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Witness:	*Matthew R. Young*
Sponsoring Party:	*MoPSC Staff*
Type of Exhibit:	*Surrebuttal Testimony*
Case Nos.:	*GR-2017-0215* *GR-2017-0216*
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MISSOURI PUBLIC SERVICE COMMISSION

COMMISSION STAFF DIVISION

AUDITING

SURREBUTTAL TESTIMONY

OF

MATTHEW R. YOUNG

SPIRE MISSOURI INC. d/b/a SPIRE
LACLEDE GAS COMPANY and MISSOURI GAS ENERGY
GENERAL RATE CASE

CASE NOS. GR-2017-0215
and GR-2017-0216

Jefferson City, Missouri
November, 2017

** <u>Denotes Confidential Information</u> **

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Q. Please state your name and business address.

A. Matthew R. Young, Fletcher Daniels Office Building, 615 East 13th Street, Room 201, Kansas City, Missouri, 64106.

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

A. I am a Utility Regulatory Auditor with the Missouri Public Service Commission ("Commission").

Q. Are you the same Matthew R. Young who has previously provided testimony in this case?

A. Yes. I contributed to Staff's Cost of Service ("COS") Report filed on September 8, 2017 in the Laclede Gas Company ("LAC") rate case designated as Case No. GR-2017-0215 and the Laclede Gas Company d/b/a/ Missouri Gas Energy ("MGE") rate case designated as Case No. GR-2017-0216. I also provided rebuttal testimony filed on October 17, 2017.

Q. What is the purpose of your surrebuttal testimony?

A. I will respond to various rebuttal testimonies presented by LAC, MGE, USW Local 11-6 ("USW"), and The Office of the Public Counsel ("OPC") regarding Pensions and

Other Post-Retirement Benefits ("OPEBs") expense, Pension Regulatory Asset, Supplemental Executive Retirement Plan ("SERP") costs, and Incentive Compensation.

PENSION EXPENSE

Q. Please summarize each party's position on ongoing pension expense as they have presented them in rebuttal testimony.

A. LAC and MGE are recommending that rates should reflect pension funding sufficient to achieve a 90% pension funded status. LAC and MGE assert that federal legislation has led to use of overstated discount rates in calculation of pension contribution amounts, which in turn leads to understated required contributions. According to their rebuttal testimony, LAC and MGE support higher funding to minimize the volatility associated with these governmental policies. To further support funding at a 90% funded level, LAC and MGE emphasize that decreases in the unfunded pension obligations (via increased cash contributions) of LAC and MGE will lead to decreases in future costs for Pension Benefit Guarantee Premiums ("PBGC").

OPC's position on pension funding is to set rates equal to pension expense as calculated under GAAP accounting standard FAS 87. OPC argues against setting rates on the funded status because that does not address understated pension liabilities, which leads to future ratepayers bearing the costs of today's obligations. Also, OPC argues that setting rates based on Employee Retirement Income Security Act ("ERISA") minimums increases the exposure of the utility to excessive fees and risks. Moreover, according to OPC, setting rates on the accrual accounting based FAS 87 method will address the inter-generational inequity issues that may arise in pension ratemaking.

Staff's position is to set rates equal to the ERISA funding requirements, which specifies that the target for funding pension liabilities should be calculated to achieve an 80% funded status. Staff takes this position because it remains to be seen if a rebound in market interest rates, expected by the federal legislators, will eventually be realized by the market.

Q. Do the positions presented by the parties carry a common concern?

A. Yes. All of the positions presented in direct and rebuttal testimonies on ongoing pension funding express concern about the assumptions used to calculate pension costs, inter-generational inequity issues, and the level of PBGC premiums. However, the party's recommendations deviate on the method required to address the concerns.

Q. Please provide an example.

A. LAC and MGE cite an "artificially high" discount rate as a reason to collect pension contributions from customers sufficient to move the pension fund to a 90% funded status[1] and OPC believes the under-valuation of the pension liability understates the actual costs incurred by today's ratepayers.[2] While the parties share similar concerns about assumptions leading to an incorrect representation of the actual costs for pensions, each party has a different recommendation for ongoing pension funding. LAC and MGE recommend rates sufficient to fund 90% of their pension liabilities, Staff recommends rate sufficient to fund 80% of their pension liabilities, and OPC recommends rates should be set based on FAS 87 expense.

[1] Buck rebuttal, page 10, lines 3-14
[2] Pitts rebuttal, page 6, lines 7-10

Q. Given the uncertain nature of the assumptions and market rates used to calculate LAC's and MGE's current pension liability, is Staff opposed to LAC's and MGE's recommendation to move the pension plans to a 90% funded status?

A. Yes. Staff's position is the most conservative as it relies on funding levels that are statutorily required. Staff's concern with LAC's and MGE's position is that LAC's and MGE's solution to solving issues with the pension-related assumptions is to raise rates. This solution addresses some of the issues, but it is at the expense of ratepayers.

Q. You mentioned the parties are concerned about intergenerational inequity. Did Staff consider the effect today's rates will have on future ratepayers?

A. Yes. If contributions to the pension trusts are set too high in rates, it could lead to a scenario where LAC and MGE obtain a funded status in excess of 100% in the future. Under this scenario, required contributions will fall to zero and PBGC premiums will be minimalized. While future ratepayers will enjoy the low cost of pensions, current ratepayers will bear the burden. To compare Staff's and the Company's direct cases, the additional ratepayer burden created by moving from Staff's position to LAC's and MGE's position is $2 million in the LAC jurisdiction and $5 million in the MGE jurisdiction (amounts subject to change in true-up).

Q. Has LAC or MGE provided evidence that establishing funding sufficient to achieve a 90% funded status is equitable for current and future ratepayers?

A. No. Paragraph 7 of the Stipulation and Agreement in LAC's prior rate case, Case No. GR-2013-0171, states that contributions made to avoid PBGC premiums shall be included in LAC's rate base in the next rate case. Given this stipulated permission, LAC could have been making contributions sufficient to reduce current and future costs since the conclusion of the prior rate case. If LAC has not made additional contributions to reduce current costs because it was concerned about rate case treatment, LAC could have simply performed a cost-benefit analysis showing PBGC premium savings to support the contributions made to the pension trust. The analysis could have measured the PBGC premium savings related to contributions that will be enjoyed by future ratepayers by comparing PBGC premiums actually incurred and PBGC premiums that would have been incurred with minimum required contributions.

