deductible, assumptions for inflation and increasing health costs are not allowed. This automatically creates a difference between the OPEB obligation which is tax deductible under IRS rules.

2. Investment income earned in a fund for non-bargaining employees is subject to current income tax.

Q. What OPEB costs calculated under FAS 106 can be economically funded at the current time?

A. The estimated OPEB obligation under FAS 106 related to "bargaining" employees can be economically funded.

Q. What funding vehicle has been the most widely recommended choice for funding the OPEB obligation related to bargaining employees?

A. The 501(c)(9) VEBA Trust is the most widely used to date. It has the following characteristics which make it an economic funding vehicle:

(1) Contributions are tax deductible;

(2) Investment income is tax free;

(3) Benefit payments to employees are tax free; and

(4) According to the actuarial firm of William M. Mercer, it is administratively simple.

Q. What regulated utility companies, that you have knowledge of, are using a 501(c)(9) VEBA Trust to fund the OPEB obligation for bargaining employees?

A. The following companies are currently using a 501(c)(9) VEBA Trust for bargaining employees, or have indicated an intent to pursue this option:

| | | |
|---|---|---|
| GTE Telephone Operations | - | Missouri |
| Contel | - | Missouri |
| AmeriTech | | |
| NYNEX | - | New York |
| California Edison Company | - | California |
| St. Louis County Water Company | - | Missouri |
| Southwestern Bell Telephone Company | - | Missouri |

Q. The fourth condition that you have recommended the Commission require before adopting FAS 106 for ratemaking purposes is that a utility company pursue the option of transferring excess pension fund assets for the purpose of paying OPEB benefits in the current year. What federal legislation permits the transfer of excess pension fund assets to pay OPEB benefits?

A. The Revenue Reconciliation Act of 1990 provides for the transfer of excess pension assets of a defined benefit plan to a health benefit account. Specific regulations are listed below:

(1) <u>One Transfer Limit</u> - One Transfer is allowed per year.

(2) <u>Limit on Amount Transferred</u> - The transferred amount may not exceed the amount that is reasonably

> estimated to be the amount that the employer will pay in the current year for current retiree health benefits.
>
> (3) Pension Fund Assets Subject to Transfer - Pension fund assets subject to transfer are assets which exceed the greater of (a) the full funding limit, or (b) 125% of the current liability.

Q. Have other companies transferred excess pension fund assets for the purpose of paying OPEB benefit costs?

A. Yes. NYNEX of New York made an excess pension asset transfer totaling $281,000,000 for the years 1990 and 1991. AT&T has also made a pension asset transfer. SBC/SWBT made a pension asset transfer in 1992.

Q. Did you receive any information from SBC supporting their decision to make a 401(h) pension asset transfer?

A. Yes. The Controller's Department of SBC made the following recommendation in an internal memo dated May, 1992:

> Since a 401(h) transfer would provide access to a significant level of cash resources otherwise in accessible, with the trade off being a modest increase in pension expense, it is recommended that SBC pursue this course of action. If the 401(h) transfer is used to fund OPEB benefits through a CBVEBA, the increase to pension expense and corresponding decrease to net income would be offset by a reduction in OPEB expense.

Q. What other state Commissions have limited the recovery of OPEB costs under FAS 106 to the amount that the utility can economically fund?

A. The adoption of FAS 106 for ratemaking purposes was limited to economic funded amounts in at least the following state jurisdictions:

California

Rhode Island

Washington

Connecticut

Massachusetts

Montana

Q. If the Commission decides to adopt the full FAS 106 accrual for ratemaking purposes as requested by SWBT, does full recovery have to be allowed in this proceeding?

A. No. The FASB Emergency Issues Task Force (EITF) came to a consensus opinion on the FAS 106 issue in January, 1993. Their decision provides for a phase-in plan option which would allow SWBT to defer the difference between FAS 106 and pay-as-you-go on their financial statements for up to five years as long as the Commission commits to full FAS 106 implementation for ratemaking purposes by the end of the five year phase-in period, with recovery of deferred costs within 20 years of the start of the deferral. This phase in approach would allow the Staff more time to study the underlying assumptions used in the FAS 106 calculation and allow the actuary to consider any health cost changes resulting from Clinton administration initiatives.

If the Commission decides to adopt FAS 106 for ratemaking purposes in this proceeding, the Staff recommends that SWBT be ordered to defer the difference between FAS 106 OPEB expense and pay-as-you-go expense for the full five year time period allowed by the EITF.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

**BEFORE THE PUBLIC SERVICE COMMISSION**
**OF THE STATE OF MISSOURI**

| | | |
|---|---|---|
| The Staff of the Missouri Public Service Commission, Complainant, | ) | |
| v. | ) | Case No. TC-93-224 |
| Southwestern Bell Telephone Company, a Missouri Corporation, Respondent. | ) | |
| and | ) | |
| In the matter of Proposal to Establish an Alternate Regulation Plan for Southwestern Bell Telephone Company | ) | Case No. TO-93-192 |

## AFFIDAVIT OF STEVE M. TRAXLER

STATE OF MISSOURI )
) ss.
COUNTY OF COLE )

Steve M. Traxler, of lawful age, on his oath states: that he has participated in the preparation of the foregoing Surrebuttal Testimony in question and answer form, consisting of 41 pages to be presented in the above case; that the answers in the foregoing Surrebuttal Testimony were given by him; that he has knowledge of the matters set forth in such answers; and that such matters are true and correct to the best of his knowledge and belief.

