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Kansas Corporation Commission  
/s/ Susan K. Duffe

In the Matter of the Application of )  
Kansas Gas Service, A Division )  
of ONEOK, Inc. for Adjustment of ) Docket No. 06-KGSG-\_\_\_\_-RTS  
its Natural Gas Rates in the State )  
of Kansas )

STATE CORPORATION COMMISSION

MAY 15 2006

 Docket  
Room

**TESTIMONY**  
**OF**  
**ROBIN L. HAGERTY**  
**ON BEHALF OF**  
**KANSAS GAS SERVICE**  
**A DIVISION OF ONEOK, INC**

**TESTIMONY**  
**OF**  
**ROBIN L. HAGERTY**  
**KANSAS GAS SERVICE**  
**DOCKET NO. 06-KGSG-\_\_\_\_-RTS**

1 **Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.**

2 A. My name is Robin L. Hagerty. My business address is Three James Center, Suite  
3 900, 1061 East Cary Street, Richmond, VA 23219.

4 **Q. BY WHOM AND IN WHAT CAPACITY ARE YOU EMPLOYED?**

5 A. I am employed by Mercer Health and Benefits Consulting (Mercer) as a consulting  
6 actuary.

7 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

8 A. I have a Bachelor of Arts degree from Vanderbilt University with concentrations in  
9 Mathematics and Economics. I am also a Fellow of the Society of Actuaries (FSA)  
10 and an Enrolled Actuary (EA). The FSA is a designation earned within the Society of  
11 Actuaries by completing a series of exams sponsored by the Society. The EA is a  
12 designation earned from the Joint Board of Enrolled Actuaries. This designation is  
13 also earned by completing a series of exams co-sponsored by the Society of  
14 Actuaries and the Joint Board. These exams focus on actuarial mathematics,  
15 determination of future liabilities of employee benefits, accounting for and funding of  
16 employee benefits. An FSA is the highest designation of achievement within the  
17 Society.

1 **Q. WOULD YOU PLEASE SUMMARIZE YOUR PROFESSIONAL BUSINESS**  
2 **EXPERIENCE?**

3 A. Yes. I have over fifteen years of experience in consulting with employers regarding  
4 their employee benefit plans. I have worked with many large corporations providing  
5 assistance for managing the retiree medical and pension plans of the respective  
6 corporations. I have worked with companies since 1989 in determining the future  
7 liabilities and associated financial accounting requirements of those plans. My work  
8 is to ensure that a company reflects its pension, retiree medical and life insurance  
9 liabilities and expense in accordance with the Statement of Financial Accounting  
10 Standards Numbers 87 and 106 (FAS 87 and 106). Much of this work revolves  
11 around the setting of assumptions and interpreting plan designs of the pension and  
12 retiree medical plans. During this period, I have assisted numerous companies with  
13 evaluating the impact of plan design and interpreting other associated accounting  
14 issues. I have worked with companies with respect to the annual accrual accounting  
15 as well as cash cost of their benefit plans, maintaining the funding vehicles of both  
16 pension and retiree medical plans and providing assistance with other issues related  
17 to the funding of retiree medical plans. I have worked for several utility companies,  
18 defense industry companies and other large corporations. I have also worked with  
19 both union and non-union welfare benefit plans. I have provided consulting  
20 assistance to ONEOK since 1997.

21 **Q. MS. HAGERTY, FOR WHOM DO YOU TESTIFY IN THIS PROCEEDING?**

22 A. I am testifying on behalf of Kansas Gas Service, a division of ONEOK, Inc. (Kansas  
23 Gas Service).

24 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

25 A. My testimony is divided into five parts:

- 1       • Part One:       Explains generally the process for determining benefit plan  
2       costs subject to FAS 87 and 106;
- 3       • Part Two:       Describes the process by which ONEOK’s FAS 87 and 106  
4       costs are determined;
- 5       • Part Three:      Explains why such costs have increased since Kansas Gas  
6       Service’s last rate case and in the most recent actuarial study  
7       conducted by Mercer;
- 8       • Part Four:      Defines Kansas Gas Service’s prepaid pension asset and  
9       support its inclusion in rate base; and
- 10       • Part Five:      Supports the need for a tariff rider for the timely true-up of  
11       actual FAS 87 and FAS 106 costs.

