EXHIBIT

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Sponsoring Party: Office of Public Counsel
File Nos.: GR-2017-0215 and GR-2017-0216

SURREBUTTAL TESTIMONY OF DAVID G. PITTS

Submitted on Behalf of the Office of the Public Counsel

MISSOURI GAS ENERGY
LACLEDE GAS COMPANY

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

November 21, 2016

BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

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

AFFIDAVIT OF DAVID G. PITTS

STATE OF TENNESSEE)
) ss
COUNTY OF CUMBERLAND)

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

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

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

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

David G. Pitts

Subscribed and sworn to me this 21st day of November 2017.

Kimberly A. Hall
Notary Public Exp. 8-6-2018

KIMBERLY A. HASTERS STATE OF TENNESSEE NOTARY PUBLIC CUMBERLAND CO.

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OF

DAVID G. PITTS

LACLEDE GAS COMPANY

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I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND YOUR BUSINESS ADDRESS.

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

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

A. Yes.

Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

A. The purpose of my surrebuttal testimony is to summarize and address the contentious pension and other post-employment benefits (OPEB) issues raised by various parties in case numbers GR-2017-0215 and GR-2017-0216.

II. PENSIONS

Q. WHAT ARE THE CONTENTIOUS ISSUES THAT HAVE BEEN RAISED IN DIRECT AND/OR REBUTTAL TESTIMONY RELATED TO PENSIONS?

A. The contentious pension issues fall into two categories: (i) Contribution Policy and (ii) Ratepayer Financing of Company pensions.

Q. DEFINE WHAT IS MEANT BY CONTRIBUTION POLICY.

A. The contribution policy focuses on the level of cash funding the Company will make to its pension trusts within the range defined by the minimum statutory amount and maximum tax-deductible amount. For 2015, this range was from $18 million to $239 million for the LAC plan (2015 Actuarial Report). Importantly, the contribution policy directly impacts the funded status of the plans, which directly impacts the asset allocation / amount of risk borne by ratepayers. [1]

Q. SUMMARIZE THE DIFFERENT RECOMMENDATIONS RELATED TO CONTRIBUTION POLICY.

A. There are three different recommendations regarding contribution policy.

Party	Recommendation	Rationale
Staff	"Staff does not generally support funding pensions and OPEBs at a	"Staff is reluctant to increase the burden of ratepayers since it remains to be seen if the rebound in market

[1] Under the existing investment policy, the allocation to fixed income investments increases as the funding status improves. An asset allocation high in fixed income investments is less risky than one with equities, since fixed income investments more closely track pension liabilities and their response to changing economic conditions.

	level above the minimum level required by statute." [2]	interest rates expected by MAP-21 and HAFTA becomes reality. If interest rates and discount rates rebound to higher levels as the legislation expected, then future LAC and MGE pension funding requirements are expected to decline, reducing the need to increase funding in the instant case." [3]
Company	"The Company is seeking … to target a funding status in the 90%+ range within the next several years." [4]	"Under the Company proposal, funding levels, albeit higher than the minimum, should be more stable and lessen the need for funding spikes due to unexpected benefit payouts or plan losses threatening to impose benefit restrictions. A higher funded status will also lessen or avoid the PBGC variable premiums." [5]
OPC	"Change funding policy to minimize the frictional costs of PBGC variable premiums." [6]	"PBGC variable premiums can be thought of as a penalty, since the payment goes to the PBGC and not the pension plan." [7]

[2] Young Rebuttal, page 2, lines 5 – 6.
[3] Young Rebuttal, page 8, lines 8 – 12.
[4] Buck Rebuttal, page 9, lines 22 – 23.
[5] Buck Rebuttal, page 10, lines 15 – 18.
[6] Pitts Direct, page 17, line 10.
[7] Pitts Direct, page 13, lines 2 – 3.

Q. DO YOU HAVE ANY COMMENTS REGARDING STAFF'S REBUTTAL TESTIMONY ON CONTRIBUTION POLICY?

A. Yes. Staff's suggestion that costs will decrease if interest rates "rebound" to higher levels is problematic for several reasons:

- Interest rates have been declining steadily over recent years, and there is no guarantee that interest rates will "rebound" at all; [8]
- The market has an expectation that interest rates will rise (as evidenced by increasing forward rates embedded in bond prices). Rising interest rates will be favorable for pension costs only if interest rates rise faster than expected. [9]
- Pension costs are a function of both asset and liability growth. While it is true that rising interest rates lower liabilities, they also lower the value of existing bond holdings (and hence, asset returns). Under the Company's LDI strategy (once fully implemented), changing interest rates are expected to have no impact on pension costs.

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[8] Consider interest rates in Japan for example, that have remained less than 1% for more than 10 years

[9] Assuming interest rates will rise faster than market expectations is tantamount to making a bet on the movement of interest rates – not a core competency for Staff (or the Company).