Q. OPC recommends that FAS 87 expense should be used to set current rates. Do you agree with this recommendation?

A. No, I disagree for two reasons. The first reason is that over recent years, the FAS 87 expense calculated by LAC's actuary has been less than the amount of contributions required by federal law under the ERISA standards. The following is a comparison of LAC FAS 87 and LAC's ERISA minimum contributions:

Fiscal Year	**FAS 87 Expense[3]**	**ERISA Minimum[4]**	**Shortfall**
2016	$11,703,607	$18,392,819	$6,689,212
2015	$14,248,643	$15,824,478	$1,575,835
2014	$14,225,003	$16,912,859	$2,687,586

Historical costs suggest that setting rates based on FAS 87 expense would not provide the cash sufficient to make the contributions required by the ERISA legislation. ERISA is federal legislation enacted in 1974 that sets minimum standards for pension funding.

[3] Source: Staff Data Request 65 – Actuary Reports
[4] Source: Pitts rebuttal – page 4, line 1

Secondly, FAS 87 has been utilized to set utility rates in the past. Staff's experience is that using FAS 87 for ratemaking leads to a considerable amount of disagreement regarding the assumptions used to calculate FAS 87. Some of these controversial assumptions include market related value vs. market value of assets, amortization periods of gains and losses, and the utilization of the corridor approach vs. no corridor approach in determining the expense amount. Also, FAS 87 expense is susceptible to changes in actuarial assumptions between periods as well as the actual return on assets compared to the expected return on assets. In historical LAC rate cases, ratemaking methodology has gone back and forth between FAS 87 expense and the contributions method, but LAC's rates have been on the contribution method since Case No. GR-2002-356.

Q. Both the utilities and OPC are concerned about unnecessary exposure to PBGC premiums resulting from the funding levels set in this case. Is Staff aware of how current funding affects future PBGC premiums?

A. Yes. In my rebuttal testimony in this case, I explored PBGC premiums at length. LAC and MGE propose to reduce future PBGC premiums by increasing current contributions to the pension trust. However, contributions to the pension trust are not the only method to increase the value of the pension assets. Pension assets also increase when the assets in the trust earn a return that is larger than the collective amounts that decrease the trust assets. The 2012 federal legislation, Moving Ahead in the 21st Century Act ("MAP-21"),[5] anticipated that as market rates rebounded, the return earned by pension trusts would increase. Staff's position is conservatively optimistic that future PBGC premiums can be avoided by an

[5] The provisions in MAP-21 and subsequent legislation will be in effect through the year 2021, absent additional legislation.

increase in the return on pension assets, and that a current increase in the amount of pension expense collected from customers for pension funding is not necessary to minimize PBGC premiums.

Q. Will higher contributions lead to reduced PBGC premium costs?

A. That seems like a logical conclusion. However, PBGC premiums will not be reduced until the variable component of the PBGC premium assessment are below the maximum premium ceiling. In 2017, the PBGC variable rate premiums were assessed by multiplying $34 by each $1,000 of unfunded vested benefits. However, the variable rate premiums are capped at $517 for each plan participant. During the 2017 plan year, MGE's PBGC variable rate premiums were limited to the maximum amount permissible.[6] In order for MGE's variable rate premiums to be less than the maximum amount, MGE's unfunded vested benefits need to be reduced by 29%. Staff has submitted a data request related to LAC's variable rate premium calculation.

PENSION ASSET

Q. Please summarize each party's position on LAC's prepaid pension asset as they have presented them in rebuttal testimony.

A. Staff supports a prepaid pension asset equal to the difference between cash contributions to the pension trust and cash collected in rates since March 31, 2010, the true-up date in Case No. GR-2010-0171, added to the March 31, 2010 book balance of LAC's prepaid pension regulatory asset. Staff then adjusted the balance for pension costs deferred prior to September 1, 1994, a time when rates were not set with regard to FAS 87 expense.

[6] Staff Data Request No. 65

OPC agrees with Staff's calculation of the prepaid pension asset, with the exception of cash contributions made in excess of the minimum required by ERISA. LAC supports the inclusion of the booked pension asset, which represents deferred pension costs since October 1, 1987, the date LAC first implemented FAS 87 accounting guidance for financial reporting purposes.

Q. OPC recommends the pension asset should be adjusted for approximately $60 million because that is the amount of "excess contributions" which were made in excess of the minimum required.[7] Do you agree with this adjustment?

A. No. Paragraph 7 of the Stipulation and Agreement from LAC's prior rate case, GR-2013-0171, states that LAC shall be allowed rate recovery for contributions it will make to avoid benefit restrictions specified by the Pension Protection Act of 2006 ("PPA"). Staff's belief is that LAC has contributed funds sufficient to avoid the restrictions outlined in the PPA.

Q. What amount is LAC supporting for the prepaid pension asset in the current rate case?

A. LAC recommends that rate base include deferred pension costs that have accumulated since LAC implemented FAS 87 for financial reporting purposes in 1987.

Q. Has LAC sought to include a pension asset in rate base in every rate case since 1987?

A. No. Staff has examined the accounting schedules in LAC's various rate cases between October 1, 1987 and September 1, 1994 and finds that both LAC's and Staff's accounting schedules do not itemize a pension asset in rate base.

[7] Pitts rebuttal, page 3, lines 6-8

Q. When was a prepaid pension asset first proposed to be included in rate base for ratemaking purposes?

A. A review of prior case's workpapers and testimony indicate that LAC's rate base did not consider deferred pension costs until Case No. GR-96-193. In that case, LAC witness Waltermire supported a prepaid pension asset in LAC's rate base.