Steve M. Traxler
STEVE M. TRAXLER

Subscribed and sworn to before me this 14th day of June, 1993.

Wanda J. King
Notary Public

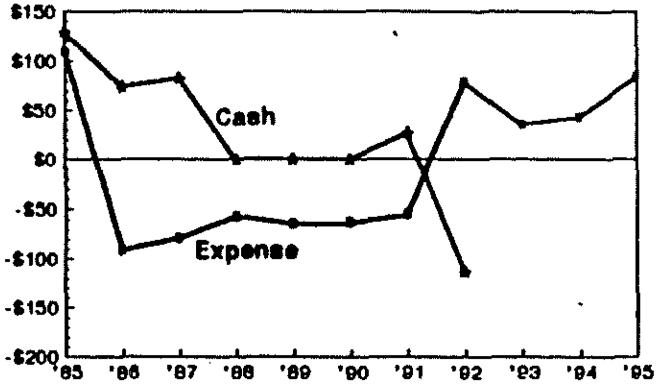
My Commission Expires: 9/4/95

OFFICIAL NOTARY SEAL
Wanda J. King
Notary Public State Of Missouri
Cole County
My Commission Expires Sept. 4, 1995

SCHEDULE 1

## Expense vs. Cash

SBC Both Plans

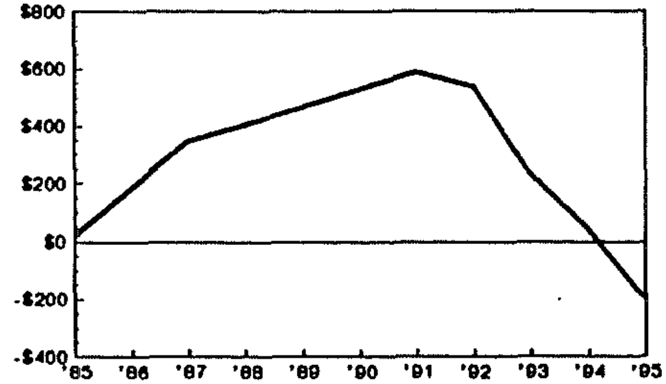



$ in Millions

Figure 9

## Prepaid Pension Expense

SBC Both Plans

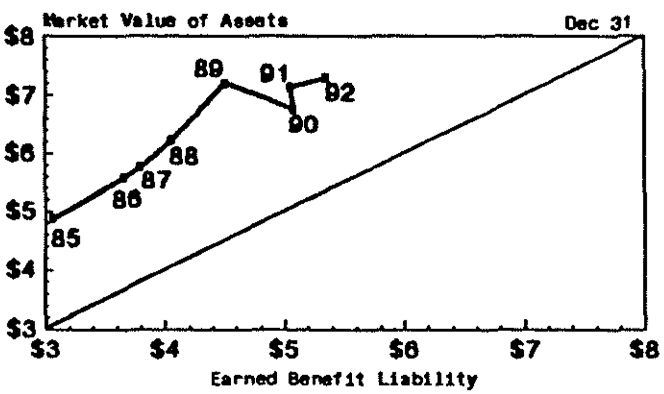



$ in Millions

Figure 10

## Shutdown Overfunding

SBC Both Plans

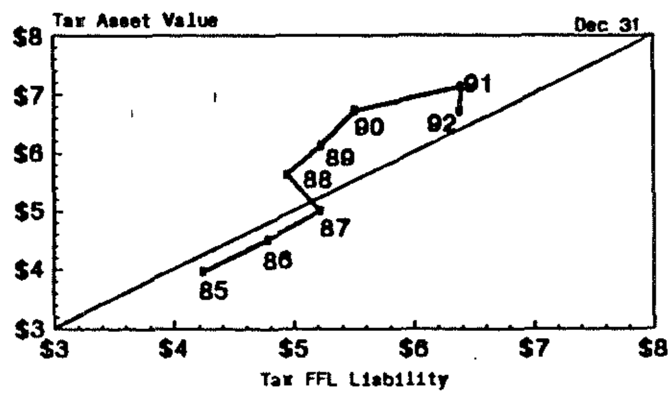



$ in Billions

Figure 11

## Tax Full Funding Limit

SBC Both Plans




$ in Billions

Figure 12