

**PECO ENERGY COMPANY  
STATEMENT NO. 11-R**

BEFORE THE  
PENNSYLVANIA PUBLIC UTILITY COMMISSION  
  
PENNSYLVANIA PUBLIC UTILITY COMMISSION

v.

PECO ENERGY COMPANY – ELECTRIC DIVISION

DOCKET NO. R-2010-2161575

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REBUTTAL TESTIMONY

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WITNESS: JOHN W. ALLEN

SUBJECTS: PENSION EXPENSE AND OTHER  
POST EMPLOYMENT BENEFIT  
COSTS

DATED: AUGUST 3, 2010

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**REBUTTAL TESTIMONY  
OF  
JOHN W. ALLEN**

5

**I. INTRODUCTION AND PURPOSE OF TESTIMONY**

6 **1. Q. Please state your name and business address.**

7 A. My name is John W. Allen. My business address is 71 South Wacker Dr.,  
8 Suite 2600, Chicago, IL 60606-4637.

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

10 A. I am employed by Towers Watson as a Senior Consultant. Towers  
11 Watson is a global consulting firm that provides actuarial and employee  
12 benefit services to Exelon Corporation and its subsidiaries.

13 **3. Q. What are your educational background and professional  
14 qualifications?**

15 A. My educational background and professional qualifications are set forth in  
16 Appendix A to this testimony.

17 **4. Q. Have you previously submitted testimony in this proceeding?**

18 A. No, I have not.

19 **5. Q. On whose behalf are you testifying?**

1 A. I am testifying on behalf of PECO Energy Company (“PECO”).

2 **6. Q. Have you testified previously on behalf of PECO?**

3 A. Yes. I recently submitted rebuttal testimony in a parallel proceeding  
4 involving PECO’s Gas Division at Docket No. R-2010-2161592.

5 **7. Q. Have you testified before this Commission in other matters?**

6 A. No, I have not.

7 **8. Q. What is the purpose of your rebuttal testimony?**

8 A. The purpose of my testimony is to respond to certain proposed  
9 adjustments to PECO’s claims for pension expense and other post-  
10 employment benefit costs (“OPEB costs” or “SFAS 106 costs”). In the  
11 course of doing so, I will describe the principal drivers of pension  
12 contributions; discuss the funded status of the applicable benefit plans; and  
13 generally explain why the levels of PECO’s pension contribution and  
14 OPEB expense amounts, in my judgment, are reasonable.

15 **9. Q. What specific issues will you address?**

16 A. I will address the following:

- 17 • The new funding rules under the Pension Protection Act of 2006  
18 (PPA), which became effective in 2008
- 19 • “Credit balance” and how it is defined/utilized under the PPA

- 1 • How recent capital market performance, together with the enactment  
2 of the PPA, have impacted PECO’s pension funded status and future  
3 contribution requirements
- 4 • The key drivers that determine future funding requirements and  
5 potential future volatility/risks to funding requirements
- 6 • Why it is reasonable and advisable to fund at a level that is higher than  
7 the minimum required
- 8 • The projected impact on contributions if Exelon/PECO were to choose  
9 not to make an incremental contribution during calendar year 2010
- 10 • The specific adjustments proposed by Office of Consumer Advocate  
11 (“OCA”) witness David Efron and Office of Trial Staff (“OTS”)  
12 Dorothy Morrissey, and
- 13 • Projected PECO postretirement welfare plan costs determined as of  
14 September 30, 2009, January 1, 2010, and June 30, 2010.

15 **II. THE PENSION PROTECTION ACT OF 2006**

16 **10. Q. What are the relevant elements of the PPA impacting PECO’s pension**  
17 **contributions?**

18 A. Among other elements, the PPA introduced the following factors directly  
19 impacting PECO’s pension contributions:

- 20 1. A change in the minimum funding requirement whereby any  
21 unfunded obligation must be fully funded within a targeted seven-  
22 year period.
- 23 2. The addition of funding percentage threshold requirements in order  
24 for plans to avoid “at-risk” status and participant benefit  
25 distribution restrictions.
- 26 3. A change in the “credit balance” such that it is often less  
27 advantageous to maintain or utilize.

1 4. Increased premiums to the Pension Benefit Guaranty Corporation  
2 (PBGC) as a result of additional benefits being included in the  
3 premium calculation.<sup>1</sup>

4 **11. Q. What is the impact of the PPA change in the minimum funding**  
5 **requirement?**

6 A. Generally, it requires employers to contribute more into their pension  
7 plans earlier in order to fund the plans to 100% of obligations within a  
8 seven-year amortization period. The PPA phased in the 100% threshold  
9 over four years (92% in 2008 up to 100% after 2010). Pre-2008 funding  
10 rules only required funding to a targeted 80%-90% level.