Q. Did the Company seek to include in its rate base all costs deferred after the 1987 implementation of FAS 87?

A. No. In his direct testimony in Case No. GR-96-193, LAC witness Waltermire testified the following:

> Q. You are also sponsoring the inclusion of the Company's net prepaid pension asset in rate base. How was the amount to be included in rate base determined?
>
> A. The prepaid pension asset included in rate base represents estimated April 30, 1996 accrued pension liability and prepaid pension assets account balances for all Company sponsored retirement plans (excluding the SERP and Directors' plans) **that have occurred since September 1, 1994, the effective date of tariffs in Case No. GR-94-220.**[8] [emphasis added]

Q. Did Staff concur with Mr. Waltermire on the timing to measure the prepaid pension asset to include in rate base?

A. Yes. Staff witness Gibbs filed direct testimony in Case No. GR-96-193, and testified the following:

> Q. What caused the Prepaid Pension Asset that you have included in rate base?
>
> A. The Prepaid Pension Asset is the result of adopting FAS 87 for the calculation of pension expense for ratemaking.

[8] Waltermire direct, page 5, lines 12 – 20, Case No. GR-96-193

> Q. How does the adoption of FAS 87 for rates create an asset that is includable for rate base?
>
> A. Prior to the effective date (September 1, 1994) of the rates established in Laclede's last rate case, the cost of service included pension expense determined on a cash contribution basis. What was booked or allowed in rates and the contributions to pension funds were theoretically the same. This has changed now that rates are being established based on the FAS 87 accrual. It is very unlikely that the actuarially determined expense level in any given year will be the same as the amounts contributed to the pension funds. In simple terms, the prepaid pension asset is the amount of contributions in excess of the FAS 87 accrual.
>
> Q. How was the prepaid pension asset balance included in rate base determined?
>
> A. The activity in the Company's prepaid pension asset and pension liability accounts were examined **for the period September 1, 1994 through April 30, 1996**. The amount included in rate base as the prepaid pension asset is the net contribution that exceeded the accrued expense exclusive of incentive compensation and FAS 88 gains and losses.[9] [emphasis added]

Based on the testimony presented in Case No. GR-96-193, both Staff and LAC were in agreement on the methodology to calculate the prepaid pension asset.

Q. Did LAC continue this methodology in its next rate case?

A. No. In Case No. GR-98-374, LAC witness Fallert (then employed as the Controller of LAC) testified in his direct testimony as follows:

> Q. You are also sponsoring the inclusion of the Company's net prepaid pension asset in rate base. How was the amount to be included in rate base determined?
>
> A. The prepaid pension asset included in rate base represents estimated June 30, 1998 accrued pension liability and prepaid

[9] Gibbs Direct, page 10, line 18 through page 11, line 13, Case No. GR-96-193

> pension asset account balances for all Company sponsored retirement plans (excluding the SERP and Directors' plans).[10]

This testimony implies LAC no longer calculated its pension asset beginning on September 1, 1994. Unfortunately, LAC offered no testimony on why it changed its ratemaking methodology.

Q. In the subsequent rate case, did Staff continue to calculate LAC's prepaid pension asset beginning with September 1, 1994 consistent with both party's calculations in Case No. GR-96-193?

A. Yes. In its direct testimony in Rate Case No. GR-98-374, Staff testifies the following:

> Q. Explain the relationship between Laclede's Prepaid Pension Asset at June 30, 1998 and their cost of service for this case.
>
> A. Laclede's Prepaid Pension Asset at June 30, 1998 must be adjusted before putting it in Rate Base for this case. The Prepaid Pension Asset at June 30, 1998 represents the accumulated difference between FAS 87 & 88 pension cost and cash contributions to the pension fund since 1987. However, FAS 87 was not used for rate making purposes for Laclede prior to the effective date of rates in Case No. GR-94-220 which was September 1, 1994. The Prepaid Pension Asset included in Rate Base should include only the accumulated cash flow difference between FAS 87 pension cost included in rates and the cash contributions to the pension fund since Sept 1, 1994.[11]

While LAC changed the methodology in Case No. GR-98-374, without explanation, used to calculate the rate base effect of the prepaid pension asset; Staff has maintained the adjustment to the booked asset in every LAC rate case since Case No. GR-94-220. Until this case, LAC had not written testimony responsive to Staff's adjustment to LAC's prepaid pension asset.

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[10] Fallert Direct, page 10, lines 16-23, Case No. GR-98-374
[11] Traxler direct, page 22, lines 22 – 23 through page 23, lines 1-8, GR-98-374

Q. LAC's rebuttal testimony in the current case provides "historical background that would provide the Commission with some additional context for this issue."[12] Does the testimony presented in historical rate cases (quoted above) support the historical background given by LAC in the current case?

A. No. LAC's rebuttal testimony in the current case would lead the reader to believe that since FAS 87 is used by LAC to account for pension expense, rates were also set based on the pension expense produced by FAS 87. The direct testimony of Staff in Case Nos. GR-94-220 and GR-96-193 (above) explains why that is simply not the case. Staff's testimony in Case Nos. GR-94-220 and GR-96-193 provides an explanation of why adopting FAS 87 for ratemaking produced an asset after September 1, 1994. It is evident in LAC's GR-96-193 direct testimony that LAC agreed with the methodology since it calculated the asset in the same manner.

Q. So although LAC has followed FAS 87 for financial reporting purposes since 1987, were rates not set using FAS 87 expense at that time?

A. No. In response to LAC's rebuttal testimony in this case, LAC appears to have overlooked a fundamental ratemaking concept embedded in accounting adjustments. The purpose of making adjustments in a rate case is to alter a test year balance to an annualized or normalized level regardless of how the test year balance was booked by a company. So when LAC states, "Since expense recognition under normal ratemaking practice starts with the amounts of expense on the company's books, it follows that rates continued to be based on expense since there in no indication to the contrary,"[13] its logic is flawed. To Staff's

[12] Fallert rebuttal, page 4, lines 16 - 18
[13] Fallert rebuttal, page 5, lines 10 – 12

knowledge, pension expense is an item that is examined and adjusted in every large rate case. Through examination of prior Laclede rate cases, both the Company and Staff examined and adjusted pension expense in every Laclede rate case from FAS 87 levels.

