STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

NORTH SHORE GAS COMPANY	:	
	:	
Proposed General Increase In Rates For Gas Service	: :	
	:	Nos. 09-0166, 09-0167 Cons.
THE PEOPLES GAS LIGHT AND COKE COMPANY	: :	
	:	
Proposed General Increase In Rates For Gas Service	: :	

Rebuttal Testimony of

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Managing Director
Huron Consulting Group

On Behalf of
North Shore Gas Company and
The Peoples Gas Light and Coke Company

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I. INTRODUCTION AND BACKGROUND

A. Identification of Witness

Q. Please state your name and business address.

A. My name is Alan Felsenthal. My business address is 550 West Van Buren Street, Chicago, Illinois 60607.

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

A. I am a Managing Director at Huron Consulting Group ("Huron"). Huron provides a variety of accounting, tax and consulting services to various industry sectors. My focus is on the regulated industry sector, primarily electric and gas utilities.

Q. On whose behalf are you offering this testimony?

A. I am presenting testimony on behalf of The Peoples Gas Light and Coke Company ("Peoples Gas") and North Shore Gas Company ("North Shore") (together, the "Utilities").

B. Purpose of Rebuttal Testimony

Q. What is the purpose of your rebuttal testimony?

A. My rebuttal testimony addresses the direct testimony of Bonita Pearce submitted on behalf of the Illinois Commerce Commission ("Commission") Staff ("Staff") and David Effron, submitted on behalf of the on behalf of the People of the State of Illinois ("AG"), the Citizens Utility Board ("CUB"), and the City of Chicago ("City").

I specifically address Ms. Pearce's adjustment to exclude Peoples Gas' prepaid pension asset from Peoples Gas' rate base while at the same time deducting North Shore's accrued pension liability from North Shore's rate base.

I address both Ms. Pearce's and Mr. Effron's exclusion of Peoples Gas' prepaid pension asset from the rate base on the incorrect notion that the prepaid pension asset represents ratepayer supplied funds.

I address Ms. Pearce's deduction from rate base of North Shore's accrued pension liability as being contrary to past Commission decisions and contrary to her previous position on this issue.

Finally, I discuss the inconsistent treatment proposed by both Ms. Pearce and Mr. Effron for deducting the liability associated with other postretirement benefits ("OPEB") from rate base but excluding the pension asset from the rate base calculation.

C. Summary of Conclusions

Q. Please briefly summarize the conclusions of your rebuttal testimony.

A. Pensions and OPEB's each represent obligations of the Utilities to provide payment to retirees. The accounting for each is similar and, accordingly, each should be treated similarly in the ratemaking process.

The pension assets recorded on the books of Peoples Gas represent investor supplied investment and should be included in rate base. North Shore's pension liability should be used to reduce rate base. Both Utilities' OPEB liability should be deducted from rate base.

Q. What is the basis for your conclusion?

A. I considered the application of Generally Accepted Accounting Principles ("GAAP") to pension assets and liabilities. Consideration of how these assets and liabilities are placed on the books of a regulated entity shows that these prepaid pension assets are investor-supplied, not ratepayer-supplied funds. Ratepayers benefit by the prepaid pension asset lowering annual pension expense and, accordingly, it is appropriate for the investors to earn a return on their investment. This is also the finding of the FERC, FCC and many other regulatory agencies who have considered the issue.

There is no reason to treat Peoples Gas' prepaid pension asset and North Shore's accrued pension liability differently. Both should receive similar consideration as rate base components.

My proposed treatment of the Utilities OPEB liability is consistent with the Utilities and this Commission's treatment of OPEB's.

D. <u>Background and Experience</u>

Q. Please describe your education and business experience?

A. I graduated from the University of Illinois in 1971 and went to work at Arthur Andersen & Co, where I was an auditor, focusing on audits of financial statements of regulated entities. I joined PricewaterhouseCoopers ("PwC") in 2002 and became a Managing Director in their Utilities Group and continued performing audits for regulated entities. I was hired by Huron Consulting Group in 2008.

At both Arthur Andersen and PwC, I supervised audits of financial statements on which the firm issued audit opinions that were filed with the Securities and Exchange Commission ("SEC"), the Federal Communications Commission, the Federal Energy Regulatory Commission ("FERC") and various state commissions. At Arthur Andersen, PwC and Huron, I consulted on a significant number of utility rate cases and helped develop testimony for myself and others on a variety of issues, including Construction Work in Progress in rate base, projected test years, lead-lag studies, cost allocation, several accounting issues (pension accounting, income tax accounting, cost of removal) and compliance with the income tax normalization requirements. The testimony was filed in Arizona, Florida, Illinois, Indiana, Michigan, Minnesota, Nevada, New Mexico, Texas, Washington and Wisconsin. I have testified before the Florida Public Service Commission, the Washington Utilities and Transportation Commission, the Arizona Corporation Commission, the Indiana Utility and Regulatory Commission, and the Illinois Commerce Commission.

Q. Have you dealt with the unique accounting, tax, and financial reporting issues encountered by regulated enterprises?

A. Yes. Throughout my career, I have focused on utility accounting, income tax and regulatory issues, primarily as a result of auditing regulated enterprises. The unique accounting standards applicable to regulated entities embodied in Financial Accounting Standard ("FAS") 71, FAS 90, FAS 92, FAS 101, and various Emerging Issues Task Force ("EITF") issues all need to be understood so that auditors can determine if a company's accounting has been applied appropriately. During my career, I have witnessed the issuance of these standards and have consulted with utilities as to how they should be applied. At both Arthur Andersen and PwC, I worked with the technical industry accounting and auditing leadership to communicate and consult on utility accounting and audit matters.

