| | |
|---|---|
| Exhibit No.: | |
| Issues: | FAS 87 and Funding of Pension Plans |
| Witness: | C. KENNETH VOGL |
| Sponsoring Party: | Empire Dist. Electric Company |
| Type of Exhibit: | Surrebuttal Testimony |
| Case No.: | ER-2004-0570 |
| Date Testimony Prepared: | November 24, 2004 |

**MISSOURI PUBLIC SERVICE COMMISSION**

**CASE NO. ER-2004-0570**

# SURREBUTTAL TESTIMONY

**OF**

**C. KENNETH VOGL**

**ON**

**BEHALF OF**

**THE EMPIRE DISTRICT ELECTRIC COMPANY**

**Joplin, Missouri**
**November 2004**

**SURREBUTTAL TESTIMONY**

**OF**

**C. KENNETH VOGL**

**CASE NO. ER-2004-0570**

**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. Are you the same C. Kenneth Vogl who previously filed testimony in this case?**

A. Yes, I am.

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

A. The purpose of my surrebuttal testimony is to respond to the rebuttal testimony of the Staff's witness Doyle L. Gibbs regarding pension expense.

**Q. What did Staff's witness Gibbs rebut in his rebuttal testimony?**

A. Mr. Gibbs rebutted the contention in my direct testimony that the use of the "ERISA minimum contribution method" for rate recovery of pension costs is unacceptable because:

1) the excessive year-to-year volatility inherent in the ERISA calculations can create test-year costs that are significantly higher or lower than actual costs incurred during the recovery period;
2) it will create inequities between generations of rate payers;
3) it is not consistent with Generally Accepted Accounting Principles ("GAAP") and, therefore, cannot be used for shareholder financial reporting purposes; and

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

**Q. The Staff contends that the pension cost under the FAS 87 method is more volatile than the cost under the "ERISA minimum contribution method". Why do you disagree with Staff's conclusion?**

A. Mr. Gibbs' analysis of the two methods does not provide an appropriate comparison of the costs produced by the two methods.

**Q. Please explain.**

A. When comparing actuarial methods for recognizing pension costs, one should understand how the methods behave in various economic environments. In my direct testimony, I used three possible economic scenarios (stable environment, volatile environment, and adverse environment) in order to illustrate the pension costs produced by the two methods under a reasonable range of potential economic environments. My comparison of the two methods showed, among other things, that the "ERISA minimum contribution method" will generally be more volatile than the FAS 87 method. As shown in the attached Schedule 1, the ERISA minimum contribution method is 3.7, 9.7, and 27.4 times more volatile under the stable, adverse, and volatile return scenarios, respectively.

Mr. Gibbs' analysis, contained in Schedule 1 of his rebuttal testimony, is based on one specific economic scenario (i.e., that which occurred during the past five to ten years) and is misleading because:

1) The FAS 87 cost included in Gibbs' analysis was Empire's actual FAS 87 cost used for financial reporting for the last six years and not the FAS 87 cost under the method proposed by Empire. Empire has proposed the use of a more standard FAS 87 methodology to reduce the volatility of the

pension expense that they are exposed to as a result of agreeing to the current methodology in prior stipulations.

2) The ERISA minimum contribution requirement during this period was $0 (except for a small required contribution of $342,348 for 2003). Obviously, there is very little volatility in a series of numbers that are all zero. However, I completely disagree that the volatility of the ERISA minimum contribution over the last six years is the best estimate of the true volatility of this method. On the contrary, the contribution holiday experienced by Empire's plan (just like most pension plans across the country) during the 1990's and early 2000's will not continue. Like most other pension plans, Empire's plan is expected to have required contributions over the next five years. Please see the expected minimum contribution requirements under various economic scenarios contained in Schedule 1. Many companies are recognizing that pension benefits are important to employees, are not free, and are even worthy of funding in advance of the ERISA minimum contribution requirements.

**Q. On page 3, line 20 through page 4, line 5, Mr. Gibbs proposes a process of setting up a regulatory asset/liability when future ERISA minimum contributions differ from the level that was included in rates. He states that this process "protects the ratepayer and the Company from over or under recovery of the pension expense that is actually incurred compared to the level of recovery in rates." He also goes on to state that if FAS 87 was used for ratemaking, then it could create "a positive cash flow that could be used for any purpose the Company desires." How do you respond to Mr. Gibbs' statements?**

A. First of all, I support a process that creates a regulatory asset/liability when the level of cost incurred during a rate period is different than the level of cost built into rates for that period. In essence, such a process would ensure that: (1) revenue collected in rates for pension costs will be contributed to the pension trust; and (2) actual contributions made by the Company into the pension trust will get rate recovery. Such a process protects both the ratepayer and the Company. To optimize the usefulness of this process, current rates should be based on a method that accrues cost as evenly as possible over the life of the plan (i.e. with as little volatility as possible). The Company has proposed to use a method which accrues costs evenly, while the method proposed by the Staff does not.

Secondly, if the FAS 87 method is used for rates, the Company is willing to contribute to the pension plan the revenue collected in rates for pension cost. This eliminates Staff's objection that positive cash flow could be used for any purpose that the Company desires. However, until the current prepaid pension asset has been recovered in rates, the Company should not be required to fund the plan.