Q. Does LAC admit that rates can, and have, been established using a methodology that deviates from GAAP FAS 87 expense?

A. Yes. In Case No. GR-2005-0284, Mr. Fallert testified the following:

> Q. Does Laclede use the calculation of pension expense for financial reporting purposes as described above in setting customer rates?
>
> A. No. Rates were set on an alternative basis pursuant to the stipulation and agreement in the Company's previous rate case, No. GR-2002-356.[14]

The alternative basis Mr. Fallert refers to is the cash contributions method, which is an alternative to setting rates on FAS 87 expense.

Q. Does LAC's rebuttal testimony in this case identify an instance where pension expense would not be set on the accrued FAS 87 expense?

A. Yes. LAC states, "Since GAAP requires pension accruals pursuant to FAS 87 and FAS 88, it logically follows that rates are based on expense calculated according to these standards unless there is evidence that the Commission has specifically authorized a different methodology."[15]

Q. Is there evidence that the Commission authorized a different methodology prior to September 1, 1994?

A. Yes. Besides the testimony filed in LAC's rate cases immediately after Case No. GR-94-220, there is more evidence to be found. In Case No. GR-92-165, LAC's rate

[14] Fallert direct, page 12, lines 4 – 7. Case No. GR-2005-0284
[15] Fallert rebuttal, page 4, lines 7 – 10, Case No.GR-2017-0215

case immediately prior to the 1994 case, both Staff and LAC filed direct testimony supporting the use of the use of cash contributions to set pension expense. Since Staff and LAC had the same methodology, and other parties did not present a different position, it is likely rates were set using the current level of cash contribution instead of FAS 87 expense. In Case No. GR-92-165, LAC witness Waltermire testified the following in his direct testimony on page 5:

> Q. What is your next adjustment?
>
> A. Adjustment 5.a., detailed on Schedule 15 of Section J, adjusts the combined cost of all Company pension and retirement income plans, (hereafter referred to collectively as "pension" or "pensions") to a contribution (or cash payment) level.
>
> Q. What is the basis of this adjustment?
>
> A. The basis of this adjustment is to record and include in the Company's cost of service annualized pension cost of $1.9 million to be paid by Laclede to fund pensions for the plan year ending September 30, 1992.
>
> Q. Does the Company currently employ a contribution basis to determine the level of pension costs for financial reporting purposes?
>
> A. No, for financial reporting purposes, the Company records its pension cost on an accrual basis in accordance with Generally Accepted Accounting Principles (GAAP).
>
> Q. Why has Laclede proposed using annualized contribution levels as the appropriate basis for establishing rates?
>
> A. The Company has proposed using annualized contribution levels as the appropriate basis for establishing rates because it provides a less volatile, more stable determination of overall pension costs from year to year. Since stability in rates is an important objective in ratemaking, the contribution method would be a more appropriate basis to use in new rates.[16]

[16] Waltermire direct, page 5, lines 2 – 27, Case No. GR-92-165

In its direct case in Case No. GR-92-165, Staff witness Rackers filed a position in agreement with Mr. Waltermire:

> Q. What approach has the Staff utilized in determining the appropriate level of pension expense?
>
> A. The Staff has utilized a contribution approach in determining the appropriate level of pension expense. The Staff recommends a contribution equal to the Employee Retirement Income Security Act (ERISA) minimum for the plan year ending September 30, 1992 for qualified pensions…[17]

Q. The direct testimonies in Case Nos. GR-92-165 and GR-96-374 show that Staff and LAC were generally aligned with regard to pension expense. Should those testimonies be taken into consideration while considering the prepaid pension asset in this case?

A. Yes. Staff finds the sworn testimony of LAC and Staff witnesses that were knowledgeable of the issue during the era in question to be more persuasive than the conclusions drawn by LAC more than 20 years later.

Q. LAC and MGE contend that during the period prior to September 1, 1994, not only was FAS 87 used for ratemaking purposes, FAS 88 was also used for setting rates. Does testimony exist that refutes LAC's and MGE's contention?

A. Yes. In LAC Case No. GR-96-193, the rate case immediately following the time period in question, Staff witness Gibbs testified the following:

> Q. What is FAS 88 and why was it excluded in the determination of the prepaid pension asset?
>
> A. FAS 88 deals with the current recognition of gains and losses related to settlements and curtailments of pension plans. The Company's employees have the option at retirement to accept annuity payments or a lump sum distribution. A lump

[17] Rackers direct, page 5, line 29 through page 6, line 4, GR-92-165

> sum distribution, for purposes of FAS 88, is a settlement requiring the recognition of a gain or a loss. During the period under review for the prepaid pension asset, the Company recorded almost $8 million in net FAS 88 gains. To record the gains, the Company would credit (or reduce) pension expense and debit (increase) the prepaid pension asset. FAS 88 gains and losses are permanent, that is, there will not be any contributions made to the pension funds in the future related to these specific gains and losses to offset the asset that was created when the gain was booked. It would not be appropriate to require the ratepayers to provide a return on an "asset" that was the result of a Company gain.

Q. Beginning on page 8 of its rebuttal testimony in the current case, LAC discusses the impact of Staff's recommendation under the GAAP FAS 71 accounting guidance. Please summarize LAC's testimony on FAS 71.

A. LAC states that it will be required under FAS 71 to record a regulatory liability to recognize that a portion of the prepaid pension asset is not recoverable through rates. The other side of the accounting entry would be a charge to pension expense. LAC goes on to cite the Stipulation and Agreement in Case No. GR-94-220, specifically a provision that states the Commission shall not consider any regulatory liability balances related to FAS 87. Laclede believes that the Stipulation and Agreement in that case prohibits the adjustment proposed by Staff in this case regarding quantification of the prepaid pension asset.

Q. From Staff's perspective, does the Stipulation and Agreement filed in Case No. GR-94-220 prohibit Staff's recommendation?

A. No. If the regulatory liabilities referenced in the Case No. GR-94-220 Stipulation and Agreement prohibited Staff's recommended adjustment to LAC's prepaid pension asset, LAC witness Waltermire would not have calculated the asset in the same manner in the following rate case. As is quoted above, during the rate case immediately following Case No. GR-94-220, LAC calculated the prepaid pension asset in rate base beginning with the effective date in rates in Case No. GR-94-220. The amount of prepaid pension asset at issue in this case relates to the costs deferred prior to Case No. GR-94-220.