Q. Have you provided training on the application of GAAP to regulated enterprises?

A. Yes. At Arthur Andersen and PwC (and now at Huron), I developed and presented utility accounting seminars focusing on the unique aspects of the regulatory process and the resulting accounting consequences of the application of GAAP. I have presented seminars, as well as delivered training on an in-house basis. Seminar participants have included utility company and regulatory commission staff accountants, utility rate departments and internal auditors, tax accountants and others. I have also conducted these seminars in-house for the FERC, several state commissions and I have presented at various Edison Electric Institute and American Gas Association ratemaking and accounting seminars.

II. ACCOUNTING RULES FOR PENSIONS AND OPEB'S

Q. In order to properly frame the pension asset, pension liability and OPEB issue, can you please describe the accounting rules related to pension and health and welfare benefit plans?

A. Yes. The accounting rules for pensions are contained in FAS 87, *Employers' Accounting for Pensions,* and FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB*

Statements No. 87, 88, 106, and 132(R). The accounting rules for OPEB's are contained in FAS 106, *Employers Accounting for Postretirement Benefits Other than Pensions*. The accounting requirements for these pronouncements are summarized in Appendix 1.

Q. Are funding requirements for pensions or OPEB's determined by GAAP?

A. No. Pension plan funding is based on management decisions with various legal considerations embodied in the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code ("IRC"). These constraints include:

- The required minimum and maximum contribution levels deductible for income tax purposes under the IRC, and
- The responsibility of the Utilities to protect the interests of the plan participants and beneficiaries.

A difference between OPEB's and pensions is that there are no ERISA or IRS requirements for funding the OPEB liability. However, both Utilities have established Voluntary Employee Beneficiary Association ("VEBA") Trusts and have contributed into the trusts. Compared to the pension requirements, the OPEB liability is significantly greater than the value of the plan assets established to pay for participant obligations. As a result, a net liability exists on the balance sheet of Peoples Gas and North Shore related to OPEB's.

The funding rules as set forth under ERISA and the IRC are different than the methodology used to determine pension expense under FAS 87. Over time, the cumulative employer contributions made to the plan and the cumulative accounting costs under FAS 87 should be equal. But in the shorter term there will be differences. To the extent that cumulative contributions to the pension plan exceed the cumulative accounting costs based on FAS 87, there is a balance sheet entry equal to the excess. This is the prepaid pension asset, representing the employer's contributions which have not yet been reflected as pension cost in the accounting records or on the financial statements.

Q. As a result of applying FAS 87 and FAS 158, what is the balance of the prepaid pension asset or accrued pension liability for Peoples Gas and North Shore?

A. For Peoples Gas, the average for the projected test year is a prepaid pension asset of approximately $152,500,000 (updated). For North Shore, the average for the projected test year is an accrued pension liability of approximately $2,800,000 (updated).

Q. What is the OPEB liability for the Utilities?

A. Peoples Gas has an average, projected test year accumulated OPEB liability, including an offsetting regulatory asset, in the amount of $87,200,000 (updated). North Shore's OPEB amount is $10,700,000 (updated).

III. <u>REGULATORY TREATMENT OF PENSIONS AND OPEB'S</u>

Q. Please explain the appropriate regulatory treatment of pensions and OPEB's.

A. Taken together, both pensions and OPEB's represent obligations of Peoples Gas and North Shore related to providing pension and health and welfare benefits to employees upon retirement. The annual cost of each is determined under GAAP in a manner that charges each period with the net cost of such benefits attributable ("earned") during the period. The annual cost is actuarially determined based on various factors as I have previously described. For GAAP purposes, because the promise to provide pension benefits and the promise to provide postretirement benefits are similar, the applicable provisions of FAS 87 and FAS 106 are similar. Likewise, the regulatory treatment of FAS 87 and FAS 106 should be handled consistently.

The pension and OPEB expense represent appropriate costs related to the employees providing service to Peoples Gas and North Shore customers. As such, this Commission has generally permitted pension and OPEB costs determined in accordance with FAS 87 and FAS 106 as allowable operating expenses when determining revenue requirements.

The issue being discussed is not the expense side of the pensions and OPEB's, but rather the appropriate treatment of the pension asset, pension liability, and OPEB liability in the ratemaking process.

IV. <u>ORIGIN OF PEOPLES GAS' PENSION ASSET</u>

Q. Why would a pension asset appear on Peoples Gas' balance sheet?

A. In simple terms, the pension asset represents the difference between the fair value of assets set aside to pay for projected benefit obligations and the projected benefit obligation.

There are two typical transactions that result in a pension asset being recorded on the balance sheet. The transactions are different, but related. One way is for the entity to make contributions to the pension fund in excess of the pension cost. This is clearly stated in paragraph 35 of FAS 87.

The other way for a pension asset to appear on the balance sheet is for the annual pension cost determined under FAS 87 to be a negative, not a positive, expense. In this situation, the “other side of the pension credit entry” is to a pension asset. The typical reason for a negative pension expense is that expected return on plan assets exceeds the other components of pension cost. In other words, the assumed investment return on plan assets is greater than the cost elements making up the annual pension cost.

Thus, the prepaid pension asset can increase over time as contributions are made to the pension fund and those plan assets earn the expected long-term return. Additionally, greater than expected actual market returns on plan assets, liability gains based on more favorable experience than expected, and plan changes all can result in a reduced or negative pension expense.

An additional reason for a negative pension expense, and particularly relevant in the case of Peoples Gas, is the result of settlement gains from plan participants accepting lump-sum distributions in lieu of a stream of pension plan benefit payments. As lump-sum distributions are made, pension obligations are eliminated and a portion of the unrealized gains are recognized in the annual pension cost determination.

In all cases, the prepaid pension asset and the related regulatory asset represents the cumulative difference between what has been contributed to the pension plan and what has been expensed under the pension accounting rules.

Q. Can the Utilities access these pension assets?

A. No. And this is an important point. ERISA requirements do not permit employers to remove money from the pension funds.