12  
13                                       **PART ONE**

14 **Q.       IN GENERAL, WHAT BENEFIT PLAN COSTS ARE SUBJECT TO FAS 87 AND**  
15 **FAS 106, RESPECTIVELY?**

16 A.       FAS 87 covers pension plans; FAS 106 covers employer-sponsored retiree medical  
17       plans.

18 **Q.       WHAT ONEOK EMPLOYEE BENEFIT PLANS ARE SUBJECT TO FAS 87 AND**  
19 **FAS 106?**

20       Specifically, the Retirement Plan for Employees of ONEOK, Inc. and Subsidiaries  
21       and ONEOK, Inc. Supplemental Executive Retirement Plan (SERP) are subject to  
22       FAS 87; the ONEOK, Inc. Postretirement Medical and Life Plan is subject to FAS  
23       106. Collectively, I will refer to these plans as the “Benefit Plans”.

24 **Q.       PLEASE EXPLAIN THE PROCESS FOR DETERMINING BENEFIT PLAN COSTS**  
25 **SUBJECT TO FAS 87 AND FAS 106.**

1 A. In 1987, the Financial Accounting Standards Board (FASB) issued Statement FAS  
2 87 which set forth the accounting requirement for determining the annual pension  
3 expense and the liabilities that are disclosed in a company's public financial  
4 statements. FAS 87 requires employers who offer a pension program to account for  
5 expenses incurred under such a plan using accrual accounting instead of cash basis  
6 accounting. This means that companies must reflect the future cost of such a  
7 program over the working lifetime of its employees. In 1990, FASB issued Statement  
8 FAS 106. This is similar to FAS 87 but, as I previously indicated, applies to  
9 employers who offer an employer-sponsored retiree medical program.

10 FAS 87 and FAS 106 require an annual valuation of a company's liabilities  
11 resulting from the pension and retiree welfare plans. From this valuation, the annual  
12 FAS 87 and 106 expenses that the company must book for the succeeding year are  
13 developed.

14 **Q. WHAT IS THE FIRST STEP IN THE VALUATION PROCESS?**

15 A. The first step in the process is to collect valuation data from the company. This data  
16 includes a census file and trust asset values as of a specific date. For FAS 106 this  
17 also includes retiree medical claims and enrollment experience over the last twelve  
18 months. The census data consists of an electronic record of basic information for all  
19 active employees of the company who participate in the plans as of the specified  
20 date. The data also includes records for all retired employees, dependents and  
21 surviving spouses who are currently eligible to receive benefits under the pension  
22 and retiree welfare plans.

23 **Q. AFTER THE DATA IS COLLECTED, WHAT IS THE NEXT STEP IN THE**  
24 **VALUATION PROCESS?**

25 A. We next review the assumptions used in the valuation to ensure that they are  
26 appropriate for the current valuation. These assumptions include the appropriate

1 discount rate, healthcare costs trend rates, and return on benefit plan assets. The  
2 Company selects the assumptions to be used in the FAS 87 and FAS 106 valuations  
3 with the concurrence of its auditors. The actuary will generally provide suggestions  
4 and commentary on the assumptions utilized as of the measurement date. Once the  
5 assumptions have been determined for the current year, we use the census data and  
6 the assumptions to determine the expected liabilities of the company. For each  
7 individual in the census file, we perform an iterative projection that estimates the  
8 pension and post retirement welfare benefits that individual is expected to receive in  
9 each future year. This projection incorporates the likelihood that an active individual  
10 will terminate without becoming eligible for benefits as well as the likelihood that an  
11 active individual will work to retirement, become disabled during his working career  
12 or expire prior to retiring. For current retirees, we estimate the future benefits  
13 payable for the rest of their lifetime as well as the future benefits payable to  
14 dependents and surviving spouses of retirees.

