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Issues: Prepaid Pension Asset, Pension Expense
Witness: Steve M. Traxler
Sponsoring Party: MoPSC Staff
Type of Exhibit: Surrebuttal Testimony
Case No.: ER-2004-0034

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MISSOURI PUBLIC SERVICE COMMISSION

UTILITY SERVICES DIVISION

SURREBUTTAL TESTIMONY

OF

STEVE M. TRAXLER

AQUILA, INC.,
d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Jefferson City, Missouri
February 2004

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the matter of Aquila, Inc. d/b/a Aquila Networks L&P and Aquila Networks MPS to implement a general rate increase in electricity.	)))	Case No. ER-2004-0034

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 following surrebuttal testimony as modified on February 27, 2004, in question and answer form, consisting of 27 pages to be presented in the above case; that the answers in the following surrebuttal testimony as modified on February 27, 2004, 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 27th day of February 2004.

Toni M Charlton

TONI M. CHARLTON NOTARY SEAL NOTARY PUBLIC STATE OF MISSOURI

TONI M. CHARLTON
NOTARY PUBLIC STATE OF MISSOURI
COUNTY OF COLE
My Commission Expires December 28, 2004

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STEVE M. TRAXLER

AQUILA, INC., d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

SURREBUTTAL TESTIMONY OF

STEVE M. TRAXLER

AQUILA, INC., d/b/a AQUILA NETWORKS-MPS (Electric)

CASE NO. ER-2004-0034

Q. Please state your name and business address.

A. Steve M. Traxler, Noland Plaza Office Building, 3675 Noland Road, Independence, MO 64055.

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 this surrebuttal testimony?

A. The purpose of this surrebuttal testimony is to address the rebuttal testimony filed by the Aquila Networks - MPS ("MPS") electric operations witness H. Davis Rooney concerning the value of the prepaid pension asset to be included in Rate Base, the method used to calculate pension expense to be included in cost of service and Mr. Rooney's criticism of the term "pay as you go" as it was used in my direct testimony to characterize the ERISA minimum contribution method for calculating pension expense for ratemaking purposes.

PREPAID PENSION ASSET ISSUE – GENERAL EXPLANATION

Q. What does a prepaid pension asset represent under the Financial Accounting Standard (FAS) 87?

A. A prepaid asset and/or accrued liability under FAS 87 represents the difference between the annual FAS 87 accrued expense on the financial statements, and the cash contribution made to the pension fund during the same year. Unless and until FAS 87 has been adopted for ratemaking purposes, the difference between FAS 87 and the cash contribution to the fund is nothing more than a "timing difference" because the accrual (FAS 87) of pension cost over the service life of an employee and the funding (ERISA contributions) of the same cost are both related to the same pension obligation due to the employee at retirement. Unlike other assets in rate base, such as plant in service or fuel inventory, a prepaid pension asset (FAS 87 expense is less than pension fund contribution) can reverse itself in the next period, and become an accrued liability (FAS 87 expense exceeds the pension fund contribution) from one year to the next. Some Missouri utilities have a FAS 87 accrued liability on their balance sheet instead of a prepaid pension asset.

It is only when this timing difference represents an **accumulated cash flow impact** on the utility, through the "ratemaking process", that a prepaid pension asset and/or accrued liability can justifiably be included in rate base. There is **no cash flow impact** on the utility for a prepaid pension asset or accrued liability under FAS 87 which resulted from "bookkeeping entries" prior to the adoption of FAS 87 for ratemaking purposes.

Q. Can you provide an example as to how the adoption of FAS 87 results in a legitimate asset for ratemaking purposes, that should be included in rate base?

A. Yes. The following example assumes that FAS 87 has been "adopted" for determining pension cost for ratemaking purposes. FAS 87 pension expense is "negative" as result of an over funded pension fund.

1) Payroll Expense	$ 3,000,000
2) FAS 87 Pension Expense	($ 1,000,000)
3) Total Cost of Service Recovery (1) + (2)	$ 2,000,000
4) ERISA Pension Fund Contribution	$ 100,000
5) Prepaid Pension Asset (4) – (2)	$ 1,100,000

In this example, the Company would only collect $2,000,000 in rates even though they have a payroll obligation of $ 3,000,000. This occurs because the excess pension fund assets that provide the "negative" pension cost under FAS 87 cannot, by law, be withdrawn from the pension fund for the general use of the Company. The $1,000,000 shortfall required to pay their payroll obligation must be financed by shareholders. Additionally, the $100,000 cash contribution to the pension fund must also be financed by shareholders because the cash contribution was not used in determining pension cost in setting rates. In this example, the $1,100,000 prepaid pension asset does represent an **investment** made by the Company in the ratemaking process.

The Staff's position on this issue properly recognizes the prepaid pension asset activity for the MPS division, which has occurred "after" the adoption of FAS 87, in rate base.

Q. Please use the same amounts used in the example in your last answer to illustrate why a prepaid pension asset calculated under FAS 87 "prior" to the adoption of FAS 87, for ratemaking purposes, does **not** result in an "asset" which should be included in rate base.

A. In this example, the ERISA pension fund contribution is used for ratemaking purposes to determine pension expense in cost of service, while FAS 87 is still used for financial reporting purposes.

1) Payroll Expense	$ 3,000,000
2) ERISA Pension Fund Contribution	$ 100,000
3) Total Cost of Service Recovery 1)+2)	$ 3,100,000
4) FAS 87 Pension Cost	($ 1,000,000)
5) Prepaid Pension Asset 2)-4)	$ 1,100,000

In this example, the Company collects $3,100,000 in rates which covers its cash obligation for payroll and the cash contribution to the pension fund. The same prepaid pension asset of $1,100,000 does **not** represent a **cash investment** required by the Company in the ratemaking process. It is really nothing more than a paper bookkeeping entry, required on the financial statements under FAS 87, to recognize the timing difference between FAS 87 pension cost and the contributions made to the pension fund. No rate base treatment can be justified in this example. The issue between the Staff and Aquila is Mr. Rooney's recommendation that FAS 87 prepaid assets, which occurred prior to the adoption of FAS 87 for ratemaking purposes, as in this example, should be included in rate base. It is Mr. Rooney's assertion, based upon his interpretation of language in prior "stipulation and agreements" that the Commission did in fact adopt FAS 87, for the MPS division, in 1987 when FAS 87 was adopted for financial reporting purposes. The Staff takes strong exception to Mr. Rooney's "interpretation" of these prior stipulation and agreements.

If Mr. Rooney's position on this issue is adopted by the Commission, the rate base for the MPS electric division will include $7,473,024 for a prepaid pension asset on the balance sheet which did not occur during the period that FAS 87 was used in setting rates for MPS. Therefore, it does **not** represent a **cash investment** required by MPS in the ratemaking process which justifies rate base treatment.

Q. Please summarize the issue between the Company and the Staff regarding the value of the prepaid pension asset to be included in rate base for the MPS Division.

A. Both the Staff and the Company are recommending rate base treatment for a prepaid pension asset calculated under FAS 87. The value of the prepaid pension asset is dependent upon the measurement date. The Staff's position is that the prepaid pension asset, to be included in rate base, is limited to the time frame between the adoption of FAS 87 for "ratemaking purposes" and September 30, 2003, the known and measurable date established for this case.

For the MPS Division, Mr. Rooney is recommending the prepaid pension asset be valued based upon activity between 1987 and September 30, 2003, with the exclusion of the activity occurring between June 29, 1993 and March 18, 1998 – the period that rates established in Case No. ER-93-37 were in effect. There is no dispute that rates established in Case No. ER-93-37 included pension expense recognition under the ERISA minimum contribution method as opposed to FAS 87.

Q. What accounts for the significant disagreement between you and Mr. Rooney regarding the proper time period to be used to determine the value of the prepaid pension asset to be afforded rate base treatment in Case Nos. ER-2004-0034?

A. It is the Staff's view that the evidence in prior Commission orders and stipulation and agreements support the Staff's assumption that FAS 87 was adopted in Case No. ER-97-394 for MPS. The effective dates for rates set in this proceeding was March 18, 1998. Only FAS 87 prepaid pension asset activity occurring after the effective date for this case can be fairly characterized as an "asset" for regulatory treatment in rate base.

Mr. Rooney's testimony relies on an incorrect interpretation of prior Commission orders and stipulation and agreements and also contradicts testimony, provided by Aquila (formerly UtiliCorp) witnesses in prior cases, in supporting a position that FAS 87 was adopted by the Commission for "ratemaking purposes" on the same date in 1987 that it was required for "financial reporting" purposes.

Q. How can the issue between Staff and Aquila be resolved?

A. The only question that needs addressing to decide this issue is when the Commission first adopted FAS 87 for ratemaking purposes for the MPS division.

PREPAID PENSION ASSET ISSUE – MPS DIVISION

Q. Why is it necessary to address the prepaid asset issue separately for the MPS and L&P divisions?

A. Mr. Rooney's arguments are based upon his interpretation of specific prior Commission orders and/or stipulation and agreements, which he asserts, demonstrates the Commission's adoption of FAS 87, for ratemaking purposes, concurrent with the date that the MPS and L&P divisions were required, under GAAP accounting rules, to adopt FAS 87 for "financial reporting" purposes in 1987. It is therefore necessary to address Mr. Rooney's arguments separately for each division.

Q. What Stipulation And Agreement is Mr. Rooney relying on regarding his assertion that MPS's rates, prior to June 29, 1993, were based upon FAS 87 for determining pension cost for "ratemaking" purposes?

A. Mr. Rooney is relying on his interpretation of one sentence in the Stipulation And Agreement approved in Case No. ER-93-37 which appears in paragraph 7 on page 7 as follows:

> 7. Signatories agree that Company's **accounts** shall reflect pension costs equal to contributions made to its established pension funds, discontinuing its previous practice under FAS 87 effective June 29, 1993. (emphasis added)

Q. Has Mr. Rooney misinterpreted the language addressing the pension cost issue in Case No. ER-93-37?

A. Yes he has. I have highlighted the reference to "accounts" in the stipulation language. The term accounts refers to the Federal Energy Regulatory Commission (FERC) accounts used by all Missouri utility companies to record their financial transactions. The fact that MPS's accounts for financial reporting, prior to the order in Case No. ER-93-37, may have reflected FAS 87 pension cost, does not provide authoritative proof that FAS 87 had been adopted by the Commission for ratemaking purposes prior to the effective date of rates established in ER-93-37.

Q. Were you either a witness and/or a supervisor on this issue in every rate case involving MPS since its 1990 case, ER-90-101?

A. Yes. I was either the witness on the pension cost issue or had responsibility for supervising the witness on the pension cost issue in every MPS rate case since 1990.

Q. With respect to your personal involvement in every MPS electric case since 1990, when did the Commission adopt FAS 87 for determining pension cost for MPS?

A. FAS 87 was adopted for the first time in Case No. ER-97-394 effective March 18, 1998. UtiliCorp's witness, Beth Armstrong, proposed the ERISA minimum contribution in her direct testimony in that case. The Staff's witness, Charles R. Hyneman, proposed the Staff's method for calculating pension cost under FAS 87. The Commission approved the Staff's recommendation for the adoption of FAS 87. The issue is addressed on pages 32 and 33 of the Commission's order.

Q. What is the primary purpose of any stipulation and agreement addressing the cost of service treatment for any revenue requirement issue?

A. The purpose of the stipulation and agreement in any case, regarding revenue requirement issues, is to specify the treatment used in setting rates in the current case and to recognize that rates will continue to reflect this treatment until the effective date of rates set in the Company's next general rate case. It is not intended to serve as authoritative proof regarding "prior" ratemaking treatment for the issue being addressed.

Q. What proof would be required to support Mr. Rooney's claim that FAS 87 had been adopted, for ratemaking purposes for MPS, since 1987 and continuing until June 29, 1993?

A. A prior Commission order resulting from a litigated case and/or an approved stipulation and agreement specifying the adoption of FAS 87, for ratemaking purposes, is necessary to support Mr. Rooney's claim that FAS 87 was adopted by the Commission for the period, 1987 – June 29, 1993 for MPS. Mr. Rooney's rebuttal testimony does not refer to any order or stipulation and agreement, issued prior to the order in ER 93-37,because none exists which addresses the adoption of FAS 87 for ratemaking purposes for MPS.

Q. In researching this issue were you able to find additional evidence regarding the ratemaking treatment for pension cost for MPS prior to Case No. ER-93-37?

A. Yes. The testimony of two UtiliCorp witnesses in Case No. ER-90-101 address the prior ratemaking treatment used in calculating pension cost for MPS.

Q. Provide the names of the UtiliCorp witnesses in Case No. ER-90-101 which address the prior ratemaking treatment for pension cost for MPS.

