

**Exh. DPK-1T
Docket TP-190976
Witness: Danny P. Kermode**

**BEFORE THE WASHINGTON
UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND PILOTS,

Respondent.

DOCKET TP-190976

TESTIMONY OF

Danny P. Kermode, CPA

**STAFF OF
WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION**

Regulatory Principles, Call Backs, Pension

May 27, 2020

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Exh. DPK-2 PSP's Response to UTC Staff Data Request No. 55

1 **I. INTRODUCTION**

2

3 **Q. Please state your name and business address.**

4 A. My name is Danny Kermode, and my business address is 621 Woodland Square
5 Loop SE, Lacey, Washington 98503. My business mailing address is P.O. Box
6 47250, Olympia, Washington 98504-7250. My business email address is
7 danny.kermode@utc.wa.gov.

8

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

10 A. I am employed by the Washington Utilities and Transportation Commission
11 (Commission) as the Assistant Director for Water and Transportation.

12

13 **Q. How long have you been employed by the Commission?**

14 A. I have been employed by the Commission since 1996.

15

16 **Q. Please state your qualifications to provide testimony in this proceeding.**

17 A. I have more than 37 years of regulatory accounting experience within both private
18 practice and in government. I have appeared as an expert witness in numerous
19 contested cases presenting financial, income tax and regulatory accounting issues. I
20 have been the Assistant Director for Water and Transportation since 2015. Prior to
21 that I acted as a senior energy policy advisor to the Commission along with having
22 the position of Commission accounting advisor. I am also a licensed Certified Public

1 Accountant with an undergraduate degree in accounting from Arizona State
2 University.

3 I have worked for the Commission for over 25 years. Prior to working at the
4 Commission, I accumulated over ten years of experience in private accounting
5 practice specializing solely in public utility regulation and was certified as a
6 Certified Financial Planner, though the certification is now inactive.

7 I am a visiting faculty member at Michigan State University's Institute of
8 Public Utilities where I have taught advanced regulatory studies and basic
9 ratemaking. Previously, I was on the faculty of the National Association of
10 Regulatory Utility Commissioners' Rate School. I have also worked as an adjunct
11 professor at St. Martin's University specifically teaching business taxation.

12 In addition, I have written a number of regulatory-focused articles in
13 nationally recognized publications including the Public Utility Fortnightly and
14 National Regulatory Research Institute Journal of Applied Regulation.

15

16 **Q. Have you testified previously before the Commission?**

17 A. Yes, I have testified before the Commission at least 13 times covering various
18 energy, telecom, oil pipeline, and water utility ratemaking issues. For example, I
19 have testified in two PacifiCorp general rate cases, Docket UE-032065 and Docket
20 UE-050684, and two Avista Corp. general rate cases, Dockets UE-070804 and UE-
21 090134. I have also testified specifically on income tax issues in a rate case
22 involving Olympic Pipeline Company, Docket TO-011472, and in the Verizon
23 Northwest, Inc., UT-040788, a general rate case. I have also testified regarding

1 regulatory treatment of income taxes among other ratemaking issues in Docket UT-
2 040788. Additionally, I provided testimony in three water company general rate
3 cases, American Water Resources, Docket UW-980258; Rainier View Water Co.,
4 Inc, Docket UW-010877; and Marbello Water Company, Docket UW-041181.

5
6 **II. SCOPE AND SUMMARY OF TESTIMONY**

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

9 A. I describe an overview of the regulatory principles and methods that Staff used to
10 arrive at its recommendations. I respond to the testimony of Capt. Quick, Mr. Tabler,
11 and Capt. Carlson regarding the use of call backs, and discuss Staff's position on the
12 proper regulatory and accounting treatment, both historically and going forward. I
13 then respond briefly to testimony provided by Capt. Quick and Mr. Tabler discussing
14 Puget Sound Pilots' (PSP) pension program. Finally, I discuss more fully Mr. Diess'
15 actuarial assessment of the pension's viability.

16
17 **Q. Please summarize your recommendations.**

18 A. My recommendations pertaining to call backs and the pension are policy focused.
19 First, regarding the issue of call backs, I recommend that the liability be reflected on
20 the financial statements of PSP for regulatory purposes. I further recommend that
21 any financial statements or other financial information filed with the Commission be
22 consistent with generally accepted accounting principles (GAAP), except where the

1 Commission may direct regulatory accounting, which may not be consistent with
2 GAAP, but is consistent with public policy.