15 All of the projected net employer benefit costs are then discounted to the  
16 valuation date to reflect the time value of money. The sum of each individual's  
17 discounted benefit cost based on current service and projected pay is the Projected  
18 Benefit Obligation (PBO) for FAS 87 purposes. For FAS 106 purposes, the  
19 Expected Postretirement Benefit Obligation (EPBO) represents all future benefits  
20 payable from the plan, including future service and increases in expected healthcare  
21 costs. These amounts are the total future plan obligation for the current population, if  
22 all future assumptions are met under each plan.

23 **Q. ONCE THE TOTAL FUTURE PLAN OBLIGATION HAS BEEN DETERMINED,**  
24 **WHAT ADDITIONAL STEPS MUST BE TAKEN?**

25 A. The annual expense must be determined. In order to do this, FASB requires us to  
26 split this total obligation in three pieces: i) benefits earned as of the valuation date,

1 including future expected pay increases for pension benefits; ii) benefits to be earned  
2 during the current year; and iii) benefits to be earned in the future.

3 The annual FAS expense is based on items (i) and (ii). The components of  
4 the FAS 87 and FAS 106 expense are as follows:

- 5 • Service Cost
- 6 • Interest Cost
- 7 • Return on Plan Assets
- 8 • Amortization of plan amendments, actuarial gains and losses and  
9 transition amounts

10 The Service Cost is the portion of the total benefit that employees will earn during the  
11 upcoming valuation year. The Interest Cost represents the time value of money for  
12 one year on the PBO (FAS 87) and APBO (FAS 106)

13 The costs for plan changes are required to be amortized over the expected  
14 future working lifetime of the current participants. Actuarial (gains) and losses are  
15 only required to be amortized if they exceed 10% of the PBO (FAS 87) and APBO  
16 (FAS 106).

17 Finally, FAS 87 and FAS 106 will offset the annual charges by the expected  
18 return on any plan assets.

19 To summarize, the annual FAS 87 and FAS 106 valuations use the  
20 population as of one point in time, the plan design applicable to that current  
21 population and the appropriate assumptions to determine the liabilities of the  
22 company's pension and retiree medical plans as of the valuation date. The liabilities  
23 and valuation assumptions are disclosed in a footnote to the company's annual  
24 statement. The subsequent year's FAS 87 and FAS 106 expense is derived from the  
25 liabilities disclosed in the footnote.

1 **PART TWO**

2 **Q. PLEASE DESCRIBE THE PROCESS BY WHICH ONEOK'S FAS 87 AND FAS 106**  
3 **COSTS ARE DETERMINED.**

4 A. ONEOK uses a September 30 measurement date for purposes of determining the  
5 FAS 87 and FAS 106 information for the Benefit Plans identified above. As of this  
6 date each year, the Benefit Plans' liabilities and the next year's expenses are  
7 determined using assumptions as required under FAS 87 and FAS 106 along with  
8 the value of the pension plan assets and postretirement medical and life plan assets.

9  
10 **PART THREE**

11 **Q. PLEASE EXPLAIN WHY SUCH COSTS HAVE INCREASED SINCE KANSAS GAS**  
12 **SERVICE'S LAST RATE CASE AND IN THE MOST RECENT ACTUARIAL STUDY**  
13 **CONDUCTED BY MERCER.**

14 A. As described above, actuarial assumptions are used to determine the estimated  
15 value of future pension and postretirement medical benefits. Though these generally  
16 represent the best assumption of future events, they may deviate from actual future  
17 experience. In addition, certain provisions of FAS 87 and FAS 106 require specific  
18 changes to assumptions annually to reflect changes to the economic environment  
19 since the last valuation. Any deviations between the assumptions for a plan year  
20 and the actual experience that the plan realized during that year create actuarial  
21 gains and losses that must be amortized and reflected in future years' expenses.