A. I will be referring to the direct testimony of Judith A. Samayoa, Vice President-Accounting and the rebuttal testimony of William R. Glasco, the Company's actuary at the time, with the firm, William M. Mercer Inc. The testimony on this issue for these two witnesses is attached to this testimony as Schedules SMT-1 and SMT-2.

Q. Please reference the direct testimony of Ms. Samayoa which addresses the historical ratemaking treatment for pension cost used in setting rates up to 1990, the year that Ms. Samayoa's direct testimony was filed in Case No. ER-90-101.

A. On page 15 of her direct testimony, Ms. Samayoa makes the following statement regarding the Commission's historical ratemaking treatment for pension cost for MPS:

> Q. Since FAS 87 has caused the contribution and the expense to differ, which amount should be included in the cost of service for ratemaking purposes?
>
> A. The contribution amount is the appropriate measure of pension cost. This is the cost actually contributed and the cost **historically recognized** by the Commission in cost of service. (emphasis added)

Ms. Samayoa's testimony directly contradicts Mr. Rooney's position that the Commission's ratemaking treatment prior to the effective date of rates in Case No. ER-93-37 was based upon the adoption of FAS 87 for pension cost.

Q. Please reference the rebuttal testimony of UtiliCorp witness William R. Glasco, which addresses the Commission's prior ratemaking treatment for pension cost.

A. On page 10 of his rebuttal testimony in Case No. ER-90-101, Mr. Glasco makes the following statement:

> Q. Since FAS 87 made pension expense for financial reporting no longer equal to employer contributions, does this mean contributions can no longer be used in the cost of service for ratemaking purposes?
>
> A. No. In my opinion, the **long established practice** of using **contributions in the cost of service** can be continued. In fact, I believe the contribution basis has the most merit and should be continued for several reasons. Using the contributions in the cost of service will result in a pattern of cost that is less volatile. " (emphasis added)

Again, like Ms. Samayoa's testimony, the testimony of the Company's actuary directly contradicts Mr. Rooney's assertion that the Commission had adopted FAS 87 for ratemaking purposes for the period between 1987 and the effective date of rates in Case No. ER-93-37, June 29, 1993. It is clear that the historical research referenced on page 21, lines 9-10 of Mr. Rooney's rebuttal testimony failed to include the review of testimony of two UtiliCorp witnesses addressing the pension cost issue in MPS's prior rate case, Case No. ER-90-101.

Q. Please summarize your testimony regarding the proper valuation of the FAS prepaid pension asset to be included in rate base for MPS.

A.

- A prepaid pension asset, under FAS 87, can only be fairly characterized as an asset for rate base treatment when the prepaid pension asset represents the cash flow impact resulting from the adoption of FAS 87 for ratemaking purposes. The Commission adopted FAS 87 for MPS in Case No. ER-97-394 effective March 18, 1998. The prepaid pension asset, which has accumulated since March 18, 1998, is the only balance sheet amount which represents an asset for rate base recognition. The examples provided on page 3 and 4 of this testimony illustrate this point.
- FAS 87 was adopted for "financial reporting" purposes in 1987. Mr. Rooney asserts that the Commission adopted FAS 87 for "ratemaking purposes" concurrent with the date in 1987 that GAAP accounting rules required FAS 87 for financial reporting. With the exception of the period when rates were in effect for Case No. ER-93-37 (June 29, 1993 –

March 18, 1998), it is Mr. Rooney's assertion that prepaid pension asset recognized since 1987 should be afforded rate base treatment.

- Mr. Rooney supports his assertion based upon his interpretation that **one** sentence in the stipulation and agreement in Case No. ER-93-37, provides conclusive proof of the Commission's prior adoption of FAS 87, from 1987 to June 29, 1993, the effective date of rates in Case No. ER-93-37. The language in a Stipulation And Agreement in Case No. ER-93-37 does not represent conclusive proof of the Commissions prior adoption of FAS 87 for MPS.
- Mr. Rooney's assertion, regarding the Commission's prior adoption of FAS 87 for MPS, is not supported by a single Commission order issued between 1987 and June 1993 supporting his claim that the Commission adopted FAS 87 for ratemaking purpose during this period.
- Finally, Mr. Rooney's assertion regarding the Commission's prior adoption of FAS 87 is in direct contradiction with the testimony from two UtiliCorp witnesses in MPS's prior rate case, ER-90-101.
- In summary, the Staff has correctly valued the prepaid pension asset, for rate base treatment, based upon activity occurring since the Commission's adoption of FAS 87 in Case No. ER-97-394 on March 18, 1998.

Q. What other Missouri utilities have entered into stipulations which treat the FAS 87 prepaid pension asset consistent with the Staff's recommendation for MPS in this case?

A. Laclede Gas (Case No. GR-2002-356) and Empire District Electric Company (Case No. ER-2002-424) have both stipulated to the use of the ERISA minimum contribution for pension cost and rate base treatment for a FAS 87 prepaid pension asset balance which **excludes** the prepaid pension asset established prior to the Commission's adoption of FAS 87 in setting rates.

PENSION EXPENSE

Q. What is the issue between the Staff and Aquila regarding current pension expense?

A. The *Staff* is proposing to use the ERISA minimum contribution for determining pension cost. The Company's witness, H. Davis Rooney, has recommended a continuation of FAS 87 for pension cost determination in his direct testimony.

Q. On page 31, Mr. Rooney states that the ERISA minimum contribution is likely to be as volatile as the FAS 87 amounts. Do you agree with this assertion?

A. No. Volatility measures the extent that the dollar value for an expense changes from one year to the next. The schedule below reflects volatility analysis from 1998–2003 for Aquila's ERISA minimum contributions and FAS 87 pension cost.

Aquila Inc. – ER-2004-0034
Annual Volatility Analysis - ERISA Contribution vs FAS 87

		Aquila ERISA Contribution	Annual Volatility	FAS 87 Pension Cost	Annual Volatility
1	1998	$0		($3,649,391)	
2	1999	$0	$0	($2,977,772)	$671,619
3	2000	$0	$0	($8,895,475)	($5,917,703)
4	2001	$0	$0	($15,267,120)	($6,371,645)
5	2002	$0	$0	($2,756)	$15,264,364
6	2003	$11,440,154	$11,440,154	$8,427,028	$8,429,784
7	Average Volatility		$2,288,031		$7,331,023

Source: Aquila Actuarial Reports and Response to DR 366

Line 7 reflects the average annual volatility for the ERISA minimum contribution is $2,288,031. On the other hand, the average annual volatility for pension cost under FAS 87 has been $7,331,023. Pension cost under FAS 87 is three times more volatile than the ERISA minimum contribution since 1998. The less volatile an expense is the more suitable it is for use in setting rates which are generally in effect for three years or more.

Q. On page 31, Mr. Rooney asserts that the Staff has failed to adjust the ERISA minimum contribution for the benefits of what they propose to disallow. Please respond to this assertion.

A. Mr. Rooney's assertion here is that the prepaid pension asset amounts - that Staff excludes from rate base because they occurred prior to the adoption of FAS 87 for ratemaking purposes - include pension fund contributions in excess of the ERISA minimum that have never been recovered in rates. However, according to UtiliCorp's actuary in Case No. ER-90-101, pension cost in rates before 1990 were based upon the use of "contributions in the cost of service" (Glasco rebuttal, page 10, attached to this testimony Schedule SMT-2). This statement does not limit the contribution amount to the ERISA minimum contribution. Mr. Rooney presents no evidence that the contributions allowed in rates prior to 1990 did not reflect the Company's total pension fund contribution.

Q. On page 31 of Mr. Rooney's rebuttal testimony, he states that the ERISA minimum contribution places unnecessary restrictions on management's discretion in determining the timing and amount of pension contributions. Please comment on this assertion.

A. The Staff has a legitimate concern in limiting management's discretion in making voluntary pension fund contributions which exceed the ERISA minimum contribution. Our review of the funding policies of many of the large utilities in Missouri in the early 1990's revealed a common practice of contributing the maximum contribution allowed under IRS regulations. The rationale provided in support of this policy was to maximize cash flow by lowering the cash payment for current income tax to the IRS. This policy had nothing to do with the adequate funding of the pension plan. The Staff will continue to consider any voluntary contribution made under extreme circumstances, as was the case in 2002 and 2003 for Aquila. These voluntary contributions were considered and allowed in the Staff's pension cost determination for this case. My direct testimony, pages 10-12, provides a detailed explanation for the ratemaking treatment given to voluntary contributions made in 2002 and 2003.

Q. On page 31 of Mr. Rooney's rebuttal testimony, he states that the ERISA rules provide for a range of allowable funding levels but the Staff has chosen to focus on the lowest possible funding level. How do you respond?

A. The ERISA regulations were enacted by legislation in 1974 to ensure adequate funding of defined benefit pension plans in the United States. Until a utility can demonstrate that the ERISA regulations won't accomplish their objective, then the safest approach for ratepayers is to rely on the ERISA regulations and eliminate the incentive for the utility to make unnecessary contributions to enhance cash flow.

Q. On page 34 of his rebuttal testimony, Mr. Rooney states that the Company is not opposed to establishing rates on a contribution method as long as the Company is given more flexibility in making voluntary contributions above the ERISA minimum contribution.

A. I have already addressed the reasons for limiting the ratemaking treatment to the ERISA minimum unless extreme circumstances justify a voluntary amount above the ERISA minimum.

Q. Would the Staff consider an alternative to its filed position on this issue?

A. Yes. The significant devaluation of the stock market in recent years has had significant negative impact on the funded status of pension plans across the country. Utility pension funds have generally fared better than some other industries, but have still experienced a significant reduction in the funded status of their pension funds. As a result, contributions under ERISA regulations are likely to significantly increase in the near future. In an effort to make sure that the utility companies recover their legitimate fund contributions in rates, the Staff would agree to a tracking mechanism which tracks actual contributions against the amount allowed for rate recovery in the most recent rate case. ERISA minimum contributions required above the amount included in the last rate case would be included in rate base and amortized over a reasonable period of time. Contributions which were less than the level allowed in the last rate case would also be tracked and used as a reduction to rate base, and amortized as an offset to pension cost in a future rate case using the same amortization period. This tracking mechanism can only be implemented if the Company were to agree to it.

ERISA CONTRIBUTIONS DEFINED AS PAY AS YOU GO

Q. On pages 35 through 38, Mr. Rooney spends considerable time criticizing the use of the term, "pay as you go" in your direct testimony, as synonymous with the ERISA minimum contribution. His specific statement is that the "use of this terminology incorrectly recharacterizes the historical accrual treatment of pensions as a "pay as you go" method." Was the use of this term in your direct testimony intended to address the "historical accrual treatment" on the Company's financial records?

A. Certainly not. The term "pay as you go" in my direct testimony accurately describes the "cash flow" difference between an accrual of pension cost under FAS 87 and the actual "cash" contributions made to "fund" the accrual. Mr. Rooney's discussion of accrual accounting on the financial statements prior to the adoption of FAS 87 for this purpose, may be informational to some, but has little if anything to do with the issues in this case in the pension cost area.

Q. Please briefly explain how the term "pay as you go" was used in your direct testimony relative to the pension cost issue in this case.

A. Prior to the House Bill 1405, requiring adopting FAS 106, for determining post retirement benefit costs other than pensions (OPEBS), for ratemaking purposes, these costs were recognized, for both financial reporting and ratemaking, based upon the actual cash outlay to cover the benefit costs for retirees. FAS 106 represents the GAAP accounting method for accruing these costs over the service life of employees consistent with the accrual of pension costs under FAS 87. The term "pay as you go" has been used routinely to be synonymous with the prior treatment of recognizing OPEBS on a cash basis when paid.

The term has been used by the Staff in a similar manner, for many years, in describing the cash flow difference between "accrual" accounting under FAS 87 and the actual "cash" contributions required under ERISA regulations. Accrual accounting for pension cost under FAS 87 does not require a corresponding cash outlay equal to the pension cost amount calculated under FAS 87 and recognized on the financial statements. The actual required cash funding of the pension obligation is calculated by the Company's actuary under ERISA regulations. In the Staff's view it makes logical sense to refer to the ERISA "cash contributions" as the " pay as you go" amount as it relates to pension costs. It has been our view for many years that this "pay as you go" terminology for pension cost is consistent with the "pay as you go" term used for OPEBS costs. I think the logic here is fairly obvious.

Q. On page 37, Mr. Rooney challenges your statement that pension expense, for MPS, prior to 1987, equaled contributions. Are you aware of any testimony from a prior UtiliCorp witness which supports your statement that MPS's pension expense, prior to 1987, equaled contributions?