3 Second, as to the pilot pension issue, I discuss my concerns regarding the
4 viability and sustainability of the current unfunded Pay-As-You-Go defined benefit
5 pension plan. I recommend that the Commission order PSP to start developing a plan
6 that would transition the current pension plan to a fully-funded defined benefit
7 retirement plan providing security and confidence in the long-term viability of the
8 promised retirement benefits for current and future pilots.

9
10 **Q. Please provide a brief overview of the remainder of Staff's testimony and**
11 **ultimate recommendation.**

12 A. Ann LaRue will discuss the results of Staff's analysis of PSP's test year results of
13 operations and contest various adjustments proposed by PSP. Scott Sevall will
14 discuss Distributable Net Income (DNI) to pilots, the number of pilots to fund, PSP's
15 rate plan, and Staff's proposed rate design. Finally, Staff recommends a total revenue
16 requirement increase of \$2,705,242, as opposed to PSP's requested increase of
17 \$13,917,658.

18
19 **III. RATEMAKING PRINCIPLES AND METHODOLOGY**

20
21 **Q. Please describe the purpose of your testimony in this section.**

22 A. The present filing by PSP is a case of first impression, meaning it is a case that has
23 not been previously considered or decided by the Commission. With no prior

1 decisions or policies guiding the Commission in its ultimate recommendation, it is
2 important that Staff clearly set out the regulatory principles and methods it believes
3 the Commission should apply to determine proper maritime pilotage rates and
4 charges that are fair, just, reasonable, and sufficient.

5 Therefore, Staff strives to put forward a fully developed case that applies a
6 rate-setting methodology that is based on sound regulatory practices and policy. To
7 the extent possible, we continue to use the same rate-setting approaches used by the
8 Board of Pilotage Commissioners (“BPC” or “Board”) to provide regulatory
9 consistency. However, since the majority of the decisions by the BPC, in recent
10 years, have been “black box” decisions, that is, decisions that contain an end result
11 but omit the details of how that end result was determined, Staff’s ratemaking
12 approach reflects a historical understanding of pilotage rate-setting in the state of
13 Washington while maintaining a strong foundation in ratemaking theory and
14 practice.

15
16 **Q. Please discuss how Staff developed its ratemaking approach for this filing.**

17 A. Staff has attempted to follow, to the extent possible, the BPC’s methods for setting
18 rates for pilotage as described in past BPC annual reports and minutes and the 2001
19 Memorandum of Understanding used to set rates from 2001 to 2005. Regrettably, the
20 pilotage ratemaking process has embraced various changing methodology and
21 techniques over time. Some years provided more supporting documentation than
22 others; however, through the years, a standard approach of setting rates, using only
23 an overall percentage increase or single line item changes only, was adopted by the

1 Board. Where possible, and when it was consistent with recognized ratemaking
2 practices, Staff has adopted the Board's approach to setting rates. Staff has modified
3 BPC's approach only where the use of a different method or technique produces a
4 more accurate result or to address specific policy concerns.

5
6 **Q. Please discuss Staff's approach to deriving the revenue requirement.**

7 A. Staff began by constructing a forward-looking cost study referred to as a *pro forma*
8 income statement. The purpose of the cost study is to estimate the costs that PSP will
9 incur during the period the new rates will be in effect. The pro forma income
10 statement is used to compute the revenue requirement that provides for the recovery
11 of operating and administrative expenses, the recovery of investment in the form of
12 depreciation expense and the cost of financing as interest expense. In addition, the
13 total revenue requirement also includes compensation for each of the pilots providing
14 service in the form of distributed net income. Ms. LaRue will provide further
15 testimony on the results of the cost study and the resulting revenue requirement.

16
17 **Q. Could you please explain further what makes the PSP pilots unique?**

18 A. In contrast to most businesses, where the owners can also work as employees, the
19 PSP organizational structure recognizes that each pilot constitutes a separate and
20 distinct business entity. That is, instead of employees, each pilot is a sole proprietor,
21 corporation, or has elected to become a Limited Liability Company. Staff recognizes
22 the scope of the Commission's economic regulation stops and goes no further than
23 the individual pilot entities.

