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Issues: FAS 87, FAS 106 and Funding
of Pension and OPEB Plans
Witness: C. KENNETH VOGL
Sponsoring Party: Empire Dist. Electric Company
Type of Exhibit: Rebuttal Testimony
Case No.: ER-2004-0570
Date Testimony Prepared: November 4, 2004

FILED³

DEC 28 2004

MISSOURI PUBLIC SERVICE COMMISSION

**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

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C. KENNETH VOGL

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**Joplin, Missouri
November 2004**

AFFIDAVIT

STATE OF MISSOURI)
) ss
COUNTY OF JASPER)

On the 2 day of November, 2004, before me appeared Charles Kenneth Vogl, to me personally known, who, being by me first duly sworn, states that he is a Principal of Towers Perrin that he has read the above and foregoing document and believes that the statements therein are true and correct to the best of his information, knowledge and belief.

Charles Kenneth Vogl
(Name)

Subscribed and sworn to before me this 3 day of November, 2004.

Andrea Agne
(Name), Notary Public

My commission expires: 2-18-07



ANDREA AGNE
St. Louis County
My Commission Expires
February 18, 2007

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.

Rebuttal 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.