A. Yes. Attached to this surrebuttal testimony as Schedule SMT-2, is the rebuttal testimony of the Company's actuary, William R. Glasco, in MPS Case No. ER-90-101. The following question and answer appear on page 8 of Mr. Glasco's rebuttal testimony:

> Q. What is meant by the term "pension expense" and how has it been determined in the past?
>
> A. Pension expense is normally thought of as the expense reflected on MoPub's financial statements for retirement plan expense. Prior to 1987, pension expense reflected in the books **equaled Mo. Pub's contribution.** It is my understanding that the contribution amount was also used utilized by the Commission in establishing rates prior to 1987. (emphasis added)

Q. Please summarize your comments regarding Mr. Rooney's criticism of your use of the term "pay as you go" as it relates to the cash funding of the pension plan under ERISA regulations and his criticism of your assertion that MPS's pension expense prior to 1987 equaled contributions.

A. I have provided a very logical explanation as to why the cash funding of the pension plan, under ERISA regulations, can be appropriately referred to as the "pay as you go" method from a regulatory perspective.

Regarding Mr. Rooney's criticism of my statement that MPS's pension expense, prior to 1987, "equaled contributions," my statement is identical to the description provided by the Company's actuary in Case No. ER-90-101. Since the actuary has responsibility for calculating pension cost for the Company, I feel more comfortable being in agreement with Mr. Glasco than Mr. Rooney.

Q. Does this conclude your surrebuttal testimony?

A. Yes, it does.

Exhibit No.	
Issue:	Various
Witness:	Judith A. Samayoa
Type of Exhibit:	Direct Testimony
Sponsoring Party:	Missouri Public Service
Case No:	ER-90-101

MISSOURI PUBLIC SERVICE

ER-90-101

DIRECT TESTIMONY

OF

JUDITH A. SAMAYOA

January 26, 1990

MISSOURI PUBLIC SERVICE

DIRECT TESTIMONY

OF

JUDITH A. SAMAYOA

Q. Please state your name, position, and business address.

A. My name is Judith A. Samayoa. I am employed by UtiliCorp United Inc. as Vice President - Accounting and Regulation. My business address is 911 Main, Suite 2000, Kansas City, Missouri, 64105.

Q. Please describe your professional and educational background for the Commission.

A. I was graduated from the University of Missouri - Columbia in 1974 with a Bachelor of Science degree in Business Administration, majoring in accounting. I am a certified public accountant and a member of the American Institute of Certified Public Accountants and the Missouri Society of Certified Public Accountants.

Q. Please recount for the Commission some of your professional experience with UtiliCorp and its divisions.

A. In 1980 I was employed by Missouri Public Service Company as the assistant manager of economic analysis. In 1982, I was promoted to manager of economic analysis and in 1985, I was named director of regulation for

UtiliCorp. I served in that capacity until September 1987 when I assumed my current position.

Prior to my employment with Missouri Public Service Company, I was a budget specialist for The School District of Kansas City, Missouri. Prior to that employment, I was an audit senior employed by Arthur Andersen & Co. in the regulated industries division, specializing in utility audits.

Q. Have you previously testified in rate proceedings before this Commission and other commissions?

A. Yes. I presented testimony in several electric and gas rate increase requests filed by Missouri Public Service Company between 1980 and 1983. During that time frame, I also presented testimony in wholesale electric rate increase requests filed by Missouri Public Service Company before the Federal Energy Regulatory Commission.

Q. What are your current responsibilities with UtiliCorp?

A. As the chief accounting officer, I am responsible for the establishment of appropriate accounting policies throughout all operations of the Corporation. The responsibility for the development and implementation of appropriate accounting procedures and practices that are consistent with the Corporation's overall accounting policies rests with accounting personnel in the divisions and subsidiaries. In conjunction with that responsibility, I oversee the preparation of all publicly released financial statements and reports. The corporate accounting group is also responsible for cost billings among entities, as well as the preparation of the annual budget.

My regulatory responsibilities include the review and oversight of divisional regulatory activities, as well as ensuring that regulatory requirements affecting UtiliCorp are fulfilled.

Q. What is the purpose of your direct testimony in this proceeding?

A. The purpose of my direct testimony is to describe the system which is employed by UtiliCorp to distribute costs among the various entities which comprise UtiliCorp. In addition, I am sponsoring employee benefit-related adjustments to the cost of service and the adjustments which result from the accounting order issued by this Commission in Case No. EO-90-114.

ACCOUNTING SYSTEM

Q. Please describe the overall nature of the accounting system employed by UtiliCorp.

A. UtiliCorp, though a single corporate entity insofar as its domestic utility operations are concerned, is comprised of several operating divisions. These operating divisions include Missouri Public Service, Peoples Natural Gas, Kansas Public Service, Northern Minnesota Utilities, West Virginia Power, and Michigan Gas Utilities. The Company also has two domestic operating subsidiaries, UtilCo Group and PSI, and one foreign subsidiary, West Kootenay Power.

Each of the entities maintains separate books and records designed to reflect the activities of that division or subsidiary on a stand-alone basis. However, because of the integrated nature of the UtiliCorp operations, costs are recorded on the books of one entity of the Corporation which are appropriately charged to other divisions or subsidiaries of the Corporation. This is particularly true of the executive and other administrative costs.

To assure that the books of each division and subsidiary properly reflect the full costs of their respective operations, costs are transferred among the various divisions, subsidiaries, and the executive headquarters so that each entity's books reflect that entity's full cost of doing business.

Q. What is the objective of the system for distributing charges from one division to another and from executive headquarters to the divisions and subsidiaries?

A. The objective of the system is to assign charges on the basis of cost incurrence. Under this system, entities responsible for the incurrence of system costs are charged those costs regardless of which entity actually expended the funds. Accordingly, those costs are relieved from the provisioning entity's books when they are charged to the cost causing entity.

Q. Where and how do these costs arise?

A. The majority of these costs arise at executive headquarters and represent either costs incurred specifically for a division or subsidiary or costs incurred for the Corporation as a whole. On some occasions, payments are made by a division or subsidiary as a result of costs incurred by another entity within the Corporation.

Q. You have indicated that a majority of these costs arise at the headquarters level. What types of costs are incurred at the UtiliCorp level which are included in the MPS cost of service?

A. UtiliCorp expends funds which relate to services and products acquired directly for MPS. It does the same for other divisions and subsidiaries. UtiliCorp also incurs costs in connection with the operation of the Corporation which are applicable to the cost of doing business for each part of the Corporation.

Q. Describe the system of cost assignment and allocation used by UtiliCorp.

A. There are two different systems. The first system serves to assign direct costs among the divisions and the subsidiaries where one entity incurs a cost on behalf of another entity. This system transfers that cost among the divisions or subsidiaries through the use of an accounts payable-receivable system for all entities. These are essentially interdivisional billings prepared on a direct cost incurrence basis.

The second system serves to distribute the costs incurred at headquarters to the entities. Such distribution is based upon direct assignment, when possible, with the remainder distributed by an allocation system.

Q. Please describe the direct assignment method for headquarters costs.

A. A number of costs are incurred at headquarters which are directly assignable to specific entities. For example, certain outside services are incurred by UtiliCorp for the benefit of a specific division or subsidiary and are then directly assigned to that entity. Also, out-of-pocket costs incurred by UtiliCorp personnel while performing services for a specific division or subsidiary are charged directly to that entity.

The actual process involves first, the request for service by an entity from the appropriate department at UtiliCorp. Second, the service or product is acquired or provided by UtiliCorp for the entity. Costs are identified and approved at UtiliCorp and the direct assignment of those charges are billed to the division or subsidiary.

This direct assignment also covers items such as the health insurance program, the life insurance program, retirement benefits, and the acquisition of casualty insurance.

Q. What is the next step in the process of cost assignment and distribution?

A. After all of the costs which are directly assignable to specific entities are identified, there exists a residual of costs which are not incurred exclusively for a specific entity. These costs are associated with the operations of the Corporation as an integrated entity. These costs include items such as Board of Directors' fees, external audit fees, cost of publicly released financial reports, income tax return preparation, shareholder relations, and treasury functions, among other items. These costs are generally distributed to the entities based upon the Massachusetts formula.

Q. What is the Massachusetts formula?

A. The Massachusetts formula is a method of allocating common corporate costs. This method was initially developed for use by the interstate compact to allocate common costs to determine the state income tax liability of multi-state corporate operations. Because of its effectiveness in this area, it was adopted by the Department of Defense and various other governmental agencies as an appropriate cost allocation system. Eventually, this procedure was employed by the Federal Energy Regulatory Commission and other state agencies, as well as the Cost Accounting Standards Board. Through the application of this formula by these agencies or groups, a widely accepted allocation method has been developed. The costs distributed by this procedure are incurred for the operation of the Corporation as a whole, usually at the corporate headquarters, but considered as applicable and appropriate costs of the divisions and subsidiaries.

Q. Has this Commission adopted the Massachusetts formula for common cost allocation purposes in determining the appropriate regulated cost of service?

A. It is my understanding that this formula or similar but modified derivations of this formula have been accepted by this Commission for use in establishing an appropriate cost of service. In the past decade, such approach has been used by other utilities operating in Missouri.

Q. What are the allocation factors used in the Massachusetts formula?

A. The Massachusetts formula is a three factor formula which is generally applied as the simple average of the relationship of sales, payroll and investment.

In application at UtiliCorp, the Massachusetts formula is the simple average of gross margin (revenue less the direct cost of energy), payroll and net plant investment for each of the divisions and subsidiaries compared to the total for the Corporation. These allocation factors or percentages are used to allocate the common costs incurred in the operation of the Corporation to the entities.

Q. Do the percentages applied in the formula change?

A. Yes. The formula is updated at least annually to reflect the most current financial data with regard to gross margin, payroll, and net investment. In the case of an acquisition, the formula is revised to reflect the operations of the newly acquired entity if appropriate.

Q. In what situation is it not considered appropriate to reflect newly-acquired entities in the formula for allocation of costs?

A. To date, that instance has arisen only once with the acquisition of the stock of West Kootenay Power, a Canadian utility corporation. Due to the unique nature of this foreign investment, it is not appropriate to allocate costs in the identical manner as previously described. In the case of WKP, a separate legal entity operating in another country, a modification to the approach is needed because certain executive headquarters costs are not applicable to that operation. Examples are administrative costs related to the domestic pension and welfare plans. These costs are incurred at executive headquarters for the benefit of employees of UtiliCorp's domestic operations. These costs are not incurred for WKP employees as separate plans are maintained for those employees in Canada and administered directly by WKP. Therefore, it would not be appropriate to allocate administrative costs related to domestic pension and welfare plans to WKP as WKP is not responsible for the incurrence of those costs in the U.S.

Q. How is WKP allocated executive headquarters costs?

A. After the identification and exclusion of executive headquarters costs that do not apply to WKP, such as the pension plan administrative costs, a residual of costs remains which are allocated to WKP using the Massachusetts formula approach.

Q. Prior to the consummation of an acquisition, how are headquarters costs associated with the acquisition recorded?

A. Once a potential acquisition subject has been identified and mutual intent to consummate the transaction exists, costs for the acquisition are incurred, identified, and recorded in a separate deferred account. This account is maintained until the acquisition is consummated, serving to capture the costs associated with such acquisition activity. Concurrently with the acquisition consummation, the deferred balance is considered a part of the acquisition and is reflected on the books of the newly-acquired entity.

If the acquisition is not consummated, but costs have been incurred and deferred, the balance in the deferred account is written off to expense.

Q. Is there a historical continuity in terms of the Corporation's allocation of these costs?

A. Yes. The Massachusetts formula was first employed by UtiliCorp in this allocation procedure in 1986 coincident with the acquisition of Peoples Natural Gas. Since that time, it has been refined from time to time, but the fundamental concept has been in effect since the initial expansion of UtiliCorp.

However, while the formula has remained essentially the same, the specific percentages used to allocate costs have changed significantly. For example, in the case of MPS, since the formula has been applied to these costs, MPS has represented as much as 58 percent of the total Corporation for allocation purposes. However, with the acquisition of various other entities, MPS currently represents only 43 percent of the Corporation for such purposes.

In fact, as a result of the allocation procedure employed and the possibility that the Corporation may continue to expand, the MPS percentage share of the entire Corporation may continue to decline as a result of that growth. The current MPS percentage, however, reflects UtiliCorp's acquisition of Michigan Gas

Utilities and thus is appropriate for test year purposes in this case.

Q. What is the gross margin amount used in the Massachusetts formula allocation?

A. The revenue base used in the formula is gross margin. It represents the revenue of the entity less the direct cost of energy delivered such as purchased gas, purchased power, and fuel expenses related to generation. Gross margin was selected to achieve a reasonably comparable factor, particularly as related to electric and gas operations.

Q. What is the payroll base used in the formula?

A. The actual payroll charged to expense is used in the calculation of the factor.

Q. What is the net investment (plant) factor used in the formula?

A. The net plant, including construction work in progress, is included in the net investment base. For divisions acquired by UtiliCorp through purchase or merger, the net plant investment related to acquisition adjustments which were incurred in connection with UtiliCorp's ownership have been excluded from the investment base.