1 **Q. Are there any other aspects of pilotage ratemaking that are unique relative to**
2 **other industries that are economically regulated by the Commission?**

3 A. Yes. Unlike other regulated industries, such as intrastate transportation, where the
4 Commission has broader authority over safety and consumer protection, the
5 Commission may only regulate the rates and charges associated with pilotage. The
6 BPC still regulates the training, licensure, and other aspects of pilotage service.

7
8 **Q. Has Staff developed a ratemaking formula similar to formulas used in other**
9 **industries that the Commission economically regulates?**

10 A. Yes. The ratemaking formula used for deriving the revenue requirement for pilotage
11 services is:

12
$$RR = Exp + Dep + Int + TDNI \qquad \text{(Equation 1)}$$

13 Where:

14 $RR =$ Revenue Requirement

15 $Exp =$ General and Operating Expenses (including taxes other than income)

16 $Dep =$ Depreciation Expense

17 $Int =$ Interest Expense

18 $TDNI =$ Total Distributable Net Income

19
20 **Q. The BPC uses the term *Target Net Income*. Please explain why Staff is not using**
21 **this term.**

22 A. We fully recognize that the Board uses the term Target Net Income, but in the
23 interest of clarity, Staff has attempted avoid terms that may be confused with other

1 concepts. Target net income is a common budgeting concept and does not fully
2 describe the concept we seek to describe. The value we need to describe is the total
3 amount of net income earned that is to be distributed to each pilot. We use the term
4 *Total Distributable Net Income (TDNI)* to describe that value.

5
6 **Q. Please explain the absence of an equity return in the pilotage ratemaking
7 formula.**

8 A. As PSP's independent auditor Ms. Norris notes in her testimony, PSP is an
9 association of professionals very much like a law firm or accounting firm, which
10 frequently have partners. Professional associations commonly choose not to retain
11 any earnings and instead distribute substantially all their earnings to their owners or
12 partners.

13 The same is true with PSP. All of PSP's net income is routinely distributed to
14 each individual pilot business entity. The current balance of PSP's equity account,
15 when adjusted for PSP's unrecorded liabilities, is negative, which is reflective of its
16 income distribution policy. The absence of a positive equity balance equates to the
17 absence of any recognition of a cost of equity since a negative equity balance cannot
18 result in any recoverable cost of capital.

19
20 **Q. Please describe the concept of TDNI.**

21 A. TDNI is the net income PSP must earn after expenses to provide each pilot with a set
22 level of DNI, that is, the net income each pilot is allowed an opportunity to earn for

1 their pilotage services. TDNI is the largest part of the revenue requirement,
2 accounting for almost two thirds of the revenue requirement.

3 TDNI can be described as:

4
$$\text{TDNI} = \text{DNI} * \text{Pilots (Equation 2)}$$

5 Where:

6
$$\text{TDNI} = \text{Total Distributable Net Income}$$

7
$$\text{DNI} = \text{Distributable Net Income}$$

8
$$\text{Pilots} = \text{Number of Funded Pilots}$$

9

10 **Q. Are income taxes or other payroll taxes recognized in either the TDNI or DNI?**

11 A. No. Pilotage ratemaking for PSP recognizes each pilot as an independent contractor
12 and as such, there is no explicit recognition of any income tax impacts on the
13 individual pilot business entities nor is there any recovery of related payroll taxes.
14 Those costs are the individual pilot's responsibility and may be different for each
15 pilot based on the form of entity selected by the pilot and each pilot's particular tax
16 circumstances.