Q. How does the prepaid pension asset relate to the FAS 87 pension cost?

A. The prepaid pension asset is the cumulative difference between what has been contributed to the pension plan and what has been expensed under FAS 87. Because the ratemaking process is based on expense, the prepaid pension asset also represents amounts that have been contributed by Peoples Gas to the pension fund that have not been recovered, or that have been treated as a negative pension expense in rates. The prepaid pension asset represents investor capital residing in the pension plan.

Q. You stated that investors are supplying the capital for the recorded prepaid pension costs. Can you explain this further?

A. Yes. For the purpose of this explanation, the term “investors” means all providers of capital including, for example, common shareholders and long-term debt investors.

The assets in the Peoples Gas’ pension plan currently exceed the accumulated benefits. The prepaid pension asset recorded on Peoples Gas’ balance sheet comes about by contributions made by Peoples Gas to the pension fund and/or crediting pension expense in accordance with FAS 87. This balance sheet amount is investor-supplied, not customer-supplied. Peoples Gas is either crediting the cash account with a contribution to the pension fund or crediting its pension costs on the income statement (based on the FAS 87 computation), reducing revenue requirements, and the source of this revenue reduction is coming from investors. The only other possible source for this credit would be the pension fund itself, but because Peoples Gas is legally prohibited from withdrawing any of the assets from the plan, the fund itself cannot be the source.

Because the credit is an investor-supplied asset, it should earn a return and be included as a component of rate base.

Q. Can you provide an illustration to clarify your position?

A. Yes. The first illustration is when Peoples Gas or any entity makes a contribution to the pension fund. The entry to record the contribution is:

Debit: Pension Asset

Credit: Cash

As with any capital expenditure, the source of the contribution is investors, as ratepayers pay for the cost of service consisting of annual operating costs and return (rate base times rate of return).

The second illustration is a simplified example of how recording a negative pension expense gives rise to a pension asset. For purposes of simplicity, I have not included any income tax effects. Assume that at December 31, 2009, the pension fund has $150 million in pension assets and the accumulated pension obligation is $100 million. This net pension fund asset is included in the pension trust and is reflected on the Company's balance sheet in accordance with FAS 158.

Next assume that the Company decides not to contribute to the pension fund in 2010, or until the funding status is closer to the accumulated benefits in the plan. In 2010, the FAS 87 calculation yields a negative pension expense of $20 million. A large reason for the negative pension expense is the expected return on plan asset component of the net pension cost computation. The Company records the following entry:

Debit:	Prepaid Pension Asset	$20,000,000
Credit:	Pension Expense	$20,000,000

This entry by itself does not affect cash flows, but results in a $20,000,000 reduction in operating expenses, which, in turn, reduces the revenue requirement and internal cash flow. Ratepayer bills are reduced for the negative pension expense and, accordingly, the entities other operating cash requirements must be made up from other sources (i.e., investors). That is why I conclude that investors are the source of the prepaid pension asset recorded on the balance sheet.

As I stated previously, it is important to remember that the Company does not have access to the pension plan assets themselves and, accordingly, such assets are not a source of cash to the Company. Thus, in my second example the pension trust still contains assets of $150 million ($50 million, net) which remain intact, earn a return, and reduce the eventual expense to be recovered from ratepayers for pension obligations. The prepaid pension cost recorded on the

Company's books, in my example $20,000,000 in effect represents a receivable from the pension plan--the source of which was investors.

Q. How does a reduced revenue requirement result in the need for investor-supplied funding?

A. The Company's sources of cash include debt, equity, advances and internally generated funds. It should be clear from the example above that the Company receives $20,000,000 less internally generated cash when the negative pension expense is considered for the benefit of the customer in the revenue requirement calculation. This causes additional requirements from other sources. These other sources represent a combination of the usual outside lenders and investors who reasonably demand a return on their investments.

To illustrate this point, it is helpful to refer again to my hypothetical example. If we assume that in a rate case test period, the Company incurred and paid allowable operating costs of $60,000,000 (without considering the negative pension expense), the Commission would set rates to recover $60,000,000 from ratepayers. Ratepayers would thus be providing revenues sufficient for the Company to pay all of the operating costs, and no external cash flow would be required. We next consider the effects on revenue requirements and outside financing requirements caused by Peoples Gas' proposed treatment of pension expense. If the $20,000,000 of negative pension expense, a non-cash credit to the income statement, is recorded, the revenue requirement would be reduced to $40,000,000. This $40,000,000 of revenue will be charged to ratepayers and used to pay $40,000,000 of the $60,000,000 of non-pension allowable operating expenses. A $20,000,000 cash shortfall results. External financing is needed to fund this shortfall.

The point is that the source of this recorded prepaid pension cost is not the ratepayer. The ratepayer has been charged for actual pension expense each period, and his or her funds are included in the pension fund to pay for plan benefits. These funds are not legally available to the Company. The FAS 87 calculation results in a reduction in expense and revenue requirements as an expected return on plan assets is computed in determining the annual expense. The Company has had to fund this ratepayer credit and has established a prepaid pension cost (a receivable from the plan), which is entitled to earn a return.

Q. Do ratepayers benefit from the negative or a reduced pension expense?

A. Yes. Peoples Gas' customers benefit from the negative pension expense through reduced operating expenses. Negative pension expense benefits investors only to the extent it reduces cash funding requirements. It does not provide an immediate cash benefit. The difference in timing between when expense is recognized and cash benefit is actually achieved is quantified through the prepaid pension asset.

Even if there is not a negative pension expense in the current period under a FAS 87 calculation, ratepayers benefit through a reduced pension expense (the expense would be lower than it otherwise would be if there were no pension asset) due to the component of annual pension cost determined by multiplying the expected return on plan assets by the plan assets themselves.