Q. Have you prepared an example which illustrates the calculation of the three factors?

A. Yes, I have. I have prepared Schedule JS-1 using the actual data underlying the allocation factors for the test year. These factors reflect the test year acquisition of Michigan Gas Utilities.

The schedule illustrates the calculations used to arrive at the gross margin level, payroll, and net investment.

Q. Could different factors such as gross plant investment instead of net plant investment be used in the Massachusetts formula?

A. Other factors could be used to develop such an allocation process. However, in my opinion, the allocation factors which are used in the UtiliCorp allocation fairly and reasonably allocate the costs associated with the operation of the Corporation.

VARIOUS ADJUSTMENTS

Q. Please describe the pension cost adjustment.

A. Adjustment Number 22 annualizes pension cost to the contribution level for 1990. This cost level eliminates a nonrecurring charge and sets the amount included in the cost of service to the estimated 1990 contribution level as provided by the pension plan actuaries.

Q. What is the basis of this adjustment?

A. The basis of this adjustment is to record and include for cost of service purposes the estimated amount to be paid by Missouri Public Service for pension costs for the test year.

Q. Why have you included the contribution level in the cost of service?

A. Historically, pension expense accounting for financial statement purposes and usually for cost of service purposes followed Accounting Principles Board Opinion No. 8. The calculation procedures generally caused pension expense to equal the contribution amount. Because of this, during the period prior to 1987, the Commission, in effect, allowed the contribution in the cost of service.

Q. How has this changed?

A. Financial Accounting Standard (FAS) 87 changed significantly financial reporting for pensions in years beginning after December 15, 1986. APB No. 8 uses a long-term interest rate assumption that changes infrequently in determining pension expense. In contrast, FAS 87 requires the use of market interest rates which vary from year to year. The effect of this change causes the contribution (the actual payment made to the pension plan) to almost always differ from the amount recorded for financial statement purposes. These amounts will equal over the life of the program, but in nearly every year there will be a difference between the two amounts -- and sometimes it will be significant.

Q. Since FAS 87 has caused the contribution and the expense to differ, which amount should be included in the cost of service for ratemaking purposes?

A. The contribution amount is the appropriate measure of pension cost. This is the cost actually contributed and the cost historically recognized by the Commission in cost of service. Further, it provides an appropriate consistent level of funding to be paid by customers through rates.

Q. Are there any other reasons why the contribution is the appropriate amount to include in the cost of service?

A. The change in accounting method has one significant impact on the amount, which strongly suggests the appropriateness of the contribution level. Under the pre-1987 standards, the pension cost was a stable expense through time. Now, the recorded amount calculated under the requirements of FAS 87 is very volatile, fluctuating annually with changes in the market value of the underlying investments and changes in the discount rate. These two major variables, changing through time, can cause the balance or the value of the portfolio to change radically from valuation to valuation. Any year-end "snapshot" of the asset value using these two different variables is certain to vary from year to year.

In contrast, the contribution level is determined by use of a long-term forecasted interest rate and a long-term plan liability. As a result of the different procedures, the contribution level is more stable from year to year than the recorded expense under FAS 87 guidelines. Since stability in rates is a reasonable objective in ratemaking, the contribution method is the most appropriate for ratemaking rather than the procedures required under FAS 87.

Q. Is there precedent for regulatory bodies to permit the contribution level in rates?

A. Yes. Several commissions have adopted the contribution method due to the undesirable volatility of a FAS 87 approach.

Q. Are you responsible for any other items included in the cost of service?

A. Yes. Under my supervision, the adjustments for employee group insurance, stock contribution plan, and the savings plan have been calculated.

Q. Please describe the MPS policy with respect to employee benefits.

A. Employee benefits are reviewed from time to time in conjunction with salary levels to ensure that the total compensation package is competitive and adequate to maintain and attract competent, qualified employees. Certain plans are designed to permit employees to accumulate ownership in the Corporation. Such ownership allows employees to become voting shareholders, providing additional interest in the Corporation and its divisions and subsidiaries.

Q. Please explain Adjustment No. 21.

A. Adjustment No. 21 is the annualization adjustment to the cost of service to reflect the MPS matching contribution to the employee savings program. This adjustment utilizes the requested payroll levels sponsored by another witness in this case and the MPS policy with regard to contributing a match.

Q. Please explain Adjustment No. 20 for employee group insurance expense.

A. The premium levels utilized in this adjustment are those rates established by the insurance carrier to be in effect during the test year. The level of employee participation in the plans is consistent with employee levels requested in the test year. No changes to the plan are projected other than premium increases that results primarily from medical expense inflation.

Q. Please explain Adjustment No. 19 for the stock contribution plan.

A. Adjustment No. 19 is the adjustment to the cost of service to reflect MPS's annualized contribution to the stock contribution plan. The adjustment is based upon three percent of the test year payroll level sponsored by another witness in this case.

Q. With respect to the accounting order issued in Case No. EO-90-114, what adjustments are you sponsoring?

A. I am sponsoring adjustments to the test year cost of service representing the request for recovery of certain deferrals permitted by the order.

Q. Please describe the accounting authority granted in the December 27, 1989 order in Case No. EO-90-114.

A. As more fully described in the MPS application in Case No. EO-90-114, MPS requested and was granted certain accounting authority with respect to two major undertakings at the three electric generating units known collectively as the Sibley Generating Station. These undertakings, estimated to cost $105 million, are the life extension project and the western coal fuel conversion project, both of which are critical to MPS's ability to continue to provide reliable electric service to its customers at a reasonable cost. The cost of these projects, scheduled to be completed through 1992, is significantly less than alternative new base load capacity.

The life extension project will extend the life of the three units by approximately 20 years. Sibley Units #1 and #2 would be retired from use in 1990, thus requiring MPS to acquire higher cost alternative sources of capacity.

The western coal fuel project will allow MPS to achieve significant reductions in SO_2 emissions at the Sibley Generating Station, thus allowing MPS to

Exhibit No.	
Issue:	Pensions
Witness:	William R. Glasco
Type of Exhibit:	Rebuttal Testimony
Sponsoring Party:	Missouri Public Service
Case No:	ER-90-101

MISSOURI PUBLIC SERVICE DIVISION

ER-90-101

REBUTTAL TESTIMONY

OF

WILLIAM R. GLASCO

JUNE 22, 1990

FILED
JUN 22 1990
PUBLIC SERVICE COMMISSION

BEFORE THE PUBLIC SERVICE COMMISSION

OF THE STATE OF MISSOURI

REBUTTAL TESTIMONY OF WILLIAM R. GLASCO

Case No. ER-90-101

Q. Please state your name and business address.

A. William R. Glasco, 2405 Grand Avenue, Suite 1100, Kansas City, MO 64108

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

A. I am a Principal with William M. Mercer, Incorporated, a human resources and actuarial consulting firm.

Q. Please describe your education.

A. I was graduated summa cum laude from Wichita State University in Wichita, Kansas in 1973 with a Bachelor of Science Degree in Mathematics. I obtained a teaching certificate in Secondary Mathematics from Central Missouri State University in Warrensburg, Missouri in 1974.

Subsequent to my college education, I began to study for the series of ten examinations administered by the Society of Actuaries. I successfully passed these examinations over the following several years and earned the designation of Fellow of the Society of Actuaries (F.S.A.) in November 1980. I also passed the examinations and met the experience requirements to become designated as an Enrolled Actuary under the federal Employee Retirement Income Security Act (ERISA) in 1981. I recently satisfied the continuing education requirements of the federal Joint Board for the Enrollment of Actuaries to maintain my Enrolled Actuary status for the three-year period beginning January 1, 1990.

Q. Please describe your employment history.

A. I was originally employed as an Actuarial Assistant with the actuarial consulting firm of Meidinger and Associates in Louisville, Kentucky in April 1974. I transferred to the firm's Kansas City office in November 1974 and was continuously employed by Meidinger until the firm was purchased by Marsh and McLennan, Inc. and merged with Marsh and McLennan's subsidiary company, William M. Mercer, Incorporated. My employment continued without interruption and I remain employed by William M. Mercer, Incorporated. (The firm operated under the name of Mercer-Meidinger-Hansen in the two years prior to April 1, 1990). My original job title was upgraded to Assistant Actuary in 1978 and Actuary in 1980. I obtained my current job title, Principal, when Meidinger was merged with Mercer in 1984.

Q. What are your job responsibilities with William M. Mercer?

A. I provide actuarial and consulting services to clients on their employee benefit programs, particularly retirement plans. I serve as the managing consultant to UtiliCorp United. Almost all services provided to UtiliCorp, including actuarial services on MoPub's pension plans, are performed by members of Mercer's 95 person staff in Kansas City. William M. Mercer, Incorporated is the largest human resources and actuarial consulting firm in the United States. I serve as a member of the Operating Committee for the firm's Southern Region as well as our Kansas City office. I also chair the Professional Development Committee within the Kansas City office.

Q. What is the purpose of your testimony?

A. The purpose is to respond to the testimony of Steve Traxler on pension expense organized as follows:

1. Background on pension funding.
2. Background on pension expense.
3. An explanation supporting the use of cash contributions in the cost of service calculation for ratemaking purposes.

4. An explanation of why it is inappropriate to use the Staff's suggested approach to pension expense determination.

5. Comments on pension "overfunding".

Q. Why is pension funding an issue in this case?

A. The Company has requested that cash contributions be recognized as the appropriate basis to use in the cost of service for establishing rates in this case. Mr. Traxler, however, recommends use of a different method described in his testimony, which results in a difference of $2 million less expense reflected in the cost of service calculation for the test year compared with the Company's proposal.

BACKGROUND ON PENSION FUNDING

Q. Describe the nature of the MPS pension plans.

A. MoPub's separate union and non-union pension plans provide a predictable source of income for employees during their retirement years. Employees earn benefits based on final average pay levels and length of service. Upon retirement, the amount calculated for each retiree is payable monthly as a lifetime annuity. The retiree receives a monthly pension check until he or she dies. As an option, an employee can elect a reduced pension that pays a survivors pension to his or her spouse for their remaining lifetime following the retiree's death.

MoPub's pension plans are "defined benefit" plans under which employees earn benefits according to a benefit formula that factors in their pay and service. For example, a defined benefit formula may provide that an employee retiring at age 62 will receive 1% of his or her four year average monthly pay times years of service. This benefit would be payable monthly for the rest of the individual's life. The employer sets aside funds, upon the advice of actuaries, to pay for the these pension benefits. The employer assumes the investment risk on the invested pension funds.

When investment performance is less or more than expected by the plan's actuary, employer contributions are adjusted up or down. Benefits to employees are not affected.

In contrast, a "defined contribution" retirement plan is one in which employer contributions are allocated to individual accounts for employees and the employees will, at retirement, be paid a lump sum distribution (or an annuity of equal value) that is simply the accumulation of employer contributions and investment income over the years. The employee bears the investment risk since his or her acount accumulation is directly affected by good or bad investment performance. The employer's financial commitment is limited to making contributions according to the terms of the plan, which can be a fixed percentage of pay or a more discretionary amount.

A defined benefit pension plan creates a long term financial obligation for MoPub. A commitment is being made now for benefits that will be paid for 50 or more years in the future. And future benefit credits will be based on payroll levels that can only be estimated now. The plan is very valuable to employees. It is undertaken to help achieve their financial security and to meet competitive standards in hiring and retaining quality employees.

Q. How does a pension actuary assist an employer in properly funding its pension plan?

A. Predicting the long-term cost of a pension plan depends on many factors. How long will employees stay with the Company? What will pay levels be when employees retire in the future? How long will employees and pensioners live? How much investment income can be earned on monies set aside to pay for plan benefits? These are just some of the factors to be taken into account.

A pension actuary is trained in the mathematical techniques used to estimate long term plan liabilities. The actuary also suggests employer contribution levels to satisfy certain funding rules of governmental authorities and to build up adequate assets to assure that benefit promises are kept. This is our primary role with respect to MoPub's plans.

Knowing that pensions are very long term obligations, the actuary helps to steer employer funding on a long term course. I have learned through experience that short term economic conditions should not be given too much weight. For example, the period of high inflation in the late 1970's and early 1980's (when the prime rate reached 20%) led many observers to say we would never see inflation levels below 6% per year. If this had proven to be true, it would have had a major effect on pension plan liabilities and funding. But high inflation did not persist after all and the long term perspective was once again validated.

Q. **What involvement does the federal government have in monitoring the establishment and funding of pension plans in the private sector?**

A. Pension plans are governed at the federal level by the Employee Retirement Income Security Act of 1974 (ERISA) and associated regulations. ERISA requires employers to set up a trust fund to accumulate assets to pay pension benefits. In MoPub's case, assets come from three sources: employee contributions, employer contributions and investment income. As long as the plan is intact, the assets can only be used to pay benefits and administrative expenses. Mo Pub cannot use the assets for any other purpose while the plan is ongoing.

