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

I. INTRODUCTION

Q. Please state your name and business address.

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

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

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

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

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

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

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

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

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

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

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

Q. Have you testified previously before the Commission?

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

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

II. SCOPE AND SUMMARY OF TESTIMONY

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

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

Q. Please summarize your recommendations.

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

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

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

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

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

III. RATEMAKING PRINCIPLES AND METHODOLOGY

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Where:

RR = Revenue Requirement

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

Dep = Depreciation Expense

Int = Interest Expense

TDNI = Total Distributable Net Income

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

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

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

Q. Please explain the absence of an equity return in the pilotage ratemaking formula.

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

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

Q. Please describe the concept of TDNI.

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

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

TDNI can be described as:

TDNI = DNI * Pilots (Equation 2)

Where:

TDNI = Total Distributable Net Income

DNI = Distributable Net Income

Pilots = Number of Funded Pilots

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

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

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

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

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

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

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

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

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

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

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

Q. Please describe the concept of DNI.

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

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

IV. COMPENSATION DAYS (CALL BACKS)

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).

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

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

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

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

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

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

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

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

[3] Tabler, Exh. WT-1T at 22:1-6.

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

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

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

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

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

accrual basis accounting. Given that PSP's gross revenue exceeds $30 million annually, the Commission should require PSP to use the same accounting methods as other large companies that are economically regulated by the Commission. Therefore, I strongly recommend that the Commission require PSP to use accrual accounting consistent with GAAP as modified by any specific regulatory accounting methodology that may be required by the Commission in any future filings.

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

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

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

[4] Norris, Exh. JN-1T at 1:16-19.

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

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

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

Dr Revenue XXX
Cr Call Back Liability XXX
To defer recognition of earned call back day

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

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

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

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

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

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

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

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

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

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

V. PILOT RETIREMENT PENSIONS

Q. Which PSP witnesses testify about the PSP's pension plan?

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

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

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

A. Yes.

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

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

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

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

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

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

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

A. The test year pension expense is $4.8 million, which is expected to grow by ten percent to $5.3 million in the rate-year. And according to Mr. Diess, the expense will continue to grow to $7.1 million by 2025.[6] Pension expense is the largest expense impacting rates reflecting 39 percent of all test year costs.

Q. Do you agree with Mr. Diess's statement that the association's PayGo method of funding its pension plan is like social security?[7]

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

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

Q. Do you agree with Mr. Diess's statement that a PayGo system is ". . . fiscally sound and . . . able to fund itself for the indefinite future. . . ."?[10]

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[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.

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

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

Q. Do you agree with Mr. Diess's statement that the association's pension plan is "viable and sustainable into the foreseeable future"?[12]

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

Mr. Diess bases his conclusion regarding the viability of the PayGo plan, on 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.

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

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

A. As with the off-book, call back liability, the lack of full accrual accounting has masked the actual financial condition and future impact on rates of the association's pension plan as it is currently structured. The nearly $5 million in annual retirement payments are dwarfed by the unrecorded projected benefit obligation (PBO) of $124,400,000 as of December 31, 2019.[14] In other words, using the proper accounting tool of full accrual accounting indicates that PSP's pension plan is underfunded by approximately $119,000,000, after the current pension payment, but before recognition of this year's growing liability to current pilots.

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

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

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.

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

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

A. Yes. According to PSP's witness Mr. Diess, the estimated service cost is $5.6 million for 2019 and nearly $5.8 million for 2020.[15]

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

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

[15] Kermode, Exh. DPK-2.

describes previous active pilot contributions to the pilot retirement fund following the 1978 amendment to WAC 296-116-320.[16]

Q. Does this conclude your testimony?

A. Yes.

[16] Tabler, Exh. WT-1T at 5:10-14.