Q. When will the prepaid pension cost reverse?

A. The prepaid pension cost will reverse at such time that the FAS 87 calculation results in positive pension expense. Once the prepaid cost is reduced to zero, an accrued liability for the pension obligation will be credited as the other side of the pension expense entry. Fairness dictates that this accrued pension liability should reduce rate base. Over the long term, the total pension expense will be equal to the pension benefits.

Q. In your example, you assume that revenue requirements are reduced for the negative pension expense. Would your answer be the same if the negative pension expense occurred outside of a rate case?

A. Yes. Even during periods where there are not rate proceedings to directly adjust rates, negative pension expense provides benefits to ratepayers in that it reduces the need for additional rate cases.

Gains or returns realized on pension fund investments do not result in positive cash flows back to Peoples Gas because such gains or returns must stay in the pension fund based on ERISA requirements. These gains or returns on pension fund assets provide a reduced or negative pension expense under FAS 87. The ratepayer receives either a direct benefit from the pension fund earnings—through reduced or negative pension expense reflected in rate cases—or through a reduced need to file rate cases. The ratepayer receives a reduction in their cost of service as a result of reduced or negative pension expense, providing both a benefit to the ratepayer and a detriment to Peoples Gas, as the ratepayer cost reduction is not offset by an actual reduction in cash outflow for Peoples Gas.

Even during periods where rate proceedings are not being filed that would directly adjust rates for the negative pension expense or to reduce the level of positive pension expense, a benefit is provided to ratepayers by reducing the need for such additional rate cases.

Q. When this issue has been addressed in Illinois in previous rate cases, Staff has taken the position that because positive pension expense was included in the test year, that the ratepayer is "paying" pension expense and the subsequent negative pension expense (pension credits) building up the prepaid pension asset in non-rate case periods is being funded by the ratepayer. Do you agree with this argument?

A. No. This position assumes that any amounts included in the test year can be tracked in subsequent periods with ratepayers over or under "paying" for expenses established in the test period. If this were the case, deferred income taxes, the OPEB liability, accumulated cost of removal, accumulated depreciation and accrued interest would need to be tracked in a similar manner to determine the appropriate rate base reduction. This simply is not done nor is it required.

Q. Do the assets in the pension trust represent "excess" contributions from ratepayers?

A. No. The pension cost for the year is actuarially determined based on a number of assumptions as I described earlier. This is the annual expense. Actuarial calculations are designed so that, over the long term, the amount of the pension contributions and expense will equal the pension benefits that will be paid under the pension plan. At any given point, pension assets may result due to plan contributions and negative pension expense. Elements of annual pension costs include expected returns on assets as well as favorable investment experience on plan investment. This experience increases the fair value of the plan assets, increasing the expected returns and reducing annual pension expense. There are no "excess" pension costs being expensed.

Q. What is the appropriate ratemaking treatment for the pension asset?

A. Peoples Gas is requesting that the prepaid pension asset be included in rate base. By doing so, the investors receive a return on their investment. Without this rate base inclusion, the prepaid pension asset is only generating a benefit for the ratepayer through lower or negative pension expense. The prepaid pension asset represents assets in the pension plan, which assets are providing a direct benefit to ratepayers because the investment income on those assets lowers the pension expense under FAS 87. Even if the pension expense is not negative, the pension expense is lower than it otherwise would have been due to the return earned on the assets in the pension plan. Accordingly, because the ratepayer benefits from a reduced or negative pension expense, it is appropriate to include the prepaid pension asset in rate base.

Q. Do you agree with Ms. Pearce's statement that "The pension asset should not be included in rate base because it was not created with funds supplied by shareholders. Rather, the pension asset has been funded from normal operating revenues collected from utility ratepayers and represents funds supplied by ratepayers."?

A. No. First, it is an established regulatory principle that ratepayers pay for service and their payments do not give them ownership of Peoples Gas or North Shore assets. Second, for Ms. Pearce's position to be accepted, she would have to show that each dollar comprising the pension asset was funded through billings to customers which, in turn, were contributed to the pension fund. This is clearly not the case as many of those contributions to the fund went to paying pension benefits to retirees. When positive pension expense exists in a period, the amount is based on the factors contained in FAS 87. The expense includes a service cost component—which, among other things, goes to pay the pension liability. The periodic expense is to pay for that periods pension cost, no more, no less.

Q. Can you further explain what you mean by tracking ratepayer funds?

A. Yes. Take the OPEB liability. Peoples Gas has accumulated on its projected test year balance sheet, an average OPEB liability, including an offsetting regulatory asset, in the amount of $87,200,000 (updated). North Shore's OPEB amount is $10,700,000 (updated). These are the amounts reflected in the test year as a rate base reduction. Staff accepts these amounts and has proposed a similar rate base reduction. If the Staff's argument on the pension asset were applied to the OPEB liability, it would be necessary to go back in time to see how the OPEB liability was built up, through direct tracing of the OPEB expense included in previous test periods. To the extent that the amount included in rates was more or less than the balance in the test year, an adjustment would be necessary to remove (or add) to the OPEB liability being deducted from rate base.

Similarly, the deduction for accumulated depreciation, deferred income taxes, and any other accrual would need to tracked and adjusted for entries to record expense in subsequent periods different that what was included in the test period.

The operating expenses included in a test year represent a level of costs that are expected to be incurred in the periods the new or adjusted rates are in effect. Ratepayers pay for "service" and such test year costs are necessary to determine the cost of service. However, absent a specific "cost tracker," actual costs will differ from the test year costs, for a variety of reasons. Actual costs may be higher or lower than the test year costs. There is no going back to recover costs in excess of those used in the test year to establish rates or going back and refunding costs that are less than those in the previous test years. Yet, that is exactly what the Staff has proposed for the pension costs.

