MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. ER-2004-0570

REBUTTAL TESTIMONY

OF

C. KENNETH VOGL

ON

BEHALF OF

THE EMPIRE DISTRICT ELECTRIC COMPANY

Joplin, Missouri
November 2004

Q.   Please state your name and business address.

A.   My name is C. Kenneth Vogl. My business address is 101 South Hanley, Suite 900, St. Louis, Missouri 63105.

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

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

Q.   Please describe Towers Perrin.

A.   Towers Perrin is an international management and actuarial consulting firm with offices in 79 locations throughout the world. We serve approximately 7,000 clients worldwide in virtually every industry as well as in the government, education, and not-for-profit sectors.

Q.   Please describe your education.

A.   I received a Bachelor of Science degree in mathematics from University of Missouri, Columbia in 1988 and a Doctorate of Philosophy in mathematics from Washington University in 1994. I completed the examination requirements for designation as a Fellow of the Society of Actuaries and received such designation in August 2000. I completed both the examination and experience requirements for designation as an Enrolled Actuary under the Employee Retirement Income Security Act of 1974 (ERISA) and received such designation in 1998.

Q.   Please describe your qualifications.

1   A.   I have been employed with Towers Perrin as a consulting actuary since 1995;

2   I was employed by William Mercer in St. Louis from 1994 to 1995. I have substantial

3   technical and consulting experience relative to employee benefit plans — including the

4   design, funding, accounting, and communication of pension and postretirement welfare

5   programs.

6   **Q.   What is the purpose of your testimony?**

7   A.   The purpose of my testimony is to rebut the Staff's direct testimony of Doyle

8   L. Gibbs and the OPC's direct testimony of Ted Robertson, which propose that The Empire

9   District Electric Company ("Empire") should recover the cost of pension benefits it provides

10   to its employees based on the ERISA minimum contribution requirement.

11   My direct testimony submitted on April 30, 2004, demonstrated that the

12   "ERISA minimum contribution method" is not a preferable method of cost recovery. Some

13   of that testimony has been included here, but the reader is referred to my direct testimony for

14   a more thorough discussion.

15   **Q**.   **Why shouldn't the "ERISA minimum contribution method" be used for**

16   **regulatory purposes?**

17   A.   The "ERISA minimum contribution method" is unacceptable because:

18   1) the excessive year-to-year volatility inherent in the ERISA calculations

19   can create test-year costs that are significantly higher or lower than actual

20   costs incurred during the recovery period;

21   2) it will create inequities between generations of rate payers;

22   3) it is not consistent with Generally Accepted Accounting Principles

23   ("GAAP") and, therefore, cannot be used for shareholder financial

24   reporting purposes; and

1   4) it discourages funding policies that are consistent with good pension plan

2   management.

3   **Q.   Can you explain what you mean when you say the "ERISA minimum**

4 **contribution method" produces excessive year-to-year volatility?**

5   A.   Yes. Essentially, under current funding rules, a low interest rate environment

6 coupled with investment losses on plan assets can create ERISA minimum required

7 contributions that are four-to-five times greater than the average long-term cost of a plan. In

8 fact, it's not uncommon for a plan today to have a minimum required contribution in excess

9 of 25% of payroll when only three years ago this same plan would not have been allowed to

10 make a deductible contribution. I will illustrate the year-to-year volatility by looking at

11 projected costs (see Schedule 1 for additional detail) under two future economic scenarios:

12   1) Scenario 1 (adverse returns) assumes that the investment returns on plan

13   assets from 2004 through 2006 equal the returns from 2000 through 2002,

14   and that the plan assets will earn 8.5% thereafter. As you can see from the

15   projected costs contained in Schedule 1, a very large contribution of $12.9

16   million would be required in 2007 as a result of the additional funding

17   charge (see my direct testimony for a discussion of this item). In fact,

18   contributions for 2007 through 2009 total about $31.5 million under this

19   scenario. The large 2007 contribution represents about 33% of payroll for

20   plan participants, and the contributions for 2007 through 2009 average

21   over 25% of payroll.

22   2) Scenario 2 (volatile returns) assumes that the investment return on plan

23   assets from 2004 alternate between 0% and 17%. Note that this scenario's

24   compound return over the forecast period will average out to the expected

1   return of 8.5%. As you can see from the projected costs in Schedule 1, the

2   incidence and amount of contributions is closely correlated to the return.

3   Although four of the ten forecast years show minimum contributions of

4                    $0, contributions for three of the remaining six years are about three times

5   the ten-year average.