The federal government has also enacted laws concerning employer funding levels. There are minimum funding requirements to help assure that enough assets are accumulated to meet benefit promises. Still, adequate funding is not guaranteed because investments can go bad and the employer bears the investment risk. For example, MoPub's pension plan assets lost 13% of their value in 1973 and then lost

15.5% the following year. That is, significant negative investment returns were experienced in these years. When investment results are poor, employer contribution requirements increase to cover these investment losses. Minimum funding requirements are recalculated annually to reflect this prior experience. Employees enjoy the benefit of knowing that the investment risk is with the Company and is not a burden for them to shoulder.

There are also rules that establish maximum tax-deductible amounts that Mo Pub can contribute from year to year. There are rules that apply each year to every plan. There are also overriding rules that apply when a plan hits the "full funding limitation" as defined by the Internal Revenue Service (IRS). In fact, it has become fairly common for employers to have a zero maximum tax-deductible contribution in the past five years. There are two reasons for this. First, investment returns have been higher than historic averages. This has led to a build up of assets that in some cases has triggered the full funding limitation to the extent no tax-deductible contribution is allowed. Second, the IRS (in 1987 legislation) has added a second way to calculate the full funding limitation so that the limitation applies to more plans. This second calculation would limit contributions to zero when plan assets equal 150% of the liability for benefits that have been accrued by plan participants for service already provided and pay already earned.

Q. Will an employer with a plan that is "fully funded" ever need to make additional contributions?

A. Under almost any scenario, the answer is yes. The IRS defines a fully funded plan as one that cannot make a contribution for the current year. No inference is made for future years. Most plans that are fully funded will have a future contribution required. This results from the fact that employees continue to earn benefits and benefits are paid out to pensioners even when the employer does not make contributions. The growth in the value of accrued benefits is typically faster than the growth in assets when no employer contributions are being made. Over time this cancels the full funding limitation and employer contributions resume.

Q. Can an employer with a plan that is "fully funded" withdraw excess assets?

A. No. Under federal government regulations, a plan must be terminated before any excess assets can be withdrawn. However, since employees earn additional benefits even when no employer contributions are made, excess assets are used to fund these future benefit accruals until the excess is used up. This allows the sponsoring employer to make indirect use of the "excess" assets by a reduction or temporary suspension of ongoing funding contributions. In accordance with the Company's recommendation to recognize cash contributions in rates, the benefits of a zero expense would flow to customers.

Q. Is there any way MoPub can recover the cost of service reduction recommended by the Staff other than possibly terminating the pension plans?

A. In my opinion, the answer is no.

Q. Please summarize the federal government's constraints on pension plan funding.

A. Employer pension funding must satisfy two sets of rules. The minimum funding requirements attempt to assure adequate funding for plan participants. The maximum funding rules prevent employers from obtaining tax deductions beyond specified limits. In fact, if an employer contributes more than the maximum tax-deductible amount for a given year, the excess is subject to a 15% excise tax payable directly by the employer to the IRS.

Because of law changes in recent years the gap between minimum required contributions and maximum tax-deductible contributions has narrowed. Employers must be careful to meet these rules. That brings to mind the story of Goldilocks and the Three Bears. Contributions can't be too little or too much. They must be "just right".

Q. Please summarize your testimony on pension funding.

A. Some of my main points are listed below:

- Pension plan liabilities are long term (50 years or more).
- Pension plan assets cannot be used by MoPub to meet operational expenses, or for any other purpose, while the plan continues.
- The employer bears the investment risk associated with the plan.
- The federal government has extensive rules that govern minimum and maximum funding.
- MoPub cannot recover the cost of the pension plans under the Staff's recommended approach.

<u>BACKGROUND ON PENSION EXPENSE</u>

Q. What is meant by the term "pension expense" and how has it been determined in the past?

A. Pension expense is normally thought of as the expense reflected on Mo Pub's financial statements for retirement plan expense. Prior to 1987, pension expense reflected in the books equaled Mo Pub's contribution. It is my understanding that the contribution amount was also utilized by the Commission in establishing rates prior to 1987.

Q. Has there been any recent change in the rules for calculating pension expense for financial reporting purposes i.e., what is published in annual reports, etc. for shareholders and the financial community to use?

A. Yes. Rules for calculating pension expense for financial reporting changed dramatically with the adoption of Financial Accounting Standard (FAS) 87, which was required to be adopted in 1987. No longer does the pension expense for financial reporting equal the employer contribution. In fact, the new methods for calculating pension expense are not even close to the rules that have to be followed to satisfy ERISA minimum and maximum funding requirements. Not surprisingly, employer contributions and pension expense can and many times are substantially different amounts in any given year. For example, MoPub's 1989 pension contribution differed by $544,000 from its 1989 FAS 87 expense. The difference was $684,000 in 1988 and $1,340,000 in 1987, with FAS 87 expense being lower in each year.

Q. Why are these amounts often so different?

A. Differences in these amounts result because FAS 87 gives more weight to current interest rates, etc. while funding rules require a longer term outlook. Because of the sensitivity to current interest rates, it has not been unusual since 1987 for FAS 87 pension calculations to result in a negative pension expense, whereas cash contributions can never go below zero.

Q. Do FAS 87 annual expenses and annual employer contributions, though differing from each other year to year, tend to "balance out" over time on a cumulative basis?

A. There is nothing inherent in the calculation of funding and FAS 87 amounts that suggests MoPub's FAS 87 expense (or Mr. Traxler's method, which is somewhat based on FAS 87) and cash contributions will even come close to "balancing out" on a cumulative basis. I will provide numbers later in my testimony that show there is no reason to believe a balance will ever be achieved for MoPub's plans. If assets equal to the negative expense amounts under FAS 87 or the Staff's method were actually withdrawn from the plan in the years the negative expense amounts occur, then it might be possible to achieve an approximate long term balance. Asset withdrawals of this type are not permitted for an ongoing pension plan as previously stated.

Q. Was FAS 87 adopted by the accounting profession because it represents a superior method for arriving at employer funding contributions?

A. FAS 87 states that one of its overriding objectives is to improve the comparability of reported pension information in employer financial statements. In my opinion, it is not intended to suggest a funding pattern. In fact, the introduction to FAS 87 contains the following language:

> "Some employers may decide to change their pension funding policies based in part on the new accounting information. Financial statements should provide information that is useful to those who make economic decisions, and the decision to fund a pension plan to a greater or lesser extent is an economic decision. The Board, however, does not have as an objective either an increase or a decrease in the funding level of any particular plan or plans. Neither does the Board believe that the information required by this Statement is the only information needed to make a funding decision or that net periodic pension cost, as defined, is necessarily the appropriate amount for any particular employer's periodic contribution." (Emphasis added.)

Q. Since FAS 87 made pension expense for financial reporting no longer equal to employer contributions, does this mean contributions can no longer be used in the cost of service for ratemaking purposes?

A. No. In my opinion, the long established practice of using contributions in the cost of service can be continued. In fact, I believe the contribution basis has the most merit and should be continued for several reasons. Using contributions in the cost of service will result in a pattern of cost that is less volatile.

ADVANTAGES OF THE CONTRIBUTION METHOD

Q. What is the first reason you would cite in support of the cash contribution basis for cost of service over the Staff's method?

A. First of all, the contribution method has been accepted by the Commission in prior years. This approach produces consistency. It allows the Company to recover its actual contributions to the pension plan, which is the best method for measuring pension costs. If no contributions are made, the ratepayers pay nothing.

Q. Does the adoption of FAS 87 by MoPub require a change in the historical ratemaking approach?

A. No. The existence of a new accounting standard for financial reporting does not cast a shadow on the reasonableness of using cash contributions in determining the cost of service for ratemaking purposes. In fact, paragraph 210 of FAS 87 describes the accounting procedures to follow in rate-regulated industries when cash contributions are used as the cost of service. A copy of this paragraph is attached to my testimony as Schedule WRG-1. In my opinion, the Financial Accounting Standards Board anticipated that the cash contribution method would remain in use following the issuance of FAS 87.

Q. Why is the use of actual contribution amounts advantageous over the use of a financial reporting figure?

A. Pension plans are long term obligations and, as previously mentioned, plan liabilities depend on many variable factors. Actuaries try to level out funding requirements over time so that wide swings from year to year are avoided. Sometimes exceptionally good or bad investment results, or other events, frustrate this goal. Still, actual dollars contributed to the plan are the best measure of cost incurred by the sponsoring employer.

On the other hand, the Staff's cost of service method results in a <u>negative</u> pension expense in the instant case. For example, the Staff's calculation of cost of service for the test year is an approximate negative $1.3 million. A negative expense translates to pension <u>income</u>. But it is certainly not income in terms of cash. The only way

MoPub could have realized a cash income in this amount for the test year would have been to take the money out of the pension fund. Again, federal law prohibits such action, absent the complete termination of the plan.

Q. You have stated your professional opinion that cash contributions are, over time, the best measure of the cost incurred by a company to sponsor a pension plan. Does the Staff's proposed method for calculating pension expense permit MoPub to recover its actual pension cost?

A. In my opinion, the Staff's method will <u>not</u> allow MoPub to recover in rates the long term cost it will incur to sponsor the plans.

Q. What implications are there for the future operation of MoPub's pension plans if the Commission adopts the Staff's recommendation in this case?

A. MoPub's objective is to recover its cost to provide each pension plan, where such cost is measured by cash contributions that are made within the allowable range governed by federal funding rules. In my opinion, if MoPub cannot recover its long term pension costs, serious consideration should be given to terminating the pension plans and replacing them with a defined contribution retirement program.

Q. Would termination of MoPub's pension plans be detrimental to MoPub or its employees?

A. Termination of the plans with replacement by a defined contribution program (such as making additional contributions to the Savings Plan or ESOP) would be a significant change in MoPub's approach to providing retirement income. Employees now enjoy the predictable benefits of a pension plan in which MoPub bears the investment risk. This is similar to my understanding of the State of Missouri's plan which the Commission employees participate in. The alternative to that is a defined contribution plan in which the employee participates in the investment process and the investment risk is shifted to the employee. If I were under either the MoPub plan or the State of Missouri plan, as an employee I would feel more comfortable staying with the defined benefit plan because of the greater assurance there will be benefits there for me when I retire. Eliminating the current MoPub pension plans would definitely add more uncertainty to MoPub's overall retirement income program, which is to the detriment of the employees.

MoPub would very likely suffer adverse participant reactions. Current pensioners and employees near retirement age should and would be particularly upset because a plan termination is an emotional threat to their security. Also, employees over age 50 would very likely suffer a loss of benefits due to the change in programs because they would be losing out on having benefits for their whole career based on their average pay in the four years just prior to actual retirement.

MoPub's 1989 pension contribution was less than 1.5% of the payroll of active participants. Yet employees continued to earn benefits for additional pay and service. If a defined contribution replacement plan were adopted, I would estimate that MoPub's contribution would have to average 6% to 8% of payroll to provide comparable benefits long term. And this cost would be ongoing. There would never be any "contribution holidays" (without loss of benefit accruals for employees) because there is no such thing as a full funding limitation for defined contribution plans. By a "contribution holiday", I mean a year or period of years in which no employer contributions are required but employee benefit accruals are not affected. This can only occur with a defined benefit pension plan.

Employees bear the investment risk in defined contribution plans. The cost estimates in the previous paragraph do not build in any factor for this shift of investment risk from the employer to the employee. It is possible employees may exert pressure on the Company for higher contributions if there is a reoccurrence of the stock market crash that was experienced in October 1987 or a more general market downturn such as was experienced in 1973-74.

Q. Would termination of MoPub's pension plans be detrimental to ratepayers?

A. It is widely accepted in the actuarial profession that it is less expensive over time to provide a given level of retirement income through a defined benefit plan as compared to a defined contribution plan. One reason is that a defined benefit plan pays out smaller benefit amounts to employees terminating before retirement than does a defined contribution plan that, on average, provides the same benefits at normal retirement age.

This defined benefit advantage is accruing to MoPub's ratepayers right now as the employer contributions to fund the pension plans are low. A replacement defined contribution plan would involve higher future employer contributions as discussed above. These higher contributions would presumably be included in MoPub's cost of service. Over the next five years the excess of the replacement plan contributions over the currently expected pension plan contributions could be $7.5 million assuming the replacement plan contributions are 6% of payroll and the pension plans would have had no contributions required.