In summary, Staff's position to fund at statutory minimums in the hopes that interest rates will rise faster than expected is speculative, results in excessive Pension Benefit Guarantee Corporation (PBGC) premiums, transfers current costs to future generations of ratepayers, and exposes ratepayers to recurring asset / liability mismatch risk under the existing investment policy.

Q. DO YOU HAVE ANY COMMENTS REGARDING THE COMPANY'S REBUTTAL TESTIMONY ON CONTRIBUTION POLICY?

A. Yes. The Company's recommended funding strategy does not meaningfully reduce PBGC frictional costs, an unnecessary ratepayer cost.[10] In addition, the Company's characterization that increased funding reduces funding spikes is misguided. Funding volatility is the direct result of asset / liability mismatch, which remains problematic for a longer period under the Company's proposed funding strategy vs. a funding strategy that minimizes pension deficits. [11]

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[10] PBGC variable premiums have been increasing steadily and are projected to continue to grow under current law

[11] The Company's investment policy targets equity holdings of 56% as of the most recent Annual Report. An equity allocation of 56% in the pension trust indicates significant asset/liability mismatch risk – likely not too different from the allocation immediately preceding the financial crisis which resulted in tens of millions of dollars of lost pension surplus.

Q. DO YOU HAVE ANY FINAL COMMENTS REGARDING CONTRIBUTION POLICY?

A. Yes. Pension cost is determined exclusively by the level of benefits being paid to pensioners. Trust contributions are a means of financing pension payments, when combined with investment returns. Delaying contributions does not lower pension costs, but instead pushes costs to the future – similar to paying for a credit card with insufficient payments to cover interest: although current cashflow is favorable, the outstanding balance continues to grow.

Funding the pension trusts at ERISA minimums has three implications, all of which are detrimental to ratepayers:

- Increased PBGC frictional costs, which can be considered a penalty for underfunding;
- Ongoing risk exposure, as the LDI policies will not fully trigger until the plan is better funded; and
- Transfer of existing pension cost to future generations of ratepayers. While it may seem advantageous for Staff to limit current pension funding, it is important to note that pension costs have already been incurred, and are a function of the benefit payments that are promised to pensioners. Limiting contributions – as Staff suggests – does not lower costs. It merely pushes costs into the future, or results in increased investment risk-taking in the hopes of reducing cash contributions.

Q. DEFINE WHAT IS MEANT BY RATEPAYER FINANCING OF COMPANY PENSIONS.

A. Ratepayer Financing of Company pensions refers to the mechanism by which ratepayers reimburse the Company for pension costs, as described below:

1. Company borrows from employees in the form of reduced current wages – and repays them over time via pension payments, a form of deferred compensation.

2. Employee qualified pensions are prefunded and paid through a trust, as required by ERISA. The combination of trust earnings and employer contributions are used to make pension payments, the deferred compensation referred to in Step 1.

3. Ratepayers are assigned pension costs during the rate-setting process in the cost of service determination. Ratepayer pension cost of service rarely equals employer contributions to the trust in Step 2, which leads to an additional layer of financing: sometimes the Company collects more in rates for pensions than they contribute to the pension trust, and other times the Company makes trust contributions that exceed the amount collected in rates. Utilities differ in how they treat the mismatch between amounts collected in rates vs. amounts funded in trusts.

Ratepayer Financing of Company pensions encompasses both the annual cost of service determination, as well as the treatment of cashflow mismatches referred to in Step 3, specifically whether and how interest accrues on such mismatches, and whether such mismatches will be recovered.

Q. DESCRIBE GENERAL TRENDS IN THE FINANCIAL MANAGEMENT OF PENSIONS FOR NON-REGULATED COMPANIES.

A. There are two major trends within non-regulated companies: (i) an increased focus / level of sophistication with respect to pension risk management, and (ii) a holistic view in which pension debt is considered within the broader context of corporate debt. These trends collectively influence contribution, investment, benefit, accounting and debt issuance policies.

Q. DESCRIBE GENERAL TRENDS IN THE FINANCIAL MANAGEMENT OF PENSIONS FOR REGULATED COMPANIES.

A. Regulated companies lag non-regulated companies when it comes to the financial management of pensions, for several reasons:

- Pension finance is complex;
- Pension costs are passed through the corporation to ratepayers via the regulatory process, which is not always efficient;
- Shareholders of non-regulated companies have a keen interest in managing pension financials since pension deficits directly impact the balance sheet – ratepayers are not as informed / engaged; and

- There is an incentive to push costs to the future: the company benefits by providing workers with higher pensions without having to pay full price, and commissions score "wins" by keeping rates low.
- There is an incentive to grow prepaid assets in rate base, as the Company earns a risk-free source of income by doing so.

