



Hot Topic – Various approaches for determining cost of pension and retiree medical benefits to be included in rates

**The exact process for determining the cost of pension and post-retirement medical and life insurance benefits (PRM) to be included in rates for gas and electric utilities varies significantly from one jurisdiction to another. The governing body might be the state Public Utility Commission (PUC), sometimes called the Public Service Commission (PSC), or it might be the Federal Energy Regulatory Commission (FERC), which has jurisdiction over interstate electricity sales, wholesale electric rates, hydroelectric licensing, natural gas pricing, and oil pipeline rates. This article will discuss some of the various approaches that are used in setting rates and will identify what might be considered as a best practice, considering the interests of both the utility and its customers. It addresses:**

- **The basis for the costs**
- **Requirements to fund**
- **Allocation of plan costs to business units**
- **Acquisitions**
- **Tracking mechanisms**

## Basis for cost

Practice varies as to whether the FAS expense or the cash contribution goes into rates, especially for pension plans. For PRM plans, the typical approach is to use the FAS expense. For pension plans, there is no consensus on the basis. Before FAS 87 was implemented, the cash contribution under the utility's funding policy was used as the basis for rates. In the years since the implementation of FAS 87, many jurisdictions have changed to use the FAS expense; but many continue to use the cash contribution under the company funding policy.

The use of the FAS expense as the basis for rates incents the utility to contribute no more than the minimum amount required under the law. A contribution in excess of the minimum amount required reduces FAS expense since it increases the expected return on assets. This in turn reduces the amounts collected in rates, thus reducing revenue and potentially earnings.

If the cash contribution is the basis for rates, there can be a significant difference between a utility's FAS 87 expense and its contribution included in rates. If a utility cannot establish a regulatory asset/liability for this difference, it will impact earnings.

## Must “cost” be funded

For jurisdictions that use the FAS 87/106 expense as the basis for rates, there is an issue of whether this expense must be funded in order to be included in rates. This funding is typically (but not always) required for PRM plans. Some jurisdictions only require funding to the extent it is tax deductible. Others require that the full amount be funded, even if some of it is not deductible. It is also common to require that the most tax efficient funding vehicles be used. In some jurisdictions, the amount of the FAS 106 expense that cannot be funded must be accounted for in an internal reserve on the books. The internal reserve is required to be credited with interest, which could be at the company’s pre tax rate of return.

For pension plans, the practice is reversed. It is not that common to require funding of the FAS 87 expense, although some jurisdictions do require it.

## Allocation of plan cost to business units

Most plans cover employees in multiple business units, whether it be utilities operating in multiple jurisdictions or regulated and non-regulated businesses. The cost, whether it is the FAS expense or the cash contribution, is usually determined for the plan as a whole. Practice varies widely as to how the total cost is allocated to the business units. Allocations can be complicated by the transfer of employees between business units. Some cost allocation approaches being used are discussed below.

- One approach that is used is to perform separate actuarial valuations for each business unit based on the demographics of its active and retired employee and use these results as the basis for the allocation. While this approach sounds simple enough, events occur over time that can complicate the process.
  - It is common to have transfers of employees between business units. How are these transfers reflected in the valuations? For each year’s valuation, do you transfer liabilities for service prior to transfer back to the original business unit? If so, does it reflect average compensation at date of transfer or projected average compensation at retirement? Or, do you transfer assets when the employees transfer? If so, what liability measure is used? Do you reflect a surplus or deficit in the plan’s funded status? What if the transfer changes the plan in which the employee participates?
  - It is not uncommon for a utility to undergo a significant restructuring of its business units. This may result in a transfer of large departments between business units or a split-up of a company into regulated and non-regulated business units. To continue this method of allocating cost would require the ability to map all of the existing retired and terminated vested employees into the business unit that contains the department in which they worked before the restructuring. This can be a very time consuming task.
- Because of the complexities identified above, a simplified approach is also used, where the total cost for the plan is allocated using a more simplified basis. Some bases that are used include:
  - Number of participants (either active or total including retirees);
  - Payroll of active participants; or
  - Service cost or normal cost of active employees.

## Acquisitions

An acquisition of a utility can complicate the accounting and rate determination process for the cost of pension and PRM benefits. The acquiring company is required to account for the acquisition using the purchase method of accounting. The acquiring company must establish a liability (or asset) on its balance sheet equal to the funded status of these plans (liability minus market value of assets). Any unrecognized prior service cost or unrecognized net gain or loss is set equal to zero. Because these unrecognized amounts are no longer amortized into the FAS expense, the FAS expense recognized in the future by the acquiring company can be much different than the acquired company would have recognized if the acquisition had not occurred. If this new FAS expense is used as the basis for rate recovery, it can hurt the utility if the new expense is lower or hurt the rate payers if the new expense is higher.

There are two alternative approaches utilities use to avoid these inequities:

- One approach is to keep two sets of books. The GAAP financial statements reflect the purchase method of accounting. The books that ignore purchase method of accounting are used to determine the expense for rate purposes.
- Under the other approach, one set of books is used that reflects the purchase method of accounting. A liability (or asset) would be established on the balance sheet to reflect the funded status. Under FAS 71, the company would also establish a regulatory asset (liability) for the unrecognized prior service cost and unrecognized prior service cost that is eliminated to the extent these amounts can be recovered in future rates. Then, the expense used for rate purposes would be the sum of:
  1. The FAS expense that reflects the application of the purchase method of accounting;  
and
  2. An amortization of the regulatory asset (liability) over an appropriate number of years.

## Tracking Mechanisms

The most significant difference that exists between jurisdictions is whether the difference between the cost included in rates and the actual cost incurred is tracked and used in determining the costs to be included in future rates. There are a number of jurisdictions that have such a tracking mechanism. As an example of how such a tracking mechanism works:

- A utility includes the FAS 87 expense for its test year in the rates it collects for several years into the future.
- Each future year, the difference between the FAS expense collected in its rates and the actual FAS expense incurred is tracked and accumulated.
- The next time the rates are re-determined, the amount included in the rates for pension expense is the FAS 87 expense for the new test year, adjusted (increased or decreased) by an amortization of the tracked difference described above.

There are many variations by which these tracking mechanisms are actually implemented, but the basic principles remain the same.

One of the real benefits to the utility of such a tracking mechanism is that it allows the utility to establish a regulatory asset or liability under FAS 71 for the difference between the actual FAS expense incurred and the amount collected in its rates. As a result, volatility in FAS expense does not impact earnings per share.

## Conclusion

As can be seen from the material above, there are numerous ways to determine the cost for pension and PRM plans included in rates. There is no right or wrong answer. While the tracking mechanism has considerable usage, it is surprising that it is not used even more broadly. With a tracking mechanism, the customers pay for the actual cost of these plans over time. It alleviates the negative financial implications of a situation like we experienced in the early 2000s, where utilities had to absorb significant increases in cost for these plans that were not recoverable in rates. Likewise, utilities will not benefit from situations like we had in the 1990s where FAS expense decreased due to good asset returns, but the utility continued to collect higher reimbursements in its rates. The tracking mechanism seems to be a fair approach to both sides – the utility and the customers.