Q. How does the federal government's involvement in pension plans support the contribution method?

A. Pension funds in the United States total to a huge amount of money. So the federal government monitors pension funding closely. This has resulted in the extensive rules mentioned earlier for minimum required and maximum tax-deductible funding. The close scrutiny applied to pension plans gives the Commission assurance that MoPub's pension contributions are a reasonable measure of plan costs over time, lending further support to the use of the contribution method for ratesetting. Other approaches, such as those based on FAS 87 expense amounts, do not come under the watchful eye of the federal government and are not designed or intended to reflect the long term cost of the plans.

Q. Does the contribution method produce over time more or less stable results than the *Staff's recommended* approach?

A. More stability (i.e., lower volatility) results from using the contribution method. This is conclusively demonstrated in the attached Schedules WRG-2 and WRG-3.

Q. Why is stability an advantage?

A. A more stable pension expense will produce less volatile cost of service adjustments and more stability in ratesetting. Because MoPub's objective is to only recover its pension costs, pension costs measured using a method that produces significantly more volatility will need more frequent review by both the Company and the Commission. Company witness Ms. Samayoa addresses this issue.

Q. Are you aware of any other costs that are similar in nature to pension costs?

A. Yes. MoPub has a program of retiree medical benefits that covers retirees until Medicare benefits apply at age 65. Benefits are financed and expensed on a pay-as-you-go basis (i.e., cost is recognized when benefits or premiums are paid by MoPub).

Q. Are the accounting rules for financial reporting of expense for retiree medical benefits likely to change in the near future?

A. Yes. The accounting profession (through the Financial Accounting Standards Board) is working on a project that will likely lead to an accounting standard similar to FAS 87 for pensions. The new standard may apply as early as 1992. Almost all employers that now use pay-as-you-go financing and expense recognition will incur an increase in expense for financial reporting. This is in contrast to the experience with pensions, where the adoption of FAS 87 has resulted in lower expense since its inception in 1987. The difference is due to the fact that no assets have been accumulated for retiree medical benefits whereas trust funds have been a required feature of pension plans for 15 years and many funds are much older than that.

Q. What will the impact be of changing the accounting method for retiree medical benefits?

A. Based on my review, the impact of the accounting change will be substantial. This expense will be reflected in the Company's financial statements. Because the two benefits are similar in nature, a contribution approach to ratesetting would address both types of costs. Since cash contribution (or premiums) is presently the accepted method for recognizing the cost of retiree medical benefits, it is consistent to apply the same method for pension cost recovery.

Q. Is there an advantage to MoPub's employees in using any particular cost of service basis?

A. Yes. MoPub's employees will benefit from the Commission's continuation of the contribution approach set within ERISA and IRS funding limits. This gives MoPub's employees the greatest assurance that the Company's funding will follow sound actuarial practice and will not be influenced by ratemaking issues long term. Conversely, the use of an alternative such as the Staff's suggested approach produces an _immediate_ conflict between the amount allowed in cost of service and the amount allowed (or required) for ERISA funding. And this conflict promises to be long lasting. Heightening the problem is the negative amount being recommended by Staff in this case.

Q. Expand on the conflict you mentioned.

A. Contributions, of course, are never less than zero. The use of a basis other than cash contributions will not allow MoPub to recover the cost of the plan and could conceivably jeopardize the plan's very future if adequate rate recovery is not allowed. This element of uncertainty should be avoided.

Q. Please summarize the advantages of the cash contribution basis.

A. A summary listing of the advantages of cash contributions is as follows:

1. Consistency with Past Practice.
2. Contributions are the Best Measure of Cost.
3. Safeguards of Federal Funding Rules.
4. Stability.

5. Comparison to Retiree Medical Benefits.

6. Security for Employees.

STAFF'S APPROACH

Q. Describe the Staff's recommendation for pension cost recovery in this case.

A. The Commission Staff, through Mr. Steve M. Traxler, has suggested a unique approach to cost of service for pensions.

Q. In general, what approach does the Staff suggest?

A. Mr. Traxler begins his computation with a FAS 87 expense methodology and then suggests two adjustments that would further reduce the FAS 87 pension expense by over $1.8 million. An allocated portion of the adjusted amount would be used in the cost of service for ratemaking purposes if Mr. Traxler's approach is adopted by the Commission.

Q. How do MoPub's preferred approach and the Staff's method for calculating pension cost of service compare as far as recognition by accredited professionals who deal regularly with pension plans?

A. The funding methods we use as MoPub's actuary are fully accepted as standard practice within the actuarial profession. These methods also satisfy the federal rules for the calculation of pension contributions under ERISA and the Internal Revenue Code. The Staff's method does not result in pension expense amounts that would meet the ERISA funding rules. Thus, a large difference between funding amounts and the Staff's expense amounts can and very likely will emerge over time. Although the Staff started with an expense number recognized by the accounting profession (albeit for a purpose that is not compatible, long term, with cost of service), it went on to develop an approach that is recognized by neither the accounting nor the actuarial profession. The Staff's approach borrows from ERISA funding requirements in some respects and patterns after FAS 87 in other aspects of the expense calculation and in the selection of certain actuarial assumptions. It also involves the selection of an expected investment rate of return based entirely on past investment performance. This is an approach unique to the Staff of the Missouri PSC as far as I have been able to determine.

Q. Does any of the Staff's testimony suggest a lack of familiarity with pension funding or expense?

A. Yes. For example, Mr. Traxler was asked if the Staff is recommending that MoPub terminate its pension plan to "eliminate the excessive funded position of the plan". (Staff testimony page 21). He responded that it is the Staff's opinion that "the overfunded status of the fund can be corrected over time if pension expense is calculated in accordance with the Staff's recommendations..." (Staff testimony page 21). This is a totally erroneous statement that suggests a lack of understanding of pension funding or expense.

Pension expense under Mr. Traxler's suggested approach has nothing to do with actual dollars contributed to the pension fund. Rather, contributions must fall within ERISA limits. The only way a pension plan's "overfunding" can be corrected is reduce funding. Lowering cost of service based on financial reporting expense does not, in and of itself, have any effect on the excess of trust fund assets over accrued benefit obligations. For example, suppose such excess is $5 million and the Staff's method is adopted by the Commission and results in a negative $1 million expense figure. The Company would account for the "expense" on its books, but no money would be added to, or taken from, the pension fund in response to the staff's expense figure. Plan assets would continue to earn investment income, benefits would be paid to retirees, accrued liabilities would increase for active employees, and the Company may or may not be required to make a contribution depending on how the ERISA funding limits applied that year. All of this activity would be independent of the pension expense entered for the year on the Company's books.

ADJUSTMENT 1

Q. Describe the Staff's Adjustment 1.

A. According to Mr. Traxler, Adjustment 1 is a recalculation of the expected investment return on pension plan assets. The expected investment return is the rate of investment income on a market value basis that is expected to be earned on plan assets in the year for which the calculation is being made. Since investment income is a source of funding, the expected investment income is applied as a credit in figuring the expense for the year. The Staff proposes to apply an 11.0% expected investment return on estimated December 31, 1989 assets in order to utilize the most current asset data. In contrast, MoPub's 1989 FAS 87 pension expense was calculated using a 9.0% expected investment return on January 1, 1989 assets (adjusted for expected contributions and benefit payments during 1989). The Staff's approach yields an expected return for the test year of $4,139,000 compared to the Company's expected return of $2,797,000 for FAS 87 in 1989. The Staff maintains that the difference, approximately $1,342,000, should be a negative adjustment to the test year pension expense for the Company as a whole.

Q. What expected investment return assumption is used in determining MoPub's pension contributions?

A. MoPub's pension contributions are determined using an 8% long term rate of return assumption as selected by the actuary. The 8% rate reflects historical rates of return achieved over the past 20 years and the actuary's expectations for long term future inflation and rates of return.

Q. Why does the Staff apparently feel an 11% rate of return assumption is more appropriate?

A. Mr. Traxler says that even the 9.0% rate of return used by the Company for FAS 87 is "unrealistically low". He cites the following historical data to support his position:

- Market value rates of return averaged 15.07% from 1985 through 1989.

- Market value rates of return for 1987 through 1989 averaged 12.02% even with a 2.65% return for 1987.
- Market value rates of return for 1979 through 1989 averaged 14.66%

I provided the data and performed the approximate rate of return calculations on which the above summary results are based. I do not dispute the summary results but do take exception to the manner in which he selected and used such data.

Mr. Traxler concludes that the 11.0% rate of return "is conservative when compared to MoPub's actual rates of return achieved on a historical basis."

Q. Explain your exception.

A. Historical rates of return can say different things depending on the period selected for measurement. I was asked by Staff to provide historical data on investment returns for the years 1975 through 1989. The Staff chose to not include returns for years 1975 through 1978, which averaged 10.71%, in presenting historical results. And no rate of return information was even requested for earlier years. Interestingly, the two years just prior to the initial year covered by the Staff's Data Request both involved significant <u>negative</u> investment returns (12.95% and 15.52% for 1973 and 1974, respectively).

If we look at the 20 year period of 1970 through 1989, the average rate of return was actually 9.87% before expenses and approximately 9.07% net of expenses.

Q. Do you have additional information to support MoPub's use of an 8% rate or to suggest an 11% rate is inappropriate?

A. Yes. Some additional comments on rates of return are as follows:

1. MoPub's 8.0% expected rate of return assumption is <u>net</u> of most investment and administrative expenses, whereas the historical rates of return we provided to the Staff are <u>before</u> such expenses. Investment and administrative expenses

have averaged 0.8% of assets for the Company's pension plan. In other words, historical returns cited above should all be reduced by 0.8% before they are evaluated in relation to MoPub's assumption.

2. Historical average nominal rates of return on long term government bonds and the S&P 500 stocks are summarized below for the past six decades:

Period	Long Term Bonds	S&P 500 Stocks	50/50% Weighting
1930 - 39	4.9%	(0.7)%	2.1%
40 - 49	2.6	8.5	5.6
50 - 59	(1.1)	19.2	9.1
60 - 69	0.8	7.7	4.3
70 - 79	3.9	5.7	4.8
80 - 89	12.5	17.3	14.9
1930 - 89	3.9	9.4	6.7

In my opinion, the 8.0% rate of return assumption used by MoPub for calculating pension contributions is appropriate in view of the rates of return by decade shown above. As an actuary, I would not use the decade with the highest rate of return (i.e., the 1980's) as the basis for setting a long term rate of return assumption.

3. The expected rate of return assumption should be selected in relationship to other assumptions, particularly the inflation and the salary increase assumptions. MoPub's inflation assumption is 4.5% and its salary increase assumption is 5.5% to determine pension expense. The difference between the expected rate of return and the inflation assumption is called the "real rate of return assumption." Based on 4.5% inflation assumption and an 11% expected rate of return, the "real rate of return" assumed is 6.5%.

The average inflation rate for the 20-year period 1970 through 1989 was in excess of 6.22%. When you compare this rate to the average net rate of return for the same period, 9.07%, the "real rate of return" was 2.85%. A "real rate of return" assumption of 6.5% is too high.

If an 11% expected rate of return is used, the inflation and salary increase assumption should be increased to reflect this rate. The increase in these assumption would increase the pension expense.

4. My firm has obtained further information on the expected rate of return used for FAS 87 purposes by the nation's largest 50 utilities as ranked annually in Fortune magazine. This information was gathered from the annual reports of these companies for the years 1987, 1988 and 1989 and is summarized below:

Expected Rate of Return	Number of Utilities Reporting an Expected Rate of Return in Category		
	1987	1988	1989
Under 8.00%	12	11	8
8.00% to 8.49%	11	6	5
8.50% to 8.99%	10	13	11
9.00% to 9.49%	8	8	9
9.50% to 10.49%	8	8	8
Above 10.49%	1	0	0
Total Utilities Reported	50	46	41
Average Rate Used	8.41%	8.50%	8.58%

5. Historical returns should not be the sole basis for selection of an expected rate of return assumption. Appropriate consideration should be given to current investments and future rates of return expected to be available at reinvestment. The uncertainty associated with future returns on reinvested assets argues against overweighting for past investment results. Also, reinvestment rates are usually pegged to long term average rates, which are well below 11%.

Schedule SMT-2-23

I believe this data further demonstrates that the Staff's 11.0% proposed rate of return assumption is too high.

Q. Part of the Staff's rationale for making Adjustment 1 is that it incorporates an estimate of asset values as of December 31, 1989, which is more current than beginning of the year data. Do you see any problem with using the year end asset information?

A. I understand the Staff's interest in using the most recent data that is available for purposes of calculating a pension expense amount for the test year. However, it is inconsistent and inappropriate to use the larger end of year asset value to compute the "credit" part of the net Staff expense amount while using the smaller beginning of the year liability amounts to figure the "charge" part of the net expense amount.

Q. Is information available to estimate the liability "charge" part of the net Staff expense amount as of the end of 1989?