Q. Can you elaborate on your position that the ratepayer is not the source of the pension asset?

A. Yes. The ratepayer cannot be the source of the pension asset. Prior to FAS 87, ratepayers were charged for pension expense in accordance with the requirements of Accounting Principles Board Opinion No. 8, which generally resulted in expensing based on funding. The actuaries established funding levels to provide for an accumulation of plan assets to meet the projected plan benefits – no more, no less. Amounts expensed were remitted to the plan to pay for plan benefits.

With the adoption of FAS 87, there was no longer a direct link between expensing and funding. As mentioned previously, under FAS 87 a distinct calculation is required each year to determine pension expense under GAAP which takes into consideration a number of factors including service cost, expected returns, interest on projected obligations, etc.

Under FAS 87, a prepaid pension asset results when there is negative pension expense or when contributions are made into the pension fund. In both instances, investors supply the funding. There is no logical alternative funding source.

Q. What are the ramifications of excluding the pension asset from rate base?

A. If the investors are not going to earn a return on their investment, the logical response for Peoples Gas is to make only the minimum required pension plan contribution resulting in greater risk to Peoples Gas' employees as to the availability of sufficient pension plan funds to pay for the ultimate plan benefits. In recent years, the risk of an underfunded pension plan to pay pension obligations to retirees and employees has increased for a number of entities and governmental bodies. The greater risk of insufficient pension plan funding leads to greater financial risk and likely increases in the cost of capital. The Commission should be encouraging adequate pension plan funding, not sending signals to Peoples Gas to do something less.

Q. Is Ms. Pearce correct when she removes the prepaid pension asset from Peoples Gas' rate base, but reduces rate base for North Shore's accrued pension liability?

A. No. As I have explained, Peoples Gas' prepaid pension asset is investor supplied and requires a return through rate base inclusion. North Shore has an accrued pension liability, not a pension asset. The accrued pension liability results from, among other things, pension expense being greater than pension contributions. Fewer pension contributions mean less expected return on pension assets in the FAS 87 calculation. The pension asset and pension liability result from the same calculations under FAS 87. To treat the accrued pension liability different from the prepaid pension asset is inconsistent and inappropriate. Further, this treatment is inconsistent with her previous testimony in Docket Nos. 07-0241/07-0242 (cons.) where she concluded that the pension asset and pension liability should be treated in the same manner.

Even Mr. Effron recognizes the need for consistent treatment of these items by not considering either one in the rate base determination.

Q. Do Ms. Pearce and Mr. Effron refer to prior Commission orders as support for their inconsistent position in this proceeding to deduct the OPEB liability from rate base but exclude the pension asset from the rate base calculation?

A. Yes. They refer to the Order in the Utilities last rate case (Docket Nos. 07-0241/0242 (cons.)). As a basis for the decision, this Order refers back to the Northern Illinois Gas Company Docket 95-0219 which differentiates between the two elements of retiree benefits by stating that " NI-GAS continues to control the ratepayer-supplied OPEB funds" implying that control is a distinguishing factor not requiring symmetrical treatment.

Q. Should this make a difference in how the pension asset and OPEB liability are treated in the rate base calculation?

A. No. Control should not be a deciding factor for determining whether an asset or liability should or should not be considered in rate base. Accumulated Deferred Income Taxes ("ADIT") are not controlled by Peoples Gas or North Shore, yet such amounts are generally considered in the rate base calculation. The determinant as to whether an item should or should not be considered in the rate base calculation is the source of the funds. If the amounts are supplied by someone other than the ratepayers (such as pension assets, OPEB's or ADIT) such funds are entitled to a return or will reduce the return and should be appropriately included or deducted from rate base. The deciding factor is the source of the funds and whether a return is to be earned or not on the investment. Because the investor has supplied the funding for the pension asset, he or she is entitled to a fair return on such funds, no different than if the investor supplied funds were financing utility property, plant and equipment.

Further, it is not clear that pension assets are beyond the control of Peoples Gas and North Shore. Investors bear much of the risk associated with a pension plan. In FAS 87, the FASB describes the fundamentals of pension accounting contained in that pronouncement with the following:

> "…recognized values of assets contributed to a plan and liabilities for pensions recognized as net pension cost of past periods are shown net in the employer's statement of financial position, even though the liability has not been settled, the assets may be still largely controlled, and substantial risks and rewards associated with both of these amounts are clearly borne by the employer."

Accordingly, while the assets in the pension plan cannot be readily accessed by Peoples Gas and North Shore, there are still a number of decisions within their control that affect risks faced by Peoples Gas and North Shore associated with pension plan administration. These risks are borne by the investor and as such are entitled to a return.

Q. Is there any basis for differentiating rate base treatment between the pension asset, pension liability or OPEB liability?

A. No. Each represents a commitment to pay retirees, either a pension or a promised health and welfare benefit. Each is determined on an actuarial basis. Each has similar factors considered in determining the periodic expense. Each has some level of funding giving rise to plan assets. I can see no reason for inconsistent treatment of any of these plan assets or liabilities in the ratemaking process.

V. PENSION ASSET AND OPEB TREATMENT IN OTHER JURISDICTIONS

Q. Have regulators in other jurisdictions addressed this issue?

A. Yes. While the Commission is not necessarily guided by other regulators, it may be instructive for them to know that other regulators have concluded that the prepaid pension asset is funded by investors and requires a return. For instance, the Federal Communications Commission ("FCC") and FERC have ruled that the pension asset/liability should receive rate base treatment in revenue requirement proceedings, as have many state regulators. Appendix 2 contains a listing of various Federal and State regulators who have included a prepaid pension asset in rate base and several citations as to basis for their conclusion.

VI. PRIOR ILLINOIS ORDERS CONCERNING PENSION AND OPEB'S

Q. Mr. Effron cites the Commission's Order from the Utilities' last rate case (Docket Nos. 07-0241/0242 (cons.) as a basis for his position. This order refers to the Northern Illinois Gas Company Order in Docket No. 95-0219 as precedent for treatment of prepaid asset treatment in rate base. Can you summarize the key factors that led to these decisions?