22 The major assumptions that have impacted the FAS 87 and FAS 106 expenses over  
23 the last few years include:

- 24 • Discount rate: FASB requires that companies value their plan liabilities using  
25 an interest rate which approximates the value that ONEOK could transfer the  
26 liability to an insurance company. Generally these rates are reflective of the



1 fixed income market. Since interest rates are used in determining each plan's  
2 present value of future benefits, the lower the interest rate, the higher the  
3 plan's liability. Each year's actuarial gains or losses are amortized over the  
4 future working lifetime of the participants, approximately ten years.

- 5 • Health care cost trend rates: Though we have assumed health care costs  
6 would increase by over 10% per year over the last few years, actual health  
7 care increases have exceeded this assumption. The cost of providing health  
8 care to retirees has therefore increased significantly as the overall cost in  
9 health care has increased. The annual difference between the anticipated  
10 increase in health care and the actual amount ONEOK is experiencing has  
11 generated actuarial losses that are being amortized over approximately ten  
12 years. ONEOK reviews the health plans each year and makes adjustments  
13 to the plans to help manage costs. Where possible, retiree contributions are  
14 increased as well. However, we have seen an increase in utilization of health  
15 services and particularly prescription drugs that have exceeded our  
16 assumptions.

- 17 • Return on Benefit Plan assets: In determining the annual FAS 87 and FAS  
18 106 expense, an assumption is made on the return that ONEOK will realize in  
19 the next year. A portfolio calculator which uses expected capital market  
20 returns is used to determine the reasonableness of this assumption each  
21 year. Over the last few years, the actual return on the Benefit Plan assets  
22 has been lower than the rate used in determining the current year's expense.  
23 This has created actuarial losses that need to be reflected in the next year's  
24 expense.

25 The cumulative impact of the actuarial shortfalls on ONEOK as a whole has  
26 been significant due to the decreases in the discount rate and the higher-than-

1 expected health care cost trend. Mr. Whitlock supports the adjustment to recognize  
2 the trend upward from the test year expenses and its impact on Kansas Gas Service.

3  
4 **PART FOUR**

5 **Q. WHAT IS KANSAS GAS SERVICE'S PREPAID PENSION ASSET?**

6 A. The prepaid pension asset of Kansas Gas Service at December 31, 2005, was  
7 \$75,742,318.

8 **Q. HOW IS A PREPAID PENSION ASSET CREATED?**

9 A. As I mentioned in Part One, FAS 87 requires accrual accounting for pension plans.  
10 The annual expense is recognized on the company's books as the benefits are  
11 earned. In most cases, a significant portion of the annual expense is attributable to  
12 active employees who will not receive a cash benefit from the plan for a number of  
13 years. Kansas Gas Service must establish a pension liability as the benefits are  
14 earned. This liability can become a prepaid pension asset in one of two ways. The  
15 first way is for the company to make a non-refundable cash contribution to the  
16 pension plan.

17 The second way for a company to have a prepaid pension asset is for the  
18 investment earnings of the trust to exceed the annual accruals of the employee  
19 benefit plan. In this situation, the annual FAS 87 expense is actually an income item  
20 (negative expense). This typically occurs in mature, well-funded plans where the  
21 company has dedicated significant funds to the pension trust in earlier years. When  
22 the annual FAS 87 expense becomes an income item (negative expense), it credits  
23 (reduces) the FAS 87 accrued liability account, which benefits customers. Over time,  
24 with consistent annual income, a prepaid pension asset can exist. In other words,  
25 the company has reserved either through cash contributions or FAS 87 income more  
26 than the current accumulated expense for the plan.