A. Yes. The FAS 87 disclosure information as of December 31, 1989, previously provided to the Staff, provides an estimated actuarial liability ("projected benefit obligation") as of that same date. We have also calculated a service cost based on December 31, 1989 estimated data.

Q. What is the effect on the Staff's annualized pension expense of using December 31, 1989 liability data as discussed above?

A. The effect is to make the pension expense less negative by approximately $240,000. The entries in Mr. Traxler's Schedule 1, Column C, Lines 1 and 2 would become +100,000 and +140,000, respectively.

Q. Do you have any other changes to suggest in the calculation of Adjustment 1?

A. Yes, I have two additional changes to suggest. One involves the level of assets to which the expected return should be applied. The other relates to recognition of plan expenses.

Q. Explain the asset level adjustment and its effect on the Staff's expense.

The expected return on assets (Schedule 1, Column B, Line 3) should not be based on the asset value as of December 31, 1989 without adjustment. Rather, the expected return should be based on an average asset amount that is adjusted for expected benefit payments and employer contributions (if any). In MoPub's case, the effect of this adjustment is to lower the expected return on assets by approximately $90,000. This is a direct increase in the Staff's expense amount.

Q. Explain the expense recognition adjustment.

A. The Staff's 11% expected return is based on historical investment results <u>before expenses</u>. MoPub's FAS 87 pension expense uses an expected return that is <u>after</u> most expenses. To conform with the Staff's approach, an expected annual expense amount reflecting all anticipated expenses, including investment management fees, should be incorporated into the expense calculation. MoPub's expenses in 1989 were $350,000, but only $60,000 was included for FAS 87 purposes. The additional $290,000 should be added to the Staff's pension expense amount.

Q. Please summarize your suggested changes to the Staff's Total Company Adjustment 1 calculation for the test year.

A. The suggested changes are as follows:

Item	Change to Staff's Adjustment 1 Amount
• Year-End Service Cost	$ +100,000
• Interest Year-End Accrued Liability	+140,000
• Adjust Assets for Expected Payouts and Contributions	+90,000
• Recognize Expense	+290,000
	$620,000

Q. In total, what would your suggested revisions do to the negative $1,841,353 "Total Company Adjustment" shown in Schedule 1, Column 3, Line 6?

A. The Total Company Adjustment would reduce to negative $1,221,353, which is an increase of $620,000 in the Staff's measure of pension expense.

Q. You stated that the Staff selected their 11% expected rate of return based on recent historical experience. Were all other assumptions used to determine pension expense under Mr. Traxler's method based on recent historical experience?

A. No, the interest discount rate was not based on recent historical experience.

Q. What does the discount rate represent and how is it selected?

A. The discount rate represents the interest rate at which benefits can be "settled" i.e., annuities can be purchased from an insurance company. The discount rate should represent the insurance company interest rate that would be used in pricing the annuities in the event they were actually purchased as of a specified date.

Q. What discount rate was used to calculate estimated pension expense under Mr. Traxler's method for 1990?

A. 8.75%.

Q. Is this rate based on recent historical experience?

A. No, it is the rate determined as of January 1, 1990.

Q. Why do you say that this is not an appropriate rate for historical purposes?

A. The 8.75% represents a rate at which annuities can be purchased from an insurance company as of January 1, 1990. Benefits earned through December 31, 1988 under MoPub's pension plans can be paid in the equivalent lump sum amount. Most terminated or retired participants under MoPub's pension plans select the lump sum option. The discount rate is inappropriate for 1990 from a historical perspective because it doesn't reflect the selection of lump sum benefits for the prior several years.

Q. Why did you not consider the payment of lump sums in selecting this discount rate for FAS 87 purposes during 1989?

A. Since benefits earned after December 31, 1988 can not be paid in a lump sum form, unless it is less than $3,500, I assumed that benefits would be paid as an annuity.

Q. If you considered the payment in a lump sum benefit form, what discount rate would have been used for 1990?

A. Lump sums payable from the MoPub Plans during 1990 will be calculated to be equivalent to monthly benefits at the Pension Benefit Guarantee Corporation i.e., PBGC, interest rates as of January 1, 1990.

Q. Who is the PBGC and how do they determine their rates?

A. The PBGC is a federal governmental agency that guarantees the pension benefits for pension plans that terminate with insufficient assets. The PBGC sets their rates by polling several insurance companies each month and using the average insurance company rates. They use these rates to determine underfunding of terminated plans.

Q. What rates are used for 1990 lump sums?

A. Lump sums are calculated at 7.25% for immediate benefits, 6.50% for deferral periods up to 7 years, 5.25% for deferral periods of 8 to 15 years and 4.00% for deferral periods in excess of 15 years.

Q. If Mr. Traxler's numbers were calculated at the above PBGC rates, what would be the adjustment to pension cost?

A. If PBGC rates were used, the total pension cost including the above adjustments to end of year liabilities, etc. would be approximately a positive $1 million expense. This amount is actually larger than the estimated company contribution of $0 even though it incorporates an 11% expected rate of return assumption.

Q. In your opinion, could the use of PBGC interest rates be considered appropriate for calculating pension cost?

A. Yes, FAS 87 states that the "discount rates shall reflect the rates at which pension benefits could be effectively settled. It is appropriate in estimating these rates to look to available information about rates implicit in current prices of annuity contracts that could be used to effect settlement of the obligation (including information about current annuity rates currently published by the Pension Benefit Guaranty Corporation)."

Q. Would use of PBGC rates be appropriate if benefits are assumed to be paid as annuities rather than lump sums?

A. Yes, as stated above, PBGC rates can be used for setting the discount rates for benefits paid as annuities.

Q. Why was the 8.75% discount rate used rather than the PBGC rates for the original calculations?

A. As FAS 87 states with respect to estimating discount rates "In making those estimates, employers may also look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits." The 8.75% discount rate used by MoPub was toward the high end of the rates allowed by FAS 87.

Q. If the Staff's proposed adjustment to the rate of returns was dropped, would you be satisfied with the resulting test year expense method?

A. No. Mr. Traxler's testimony on pension expense builds from a FAS 87 starting point and has further complications. I do not believe either FAS 87 or the Staff's approach is the proper basis for cost of service.

<u>ADJUSTMENT 2</u>

Q. Please describe the nature and effect of the Staff's proposed Adjustment 2.

A. Adjustment 2 calls for a recalculation of the amortization of unrecognized gains or losses (in the context of FAS 87) utilizing a 5-year amortization period. This adjustment reduces the total MoPub pension expense by $499,223 per the Staff's Schedule 1, Column C, Line 5.

Q. Explain what is meant by "gains or losses".

A. "Gains or losses" occur when the actual experience of a pension plan as to investment returns, employee pay increases, employee turnover, mortality, retirement rates, etc. differ from the experience predicted by the actuarial assumptions underlying the calculation of Company contributions, FAS 87 pension expense, or the Staff's pension expense.

Q. What is meant by "unrecognized" gains and losses?

A. It is inevitable that gains and losses will occur during the life of a pension plan. Actuarial funding methods and the FAS 87 accounting standard describe how gains and losses should be handled as they arise. In some cases, FAS 87 in particular, the expense method may allow for gains and losses to build up to some minimum level before they even enter into the expense calculation. While the net cumulative gain or loss is below the threshold magnitude, it is said to be "unrecognized." The same term can be applied to that part of a gain or loss that will be factored into the expense calculation in future years through an amortization process.

Q. Would the Staff's method permit gains and losses to accumulate to some minimum threshold magnitude before recognition and amortization begins?

A. No. The amortization process would begin in the year following the year giving rise to the gain or loss. However, at the time it is initiated the Staff's method would include a 5-year amortization of the unrecognized gain that existed in MoPub's plans under FAS 87 as of December 31, 1989. A big part of that gain was derived from the investment return in excess of 20% achieved by the pension fund in 1989.

Q. Are there any general implications of the Staff's proposed Adjustment 2?

A. Yes. Adjustment 2 will cause the Staff's expense method to be much more volatile than cash contributions.

Q. Has your firm performed any actuarial calculations to compare the volatility of pension cost of service amounts using your suggested approach, cash contributions, and the Staff's recommended approach?

A. Yes. Calculations were performed under my direction to project the pension cost amounts that would result under the two alternatives for each of the next four years under two economic scenarios. One projection assumes general inflation and interest rate experience will duplicate the years 1970-1973, when average investment returns were low (4.3%). The other projection assumes experience will match the period of 1976-1979, when average investment returns were relatively high (10.1%). The gross rate of return and discount rates used for these projections are summarized below:

Projection Year	Gross Rate of Return 70-73 Experience	76-79 Experience
1990	8.85%	17.60%
1991	7.45%	(.19)%
1992	16.31%	8.95%
1993	(12.95)%	14.75%

Projection Date	Discount Rates 70-73 Experience	76-79 Experience
1/1/90	8.75%	8.75%
1/1/91	5.75%	8.00%
1/1/92	5.50%	8.25%
1/1/93	7.75%	8.75%
1/1/94	8.25%	10.00%

Such projections, of course, require a lot of assumptions to be made concerning future investment performance, employee pay increases, general inflation rates, trends in interest rates, etc. It would be inappropriate to rely on the projection to accurately predict specific dollar expense amounts. However, the projection results are very useful in picturing the general level of expense amounts and the pattern of variability in amounts from year to year under the two alternatives. This allows a comparison of volatility.

Q. Can you summarize the results of the 4-year projection study?

A. Yes. Schedules WRG-2 and WRG-3, which are attached to my testimony, are line graphs that show the year-by-year cost of service amounts that would result under the two alternatives if experience unfolds according to the assumptions made. Note that the pattern of Company contributions is similar under the two scenarios, whereas the expense shows marked differences between the different economic projections.

Q. Why are employer contributions zero during most of the projection period?

A. The projection calculations include a calculation of the IRS full funding limitation for each year. Under the assumptions made, MoPub's contribution would be limited to zero by the full funding limitation in the first three years covered by both projection scenarios. This represents the period that "excess" assets are used up, since employer contributions resume in the fourth year.

Q. Do Schedules WRG-2 and WRG-3 allow you to draw any conclusion concerning the relative volatility of the two alternative approaches to pension cost of service?

A. Actuaries generally define volatility as the change in amounts from one year to the next. MoPub's cash contributions are projected to be zero over the next three years under either scenario, so that little volatility is displayed. The Staff's amounts are readily seen to be much more volatile in each Schedule.

Q. Have you performed any other projections of future expense levels?

A. Yes. Projections were performed under my direction to test whether the Staff's expense and Company contributions would "balance out" such that they would be roughly equal over the next 20 years (1990 through 2009).

Q. What approach did you take for setting assumptions about future economic experience?

A. I assumed all the assumptions used in 1989 for the Company's FAS 87 calculations would remain the same in the future. I also assumed Mr. Traxler's 11% expected rate of return assumption would remain the same under the Staff's method. I assumed that actual experience in future years would exactly match the actuarial assumptions except for actual investment returns, which would be a steady 11% per year or, alternatively, a steady 9% per year.

Q. In the projection in which a steady 11% actual return is assumed, did expense amounts under the Staff's method and Company contributions balance out over the 20-year projection period?

A. No. Contributions were projected to be zero throughout the period due to the full funding limitation. The Staff's expense remains negative and grows to a negative $4,000,000 at the end of the projection period. Over the 20-year period, the difference between the Staff's cumulative expense amount and Company contributions is a negative $51 million.

Q. What were the projection results assuming actual investment returns are 9%?

A. Company contributions would be zero for five years and then contributions would resume. Contributions reached $2.3 million per year in 2009. The Staff's expense amount remained negative throughout the projection period. Over the 20-year period, the difference between the Staff's cumulative expense amount and the Company contributions is a negative $41 million.

Q. What do these large cumulative negative differences in expense mean?

A. They convey two important messages. First, the Staff's method and Company contributions do not even come close to balancing out in the foreseeable future. Second, the Company will not be able to recover its pension contributions in rates if the Staff's method is adopted by the Commission for ratemaking purposes. As previously mentioned, this result could and should cause the Company to seriously consider terminating the plans.

Q. Can you summarize your opinion on the appropriateness of the Staff's proposed cost of service basis?

A. Yes. The Staff's recommendation builds from the wrong cornerstone - FAS 87. The Staff then proposes two adjustments that, in my opinion, have been demonstrated to make the Staff's proposed method even more inappropriate.

PENSION OVERFUNDING

Q. Do you have any other testimony concerning MoPub's pension plans?

A. Yes. I would like to comment on pension overfunding in response to Steve Traxler's testimony.

Q. Do you agree with Mr. Traxler's statement (page 20) that MoPub's pension plans are overfunded?

A. Like most actuaries, I use the term "overfunded" very reservedly. Since pension funding is a dynamic process, a snapshot of a plan's funded status today can be a lot different than the picture looked even a year ago. The picture of MoPub's funded position as of December 31, 1989 (page 20) comes at the end of a year in which the market value rate of return on fund assets exceeded 20%. It's not surprising the funded status is very solid at that measurement date.