17

18 **Q. Please discuss the use of the *number of funded pilots* in the derivation of the**
19 **TDNI.**

20 A. Although the concept of the "number of pilots" may appear to be relatively
21 straightforward, its derivation for ratemaking purposes is actually more nuanced in
22 practice and can be defined in five different ways depending on how the term is

1 used. For pilotage ratemaking purposes, Staff has defined the term *number of pilots*
2 for clarity as follows:

- 3 1) Actual Pilots – the number of licensed pilots currently accepting
4 assignments.
- 5 2) Projected Pilots – the number of pilots that are expected to be accepting
6 working assignments during the rate-year.
- 7 3) Approved Pilots – the number of pilots that have been approved to be
8 licensed by BPC.
- 9 4) Implied Pilot Count – the number of pilots necessary to maintain the
10 standard assignment level based on the rate-year projected vessel traffic.
11 It is derived by dividing the rate-year projected vessel traffic by the
12 standard assignment level.
- 13 5) Funded Pilots – the number of pilots recognized for ratemaking purposes,
14 used to determine TDNI.

15 Since the TDNI is ultimately distributed to the pilots as compensation, selecting the
16 appropriate pilot count is critical to proper rate-setting. As discussed further by Mr.
17 Sevall, for ratemaking purposes, Staff uses the *implied pilot* count to derive the
18 *number of funded pilots*. Stated another way, Staff recommends that in this case the
19 number of funded pilots should be the same as the implied pilot count.

20
21 **Q. Is this an example of Staff adopting a different approach than the Board?**

22 A. Yes. Prior to 2009, the BPC consistently used the *approved pilots* number as a factor
23 in setting the TDNI. This was appropriate for the Board since the Board has the

1 authority to set the projected year's *approved pilot* number, it could, after setting the
2 appropriate pilot level, integrate the new pilot level directly into the new revenue
3 requirement. The Commission does not have that authority.

4 Further, Staff recognized that the Commission's use of the Board's *approved*
5 *pilots* could result in a revenue requirement that fails to reflect a changing
6 environment. The recent impact on ship traffic, from the COVID-19 pandemic, is a
7 good example of a circumstance that demands the use of a different approach to
8 reflect current conditions. With ship traffic dramatically decreasing since the BPC
9 last set the latest approved pilots' number, the use of the larger approved level of
10 pilots instead of the implied pilot number would result in an overstated TDNI.

11
12 **Q. Please describe the concept of DNI.**

13 A. DNI is the projected amount of net income each pilot would earn if the total number
14 of *implied pilots* was active and providing pilotage services. The Commission should
15 not consider DNI as a salary or wage because each pilot is an independent business
16 entity and not an employee of PSP. Additionally, DNI is not a guaranteed payment.
17 As with all Commission-regulated, investor-owned companies, the pilots bear the
18 risk of the enterprise, reaping the benefit when there are excess earnings and bearing
19 the cost when there are insufficient earnings. As explained further by Mr. Sevall,
20 Staff calculated TDNI by multiplying DNI by the implied pilot count or *number of*
21 *funded pilots*:

22 $TDNI = DNI * Pilots$ (See equation 2 above).

1 IV. COMPENSATION DAYS (CALL BACKS)

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Q. One of the fundamental issues before the Commission in this case is the regulatory treatment of the concept of call backs. Please briefly describe the practice of call backs and how the Puget Sound Pilots use it to provide board-on-arrival service.¹

A. PSP maintains a board-on-arrival goal where PSP will have a pilot on-site and available to complete the assignment regardless of weather conditions, date, or time of day when a vessel orders a pilot and provides the requisite information within a specific time period.² . However, maintaining the required number of pilots on-duty can be challenging. According to Capt. Quick, PSP has elected to staff its watches at the average demand level, which is by design insufficient during peak periods. To compensate for those times where average demand staffing does not provide a sufficient number of on-duty pilots for the peak demand, PSP uses call backs. Staff understands a “call back” as an instance when an off-duty pilot is asked to take a pilotage assignment.

Q. Should the Commission be concerned about PSP staffing at an average demand level?

¹ *Board-on-arrival* can mean meeting a ship coming into the sound or boarding a ship departing one of the sound’s harbors or anchorage zones to provide pilotage services.
² *Washington State Pilotage Final Report and Recommendations*, Washington State Joint Transportation Committee (January 18, 2018) at 33. Staff requests that the Commission take official notice of the cited information pursuant to WAC 480-07-495(2).

1 A. No. Average staffing is a commonly used method of staffing in service industries
2 that experience variable service demands. One common example of average demand
3 level staffing is cashier staffing at a grocery store. The store's management will set
4 the number of cashiers to promptly serve the store's average number of customers;
5 however, when there is a surge, other qualified employees are called up to handle the
6 times when the number of customers checking out is above average.