1 **Q. HOW HAS THE COMMISSION TREATED PREPAID PENSION ASSETS?**

2 A. Customers have benefited from the negative pension expense in the form of lower  
3 rates; however, Kansas Gas Service has not benefited from a corresponding  
4 reduction in its cash expenses. This net cash outlay has resulted in a prepaid  
5 pension asset which deserves rate base recognition. Such rate base treatment was  
6 supported by Staff and adopted by the Commission in Docket No. 04-AQLE-1065-  
7 RTS. This same rate base treatment of the prepaid pension asset was included in  
8 the Stipulation and Agreement approved by the Commission in Docket No. 04-  
9 KCPE-1025-GIE.

10 I would note that, through Adjustment No. WC 3, sponsored by Company  
11 witness Don Whitlock, accrued pension cost for the SERP and the accrued retiree  
12 medical liability have been included as offsets to rate base. These items represent a  
13 source of customer-provided capital. The proposed treatment of these liabilities is  
14 consistent with the inclusion in rate base of the prepaid pension asset, which is  
15 company-provided capital.

16  
17

**PART FIVE**

18 **Q. EARLIER YOU INDICATED YOU SUPPORTED THE IMPLEMENTATION OF A**  
19 **PENSION AND EMPLOYEE BENEFIT RIDER. PLEASE PROVIDE SOME**  
20 **BACKGROUND INFORMATION ON HISTORIC FAS 87 AND 106 COSTS.**

21 A. Pension and retiree medical expense represents a significant cost to Kansas Gas  
22 Service. The recent measures taken to limit increases in postretirement medical  
23 costs are discussed by Company witness Brad Dixon. Notwithstanding the  
24 measures by Kansas Gas Service in this area, FAS 106 costs have increased  
25 dramatically since the last rate proceeding. Likewise, pension costs have increased

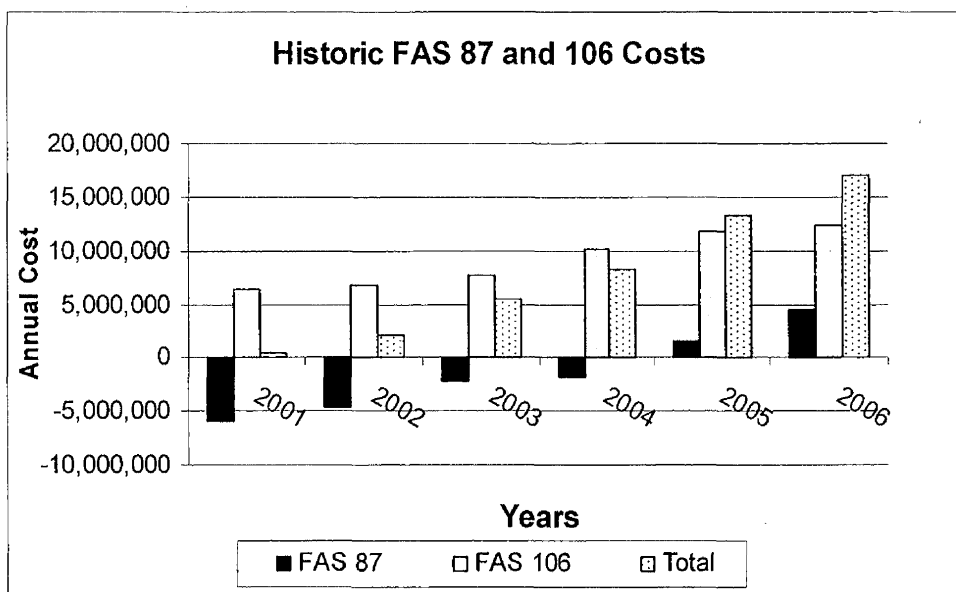
1 from negative (\$5.9) million in 2001 to \$4.6 million in 2006. The chart identifies such  
 2 costs for the period 2001 – 2006.