Q. DESCRIBE GENERAL TRENDS IN UTILITY RATE-SETTING WITH RESPECT TO PENSIONS.

A. Within the last 10 years there has been a massive runup in the level of prepaid pension assets within the regulated utility sector. [12] For those companies that include prepaid pension assets in rate base, there has been a simultaneous source of risk-free profit to the Company – effectively, excess finance fees. Importantly, prepaid pension assets are not used or useful in the delivery of utility services. Rather, prepaid pension assets represent legacy debt *for services already rendered.* Utility commissions throughout the country

[12] For example, the LAC prepaid pension asset (GAAP basis) has increased from $94 million as of 3/31/2010 to $146 million as of 6/30/2017, despite Stipulations that called for an amortization of the prepaid. Staff Direct, p. 68

are becoming aware of this issue, and actively taking steps to address both the legacy costs as well as the interest accruals on such costs.

Q. SUMMARIZE THE DIFFERENT RECOMMENDATIONS RELATED TO RATEPAYER FINANCING OF COMPANY PENSIONS.

A. There are three different recommendations regarding Ratepayer Financing of Company pensions.

	Staff [13]	Company [14]	OPC [15]
General Approach	Continuation of prior ratemaking treatment, with exceptions	Continuation of prior ratemaking treatment, with exceptions	Legacy amortization
Cost of Service – annual charge	Statutory minimum (80% funding target)	Enhanced minimum (90% funding target over time)	FAS 87
Cost of Service – amortization period	8 years	10 years	20 years
Prepaid subject to amortization	LAC: prepaid pension asset (GAAP) minus pre-94 deferred FAS87 minus pre-96 deferred FAS88	Full GAAP prepaid pension asset, combined basis	Same as Staff, further reduced for excess contributions above statutory minimum or amounts necessary to avoid benefit

[13] Young Rebuttal, p. 2
[14] Buck Direct, p. 10
[15] Pitts Rebuttal, p. 8

	MGE: prepaid pension asset (GAAP)		restrictions / PBGC variable premiums
Finance charge on prepaid	Pre-tax WACC	Pre-tax WACC	Cost of debt
New additions to prepaid included in rate base	Excess contributions necessary to avoid benefit restrictions or PBGC variable premiums	Same as staff	No restrictions

Q. DO YOU HAVE ANY COMMENTS REGARDING STAFF'S REBUTTAL TESTIMONY ON RATEPAYER FINANCING OF COMPANY PENSIONS?

A. Yes. As mentioned previously, contributions should be larger than the ERISA minimum to avoid unnecessary PBGC penalties. In addition, the amount of prepaid included in rate base should be adjusted to reflect excess contributions, [16] and unamortized balances should accrue at cost-of-debt vs. pre-tax WACC.

Q. DO YOU HAVE ANY COMMENTS REGARDING THE COMPANY'S REBUTTAL TESTIMONY ON RATEPAYER FINANCING OF COMPANY PENSIONS?

[16] Pitts rebuttal, p. 4.

A. Yes. As mentioned previously, contributions should be larger than proposed to avoid unnecessary PBGC penalties. In addition, the amount of prepaid included in rate base should be adjusted as indicated above in Staff comments, [17] and accrue at cost-of-debt vs. pre-tax WACC.

Q. DO YOU HAVE ANY FINAL COMMENTS REGARDING RATEPAYER FINANCING OF COMPANY PENSIONS?

A. Yes. The Commission should direct the Company to seriously address the legacy pension debt issue, and discontinue the practice of assessing interest charges on prepaid pension assets at pre-tax WACC. While this is a complicated subject, other jurisdictions have successfully addressed these issues.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS ON REBUTTAL TESTIMONY?

A. Yes. Mr. Buck has incorrectly characterized my testimony as advocating securitization of the pension / opeb asset. [18] In fact, I have advocated a strategic financing review in

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[17] These adjustments are consistent with the positions taken by Staff in prior rate case direct testimony
[18] Buck Rebuttal, p. 12

which securitization is evaluated against other approaches.[19] As companies restructure debt in changing economic environments, it is only fair that ratepayers be afforded similar opportunities.

III. OPEBS

Q. WHAT ARE THE CONTENTIOUS ISSUES THAT HAVE BEEN RAISED IN DIRECT AND/OR REBUTTAL TESTIMONY RELATED TO OPEBS?

A. The primary issue of contention for OPEBs is the amount of benefits being provided to LAC, which are more than 10 times as "rich" as the benefits being provided to MGE. As indicated in prior Direct and Rebuttal, OPC recommends an independent OPEB benefit review to ensure LAC benefits are not excessive.[20]

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.

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[19] Pitts Direct, p. 17
[20] Pitts Rebuttal, p. 12