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BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE APPLICATION OF UNITED WATER IDAHO INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER SERVICE IN THE STATE OF IDAHO	Case No. UWI-W-04-04

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

REBUTTAL TESTIMONY OF DAVE DEGANN

ON BEHALF OF UNITED WATER IDAHO INC.

Q. Please state your name and business address.

A. My name is David Degann. My business address is 125 Chubb Avenue, Lyndhurst, New Jersey 07071.

Q. Please state the purpose of your testimony in this case.

A. I was requested by United Water Idaho to review and comment on the testimony of Staff Witness English regarding the appropriate ratemaking allowance for pension cost.

Q. Please state your qualifications.

A. I serve as the Enrolled Actuary under ERISA for the United Water Plans and offer the advantage of almost two decades of experience in working specifically with these Plans. I have provided expert witness testimony for regulated entities related to this area of specialty of pension actuarial issues. I am Cum Laude graduate of the College of Insurance, with a bachelor of Business Administration. I hold a Master of Business Administration from Pace University, with a concentration in Taxation. I am an Enrolled Actuary (#25) and a Fellow in the American Society of Pension Actuaries and the Conference of Consulting Actuaries and a member of the American Academy of Actuaries. I have served as a General Chairman, American Society of Pension Actuaries Education & Examination Committee, and as a member of the Joint Board for the Enrollment of Actuaries Advisory Committee on Testing and Education. I am an Executive Vice President of Aon Consulting Group. My current responsibilities are to manage and supervise all actuarial and benefit consulting in the Northeast Region, and for Aon's Merger & Acquisition Practice. As the actuary for United Water, my responsibilities are to accurately measure the liabilities and costs of the Company's benefit programs, and to advise the Company of appropriate expense, accrual or funding rates so that such costs and liabilities are accounted for and so that assets are accumulated by a rational method.

I bring more than 40 years of actuarial and benefits plan consulting experience. In my present position, I am responsible for actuarial and benefit consulting for some of the largest and most complex corporate organizations in the United States, such as Crown Cork & Seal Company, Inc., Bethlehem Steel Corporation and Cathay Pacific Airways, Ltd.

Q. Please state your understanding of Staff Witness English's testimony and recommendations.

A. Mr. English recommends that the Company's recoverable pension expense be determined by reference to its ERISA contribution, rather than its actuarially determined pension cost under FAS 87. This reduces the 2004 recoverable cost from $637,046 as claimed by the Company to $162,454 as recommended by Staff (Exhibit 108). This cash methodology has some serious flaws as I will demonstrate in more detail below. As I read his testimony, he bases his recommendation on several points:

1. The FAS cost is "artificial" and has "no connection to real world values". (p. 20)

2. The sizable revenue increase requested justifies a reduction in pension cost. (p. 21)

3. Required plan funding under ERISA will not cause future costs to rise dramatically. (p. 24)

4. "There is growing concern among accounting professionals regarding the use of FAS 87 and the potential for manipulation of financial statements" (p.16)

It is my professional opinion that Staff's reliance on these points inappropriate, and that established accounting and regulatory principles require the use of FAS 87 to determine recoverable pension cost.

Q. Please explain.

A. Let me address each of the flaws in Mr. English's testimony:

1. FAS 87 expense results are, in fact, a direct function of "real-world" plan financials. FAS 87's entire methodology is geared to developing a realistic, accurate measure of the costs of a year's worth of pension accrual. FAS 87 expense is calculated by recognizing the value of plan assets at market value, reflecting the current economic conditions in the marketplace and explicitly recognizing the benefit accruals earned in pensions for participants each year. One example of how much FAS 87 is tied to actual "real

world" conditions relates to the fact that the discount rate selected must be the rate "at which the pension benefits could be effectively settled"...looking at "*current* prices of annuity contracts… and rates of return on high-qualify fixed income investments *currently* available". [FAS 87, paragraph 44- Italics added for emphasis]

2. Mr. English suggested that the fact that pension expense increased means that the FAS 87 method should be abandoned and another (cash funding) be applied. Selecting a cost method based upon how high or low costs are in a given year is not an appropriate decision process, particularly for pension costs which rely upon cost over many years (usually 20 to 30) not a given year.

If rate recovery were based upon selecting the minimum cost of the various methods without any regard to the actual fundamentals of continuing program costs, rate recovery would be insufficient to maintain the program. The fact that program costs increased merely reflects what has actually occurred in the real world with respect to the program liabilities growing and the value of plan assets in today's market underperforming. Please see the table below.