Also, the Stipulation and Agreement only precludes consideration of FAS 87 liabilities existing on the books of Laclede as of the effective date of the tariff sheets authorized in that case. Staff's recommendation in this case does not consider any regulatory liability balances as of September 1, 1994.

Q. Do you agree with LAC's analysis of the accounting entries required under FAS 71?

A. No. After reviewing FAS 71, I cannot identify GAAP guidance that would dictate the creation of a new regulatory liability if Staff's prepaid pension asset adjustment is adopted. However, I do agree that in the event that the amount of a prepaid asset is determined, LAC's accountants and external auditors will need to form a consensus on the correct GAAP accounting. Staff's recommendation reflects a long-standing position (which was LAC's position at one point in time) that a portion of LAC's booked prepaid pension asset is not recoverable in rates.

Q. Are there any other considerations for the Commission to consider regarding pension funding?

A. Yes. USW's rebuttal testimony stresses the importance of the ability for LAC and MGE to meet its pension obligations.

Q. Does Staff agree with USW's concerns?

A. Yes. Staff fully supports funding LAC's and MGE's pension contributions through rates and the inclusion of a pension asset in LAC's rate base. While Staff's position limits the amount of LAC's rate of return to what was historically supported, Staff's position does not affect LAC's ability to fund future pension costs.

SERP EXPENSE

Q. Please summarize the difference between Staff's normalized SERP expense and LAC's and MGE's normalized SERP expense.

A. Staff's adjustment differs from LAC's and MGE's adjustment largely because of a timing issue. While Staff normalized SERP expense using fiscal year data as of twelve months ending September 30, LAC and MGE normalized SERP expense using calendar year data.

Q. Why did Staff choose to use fiscal year data in its normalization?

A. The true-up date in this case is September 30, 2017, which coincides with the end of LAC's fiscal year. By organizing historical SERP payments by fiscal year, there will be another 12 month period to consider for the true-up SERP expense adjustment. Data organized by calendar year would leave a nine month period on the end of the analysis.

Q. Please summarize OPC's position on SERP expense.

A. OPC's position annualizes annuity payments that were ongoing as of June 30, 2017, after normalizing what OPC deemed an "excessive payment." OPC is also opposed to including lump sum SERP payments in the cost of service and recognizing the accounting practice of capitalizing SERP expense.

Q. What is OPC's rebuttal testimony regarding Staff's position?

A. OPC's rebuttal testimony covers several aspects of Staff's SERP expense adjustment. OPC criticizes Staff's position for 1) its departure from prior Staff methodologies in other utility rate cases including the application of Mr. Hyneman's idea of a "reasonableness test", 2) capitalization of SERP expense, 3) violation of the known-and-measurable standard, and 4) assignment of LAC SERP costs to MGE.[18]

Q. Regarding OPC's discussion of prior Staff methodologies in other utility rate cases, do you believe Staff has a blanket approach to SERP expense?

A. No. OPC's lengthy testimony comparing Staff's current case to Staff's methodology in prior Kansas City Power & Light ("KCPL") rate cases can, for the most part, be disregarded. In each large utility rate case, Staff examines SERP expense, and the circumstances that drive SERP expense, to form a recommendation relevant to each utility. Since SERP expense is audited on a case-by-case basis, Staff does not have a blanket approach to annualize or normalize SERP costs.

Q. Is there evidence that Staff's position on LAC's SERP costs in the current case is not fundamentally different than in prior LAC rate cases?

A. Yes. In LAC Rate Case No. GR-2010-0171, Staff's Cost of Service Report describes the SERP treatment as, "…a five-year average of the actual payments for the period October 1, 2004 through September 30, 2009." In the current case, Staff again utilized a multi-year average of actual SERP payments to calculate normalized SERP expense. Also included in Case No. GR-2010-0171 is Staff's support of applying a capitalization ratio to normalized SERP costs. I presented facts outlining this prior Staff position in my rebuttal testimony. Staff's position of capitalized SERP costs in prior LAC rate cases is also contrary to what OPC has outlined as Staff's historical methodology. Ultimately, Staff cannot find evidence of a LAC rate case that Staff has not supported capitalized SERP costs, which is contrary to OPC's belief of "Staff's methodology".

[18] Hyneman rebuttal, pages 16 - 31

Q. Regarding SERP expense, what has OPC's position been in prior LAC rate cases?

A. Staff is not aware of any OPC testimony in prior LAC rate cases that present a position on ongoing SERP costs.[19]

Q. OPC discusses the known-and-measurable standard in its rebuttal testimony. What is the known-and-measurable standard?

A. While annualizing or normalizing costs to include in a utility's rates, those costs must have already been incurred or will undoubtedly be incurred in the future (known). The quantity of costs must also be measurable with certainty (measurable). An example of applying the known-and-measurable standard to a utility's cost is a typical payroll adjustment. A utility that has occurred payroll costs in the past and will undoubtedly incur payroll costs in the future has met the "known" portion of the standard. However, payroll costs are not measurable in the future because of variations in wages, headcount, and employee turnover. Since future payroll costs are variable, the current payroll costs represent the most recent payroll costs that are measurable for ratemaking purposes.

Q. Do you agree with OPC that since Staff included historical lump-sum payments in its normalization, Staff did not apply the known-and-measurable standard in this rate case?

A. No. Staff examined actual SERP payments made during the years prior to September 30, 2016. These costs are known-and-measurable because they have already been incurred and the size of each payment is certain. OPC criticizes Staff because it believes that

[19] In LAC Rate Case No. GR-2010-0171, OPC submitted testimony regarding the use of a tracker for SERP costs, but did not oppose overall SERP costs.

lump-sum payments are unpredictable in timing and in size. Contrary to OPC's conclusion, Staff has reviewed the frequency of LAC's historical lump-sum SERP payment activity, which is displayed below:

Fiscal Year[20]	2010	2011	2012	2013	2014	2015	2016
No. of Lump-Sums	1	3	2	4	2	2	1
No. of New Annuities	0	0	0	0	0	0	0

Historical experience of known-and-measurable SERP costs show that lump-sum payments can be reasonably expected to recur and OPC's position does not correctly recognize the recurring nature of lump-sum payments. As noted above, lump-sum SERP payments have been made in each of the last 7 years; therefore, it is not appropriate to simply ignore these actual costs unless they are determined to be unreasonable or imprudently incurred.