6   This volatility is clearly inappropriate for regulatory purposes. If a large increase in

7   contributions occurs during a test-year, then rate payers will be overcharged. Similarly, if the

8   increase occurs during a non-test-year, the company will be required to make a large cash

9   contribution despite collecting a smaller amount (or even nothing) in rates. Even though a

10   regulatory asset/liability may be established to account for these differences, the "ERISA

11   minimum contribution method" is likely to result in very large regulatory assets, which will

12   need to be addressed in future rate cases by future Staffs.

13   **Q.**   **You also state that the "ERISA minimum contribution method" creates**

14   **inequities between generations of rate payers. Please explain.**

15   A.   Given the long-term nature of pension obligations, the ideal method would

16   allocate the true cost of the plan evenly over this long-term period. However, since the "true

17   cost" cannot be determined in advance, the next best approach is to choose a method that

18   produces a stable cost recognition pattern (i.e., is less volatile) in various economic

19   environments. Due to the volatility discussed in the previous question, the "ERISA

20   minimum contribution method" does not produce this stable pattern of cost recognition. As

21   demonstrated by the cost projections in Schedule 1, the "ERISA minimum contribution

22   method" would produce costs over the next several years well below the average cost over

23   the next ten years.

24   I have used the investment scenarios described above to illustrate this point.

1   1) Scenario 1 (adverse returns) projects an average contribution of $5.3

2   million over the next 10 years. It also projects an ERISA minimum

3   required contribution of $0 for 2004 and $0.5 million for 2005. Based on

4   the average contribution ($5.3 million), roughly $10.1 million of costs that

5   should be borne by rate payers for 2004 and 2005 will be deferred to rate

6   payers after 2005.

7   2) Scenario 2 (volatile returns) projects an average contribution of $3.2

8   million over the next 10 years. It also projects total ERISA minimum

9   required contributions of just $0.5 million for 2004 through 2006. Based

10   on the average contribution ($3.2 million), roughly $9.1 million of costs

11   that should be borne by rate payers for 2004 through 2006 will be deferred

12   to rate payers after 2006.

13   Even though it currently generates a lower level of cost, the Staff's (and the OPC's)

14   proposed method does not *eliminate* or *reduce* costs. It simply *defers* the recognition of

15   those costs to a future period, resulting in larger future costs and the generational inequity

16   discussed in the above illustrations. In fact, continuing the "ERISA minimum contribution

17   method" will exacerbate the generational inequity that was produced by the rate recovery

18   methodology used since 1994.

19   **Q.   What do you mean by the generational inequity that was produced by the**

20   **rate recovery methodology since 1994?**

21   A.   In 1994, when FAS 87 was accepted by the PSC staff as the basis for rate

22   recovery, the PSC staff required ten-year amortization of gains and losses (PSC staff moved

23   to a five-year amortization period in 1995).This requirement, coupled with the use of the fair

1   value of plan assets, accelerated the recognition of the "paper gains" at that time and as a

2   result produced "pension credits," not costs, of about $12.9 million.

3   As a result of the market correction during 2000, 2001, and 2002, these "paper

4   gains" no longer exist, and the credits passed through to rate payers of the 1990's must be

5   "paid back" by future rate payers per the stipulation agreement of 2002.

6   **Q.   Is Empire able to use the "ERISA minimum contribution method" for**

7   **purposes of financial reporting to shareholders?**

8   A.   No. Under Generally Accepted Accounting Principles ("GAAP"), Empire

9   must recognize pension cost in accordance with Statement of Financial Accounting

10   Standards No. 87 ("FAS 87"). The "ERISA minimum contribution method" does not satisfy

11   the requirements of FAS 87. A detailed description of both FAS 87 and the ERISA minimum

12   contribution requirements, including the differences between the two, is included in my

13   direct testimony.

14   **Q.   Even though the "ERISA minimum contribution method" cannot be used**

15   **for shareholder reporting purposes, will it produce costs similar to that recognized**

16   **under FAS 87?**

17   A.   Over the life of the plan, both methods must generate the same total employer

18   cost. However, annual costs are often very different over the shorter-term. For example, the

19   2003 ERISA minimum required contribution was approximately $0.3 million, while the FAS

20   87 cost was $3.8 million for 2003.

21   Generally, FAS 87 can spread the cost of a plan as evenly as possibly over a long

22   period of time, whereas the "ERISA minimum contribution method" reacts abruptly to

23   changing economic conditions by generating very high costs for underfunded plans and zero

24   cost for only slightly overfunded plans.