Q. Do you agree that MoPub's pension assets exceeded its current accumulated pension benefit liability by 79.7% on December 31, 1989?

A. I agree that the numbers presented by Mr. Traxler are accurate. However, the liability figure used in this comparison to assets is based on FAS 87 disclosure information using an interest discount rate of 8.75%. If the plans had been terminated on December 31, 1989 and benefits to participants had been distributed in lump sum payments, the liability would have been approximately $27,660,604, rather than $20,811,025. A comparison of the funded status under these alternatives for measuring liabilities is as follows:

	FAS 87 Disclosure*	Plan Termination**
Market Value Assets	$37,390,965	$37,390,965
Benefit Liabilities	20,811,025	27,660,604
Excess of Assets over Liabilities	$16,579,940	$ 9,730,361
Excess/Liabilities	79.7%	35.2%

* *Liabilities calculated using an 8.75% discount rate.*

** *Liabilities calculated using plan termination factors of the federal Pension Benefit Guaranty Corporation as of January 1, 1990.*

The 35.2% excess of assets over liabilities on a plan termination basis is not unreasonably high. Some plan termination "cushion" should be maintained to allow for the possibility of a downturn in investment results.

Q. Could this 35.2% "cushion" be lost due to poor investment results anytime in the near future?

A. Yes. In fact, if investment experience in the next two years matches the experience of 1973-74, the entire plan termination surplus would be eliminated.

Q. Do you agree with Mr. Traxler's statement on page 21 that "an overfunded pension fund results when pension expense has been overstated?"

A. For plans such as MoPub's that have sizeable assets, investment performance from year to year will be the more dominant factor in any "snapshot" of the plan's funded position. For example, MoPub's aggregate pension contributions for the years 1985 through 1989 totaled $5.3 million. These contributions fall short of actual benefit payments made during the 1985-89 period, approximately $11.8 million, by $6.5 million. Mr. Traxler's testimony points out that investment income (market value basis) during these same five years amounted to $22.2 million -- <u>four times</u> the amount of employer contributions. Clearly, investment returns have been the major contributor to the improved funded status of the plans over this time period. MoPub bears the investment risk for the plans, however, which means poor investment performance in the future would erode the funded position.

Q. Does the full funding limitation, as incorporated in ERISA funding rules, help control "overfunding"?

A. Yes. We know that the full funding limitation added by OBRA '87 legislation applies to the extent no tax-deductible employer pension contributions are required or permitted when plan assets reach 150% of the value of benefits already earned under the plans. This present value of benefits is calculated at an interest rate that must fall within 10% of the most recent four-year weighted average yield of 30-year Treasury bonds. MoPub used an 8.5% rate as of January 1, 1989. Use of this relatively high rate means the 150% level will be reached well before the plan termination surplus reaches 50% of the value of accrued benefits. In some cases the "old" (i.e., pre-OBRA '87 legislation) full funding limitation will apply even before the 150% alternative is triggered.

In my opinion, the full funding limitation adequately serves to curb "overfunding" attributable to employer contributions. Of course, outstanding investment returns can still contribute to a high ratio of assets to the value of accrued benefits.

Q. If a plan subject to the full funding limitation can be said to be "overfunded", is there any way that MoPub's ratepayers can benefit from the overfunding without terminating the plan?

A. Yes. The overfunding flows back to ratepayers in the form of a "contribution holiday." While no contributions are being made, excess assets are used to make benefit payments to terminating or retiring employees and to absorb the cost of additional benefit accruals for active employees.

Q. Please summarize your position on the appropriate method to be used in determining pension costs for ratemaking purposes.

A. I believe actual Company contributions to the pension plans, within ERISA funding rules and IRS tax-deductible limits, represent the best method for determining pension costs for ratemaking purposes. As Ms. Samayoa states in her rebuttal testimony, the expected 1990 Company contribution is zero and this amount should be accepted by the Commission for ratemaking purposes. The Staff's recommended negative pension cost should be rejected by the Commission.

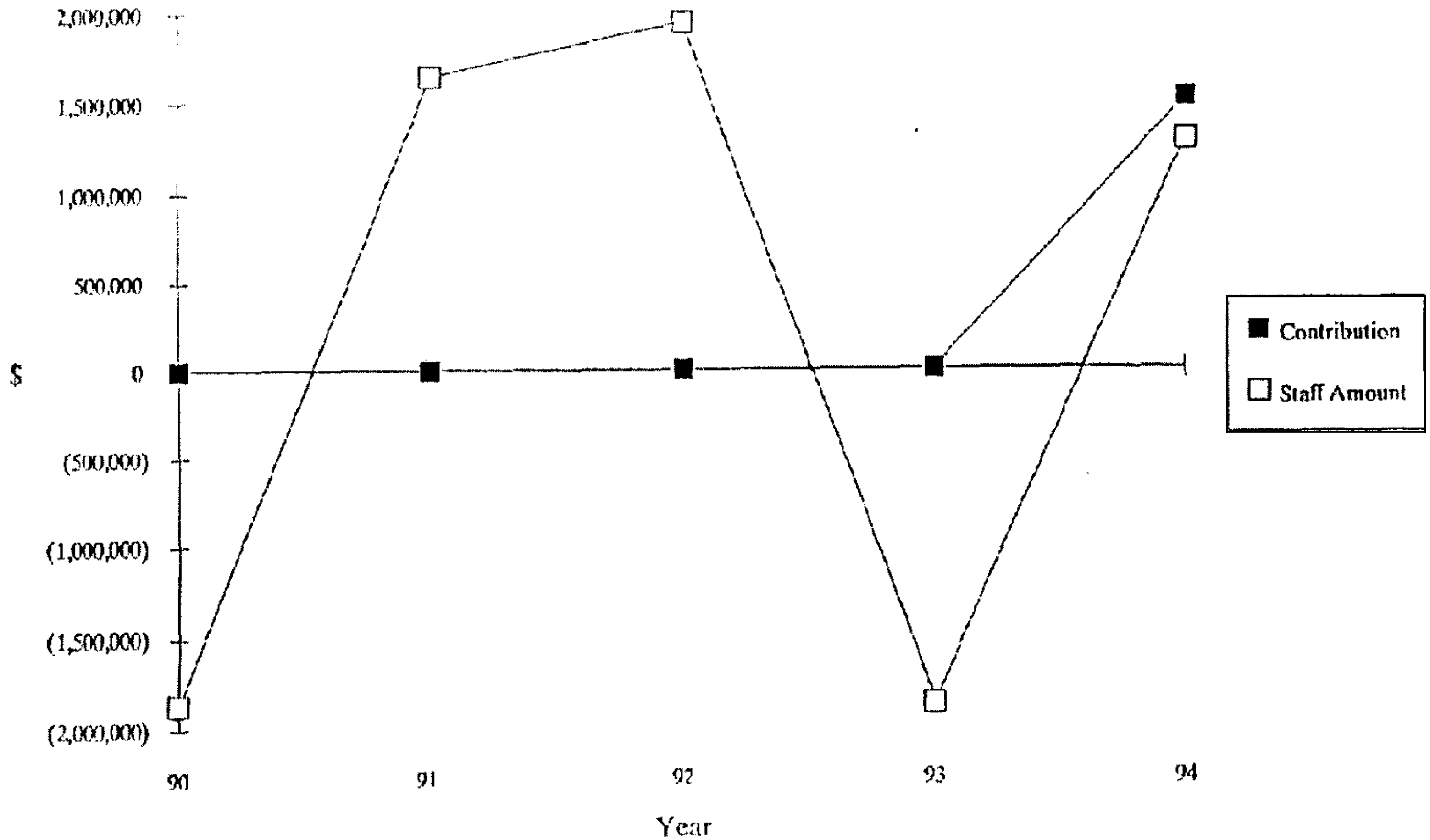
Q. Do you have any other testimony on the pension plan?

A. Not at this time.

210. Some respondents argued that accounting requirements should be different for employers subject to certain types of regulation (rate-regulated enterprises) or for employers that have certain types of government contracts for which reimbursement is a function of costs incurred. In both of those cases it was noted that a change in reported net periodic pension cost might have a direct effect on the revenues of the employer (lower cost would result in reduced revenues), or conversely, that increases in reported net periodic pension cost would not be recoverable. The Board understands the practical concerns of those respondents, but it concluded that the cost of a particular pension benefit is not changed by the circumstances described and that this Statement should include no special provisions relating to such employers. For rate-regulated enterprises, FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation,* may require that the difference between net periodic pension cost as defined in this Statement and amounts of pension cost considered for rate-making purposes be recognized as an asset or a liability created by the actions of

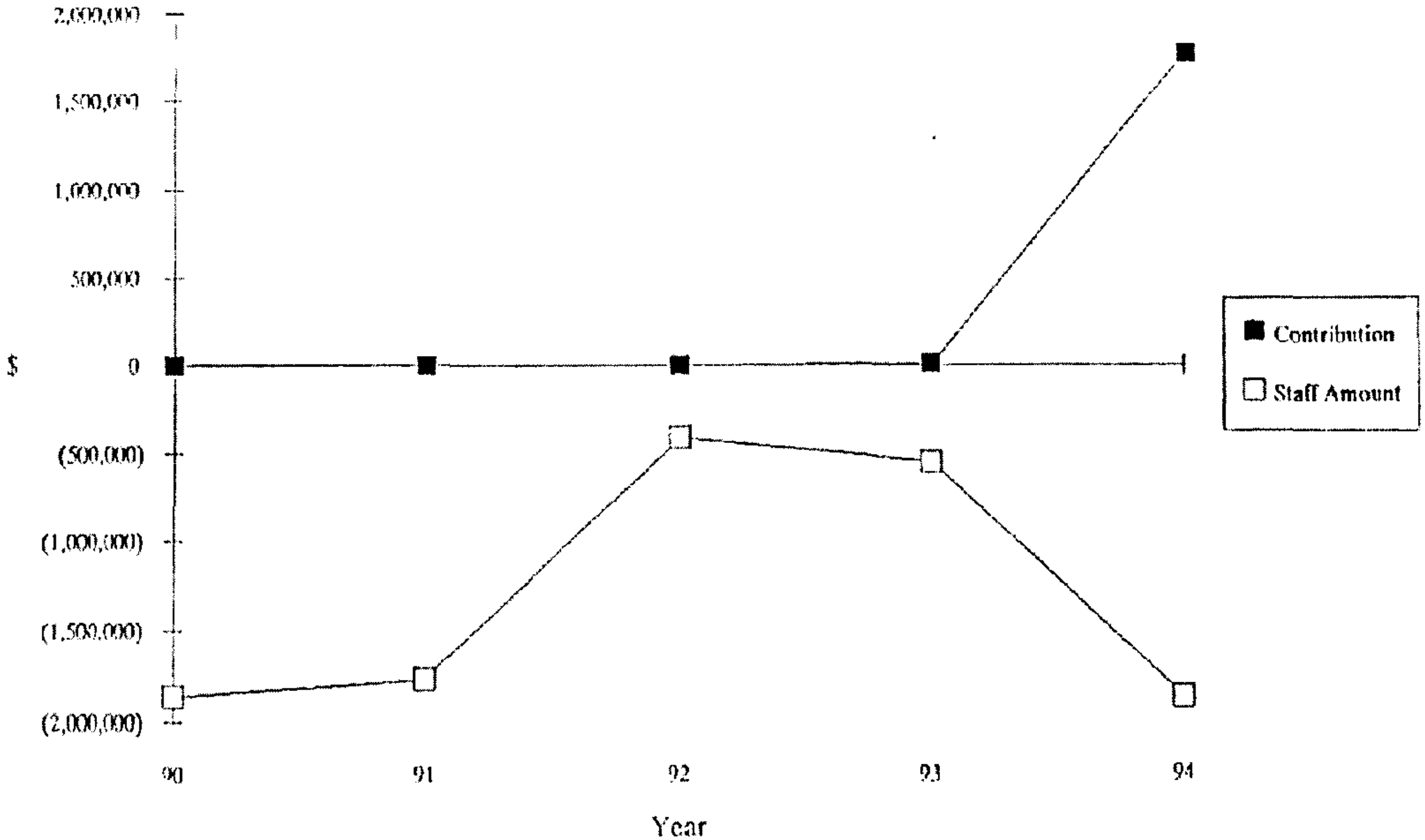
the regulator. These actions of the regulator change the timing of recognition of net pension cost as an expense; they do not otherwise affect the requirements of this Statement.

Schedule WRG-2.   MOPUB Pension Cost of Service



Schedule SMT-2-38

Schedule WRG-3.   MOPUB Pension Cost of Service



Schedule SMT-2-30