**Kansas Gas Service  
 Historic FAS 87 and FAS 106 Costs\***

Year	FAS 87	FAS 106	Total
2001	\$(5,979,384)	\$ 6,406,162	\$ 426,778
2002	\$(4,651,188)	\$ 6,796,905	\$ 2,145,717
2003	\$(2,160,060)	\$ 7,627,341	\$ 5,467,281
2004	\$(1,748,246)	\$10,043,082	\$ 8,294,836
2005	\$ 1,475,265	\$11,860,368	\$13,335,633
2006	\$ 4,573,932	\$12,354,756	\$16,928,688

\* Gross Costs

3 The cost data is depicted graphically below.



4  
 5 The increase in pension costs is even more dramatic than that of FAS 106 costs.  
 6 The primary reason for this difference is the result of asset performance within the  
 7 pension plan trust. Other reasons for this volatility are discussed in my earlier  
 8 testimony.

9 The current costs for FAS 87 and 106 are significantly higher than in the last  
 10 Kansas Gas Service rate proceeding, contributing to the significant Operating  
 11 Income shortfall experienced in the test period.

1 **Q. IS IT A FOREGONE CONCLUSION THAT COSTS WILL CONTINUE TO**  
2 **INCREASE AT THE SAME RATE AS THEY HAVE OVER THE PREVIOUS 5**  
3 **YEARS?**

4 A. No. It is difficult to predict what FAS 87 and 106 costs beyond 2006 will be, since  
5 they are strongly dependent on asset return in the trust, future fixed income interest  
6 rates and healthcare trend rates. It is possible such costs may decline in future  
7 periods, just as it is possible such costs will continue to increase. If such costs  
8 increase significantly in the future as they have in the past, Kansas Gas Service may  
9 not have an opportunity to achieve its authorized return on equity established in this  
10 case. If such costs decline in future periods, such decreases would not be timely  
11 passed on to consumers due to regulatory lag.

12 **Q. WHAT SOLUTION ARE YOU OFFERING TO PROTECT BOTH CONSUMERS**  
13 **AND ONEOK SHAREHOLDERS FROM THE ANTICIPATED VOLATILITY IN FAS**  
14 **87 AND 106 COSTS?**

15 A. Given the likelihood that future FAS 87 and 106 costs may vary dramatically from  
16 those incurred in 2006, a mechanism that captures the variance between these costs  
17 embedded in rates and actual costs incurred is appropriate. The proposed rider  
18 accomplishes this goal. If FAS 87 and 106 costs increase, such increase would be  
19 recovered from customers in the subsequent year. Likewise, if costs decrease they  
20 would be flowed back to customers in the subsequent year. Kansas Gas Service  
21 witness Mr. Frank Garver discusses the mechanics of this rider in his testimony.

22 The proposal protects consumers from the potential that costs embedded in  
23 rates will exceed actual costs incurred in future years. Conversely, the proposal also  
24 protects Kansas Gas Service from the potential that future FAS 87 and 106 costs will  
25 exceed that embedded in rates. The proposal strikes a balance between customer

1 and shareholder interests by ensuring that specific benefit costs will be recovered  
2 from customers; nothing more, nothing less.

3 **Q. DOES THIS COMPLETE YOUR TESTIMONY.**

4 **A. Yes.**

**VERIFICATION**

STATE OF VIRGINIA            )  
  ) ss.  
COUNTY OF HENRICO        )

Robin L. Hagerty, being duly sworn upon her oath, deposes and states that she is a Principal with Mercer Health and Benefits Consulting; that she has read and is familiar with the foregoing Testimony filed herewith; and that the statements made therein are true to the best of her knowledge, information, and belief.

  
\_\_\_\_\_  
Robin L. Hagerty

Subscribed and sworn to before me this 8<sup>th</sup> day of May, 2006.

  
\_\_\_\_\_  
NOTARY PUBLIC

My appointment Expires:  
3/31/09