3. Contrary to Mr. English's suggestions, the required ERISA Minimum Funding contributions are expected to dramatically increase for these particular qualified pension plans, given their funded history, current asset values and current liability levels. As the plan actuary, I have advised United Water that the cash contribution

requirements for its defined benefit plans will increase dramatically to address the significant unfunded status of these plans. Below we show the deficit position of both plans as of 1/1/05:

	UW Idaho Non-Bargaining	UW Idaho Bargaining	Total
Current Liability for ERISA Funding at 1/1/05	$6,162,000	$5,053,000	$11,215,000
Assets at Market Value at 1/1/05	$4,044,000	$3,711,000	$7,755,000
Funded Status	$(2,118,000)	(1,342,000)	(3,460,000)
Funding Ratio	66%	73%	69%

Because of the pension plan's funded status with plan assets covering only 69% of liabilities, the ERISA Minimum contributions will require that United Water contribute significantly higher amounts to bolster the funded position. When plans fail to retain a satisfactory funded position, the ERISA Minimum contribution adds a Deficit Reduction Contribution, which accelerates contributions and requires an employer to make cash contributions that pay off the unfunded obligations in 3 to 5 years.

4. Contrary to Mr. English's testimony, FAS 87 is a stable accounting measure which has now been in effect for over 20 years in the U.S. and is serving as a model in many respects for international standards. FAS 87 has served to provide plan sponsors a consistent method of computing an annual expense amount, separate and distinct from a plan's generally voluntary and variable funding deposits to the plan. The annual expense amount was defined to reflect accrual accounting for pension plans, making sure that the cost

of pension benefits are expensed during the time earned – supporting a matching principle of whatever a company is promising in benefits to be charged against company revenue at that time.

I believe that Mr. English is referring to the highly publicized recent debates revolving around the appropriate actuarial *assumptions,* rather than any issues related to the fundamentals of FAS 87 expense. Further, such debates on assumptions impact both funding and expense. Selecting appropriate actuarial assumptions has been a focus largely because of turbulent economic times. In general, virtually all plan sponsors, including United Water, have made adjustments to the expected long-term yield on plan assets to reflect the lower investment yields. Finally, with reduced inflation levels, the discount rate used to determine program liabilities has been dramatically reduced (resulting in increased liabilities).

Q. Why is FAS 87 the proper approach in setting rates?

A. FAS 87 is the proper approach for rate recovery. Only FAS 87 provides accurate accrual accounting which produces equitable results for generations of customers, and also offers a consistent stable methodology with no discretion from a company on how it is determined. Below we describe the major advantages that distinguishes FAS 87 as the proper approach for rate setting:

- Avoids volatility in expense from year to year
- Avoids underfunding and ensures as much as possible that plan assets will be sufficient to meet retiree needs over the long term
- Matches costs with benefits under accrual basis,
- Provides a stable FAS methodology
- Is consistent across companies
- Follows generally accepted regulatory practice
- Follows the recommended past decisions of the PUC in the last case when FAS pension income REDUCED expense
- Follows the current recommended basis of the PUC related to FAS 106 costs, which mirror the same principles as under FAS 87

I discuss each of the above briefly below:

- Avoids volatility in expense from year to year. FAS 87 expense methods include defined amortizations of actuarial gains/losses, making such method less volatile from year to year.
- Avoids underfunding**.** In the event the Commission were to modify its past decisions to move to a cash contribution basis, United Water would be faced with deferred recognition of expense/cost in rates and in fact may not have proper financial reserves to properly make contributions to the pension plan. In other words, without accrual recognition of program costs, when the cash requirements are demanded, United Water may not have the financial ability to pay such contributions as ERISA demands. If United Water cannot afford to pay the contributions, then the programs are ultimately remanded to the PBGC for insufficient funding. Certainly, I do not recommend that any situation put such risks on a long-standing program designed to address fundamental retirement security needs.

Matches costs with benefits under accrual basis. Accrual accounting under FAS 87 aligns program costs with the proper generation of customers in the rates. By using FAS 87 expense/(income) methods, the costs associated with active employees working to deliver water services to customers in each year are recognized during that year – not assigned to another year.

Accrual accounting has long been recognized as the preferred method of charging back the costs of pensions. "Accrual accounting goes beyond cash transaction to provide information about assets, liabilities, and earnings" [FASB 87 Introductory Comments]. The concept is that while an employee is actively working and delivering services to the company and customers, any deferred compensation must be recognized against company books during active employment. Waiting to recognize benefits promised – and earned – until retirement or until the company is required to make cash contributions to the fund results in inequitable and volatile year-by-year results.

If the PUC were to apply a method that does not follow accrual accounting, there is a mismatch of revenues and expenses, and the wrong generation of customers winds up paying for costs of other customers. Accrual accounting under FAS 87 offers an equitable method that follows the PUC guiding principles of matching revenue and expenses.