Q. Did Staff consider any special circumstances in its analysis of lump-sum payments?

A. Yes. One of the lump-sum payments in 2012 is tied to the departure of the Laclede Group's former CEO. Staff does not expect a CEO's departure to be a recurring driver of SERP cost. This is one reason Staff did not include 2012 in its normalized SERP expense. However, the remaining SERP payments represent the departure of various other highly-compensated employees, which Staff believes is a recurring driver of SERP expense.

Q. For the recurring lump-sum payments, did Staff address the volatility of the amounts of SERP payments?

[20] Staff does not have complete data for the fiscal year 2017

A. Yes. Staff recognized the volatility related to the size of SERP payments and chose to average historical payments. The effects of volatility are negated by the attributes of averages. In other words, the purpose of an average is to combine high data points with low data points to produce a <u>going-forward</u> amount. This normalization technique is used regularly in other cost areas of a rate case. The most comparable expense that is normalized is injuries and damages, which are sporadic and highly volatile in nature.

Q. Beginning on Page 30 of Mr. Hyneman's rebuttal testimony, OPC opposes assigning LAC's SERP costs to MGE. Do you agree with OPC's argument?

A. No. OPC is disregarding a fundamental ratemaking concept regarding the methods and purpose of setting rates. Generally, annualized or normalized costs are based upon historical data but the purpose of using historical data is to form a representation of <u>future</u> costs. In the current case, Staff has assigned SERP costs to the MGE jurisdiction because MGE will benefit from the services of current and future LAC employees. Assigning SERP costs to MGE in this rate case is reflective of MGE's benefit of costs incurred by LAC going forward.

<u>INCENTIVE COMPENSATION</u>

Q. Please summarize the rebuttal testimony of the other parties.

A. USW Local 11-6 Witness Boyle presented rebuttal testimony stressing the importance of incentive compensation to his union, LAC and MGE, and the ratepayers. LAC and MGE witness Buck presents testimony arguing against Staff's incentive compensation adjustment to plant in service and the accumulated depreciation reserve. Also, LAC witness Mispagel rebuts Staff's overall position on incentive compensation for various reasons.

Q. Regarding LAC's response on Staff's adjustment to plant in service and the accumulated depreciation reserve, what is LAC's argument?

A. First LAC recognizes that Staff's adjustment to rate base is a byproduct of Staff's overall position on incentive compensation. LAC believes that all of its incentive compensation is justified, so no adjustment to rate base is necessary from its perspective.

Q. Does LAC argue that no matter what determination is made on this issue, there is another reason an adjustment to rate base is inappropriate?

A. Yes. LAC states that its legal counsel advises that, "…it would be legally impermissible to change the treatment of rate base items that were included in rates…" as a result of a previous rate case. LAC goes on to explain its belief that the negotiations that occurred during LAC's prior rate case disposed of the incentive compensation issue and this issue is now closed.[21]

Q. Does the Stipulation and Agreement in LAC's prior rate case dispose of the incentive compensation issue?

A. No. The Stipulation and Agreement in Case No. GR-2013-0171 does not identify incentive compensation. Staff's positions in the two previous LAC rate cases were to remove disallowed amounts of incentive compensation from plant-in-service and accumulated depreciation reserve. Also, from Staff's perspective, capitalized incentive compensation was not included in rate base in LAC's prior case.

Q. Does the Stipulation and Agreement in LAC's prior rate case contain language that indicates this issue is not disposed of?

[21] Buck rebuttal, page 22, line 18 through page 23, line 7

A. Yes. Since incentive compensation was not expressly specified, the appropriate language is in paragraph 27 of the Stipulation and Agreement in GR-2013-0171, which states the following:

> 27. Except as otherwise expressly specified herein, none of the signatories to this Stipulation and Agreement **shall be deemed to have approved or acquiesced in any ratemaking or procedural principle, including, without limitation, any method of cost determination** or cost allocation, depreciation or revenue-related method, or any service or payment standard; and **none of the signatories shall be prejudiced or bound in any manner by the terms of this Stipulation and Agreement** in this or any other Commission or judicial review or other proceeding, except as otherwise expressly specified herein. **Nothing in this Stipulation and Agreement shall preclude the Staff in future proceedings from providing recommendations** as requested by the Commission nor limit Staff's access to information in any other proceedings. Nothing in this Stipulation and Agreement shall be deemed a waiver of any statute or Commission regulation. [emphasis added]

Q. Other than incentive compensation adjustments to rate base, are there additional disagreements between LAC and Staff regarding incentive compensation?

A. Yes. LAC's rebuttal of Staff's overall position on incentive compensation is presented by LAC witness Mispagel. The overall incentive compensation issue can be separated into two categories. The first disagreement involves incentive compensation related to financial benchmarks such as financial earnings and the second disagreement involves incentive compensation related to the usefulness of individual metrics.

Q. Regarding incentive compensation based on financial earnings, has this issue been brought to the Commission in LAC and other utility rate cases?

A. Yes, in several cases beginning as early as 1987 and most recently in KCPL's Case No. ER-2007-0291. Staff is aware of the following cases in which the Commission decided against allowing in rates incentive compensation tied to financial benchmarks:

- EC-87-114 Union Electric
- TC-89-14 Southwestern Bell
- TC-93-224 Southwestern Bell
- GR-96-285 Missouri Gas Energy
- GR-2004-0209 Missouri Gas Energy
- ER-2006-0314 Kansas City Power & Light
- ER-2007-0291 Kansas City Power & Light

Q. In historical rate cases, has the Commission, or Staff, attempted to design a utility's incentive compensation program?