11 **12. Q. What is the impact of introducing “at-risk” and “benefit restrictions”**  
12 **funding percentage thresholds?**

13 A. Plans that fall below an 80% funding threshold will be considered “at-  
14 risk” and/or trigger restrictions in the amount of certain distributions for  
15 plan participants. If a plan is “at-risk”, the plan sponsor is required to  
16 distribute notices to all participants indicating that the plan is at risk and  
17 that the plan will be subject to accelerated minimum funding requirements  
18 based on a higher target liability. If a plan falls below the benefit  
19 restriction threshold, it will be prohibited from fully paying out certain  
20 distributions, such as lump sum payments to cash balance plan  
21 participants.

<sup>1</sup> The PBGC is a federal agency created by the Employee Retirement Income Security Act (“ERISA”) to protect pension benefits in private sector traditional pension plans.

1   **13.    Q.    What is a “credit balance” and how is it utilized?**

2           A.    The credit balance is a notional amount that represents the accumulated  
3                   value of prior year contributions in excess of that year’s minimum  
4                   required contributions. Some or all of the credit balance may be used to  
5                   satisfy future minimum required contribution amounts, subject to certain  
6                   limitations. The existence of a credit balance does not suggest that a plan  
7                   currently has a surplus funded status; it simply means that in past years the  
8                   plan sponsor contributed in excess of the minimum required. The credit  
9                   balance held by the Exelon Corporation Retirement Plan (ECRP) was \$1.7  
10                  billion at January 1, 2010 and is largely attributable to a significant  
11                  voluntary contribution made in 2005 (a total contribution of \$2 billion, of  
12                  which PECO contributed \$110 million).

13   **14.    Q.    Why is it often less advantageous to maintain or utilize the credit**  
14                  **balance under the PPA than under the prior funding regulations?**

15           A.    The PPA requires, for purposes of determining whether or not the plan’s  
16                  funding percentage is at least 80%, that the portion of the assets earmarked  
17                  as credit balance be removed from the plan assets. The formula for  
18                  determining the funding percentage for this purpose is: (actuarial value of  
19                  plan assets LESS credit balance)/obligation. Therefore, plan sponsors  
20                  may be compelled to forfeit all or a portion of the credit balance (and thus  
21                  not reduce the actuarial value of the plan assets) in order to meet the 80%  
22                  threshold to avoid being “at-risk” and/or to avoid benefit restrictions.



1 Under the PPA, for purposes of determining the required contributions,  
 2 asset returns that differ from the expected rate of return are amortized over  
 3 a seven-year period. As a consequence, the substantial decline in asset  
 4 values experienced in 2008 will continue to increase contribution levels  
 5 for the next several years. This impact, however, will be partially offset  
 6 by better-than-expected asset returns in 2009. Based on June 30, 2010  
 7 economic assumptions, expected PECO contributions for 2010 - 2012  
 8 average \$57.8M per year and are as follows on an annual basis<sup>2</sup>:

	(\$ millions)			
	2010	2011	2012	2013
Contributions	\$73.9	\$46.4	\$53.2	\$43.8

13 **16. Q. What would be the projected impact on future year contributions if**  
 14 **PECO did not make an incremental contribution during calendar**  
 15 **year 2010, and, instead, only contributed an amount necessary to meet**  
 16 **ERISA requirements and avoid “at risk” status and benefit**  
 17 **restrictions?**

18 A. Listed below are the projected PECO contributions for 2010 - 2013 based  
 19 on June 30, 2010 economic assumptions, assuming no incremental  
 20 contribution during 2010:

<sup>2</sup> The 2010 contribution assumption has increased to \$73.9 million due to updated demographic information received subsequent to our December 31, 2009 actuarial valuation (consistent with our historical practice). It is my understanding, however, that PECO does not intend to revise its initial pension cost claim, as corrected, of \$71.2 million.

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(\$ millions)

	2010	2011	2012	2013
Contributions	\$50.6	\$70.9	\$53.3	\$43.9

Cumulative contributions during the period 2010-2013 are approximately the same whether or not the incremental contribution is made in 2010 (approximately \$1.4 million higher without the incremental contribution).