7 PSP's use of call backs is not alarming. Rather, call backs are a necessary
8 element of using average, rather than peak, level staffing. However, Staff is
9 concerned about the misunderstanding of the financial and accounting treatment of
10 call back days, which are also referred to as compensatory days..

11

12 **Q. Please briefly describe how call backs are related to call back days or**
13 **compensatory days.**

14 A. Compensatory days are earned when an off-duty pilot accepts a pilotage assignment.
15 This happens when a ship is scheduled to arrive, or is ready to depart, and all on-duty
16 pilots are either (a) previously assigned, (b) not qualified for that type of ship, or (c)
17 not available due to the fatigue rules. If no on-duty pilots are available, the
18 dispatcher must choose to either delay the ship to await a qualified on-duty pilot to
19 handle the assignment or look at the off-duty roster and "call back" an eligible pilot
20 to accept the assignment. Because of PSP's goal of board-on-arrival, PSP tends to
21 prefer using the latter option.

22

1 **Q. Would you please describe in more detail your concerns regarding the financial**
2 **and accounting treatment of call back days and the accrual of the off-book**
3 **liability?**

4 A. A close review of the current and past treatment of call back days revealed a
5 longtime misunderstanding in the accounting of the call back days, as incurred,
6 resulting in flawed comprehension of the financial reality of a material accrued
7 liability.

8 PSP's case presents as a given, that only call back days used for retirement
9 need to be funded through increased rates. However, PSP also states that call back
10 days used during any other period cost nothing.³ This latter position underscores the
11 reality that there are no additional costs incurred by PSP currently or in a later period
12 by having an off-duty pilot accept an assignment.

13 It should be noted that the BPC has previously set rates to include
14 compensation for "unfunded" call back days by imputing into rates the "cost of call
15 back days" associated with retiring pilots. To clarify, even though the idea that call
16 back days are unfunded has been accepted as true over the years, the assertion is
17 wrong. The moment the pilot moved the ship and the ship owner was charged for the
18 ship movement; the call back was fully funded. Stated another way, because the ship
19 owner has already paid for the ship movement, i.e., the service, there is no basis for
20 an additional charge simply because the pilot called back decides to defer the use of
21 it to retirement. Adding a charge for call back days is effectively a type of double-
22 counting leading to a double-payment.

³ Tabler, Exh. WT-1T at 22:1-6.

1 **Q. Do you have an opinion on how this misconception originated and how, in the**
2 **future, the association can become more aware of the financial reality of call**
3 **back days?**

4 A. Yes. The origin of the misconception most likely is the result of PSP maintaining its
5 books and records on a modified cash basis. This accounting method allows PSP to
6 avoid recognizing the impact of significant liabilities, such as the off-book liability
7 of call back payments, on its financial statements. On the other hand, full accrual
8 basis accounting would require a reduction to revenue equal to the deferred value of
9 the call back, which in turn would result in a reduced TDNI. The deferred revenue
10 would result in funds being available to pay for the call back days used at retirement.

11 In other words, if PSP had recorded the call back liabilities on an accrual
12 basis, as incurred, in its books and records, TDNI would have decreased as a result
13 of deferring the distribution of the call back revenue to the period the pilot actually
14 uses the call back day.

15
16 **Q. Do you have an opinion on the continued use of the modified cash basis for**
17 **regulatory purposes by PSP?**

18 A. Yes, I do. Of the many companies that the Commission economically regulates, only
19 the smallest companies provided their financial statements to the Commission using
20 a cash or modified cash basis. Those small companies rarely have revenues
21 exceeding a few hundred thousand dollars. In contrast, the state's largest privately
22 owned water companies, Washington Water and Rainier View Water, have total
23 revenues of \$12.9 million and \$7.1 million, respectively, and both use full GAAP

1 accrual basis accounting. Given that PSP's gross revenue exceeds \$30 million
2 annually, the Commission should require PSP to use the same accounting methods as
3 other large companies that are economically regulated by the Commission.

4 Therefore, I strongly recommend that the Commission require PSP to use accrual
5 accounting consistent with GAAP as modified by any specific regulatory accounting
6 methodology that may be required by the Commission in any future filings.