- Provides a stable FAS methodology. Unlike cash funding requirements which have been modified numerous times, the specific requirements of FAS 87 have been retained virtually unchanged since 1985. That's 20 years of stability and reliability. On the pension cash funding side, we see a much different picture in the past and going forward, with multiple changes to the methods of computation. In fact, in 2005, the Administration has proposed funding legislation (if passed, to be effective in 2006) which will be the most sweeping fundamental change since ERISA's passage. The Administration's funding requirements are intended to force many plan sponsors to contribute far more than current Minimum funding requirements. On the FASB side, there are no plans for any changes – merely a continuation of the 20 years of stability we have seen already.
- Is consistent across companies. FAS 87 is the consistent US GAAP methodology for recognizing the annual costs of pension benefits. All companies in the US follow this method.
- Follows generally accepted regulatory practice.
- Follows the recommended past decisions of the PUC in the last case when FAS pension income REDUCED expense.
- Follows the current recommended basis of the PUC related to FAS 106 costs, which mirror the same principles as under FAS 87. We note that the commission has endorsed FAS 87 in all prior years, and

currently continues to apply accrual expense accounting for FAS 106 purposes for rate recovery.

Q. Do you have experience with the regulatory treatment of this cost for other clients in other jurisdictions?

A. Based upon Aon Consulting's experience with regulated utility companies, the general practice adhered to applies annual expense under FAS 87 for pensions and FAS 106 for retiree medical benefits to determine:

- Annual expense recognized for purposes of computing an organization's P&L (Profit & Loss), and also for consistency;
- Annual rating costs recognized for purposes of passing on a company's pension costs to the consumer.

In this way, complete consistency exists between:

- What a company is required to report as annual expense/(income) for pension benefits; and
- What customers pay for in rates.

This one-to-one correlation ensures that as a company records pension expense or (income), the same amount is reflected in rates. If cash funding or another approach were employed a company's rating basis could be dramatically different than what is recorded each year in its books.

Below are specific cases where the Regulatory Commission ruled that annual expense under FAS 87 is the required rate basis:

- Since 1995, the Board of Public Utilities of the State of New Jersey has based its rating costs on the pro forma pension expense/(credit) as computed by the pension actuary each year. Specifically, the Commission applied a "pay-as-you-go" expense approach for rate recovery purposes. The amount accrued as an expense in determining the organization's financial status is the same amount applied in rate recovery.
- Since 1992, the Public Service Commission of the State of New York has also required the application of FAS 87 pension expense/(income), with only a review of the key assumptions applied in such computation.

Q. In your opinion, what would be the result if the Commission follows the Staff recommendation of applying ERISA Minimum Cash Contributions instead of FAS 87?

A. First, if no rate recovery would be available until cash ERISA contributions were required, United Water Idaho would still be required by GAAP to record the FAS expense on its books and revenues with no matching rate recovery amount. Then, at the time that cash contributions would be required, it is quite possible that the Company will not have the financial reserves and strength to cover such contributions, because insufficient rate recovery was provided in the past. Essentially, providing rate recovery at a fraction of the program costs puts the Company in a compromised financial position, most likely forcing the Company to reduce and/or eliminate future pension plan benefits in entirety for active employees. By deferring the costs of benefits promised (essentially by insisting on an interest free loan with balloon payments at the end), the PUC is gambling with the retirement security of active long-service employees. In fact, this is precisely the situation that FAS 87 was trying to correct – numerous companies opting to recognize only "pay-as-you-go" cash costs instead of matching accrual costs with revenue. It was all too common for companies to make benefits promises, book no program costs and later renege on promises by eliminating benefits when the cash costs were too great a burden. Essentially, a decision to apply ERISA Minimum Cash Contributions instead of FAS 87 may force a decision by the Company to reduce or eliminate the promised pension benefits for United Water Idaho active employees retiring in the future.

Second, this approach has equally serious long-term impacts on the Company's customers, as was the case when ERISA existed in 1974 prior to the accounting profession issuing the FAS 87 standard in 1985. Without the discipline and requirements of FAS 87, companies had too much discretion under ERISA to defer the costs. For regulated companies, the ERISA approach forces future customers to pay for past costs.

Third, ERISA Minimum rules require that pension deficits be funded in a very short time (3 to 5 years), much akin to a balloon loan structure. This makes the problem of deferring what is being spent today much more severe. There is never any guarantee that a Company can later pay for amounts spent today, and chances of payment later are riskier when the payments are so large that are being deferred. United Water Idaho's current pension plans have plan assets insufficient to cover existing benefits promised by some $3.5 million. This suggests cash funding of millions of dollars each year, when the time comes for the payments. As the plan actuary, I expect such cash contributions to be required in the next 3 to 5 years, with the ERISA Minimum Contribution requirements already applying for the bargained plan in 2003 and 2004, with future cash contributions forecasted to dramatically accelerate. If no rate recovery is provided using the traditional FAS 87 accrual method, the Company will not have proper financial reserves to make these payments. Only FAS 87 expense accrual adequately prepares the Company to be able to make these cash contributions.

Q. Does this conclude your testimony?

A. Yes.