A. No. Overall, the Commission has decided that while the utility has every right to offer whatever compensation packages it wants, those costs should be borne by shareholders if they show no tangible benefit to ratepayers. This point is important while considering USW's rebuttal testimony, which expresses concern about exclusion of these costs in rates. By applying the Commission's past guidance on this issue to the current rate case, Staff is not attempting to reduce the total compensation of LAC and MGE employees.

Q. How has the Commission decided earnings-based incentive compensation in the previous rate cases?

A. The Commission has determined that compensation based on corporate earnings is focused on shareholder wealth maximization and should be assigned to the shareholders. Also, corporate based earnings provide an incentive for management to focus on the non-Missouri regulated portions of the overall corporate structure (including non-regulated business segments and out-of-state utilities), which could be to the detriment of Missouri-regulated ratepayers. Lastly, the Commission has expressed concern that an incentive to maximize earnings could compromise service to ratepayers by reducing costs that are related to the quality of service. The Commission historical decisions are summarized in its Report and Order in KCPL's rate case, Case No. ER-2007-0291. Beginning on page 49 of that Report and Order:

> KCPL has the right to tie compensation to EPS. However, because maximizing EPS could compromise service to ratepayers, such as by reducing maintenance, the ratepayers should not have to bear that expense. What is more, because KCPL is owned by Great Plains Energy, Inc., and because GPE has an unregulated asset, Strategic Energy L.L.C., KCPL could achieve a high EPS by ignoring its Missouri ratepayers in favor of devoting its resources to Strategic Energy. Even KCPL admits it is hard to prove a relationship between earnings per share and customer benefits. Nevertheless, if the method KCPL chooses to compensate employees shows no tangible benefit to Missouri ratepayers, then those costs should be borne by shareholders, and not included in cost of service. [footnotes omitted]

Q. Is LAC and MGE aware of the prior Commission decisions listed above?

A. Yes. LAC and MGE express their disappointment with prior commission decisions in their rebuttal testimony.[22]

Q. In LAC's and MGE's rebuttal testimony, they make the statement, "The Commission should not only compensate management for financial and operational incentives, but should question any company that does not have such incentives." Does Staff agree with LAC's and MGE's opinion?

A. No. Staff believes the Commission should question a utility that is fully aware of several Commission decisions that protect customers from the risks inherent in earnings based incentive compensation but does not consider the Commission's concerns while structuring its compensation package.

[22] Mispagel rebuttal, page 9, line 20 through page 10, line 12

Q. Regarding Staff's review of LAC's and MGE's individual component of the incentive compensation plan, what criteria did Staff use to evaluate the individual objectives?

A. As outlined in Staff's Cost of Service Report,[23] Staff reviewed the goals for individual incentive compensation with the following criteria:

- Goal provides the employee an incentive to perform at a level that is above what is already required for the applicable job title
- Goal is objective and measurable
- Goal is related to Missouri regulated operations
- Goal requires improvement over past performance
- Goal, if achieved, shows a direct link to overall ratepayer benefit

Q. What is LAC's and MGE's response to the criteria used by Staff?

A. LAC and MGE state their agreement with the first three criteria listed above, but is of the opinion that those criteria are reflected in individual goals. LAC and MGE do not concur that the last two criteria are necessary to structure effective incentives.[24]

Q. Why did Staff choose the first criterion, which expects goals to incent employees to perform at a level above what is required in their regular job duties?

A. The purpose of the incentive compensation plan is to place a portion of each employees market compensation "at-risk". The compensation is at-risk because if the employee fails to meet the goals set during the plan year, they will receive compensation that is <u>less</u> than their target compensation. Conversely, if an employee exceeds their individual goals, they will receive <u>more</u> than their target compensation. If goals are set that do not challenge an employee to perform above what is already required, their compensation is no longer at-risk, but is compensation that is practically guaranteed. During the plan year 2016,

[23] Staff Cost of Service Report, page 103, line 10 - 15
[24] Mispagel rebuttal, page 11, line 13 through page 12, line 2

LAC's and MGE's actual payout for individual incentive compensation was approximately 13% above the individual target (market) compensation. Utility rates should not include compensation that is above market compensation only because they individual metrics fail to place compensation at-risk.

Q. During your review of individual objectives, did you find that many goals do not place compensation at risk?

A. Yes. Clear examples of how individual objectives are not challenging employees to perform above the level already required are:[25]

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The above examples illustrate goals that are nothing more than expected daily duties of all employees in the performance of work assignments.

Q. Why did you choose the second criterion, which expects goals to be objective and measurable?

A. Goals should be objective and measurable to avoid arbitrary awards to employees due to a lack of a way to measure the employee's performance. The Commission expressed this preference in Union Electric's Case No. EC-87-114. The Report and Order in EC-87-114 states:

[25] Source: Staff Data Request No. 61

> …an acceptable management performance plan should contain goals that improve existing performance, and **the benefits of the plan should be ascertainable** and reasonably related to the incentive plan. [emphasis added][26]

Q. During your review of individual objectives, did you find that many goals were not objective and measurable?

A. Yes. Out of all of Staff's criteria, this is the area where individual objectives failed the most. Examples of goals that were not objective and measurable are:[27]

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Q. Why did you choose the third criterion, which expects goals to be related to Missouri operations?

A. In multiple Report and Orders, the Commission has expressed its preference to assign shareholders incentive compensation costs if incentives are based on earnings that represent total company operations, as opposed to Missouri regulated operations. The Commission most recently expressed its concern in KCPL's Case No. ER-2007-0291, where it discusses KCPL's non-regulated affiliate, Strategic Energy:

> What is more, because KCPL is owned by Great Plains Energy, Inc., and because GPE has an unregulated asset, Strategic Energy L.L.C., it follows that KCPL could achieve a high EPS

[26] In the Matter of Union Electric Company, 29 Mo. P.S.C. (N.S.) 313, 325 (Report & Order, 1987)
[27] Source: Staff Data Request No. 61

> by ignoring its Missouri ratepayers in favor of devoting its resources to Strategic Energy.

Q. During your review of individual objectives, did you find that some goals were not related to Missouri operations?

A. Yes. The individual goals of certain executives are also based on Spire's achievement of earnings. Spire's earnings include the performance of non-regulated, and non-Missouri business units of Spire.