**Q. Do you agree with Mr. Gibbs' assertion that the expected allocation of costs over the next several years under the "ERISA minimum contribution method" is not expected to create generational inequity?**

A. No. ERISA minimum required contributions are almost certain over the next ten years as shown in my direct testimony, which showed the ERISA minimum contributions under various economic scenarios: stable, volatile, adverse. Under each scenario, the ERISA minimum contribution is $0 for 2004 and then becomes nonzero during the next 10 years.

Pension benefits are valuable to employees and are not free to plan sponsors. The Staff has proposed building $0 into rates (because the ERISA minimum contribution

requirement is $0 for 2004), while it is very likely that total cost under the ERISA minimum contribution method is likely to be in the range of $17 million (under the stable 8.5% return scenario) to $53 million (under the adverse return scenario) over the next ten years. It would appear to me that the Staff's method backloads the recognition of costs for ratepayers and therefore would be characterized as causing generational inequity.

This backloading not only impacts current customers who move before cost is allocated, but also those costumers who don't move. As a customer, assuming that the cost is expected to be $10 for the next 10 years, I would prefer paying $1 each year rather than paying $0 for the first 5 years and $2 for the next 5.

**Q. Mr. Gibbs disagrees that the use of the ERISA minimum contribution method for rate recovery discourages funding policies that are consistent with good pension fund management. Specifically he writes, "I think it is ironic that on one hand EDE claims that the ERISA minimum is unacceptable because it creates generational inequities and then claims that ERISA minimum is unacceptable because it won't allow the Company to make contributions in excess of ERISA minimum funding requirements." How would you respond to this assertion?**

A. I'm surprised that Mr. Gibbs finds it ironic that both claims are made by the Company. I don't understand why he would make that statement.

With regard to the first claim, that the ERISA minimum contribution method creates generational inequity, I have responded above in this surrebuttal testimony.

With regard to the second claim, that the ERISA minimum contribution method won't allow the Company to make contributions in excess of ERISA minimum funding requirements, let me continue with the simple example that I used previously. Assume the following:

1. ERISA minimum contributions for the next 5 years are $0

2. ERISA minimum contributions for years 6 through 10 are $2

Under the ERISA minimum contribution method, if the Company funded $0 in years 1 through 5 and $2 in years 6 through 10, the full $10 would be recoverable in rates.

However, if the company chose a more stable funding policy (which many companies are now doing in light of recent market experience) of funding $1 each year, then the Staff's ERISA minimum contribution method would allow the recovery of only $1 of the $10 in total contributions. It would appear to me that this stable funding policy would be better for ratepayers (from a generational perspective), better for the plan (from a security perspective), and better for the Company (from a cash flow perspective), but would not be a serious option because of the lack of rate recovery for the full $10.

**Q. Why do you say the ERISA minimum contribution method would not allow the recovery of the full $10 in your simple example?**

A. The early pre-funding (i.e., $1 for each of the first five years in the above example) becomes part of the calculation of the ERISA minimum contribution requirement in future years. It becomes a "credit balance" which is used as an offset to the minimum contribution requirement in future years. In my example, the $1 funded for each of the first five years has accumulated to $5 (ignoring interest) at the end of year five since the ERISA minimum contribution was $0 each year. Therefore, the ERISA minimum contribution requirement in year six, which would have been $2, is now reduced to $0 because of the application of the "credit balance". The $2 is "paid for" by the $1 that is funded plus $1 of the "credit balance", and the credit balance is reduced to $4. This process will continue throughout the ten-year period. The result in this simple example would be that the only time the Company actually funded exactly the amount of the ERISA minimum contribution was

the $1 contributed in year ten. In all other years, the Company contributed an amount in excess of the ERISA minimum required contribution.

**Q. Mr. Gibbs also states on page 7, lines 8 – 11 "Including in rates the contributions that are prescribed according to laws that are specifically enacted to provide security to employee pension funds, in the Staff's opinion, promotes sound pension fund management". Do you have a response to this statement?**

A. Yes. First of all, ERISA minimum required contributions are just that – the "minimum" required contributions under the law – not the only contributions allowed under the law. In fact, in most cases companies are allowed to contribute in excess of the minimum required contribution and receive a tax deduction. ERISA provides for a range of contributions to be made to a qualified pension plan and the ERISA minimum contribution serves as one extreme of the range.

Secondly, I would not agree that funding only the plan's ERISA minimum contribution is sound pension plan management. The primary reason is that the ERISA minimum contribution is generally $0 when the plan is only slightly overfunded. Given the volatile nature of plan assets, a plan can swing from underfunded to slightly funded and back again very quickly. When plans become underfunded, the ERISA minimum contribution requirement can become very large. I generally recommend funding policies that smooth out expected contributions to avoid the peaks and valleys described above.

Finally, as the late 1990's taught us, minimum required contributions of zero don't mean pension benefits are free. The bull market of the 1990's was almost completely wiped out by the bear market of the early 2000's, and as a result many companies are contributing millions of dollars into their pension funds today to partially compensate for the lack of pension funding during the 1990's. It would be inappropriate to assume that these valuable

pension benefits have no current cost just because the current ERISA minimum contribution requirement is $0.

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

A. Yes it does.

Surrebuttal Testimony of C. KENNETH VOGL
EMPIRE DISTRICT ELECTRIC COMPANY
Case No. ER-2005-0570
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.
Economic scenarios are as follows: (1) adverse – returns for 2004 – 2006 equal actual returns for 2000 – 2002 (i.e., -0.7%, -1.0% and -9.2%, respectively), followed by returns of 8.5% per year; (2) volatile – returns alternating between 0% and 17%; (3) stable – 8.5% per year.