A. The factors cited for removing the pension asset from rate base is that such asset is ratepayer funded. The factor deducting the OPEB liability from rate base is that the OPEB liability is under the entity's control.

Q. Do you agree with the Commission's assertion that plan contributions are ratepayer-funded?

A. No. As I have stated previously this is contrary to the basic principle that ratepayers pay for utility service. Two components of a ratepayers cost of service are pension and OPEB costs computed on an actuarially determined basis. They are paying for their service and nothing more or less. The funds remitted by utility customers to Peoples Gas and North Shore are for their utility service and are recognized as revenue by these entities. The customers do not obtain ownership rights in Peoples Gas and North Shore assets by virtue of paying their utility bills. The entities make cash distributions for things like construction, dividends, interest, payroll costs, benefit costs from cash that is either generated from operations, or from debt or equity issuances. Each of these options is ultimately the responsibility of the investors and not the ratepayers funds.

Q. The Commission Order cited by Mr. Effron (Order, Docket Nos. 07-0241/0242 (cons.)) discusses the Commission's assertion that whether contributions take place or not is irrelevant for purposes of determining whether pension assets should be a rate base addition. Is this consistent with their prior positions taken with respect to this issue?

A. No. In its Order in Docket No. 95-0219, the Commission made a distinction between pension assets created through pension trust investment activity as compared to plan contributions. As the Order indicates:

> "The same pension credit and investment return factors which led to the creation of the pension credits in the GTE case are the factors which created the Pension Asset in this docket. Contrary to the Company's position, the CILCO order provides no guidance in the question before us because NiGas had made no cash contributions to its pension trust similar to those made in CILCO, and since it was not a disputed issue in that case, and the Order itself was silent on the issue. Thus, the Commission finds that the proposal to eliminate the net Pension Asset from ratebase is consistent with past Commission orders which found that the overfunded pension asset was created from ratepayer-supplied funds."

Q. Have there been any recent orders by the Commission which have allowed inclusion of a pension asset or pension contribution in rate base?

A. Yes. It is my understanding that the Commission's Order on Rehearing in Docket No. 05-0597 (Commonwealth Edison Company) allowed an $803 million pension contribution by the utility's ultimate parent company in rate base. Interestingly, in that proceeding, the Commission was persuaded that "ComEd has incurred a cost and that customers have derived some benefit as a result of the pension contribution" (Order on Rehearing, p. 28). A return based on what would have been the utility's long term debt rate, if it had financed the contribution, was allowed on this pension contribution in the rehearing order.

Q. Do the facts in that case differ from those present in this case?

A. The facts are somewhat unique due to the magnitude of the pension contribution involved. It is my understanding that Exelon Corporation, Commonwealth Edison Company's parent company, infused $803 million to fund the pension contribution. Generally pension contributions would not be able to be tracked to specific debt or equity issuances, or internally generated funds. However, I consider each of the fund sources above to be investor supplied and accordingly, pension assets should be included in rate base regardless of whether you can specifically trace the funds to a specific item.

In Docket No. 05-0597, there was a clear link between the pension contribution and investor funding. Exelon Corporation borrowed money and made a direct contribution to the pension fund. The rehearing order decided that because the increase to the pension fund results in lower pension expense (negative), and it is clear that investors supplied the funds that produced the lower pension expense, it is only fair that such investment (on the part of investors) receive a return. As mentioned, there was a direct contribution made to the pension fund, the source of the direct contribution was a borrowing and the appropriate return for this directly traceable borrowing was a debt return.

The only difference I can see between that case and the current case involving Peoples Gas is that the source of the pension asset is not as direct. Peoples Gas' pension asset cannot be traced to a specific investor or source of investment (i.e, a debt borrowing with a specific return). However, as I have explained, the source of Peoples Gas' pension asset is a combination of debt and equity investors—either through direct contributions (similar to Commonwealth Edison Company) or through negative pension expense, a non-cash credit reducing cash flows producing a requirement to obtain investor funds to "pay" for other cash expenses. But, in either case, the source of the prepaid pension asset is the investor, not the ratepayer, requiring a return on such investment.

Q. Does the Order on Rehearing in Docket No. 05-0597 address funding guidelines for pension plans?

A. Yes. In that order (at page 28), the Commission states:

> "The record shows that the contribution assisted in providing adequate funding for the retirement obligations to ComEd's workforce and that ComEd's customers saved $30.2 million as a result of that contribution."

The meaning of this is clear. Adequate funding of the pension plan is important to the Commission. The closer a pension plan is to fully funded the more likely it is to result in a pension asset if asset returns exceed the expected return. The funding amounts clearly reduce costs to ratepayers by increasing the level of pension plan assets upon which investment returns can be earned. Larger than expected asset returns also increase the amount of pension plan assets upon which investment returns can be earned. The important distinction is that all the assets and all the obligations are owned by the regulated entities.

VII. <u>CONCLUSIONS</u>

Q. Please summarize your conclusions.

A. Peoples Gas' prepaid pension asset and North Shore's accrued pension liability result from the interaction of pension expense and funding. To the extent a pension asset exists, as is the case for Peoples Gas, the source of such asset is investor-supplied funds and, accordingly, is entitled to a return. Ratepayers benefit from the pension asset by way of a reduced or negative pension expense and it is only appropriate for the source of the pension asset to receive a fair return on their funds. Likewise, it is appropriate to reduce rate base when an accrued pension liability exists, as is the case for North Shore.

Consistency also dictates that the OPEB liability, representing the excess of the liability for post retirement benefits over the assets that exist for such purpose, be deducted from rate base.

The pension plan and OPEB represent obligations of the Utilities for future payments to retirees. The expense each year is determined under GAAP and includes an appropriate allocation of the amount of the obligation attributable to the current year. The resulting asset or liability should be treated consistently in the ratemaking process.