7
8 **Q. You stated in response to an earlier question that any assertion that call back**
9 **days are unfunded is wrong. Could you discuss further how you arrived at your**
10 **conclusion?**

11 A. To clearly understand the accounting subtleties of call backs, one must recall that the
12 PSP is an association of "sole proprietors and corporations who band together as an
13 association for administration, dispatch, expense consolidation purposes and receive
14 equal individual annual income distribution."⁴ The pilots are not employees of the
15 association and therefore do not earn overtime or other employee-related benefits.
16 Rather they take on the burdens and obligations that come with ownership, as well as
17 the benefits.

18 When a pilot is called back from an off-duty status, the pilot accepts an
19 assignment to move a ship into or out of Puget Sound. A ship move takes between 7
20 to 8 hours on average and results in a charge, consistent with tariff, to the ship
21 owners and increased revenue to PSP. The revenue includes the cost of the pilot,
22 which must, by design, also incorporate the associated cost of the compensation day.

⁴ Norris, Exh. JN-1T at 1:16-19.

1 Standard accounting principles recognize this basic transaction by increasing
2 accounts receivable (dr) and increasing revenue (cr). However, under the modified
3 cash basis of accounting, there is no further accounting performed to recognize the
4 creation of a liability of PSP to the called back pilot, instead an off the books memo
5 is recorded.

6

7 **Q. If the association maintained its books using full accrual basis accounting, how**
8 **would the liability of the call back days be recorded?**

9 A. PSP has traditionally provided a compensatory day for each call back day. To record
10 PSP's obligation to provide the time off, an entry would create the liability and
11 reduce revenue. In accounting terms, a debit (reduction) to revenue and a credit
12 (increase) to call back liability.

13

Dr Revenue XXX
Cr Call Back Liability XXX

To defer recognition of earned call back day

14

15 This accounting methodology is required to maintain the matching principle,
16 matching the expense, the cost of the pilot, with the revenue the pilot generated. The
17 recognition of the reduction of revenue is important. The impact of using accrual
18 accounting, instead of the modified cash basis currently being used by PSP, is that
19 the modified cash basis overstates revenue, for the period, resulting in overstated
20 earnings. All of the overstated earnings are then distributed to the pilots as
21 distributed net income, instead of recognizing those earnings the funding for the later
22 period. Prematurely releasing revenue required to fund compensatory days in

1 subsequent periods means that the necessary revenue will no longer be available to
2 match the cost of the pilot when the pilot decides to use a compensatory day.

3
4 **Q. Do you have any other concerns regarding the unrecorded liability for call back**
5 **days?**

6 A. Yes. The valuation of the call back liability is overstated, in my opinion. As of
7 December 2019, the balance of the liability is valued at \$6.9 million. The problem,
8 from a regulatory perspective, is that the value is estimated by using the most recent
9 DNI to value the outstanding call back days. This approach assumes the value of call
10 back days changes as DNI changes, which artificially inflates the amount of the call
11 back liability over time. Instead, I believe that the call back liability should be valued
12 based on when the call back was accrued, which would be the same amount that
13 would be recorded in the accrual basis journal entry. Each year would create a cost
14 “layer” that would be tracked and based on that year’s deferral, the total of which
15 would be the current liability.

16
17 **Q. Using your method, what would be the current balance of the liability account?**

18 A. PSP unfortunately does not have the necessary information readily available – thus
19 the calculation cannot be easily computed now. However, I recommend that if the
20 Commission requires accrual accounting, the amount should be computed based on
21 the current record of liabilities.

1 **Q. Based on your accounting analysis, should PSP’s ratepayers be obligated to**
2 **fund the call back liability?**

3 A. No. My analysis clearly shows that there is no obligation to fund call back liabilities,
4 further than the amount already received for services. The liability was incurred, and
5 the revenue earned, when the pilot accepted the call back assignment and the service
6 was performed. Any remaining obligation is the obligation of PSP to one of its pilots
7 and should be “below the line,” that is, outside of regulatory consideration.