Q. In its rebuttal testimony, LAC and MGE state, "…over the past several years, executives at Laclede, including the CEO, have received incentive compensation for meeting growth objectives."[28] Has Staff reviewed actual individual objectives over the past several years?

A. No. LAC and MGE were only able to provide the individual objectives for plan year 2016. However, based on LAC's and MGE's statement, it appears at least the executive's individual incentives were not strictly based on Missouri regulated operations.

Q. Why did you choose the fourth criterion, which expects goals to require improvement over past performance?

A. Improvement of performance is expressed by the Commission in its Report and Order in Union Electric's Case No. EC-87-114. The Report and Order is quoted above but I will present the order here also:

> …an acceptable management performance **plan should contain goals that improve existing performance**, and the benefits of the plan should be ascertainable and reasonably related to the incentive plan. [emphasis added][29]

[28] Mispagel rebuttal, page 8, lines 15 - 16
[29] In the Matter of Union Electric Company, 29 Mo. P.S.C. (N.S.) 313, 325 (Report & Order, 1987)

Q. During your review of individual objectives, did you find that goals did not require improvement over past performance?

A. Yes. Although this criterion is closely related to Staff's criterion that goals should be objective and measurable, there are certain goals that are measurable but do not call for an improvement of past performance:[30]

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Q. Why did you choose the fifth criterion, which expects goals to incent behavior that leads to the ratepayer's benefit?

A. This criterion is an extension of the Commission's decisions on earnings based incentive compensation. Like corporate earnings objectives, individual goals can be structured that creates a risk that leads to a deterioration of service quality. For example, if a utility cuts costs substantially in the customer service area, this could result in reduction to customer service quality.

Q. During your review of individual objectives, did you find goals that created an environment that is not in the interest of ratepayers?

[30] Source: Staff Data Request No. 61

A. Yes. Some individual objectives appear to be an attempt to shift resources from O&M projects to capital projects. Due to the nature of Missouri Infrastructure System Replacement Surcharge ("ISRS"), shifting resources into capital costs that are eligible for recovery outside of a rate case features a positive regulatory lag effect (from the utility's perspective) but may not be in the ratepayer's interest. Staff reviewed other objectives that are structured to avoid operational exceptions during a regulatory audit. Further, Staff reviewed objectives that are focused on influencing legislation or centered on increasing LAC's and MGE's influence with 3rd party organizations. The actual objectives discussed by this paragraph are shown below:[31]

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Department	**Objective**

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[31] Source: Staff Data Request No. 61

Q. During your review of individual objectives, did you find goals that Staff would support in rates?

A. Yes. LAC and MGE provided Staff with each 2016 individual objective, which amounted to approximately 6,500 lines of goals by employee. While some of the goals were structured in accordance with Staff's criteria, the acceptable goals were a vast minority. The objectives I presented in this testimony are the more illustrative examples of how LAC and MGE have structured their individual incentive compensation plan and the examples are representative of the tone of the individual incentive plan on the whole. Overall, LAC's and MGE's incentive plan fail to accomplish its purpose, which is "to motivate, reward and align the interests of employees with all stakeholders, including customers."[32] LAC and MGE purport to incent this overall objective by placing a portion of each employee's compensation at-risk, but a review of the individual objectives show that the individual incentive plan does not provide the desired incentive.

Q. Have you found evidence that LAC and MGE deemphasize the importance of the individual incentive plan?

A. Yes. For non-union employees, failure to qualify for the individual component of the Annual Incentive Plan does not disqualify the employee from receiving awards for the Company's achievement of its earnings metrics.[33] In other words, a poorly-performing employee can still receive an incentive award as long the overall shareholder earnings expectations are met. For union employees, payouts based on team-level performance are

[32] Mispagel rebuttal, page 5, lines 9 - 10
[33] Staff Data Request No. 61.2

only awarded if the overall shareholder earnings expectations are met.[34] Note that this clause is a negotiated term in the union contracts.

Q. If the Commission were to find that Staff's analysis of the individual incentive plan is flawed, what course of action should the Commission take?

A. If the Commission finds Staff's argument unpersuasive, the Commission should grant individual incentive compensation expense at the recommended 2016 payouts, assuming 100% achievement and be subject to shared services allocations, O&M factors, and 401k loadings. This treatment would recognize that the current individual incentive goals do not incent superior performance, but are instead designed to guarantee compensation to LAC and MGE employees.

<u>SEVERANCE COSTS</u>

Q. Please summarize LAC's and MGE's rebuttal testimony on severance costs.

A. LAC and MGE stated they would not oppose Staff's adjustment for severance costs, other than those severance costs that should have been designated as transition costs.

Q. What was Staff's intent while calculating the severance costs adjustment?

A. Staff's intent was to remove all severance cost from the test year balances held by O&M expense accounts. Staff witness Keith Majors is also addressing severance costs that are classified as transition costs. To the extent Staff members incorrectly adjusted O&M expense accounts, Staff will work with LAC and MGE to correct the adjustment. However, should a difference in philosophy concerning this item between the parties surface during this

[34] Boyle rebuttal, page 2, line 44 -45

case's pendency, Staff reserves the right to present and defend its position in true-up testimony.

Q. Does that conclude your surrebuttal testimony?

A. Yes.

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

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

AFFIDAVIT OF MATTHEW R. YOUNG

STATE OF MISSOURI)
) ss.
COUNTY OF JACKSON)

COMES NOW MATTHEW R. YOUNG and on his oath declares that he is of sound mind and lawful age; that he contributed to the foregoing Surrebuttal Testimony; and that the same is true and correct according to his best knowledge and belief.

Further the Affiant sayeth not.

Matt Young

MATTHEW R. YOUNG

JURAT

Subscribed and sworn before me, a duly constituted and authorized Notary Public, in and for the County of Jackson, State of Missouri, at my office in Kansas City, on this 20th day of November, 2017.

Tammy Morales

Notary Public

NOTARY PUBLIC NOTARY SEAL STATE OF MISSOURI

TAMMY MORALES
My Commission Expires
January 7, 2018
Clay County
Commission #14451086