**17. Q. What are the key drivers that determine future funding requirements and potential future volatility/risks to funding requirements?**

A. Along with the PPA funding rules themselves, the primary drivers of future funding requirements are the plans' current funded status, projected trust investment returns, and projected liability discount rates. In most cases, volatility in future funding requirements can be reduced significantly by contributing a level or targeted annual amount over time, with adjustments for market conditions. The objective is to achieve risk-adjusted returns that will balance the liquidity requirements of the plans' liabilities while striving to minimize the risk of significant losses.

**18. Q. Why is it reasonable and advisable to fund at a level that is higher than the minimum required?**

A. It is reasonable and advisable to fund at a level that is higher than the required minimum funding level for the following reasons. First, it shows that the Company is being responsible in funding its obligation to

1 its employees. Second, by improving the funding status sooner, it reduces  
2 the overall contributions that need to be made into the pension plan as the  
3 trust assets earn a return on the assets over a longer period. This reduces  
4 also the variable premiums required to be paid to the PBGC. Third, it  
5 provides a more manageable funding plan with more stability and  
6 flexibility and helps mitigate the potential risk of an extremely large  
7 contribution requirement in future years.

### 8 III. RESPONSE TO OPPOSING PARTY TESTIMONY

9 **19. Q. Have you reviewed the direct testimony of David J. Effron on behalf**  
10 **of the Office of Consumer Advocate?**

11 A. Yes.

12 **20. Q. What does Mr. Effron recommend in terms of PECO's pension**  
13 **expense allowance for ratemaking purposes?**

14 A. Mr. Effron recommends that PECO's pension allowance be based on the  
15 average of cash contributions over the four year period 2007-2010, or  
16 approximately \$28.6 million. After allocating those costs between capital  
17 and expense and determining how much of the expense should flow to  
18 PECO's electric operations, Mr. Effron proposes that PECO be allowed to  
19 recover approximately \$12.3 million on an annual basis, or roughly \$18.6  
20 million less than the Company's claim.

1     **21.     Q.     Please comment upon Mr. Effron’s proposal.**

2           A.     There are a number of problems with his recommended approach. First,  
3           the four-year average includes 2007 contributions, which were made prior  
4           to the effective date of the PPA and therefore were determined under a set  
5           of less stringent pension plan funding laws. Second, his four-year average  
6           includes years where PECO elected to utilize the credit balance to satisfy  
7           the minimum required contributions for the ECRP. Under the pension  
8           plans’ current funded status, under most reasonable sets of economic  
9           assumptions, using the credit balance to satisfy minimum required  
10          contributions does not eliminate contributions; rather it simply defers them  
11          until a later date (“pay now or pay later”). Thus, by including years in the  
12          average during which PECO did not contribute to the plan, the  
13          recommended approach understates the projected contributions to the plan  
14          because there indeed was a minimum contribution required, but it was  
15          satisfied by utilizing credit balance. Perhaps more significantly, based on  
16          the Company’s projections at June 30, 2010, it is expected that the credit  
17          balance will no longer be available after 2010 after it is utilized to meet  
18          2010 contribution requirements and forfeiting amounts necessary to  
19          exceed funding percentage thresholds to avoid at-risk status and benefit  
20          restrictions. Third, and as discussed previously, the poor economic  
21          conditions in 2008 significantly increased the unfunded status of the plans,  
22          requiring greater contributions in future years to make up the shortfall.  
23          Finally, the amounts necessary to meet the minimum ERISA’s funding

1 requirements and amounts necessary to avoid benefit restrictions and at-  
2 risk status are substantially in excess of \$28.6 million for each year from  
3 2010 through 2013.

4 **22. Q. Have you reviewed the direct testimony related to pensions of Dorothy**  
5 **Morrissey on behalf of Office of Trial Staff?**

6 A. Yes.

7 **23. Q. Please summarize Ms. Morrissey's pension cost recommendation.**

8 A. Ms. Morrissey recommends disallowing the planned \$24.5 million  
9 incremental contribution on the grounds that the Company can use the  
10 ECRP credit balance to satisfy current and future contributions.  
11 Consequently, she would establish PECO's pension expense allowance  
12 based on an assumed 2010 contribution of only \$46.7 million. This  
13 translates into an expense amount of approximately \$20.1 million for  
14 PECO's electric operations, or about \$10.7 million less than the  
15 Company's claim. Additionally, Ms. Morrissey cites concerns about  
16 customer affordability as a reason to disallow any incremental  
17 contributions.