Q. Does this complete your rebuttal testimony?

A. Yes.

ACCOUNTING FOR PENSIONS AND POSTIREMENT BENEFITS

The primary accounting rules for pension plans are contained in FAS 87, *Employers' Accounting for Pensions* ("FAS 87"), and FAS 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*("FAS 106"). There is other guidance on the subject but FAS 87 and FAS 158 are the relevant pronouncements for the pension asset issue in this proceeding. Briefly, FAS 87 and FAS 158 require that periodic pension expense and any related asset and liability be actuarially determined.

The financial and reporting guidance for employers offering postretirement benefits other than pensions is contained in *FAS 106, Employers' Accounting for Postretirement Benefits Other than Pensions* ("FAS 106"). The pronouncement requires OPEB to be recorded on an accrual basis.

The provisions of FAS 106 are similar in many ways to the provisions of FAS 87 in that the OPEB costs are actuarially determined.

FAS 87

FAS 87 requires an annual, actuarially-determined calculation of pension cost. The net cost for the period recognized the consequence of events and transactions affecting a pension plan and is recorded as a single net amount in the financial statements. This approach aggregates the compensation cost of promised benefits, interest cost resulting from deferred payments of these benefits and the results of investing plan assets.

Under FAS 87, the pension cost consists of several factors:

1) Service cost. The service cost is the actuarial present value of pension benefits calculated under the applicable pension benefit formula and attributed to current employees' service during the period. Actuarial assumptions reflecting the time value of money (discount rate) and the probability of payment (assumptions about mortality, turnover, early retirement, etc.) are factored into the computation.

2) Interest cost. The interest cost or accretion component is the increase in the projected benefit obligation due to the passage of time. This component essentially recognizes that the anticipated benefit plan payments are one year closer to being paid from the pension plan.

3) Expected return on plan assets. The expected return on plan assets is calculated by applying the expected long-term rate of return on plan assets to the market value of the plan assets. It is important to note that the long-term rate of return is used so that shorter-term increases or decreases in returns are not directly affected in this component of pension costs. The market value of plan assets can be either fair market value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years.

4) Gains and losses. Gains and losses are changes in the level of either the projected benefit obligation or plan assets resulting from actual experience compared to the assumptions. Asset gains and losses are the differences between the actual and expected return on plan assets during a period. Plan obligation gains and losses are differences between the actual liability and the expected liability at the end of the measurement period. FAS 87 does not require such gains and losses be recognized as a component of

pension costs in the period in which they occur, instead, such gains and losses are amortized. The amortization of unrecognized gains and losses will be included as a component of net pension cost for a year if, as of the beginning of the year, the unrecognized gain or loss exceeds ten percent of the greater of the projected benefit obligation or the market value of the plan assets (this is referred to as the “corridor”). If amounts exceed the corridor, pension cost is increased by the gain or loss in excess of the corridor divided by the remaining future service lives of plan participants.

5) Unrecognized prior service cost. The final component of pension cost for a period is unrecognized prior service cost, generally occasioned by plan amendments changing the plan benefits. FAS 87 provides for changes in benefits due to plan amendments be recognized over the remaining future service lives of plan participants.

Each of the pension cost components are required to be disclosed in the financial statement footnotes.

FAS 106

The provisions of FAS 106 are similar, in many respects, to those in FAS 87. Both pronouncements require measurement, on an actuarially determined basis, of the promise to provide benefits to retirees or employees upon retirement. The annual cost determination consists of 1) service cost, 2) interest cost, 3) expected return on plan assets, 4) gains and losses and 5) prior service cost. These factors are similar to those described under FAS 87.

Unlike pensions, there are no ERISA or IRS requirements with respect to contributions or minimum/maximum funding levels for OPEB’s.

FAS 158

This pronouncement requires full balance sheet recognition of the funded status of defined benefit pension and OPEB benefit plans. This standard was effective for public companies for fiscal years ended after December 15, 2006.

The key provisions of FAS 158 include full recognition of the funded status on the balance sheet. Under FAS 87 and FAS 106, only disclosure of the funded status of the plan was required. The funded status is the difference between the fair value of plan assets and the benefit obligation. In order to record the funded status in the balance sheet, the previously unrecognized amounts for gains and losses, prior service costs or credits and transition obligation are recorded as a component of other comprehensive income within the stockholders' equity section of the financial statements. FAS 158 has no impact on the expense amounts recorded for pension and OPEB expense.

Regulated entities whose rates charged to customers include pension and OPEB costs based on the requirements of FAS 87 and FAS 106 (People Gas and North Shore) do not use accumulated other comprehensive income to record unrecognized gains and losses, prior service costs or credits and transition obligation. Rather, a regulatory asset or regulatory liability is established to record these amounts as long as it is probable that the pension and OPEB amounts expected to be included in future rates will continue to be calculated on the basis of FAS 87 and FAS 106.

The impact of FAS 158 is that the net balance sheet amounts under FAS 158 equal the net amounts recorded under FAS 87 and FAS 106. This is because the full funded status of the plan (plan assets less the accumulated benefit obligation) is recorded in the respective balance sheet accounts and a corresponding regulatory asset or regulatory liability is recorded for the unrecognized amounts.

As a result of implementing FAS 158, a portion of the previous prepaid pension asset was reclassified to a regulatory asset. The sum of the prepaid pension asset and regulatory asset represents the amount of the pension asset at issue in this proceeding. For OPEB's, the sum of the OPEB liability and regulatory asset recorded under FAS 158 is the amount of OPEB liability at issue in this proceeding.

APPENDIX 2

REGULATORY TREATMENT OF PENSION ASSET AND OPEB'S IN OTHER JURISDICTIONS

The issue of rate base inclusion of the prepaid pension asset has been raised in rate proceedings in a number of Federal and State jurisdictions. Likewise, the symmetrical treatment of the pension asset and the OPEB liability has been addressed.