1   In addition, both the methodology and the economic assumptions used to

2   calculate the ERISA minimum contribution are very different from those used to determine

3   FAS 87 cost. These differences are discussed in detail in my direct testimony.

4   **Q.   How does the "ERISA minimum contribution method" discourage**

5   **funding policies that are consistent with good pension plan management?**

6   A.   Since only the ERISA minimum contribution is reflected in rates,

7   contributions in excess of the minimum required have no means of being recovered in rates.

8   The inflexibility of the "ERISA minimum contribution method" makes it extremely difficult

9   to manage the pension plan properly. For example, many organizations often make

10   voluntary contributions in excess of the ERISA minimum requirements in order to reduce the

11   premiums that must be paid to the Pension Benefit Guaranty Corporation. However, such

12   larger contributions would not be recognized costs under the current regulatory method for

13   Empire. In fact, making a larger contribution now would actually reduce future ERISA

14   minimum contribution requirements on a dollar-for-dollar basis and may never be

15   recoverable under the current method.

16   As another example, many organizations also make voluntary contributions in

17   excess of the ERISA minimum requirement in order to avoid the extreme volatility illustrated

18   previously. This is done by keeping the plan funded sufficiently to avoid the "additional

19   funding charge" that makes the ERISA contribution requirement so volatile. While this is

20   often a good business practice, additional contributions would not be recognized costs under

21   the "ERISA minimum contribution method".

22   In essence, the "ERISA minimum contribution method" discourages voluntary

23   contributions that are consistent with good business and pension plan management practices.

24   **Q.   Is there anything else?**

1   A.   Yes. It is my understanding that, since my direct testimony, an update to FAS

2   106 has been reflected in Staff's latest revenue requirement and was agreed to by both

3   parties.

4   **Q.   Please summarize your rebuttal testimony.**

5   A.   Currently, Empire recovers a cost equal to the ERISA minimum funding

6   requirement for its pension plan. However, this "ERISA minimum contribution method" is

7   unacceptable because:

8   1) the excessive year-to-year volatility inherent in the ERISA calculations can

9   create test-year costs that are significantly higher or lower than actual costs

10   incurred during the recovery period;

11   2) it will create inequities between generations of rate payers;

12   3) it is not consistent with Generally Accepted Accounting Principles ("GAAP")

13   and, therefore, cannot be used for shareholder financial reporting purposes;

14   and

15   4) it discourages good pension plan management policy.

16   Under current funding rules, a low interest rate environment coupled with investment

17   losses on plan assets can create ERISA minimum required contributions in a given year that

18   are four-to-five times greater than the average long-term cost of a plan. This result is clearly

19   inappropriate for regulatory purposes.

20   **Q.   Does this conclude your testimony?**

21   A.   Yes it does.

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EMPIRE DISTRICT ELECTRIC COMPANY
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Schedule 1 – Illustration of Cost Volatility Under the "ERISA Minimum Contribution Method"

A. FAS 87 cost vs. ERISA minimum contribution requirement						
	adverse returns		volatile returns		stable returns	
	FAS 87	ERISA	FAS 87	ERISA	FAS 87	ERISA
2004	2.8	0.0	2.8	0.0	2.8	0.0
2005	3.0	0.5	3.0	0.5	2.8	0.0
2006	3.7	9.2	3.2	0.0	2.9	0.0
2007	4.3	12.9	3.5	2.5	3.0	0.3
2008	4.4	10.2	3.7	2.2	3.2	2.5
2009	4.6	8.4	3.8	9.2	3.2	2.7
2010	4.8	2.8	3.5	0.0	3.0	2.8
2011	5.1	3.0	3.7	9.3	3.1	3.0
2012	5.1	3.1	3.6	0.0	3.2	3.1
2013	5.0	3.3	3.7	8.2	3.3	3.3
average	4.28	5.34	3.45	3.19	3.05	1.77

B. Absolute value of change in cost from prior year.						
2005	0.2	0.5	0.2	0.5	0.0	0.0
2006	0.7	8.7	0.2	0.5	0.1	0.0
2007	0.6	3.7	0.3	2.5	0.1	0.3
2008	0.1	2.7	0.2	0.3	0.2	2.2
2009	0.2	1.8	0.1	7.0	0.0	0.2
2010	0.2	5.6	0.3	9.2	0.2	0.1
2011	0.3	0.2	0.2	9.3	0.1	0.2
2012	0.0	0.1	0.1	9.3	0.1	0.1
2013	0.1	0.2	0.1	8.2	0.1	0.2
avg chng	0.27	2.61	0.19	5.20	0.10	0.37
ratio of avg change		9.67		27.37		3.70

*Note that forecasts of costs are based on liabilities provided by Watson Wyatt.