18 **24. Q. Please respond to Ms. Morrissey's recommendation.**

19 A. As previously discussed, it is expected (based on June 30, 2010 economic  
20 assumptions) that the credit balance will no longer be available to the

1 Company to offset future required contributions to the ECRP after 2010.  
2 In addition, Ms. Morrissey's concerns over customer affordability do not  
3 justify disallowance of the incremental contribution, as deferring an  
4 incremental contribution in 2010 will simply require higher contributions  
5 in future years. Indeed, deferring an incremental contribution in 2010 will  
6 simply require higher contributions in future years. In fact, if the \$24  
7 million incremental contribution is not made in 2010, PECO will be facing  
8 a significantly larger contribution in 2011.

9 **25. Q. Please summarize your position regarding PECO's pension expense**  
10 **claim?**

11 A. Based on the Company's significant unfunded obligation, substantial  
12 contributions to the plans will be required over the next several years.  
13 Contributing minimum amounts would expose the Company to  
14 considerable variability in pension contribution requirements and/or  
15 penalties, as contributions are very sensitive to economic conditions.  
16 Based on the pension funding studies we have conducted at the request of  
17 Company management, contributing an incremental amount in 2010 is  
18 expected to help minimize large contribution spikes in future years,  
19 assuming economic conditions are consistent with assumptions used in our  
20 modeling.

21 **26. Q. OCA witness Effron has also recommended that PECO's claim for**  
22 **OPEB costs be reduced by \$3.662 million. Please comment.**

1           A.     As noted by Mr. Effron, PECO’s OPEB claim equals \$22.6 million and is  
2                    comprised of its electric operations’ share of two components: (1) a  
3                    previously approved amortization of PECO’s “transition obligation” of  
4                    \$4.987 million and (2) an annual accrual amount of \$17.637 million. Mr.  
5                    Effron does not challenge the amortization, but notes that the estimated  
6                    annual accrual dropped to \$13.975 million in a more recent (January 2010)  
7                    actuarial study prepared by Towers Watson.

8   **27.    Q.    Do you believe that Mr. Effron’s proposed adjustment should be**  
9                    **adopted?**

10          A.     No, I do not. Based on a more recent analysis utilizing June 30, 2010 data  
11                    (see the Company’s response to Interrogatory OTS-RE-112), and after  
12                    taking into account the anticipated effects of (1) a renegotiated  
13                    prescription drug contract, (2) recent healthcare reform legislation, and (3)  
14                    changes in economic conditions (most notably a significant decrease in  
15                    discount rates resulting in an increase to future estimated costs), it is  
16                    estimated that PECO’s annual OPEB costs (exclusive of the amortization)  
17                    will average \$38.1 million over the 2011-2013 period, or very much in  
18                    line with the \$38.3 million figure for 2010 which the Company used as the  
19                    starting point for purposes of preparing its rate filing. Company  
20                    management expects PECO Electric’s annual OPEB expense accrual to  
21                    average \$17.6 million over that same period, which is virtually identical to  
22                    its \$17.637 million claim in the case.

1 28. Q. Does this complete your rebuttal testimony?

2 A. Yes, it does.

## **Appendix A**

### **John W. Allen, E.A., M.A.A.A.**

#### **Relevant Experience/Specialization**

In addition to his client relationship responsibilities, Mr. Allen's primary areas of technical expertise include retirement financial management and valuation of defined benefit pension and retiree welfare plans, preparation of accounting and funding valuations and related reporting, and all aspects in pension plan administration including application of ERISA statutes and applicable IRS Code and regulations. He has been integrally involved in mergers and acquisitions, strategic design/implementation of benefit program/rewards changes, union negotiations support and workforce planning and restructuring programs. Mr. Allen has substantial experience in IRC Section 401(a)(4) nondiscrimination testing, nonqualified plan valuation and design, and pension plan funding and investment strategy.

#### **Role at Towers Watson**

Mr. Allen is a senior level associate in the Towers Watson Chicago office. He joined Towers Watson in January 2000 and has over 21 years of employee benefits consulting experience. His primary role is as a client relationship manager, a retirement/actuarial technical resource and a people manager for senior level associates. He also co-leads a U.S. national training program for retirement plan nondiscrimination testing. Prior to Towers Watson, Mr. Allen worked for seven years in PricewaterhouseCoopers' Global Human Resources Solutions practice and for five years at Deloitte & Touche's Actuarial Benefits and Compensation Consulting practice.

#### **Education and Credentials**

Mr. Allen received his Bachelor of Science degree in Actuarial Science from the University of Illinois at Urbana-Champaign in 1988. He is an Enrolled Actuary under ERISA and a Member of the American Academy of Actuaries.