8

9 **Q. Has PSP asked for recovery of any of the call back obligation in its current**
10 **filing before the Commission?**

11 A. No. PSP does not request recovery of call back days. However, as Capt. Tabler
12 testifies, in the past, there have been additional FTEs added to the required number
13 of pilots for ratemaking purposes to allow recovery of the cost of call back days used
14 by retiring pilots that are not actually providing any pilotage services.⁵ It is important
15 for Staff to put on the record its opposition to any attempt to double collect for
16 services performed in a prior period.

17

18 **V. PILOT RETIREMENT PENSIONS**

19

20 **Q. Which PSP witnesses testify about the PSP’s pension plan?**

21 A. Capt. Quick, Mr. Tabler, and Mr. Diess.

22

⁵ See generally Tabler, Exh. WT-1T at 23:14 - 24:11.

1 **Q. Have you read their testimony regarding PSP's pension plan?**

2 A. Yes.

3

4 **Q. Will you please describe PSP's retirement plan?**

5 A. Yes. PSP's retirement plan is an unfunded defined-benefit plan that is based on
6 years-of-service multiplied by 1.5 percent of a pilot's distributed net income received
7 during the pilot's last three years of service before retirement. PSP's retirement plan
8 has no cost-of-living adjustment mechanism.

9

10 **Q. Please discuss what you mean when you say the plan is unfunded.**

11 A. An unfunded retirement plan is a plan that has no accumulated invested assets that
12 are used to pay benefits as beneficiaries retire. Instead, benefits are paid out of
13 current operating resources. This type of plan is commonly referred to as a Pay-As-
14 You-Go or PayGo plan.

15

16 **Q. Is the retirement liability reflected on the financial statements of the**
17 **association?**

18 A. No. Since the pension is funded as a PayGo plan, the association has elected to
19 exclude the value of the future liability in its financial statements, instead PSP
20 reflects the annual payment to retirees as an expense.

21

22 **Q. What is the estimated amount of pension expense for the rate-year?**

1 A. The test year pension expense is \$4.8 million, which is expected to grow by ten
2 percent to \$5.3 million in the rate-year. And according to Mr. Diess, the expense will
3 continue to grow to \$7.1 million by 2025.⁶ Pension expense is the largest expense
4 impacting rates reflecting 39 percent of all test year costs.

5
6 **Q. Do you agree with Mr. Diess’s statement that the association’s PayGo method of**
7 **funding its pension plan is like social security?**⁷

8 A. No. Several other PSP witnesses made the same analogy comparing the PayGo
9 method of funding to how social security is funded. Their comparison is incorrect
10 and misleading on several levels.⁸

11 First, the social security system is funded with a \$2.9 trillion trust account.
12 The PSP PayGo pension is totally unfunded.⁹ Second, all those who are eligible for a
13 social security pension contribute a portion of their earnings throughout their
14 working life to the social security pension system. The pilots, on the other hand,
15 make no individual contributions to their plan. The pilots instead depend solely on
16 the ratemaking process to fund and recover annual pension costs.

17
18 **Q. Do you agree with Mr. Diess’s statement that a PayGo system is “. . . fiscally**
19 **sound and . . . able to fund itself for the indefinite future. . . .”?**¹⁰

⁶ Diess, Exh. SD-02 at 2.

⁷ Diess, Exh. SD-1T at 2:21 - 3:3.

⁸ Quick, Exh. GQ-1T at 24:13-16; Tabler, Exh. WT-1T at 4:5-6.

⁹ *Summary: Actuarial Status of the Social Security Trust Funds*, Office of Retirement and Disability Policy (April 2020) available at: <https://www.ssa.gov/policy/trust-funds-summary.pdf>. Staff requests that the Commission take official notice of the cited information pursuant to WAC 480-07-495(2).

¹⁰ Diess, Exh. SD-1T at 2:21 - 3:3.

1 A. No. In my opinion, there are no unfunded pension plans that are fiscally sound because
2 an unfunded plan is inherently dependent on stable economic conditions. For example,
3 Mr. Diess says, “[s]ince there are no invested assets, there is no investment risk.”¹¹ He
4 fails to mention there remains business risk. That is the risk that a business will be
5 affected by an economic downturn. The most obvious example is the current economic
6 impact of the COVID-19 pandemic. Washington is already experiencing shipping
7 decreases, affecting PSP’s revenue, which in turn affects its ability to meet its pension
8 obligations absent additional rate relief. A fully funded plan would not experience the
9 same immediate impact on the viability of the plan.