The FCC and FERC both have permitted rate base inclusion of the pension asset. In addition, while I have not surveyed each jurisdiction on the issue, regulators in the following states have included a return on the pension asset, typically through inclusion in rate base:

FCC	FERC
Arkansas	Michigan
Colorado	Missouri
Connecticut	New Mexico
Delaware	Oklahoma
District of Columbia	Oregon
Florida	Rhode Island
Georgia	Texas
Indiana	Virginia
Kentucky	Washington

Maryland	Wisconsin
Massachusetts	Wyoming

Several quotes from the decisions of these regulators are instructive.

In Docket No. ER08-129-000, page 8, the FERC concluded:

> "[P]repaid pensions arise when the income earned on pension funds accumulated in an external trust exceeds the net periodic pension cost, i.e., the current year's pension income exceeds the current year's pension expense. By law, a utility cannot withdraw such income, although it is required (under Generally Accepted Accounting Principles) to reflect the income as a reduction to its pension expense…. At the same time, the utility records a corresponding amount of prepaid pensions. If that reduction in pension expense is used in determining a utility's rates, there will be a corresponding reduction in the amounts collected from ratepayers. Because a utility cannot withdraw the pension income, it will be out-of-pocket for the amount of pension income that has reduced rates, i.e., it must reduce its pension expense by the amount of income, even though it is not allowed to receive such income from the pension trust. Thus, when a utility's rates have been reduced by pension income, but the utility has not received such income from the external trust, it will have to finance such amount, and is entitled to include the pension income in rate base."

In FCC Docket No. 96-22, the FCC concluded that prepaid OPEB liabilities should be treated in a similar manner for rate base asset determination. As stated:

> "Therefore, if a carrier can show that any of its assets recorded in Account 1410 (including prepaid OPEB) meet the used-and-useful standard, we will allow that asset to be included in the interstate rate base. This decision is consistent with our treatment of similar costs, such as prepaid pension costs, which we referenced in the NPRM. A certain amount of prepaid pension costs are allowed in the rate base because these costs can earn a return that later reduces expenses. Thus, any prepaid OPEB costs that meet the used and useful standard will be allowed, similar to prepaid pension costs."

The District of Columbia Public Service Commission permitted Potomac Electric Company to include the prepaid pension asset in rate base (Order 14712 Issued January 30, 2008). They concluded:

> "The Commission finds that investor-supplied cash contributions have resulted in an asset from which PEPCO's customers receive a tangible benefit in the form of reduced pension expenses. Therefore, investors are entitled to earn a return on the capital they provided. If the Prepaid Pension Asset is included in rate base, the related OPEB Liability should also be included as a reduction."

The Massachusetts Department of Telecommunications and Energy has permitted pension expense to be recovered through a pension tracker and allows a return on assets for uncollected amounts. Under the Pension Adjustment Mechanism in that state, the amount of pension costs collected in rates is reconciled with the pension expense computed in accordance with FAS 87. The following quote from The Boston Gas Company Order D.T.E. 03-40 confirms that carrying charges are allowed as a component of pension costs through the Pension Adjustment Mechanism:

"As an initial matter, we note that the Department has, in the past encouraged companies to prefund pension and PBOP plans in order to take advantage of the tax-exempt status of IRS-qualified pension and PBOP plans. D.P.U. 92-111, at 226 -227. The prefunding of these plans maximizes the ability of companies to accumulate earnings on pension trust investments on a tax free basis, thereby producing lower overall costs. Id. In addition, the poor market performance of the past several years, coupled with an extraordinary decline in interest rates, has required the Company to make even greater contributions to fund their pension plans. (Exh. KEDNE/JFS-1) JFB-1, at 34). These payments may result in an unusually high prepaid pension balance (id) Because of the benefits which inure to ratepayers from these payments and the fact that prepaid balances arise from forces at work in the economy at large and outside the Company's control, the Company should no longer absorb the money costs on these significant cash outlays. Accordingly, we will allow carrying charges to be recovered from customers on the prepaid pension and PBOP balances."

Note that in the FCC, District of Columbia and Massachusetts Commission decisions cited above, symmetrical treatment of pension and PBOP ("OPEB") was required as compared to the situation in this case (and others in Illinois) where there is different treatment of pensions as compared to OPEB.

In PSC Docket 05-304 in a case involving Delmarva Power & Light Company, the Delaware Public Service Commission concluded:

"However, we believe that the pre-paid pension asset is appropriately included in rate base because it is caused by a negative pension expense, which both reduces base rates, resulting in rates that are lower than they otherwise might be, and at the same time creates a cash working capital requirement. We also recognize that the Company has no access to this asset to use for other operating expenses; it is precluded by federal law from using any of the money it has collected for pensions for any other purpose."

In Texas Docket 33309, the rate order allowing the pension asset in rate base contained the following finding of fact:

"The ALJ's were not persuaded by OPC's argument that only cash contributions to the pension fund from investors should be allowed. Although a portion of the asset originated from actuarial adjustments and amortization of deferred investment gains on investor supplied funds rather than cash contributions, the entire prepayment asset and the earnings generated by it originated from TCC's (the utility) prior contributions under ERISA. Further, the entire asset belongs to TCC and its shareholders and it offsets current pension expenses to the benefit of ratepayers. The fact that part of the asset results from proper accounting entries under GAAP rather than a cash infusion during specific years does not change the nature of the prepayment asset or its effect in offsetting future expenses."

This Texas case concluded that not only direct contributions to the pension fund were investor supplied, but the pension asset created by reduced or negative pension expense also requires a return. It appears that an important consideration was that the ratepayer receives a benefit from the pension asset through a reduced or negative pension expense and should pay a return to the investors who supplied the funds used to produce this benefit.