10 The difference between business risk and investment risk is that a good
11 investment manager can diversify investments to mitigate the impact of a changing
12 economy (investment risk) relatively quickly. A business cannot rapidly change its
13 business model (business risk) and instead must weather out the storm.

14

15 **Q. Do you agree with Mr. Diess’s statement that the association’s pension plan is**
16 **“viable and sustainable into the foreseeable future”?**¹²

17 A. No. I have concerns as to the long-term viability and sustainability of PSP’s
18 retirement plan if the status quo is accepted and there is no effort to begin addressing
19 what I see as one of the most serious issues in this case.

20 Mr. Diess bases his conclusion regarding the viability of the PayGo plan, on
21 the perceived unrestricted access of PSP to obtain funding from increased revenues.

¹¹ Diess, Exh. SD-1T at 5:13-15.
¹² Diess, Exh. SD-1T at 6:1-2.

1 Mr. Diess suggests that revenues collected from higher rates charged to the maritime
2 industry are somehow contributions from current active pilots.¹³ Clearly they are not.

3

4 **Q. Please explain in more detail your concern about the viability and sustainability**
5 **of the plan?**

6 A. As with the off-book, call back liability, the lack of full accrual accounting has
7 masked the actual financial condition and future impact on rates of the association's
8 pension plan as it is currently structured. The nearly \$5 million in annual retirement
9 payments are dwarfed by the unrecorded projected benefit obligation (PBO) of
10 \$124,400,000 as of December 31, 2019.¹⁴ In other words, using the proper
11 accounting tool of full accrual accounting indicates that PSP's pension plan is
12 underfunded by approximately \$119,000,000, after the current pension payment, but
13 before recognition of this year's growing liability to current pilots.

14

15 **Q. Could you explain the PBO and its impact on future rates?**

16 A. The PBO is a pension accounting measurement used in GAAP to record the current
17 value of a pension obligation. It is the present value of the association's future
18 pension obligation to its pilots. In other words, the \$124.4 million is the amount PSP
19 would need to invest now to cover all of its future pension obligations to its pilots:
20 that is, to be fully funded.

21

22 **Q. Please explain the concept of annual service cost on an accrual basis.**

¹³ Diess, Exh. SD-1T at 5:12-15.

¹⁴ Kermode, Exh. DPK-2.

1 A. The annual service cost measures the increase in pension obligation incurred during
2 the year. That is, annual service cost reflects the required amount PSP should be
3 setting aside each year to cover current working pilots' future pension benefits.

4
5 **Q. Do you know the annual service costs currently being incurred by PSP?**

6 A. Yes. According to PSP's witness Mr. Diess, the estimated service cost is \$5.6 million
7 for 2019 and nearly \$5.8 million for 2020.¹⁵

8
9 **Q. What is your recommendation regarding pensions in this proceeding?**

10 A. I support the continued use of the PayGo method of funding PSP's pension and that
11 it remains a defined benefit plan for purposes of this proceeding. However, the long-
12 term consequences of ignoring any red flags revealed by proper accounting is risky.
13 Continued reliance on PayGo and its exposure to business risk are particularly
14 dangerous in economic downturns as a means of funding retirement plans for future
15 retirees. Therefore, in order to ensure its ability to continue to make retirement
16 payments to its retirees at the lowest cost, I recommend that the Commission order
17 PSP to initiate discussions to develop a plan that will provide a transition to a fully-
18 funded, defined benefit retirement plan. Such a plan will provide security and
19 confidence in the long-term viability of the promised retirement benefits to current
20 and future pilots. I also recommend that any proposed plan include some discussion
21 of the reestablishment of retirement fund contributions by active pilots. The
22 contributions would be similar to those described by PSP witness Capt. Tabler, who

¹⁵ Kermode, Exh. DPK-2.

1 describes previous active pilot contributions to the pilot retirement fund following
2 the 1978 amendment to WAC 296-116-320.¹⁶

3

4 **Q. Does this conclude your testimony?**

5 A. Yes.

¹⁶ Tabler, Exh. WT-1T at 5:10-14.