Alternative Rate Structure Evaluation: Pension Rider Meeting Overview

INTRODUCTION

As part of the Alternative Rate Structure Analysis, the Philadelphia Water Department (PWD or the Department) is evaluating potential changes to the Department's current rate structures. The Department is exploring the potential recovery of other costs (or portions thereof) via a reconcilable rider mechanism like the Tiered Assistance Program (TAP) Rider which the Rate Board adopted as part of the 2018 Rate Proceeding.

The primary reasons to consider using a rider as a cost recovery mechanism is the ability of a utility to control the expense and whether the cost is easily identifiable. Expenses with these general characteristics may be candidates for recovery via a rider mechanism. Using a rider allows the utility to better reconcile costs and revenues with actual experience and closer to the period in which they occur. Moreover, a rider framework does not require a full rate proceeding.

Pensions is an expense category with characteristics like those outlined above. Pensions have historically been one of the more difficult areas of operating expenses to project in the context of the Department's 5-Year plan as well as during prior rate proceedings. Beyond that, actual expenses have often exceeded budgetary numbers. The Department's difficulty with accurately projecting pension costs is due to several factors, including, but not limited to, the following:

1. The varying overall performance of the City's pension plans;
2. The complex calculations involved in determining the pension liabilities, which are handled by an outside firm; and
3. The increasing proportion of the Department's staffing levels in comparison to the rest of the City which influences the Department's portion of pension costs as well as associated normal and early retirements which help in determining overall annual payouts to beneficiaries.

BACKGROUND

Pension costs are one of the single largest operating expenses for the Department. Pension costs have nearly doubled since FY 2011 and now account for nearly 10 percent of the Department's total annual obligations. This increase in cost is due in part to:

- Required increases in pension plan contributions;
- Changes in City policy requiring funding of pension costs as an operating expense;
- General increases in staffing levels for the Department; and
- Increased allocation of the total pension based upon the Department's proportion of the number of overall staff employed by the City.

The Department's pension costs are projected to further increase from approximately $75 million in FY 2019 to $88 million by FY 2024, according to the most recent 5-Year Plan. The projected increases in the 5-Year Plan assume the same level of anticipated pension plan performance currently being realized[1].

[1] If pension plan assets decrease as a result of an investment market downturn, increased contributions may be required resulting in further increases to pension expenses in future years.

With pension expenses comprising nearly 10 percent of the Department's annual obligations, under/over-performance of pension-related expenses versus projections can have a material impact on fund balances and the Department's requirement to fund 90 percent of its senior debt service requirement from the net revenue provided via current rates.

OVERVIEW OF RATE RIDER MECHANISMS

In ratemaking, many public utility commissions throughout the U.S. have allowed the use of rate mechanisms to help reduce regulatory lag, encourage investment in facilities, and mitigate large increases to customers. These rate mechanisms provide an avenue for the utilities to recover costs outside of a general rate increase, thus allowing for more immediate and efficient cost recovery. The rate mechanisms vary by utility and governing commission. The following are a few types used by utilities:

- Infrastructure Replacement
- Weather Normalization
- Energy Efficiency
- Lifeline (low income, elderly programs)

Other costs utilities have been dealing with are Pension and Other Post-Employment Benefits (OPEB). Pension and OPEB costs continue to fluctuate annually, making it hard for utilities to forecast these costs accurately. Many utilities and cities have a large unfunded pension liability, and this liability is a growing concern amongst municipalities. Some areas of the country are taking proactive steps to deal with the matter of pension costs. In the Northeast, the Massachusetts Department of Public Utilities (MDPU) and in the West, the California Public Utilities Commission (CPUC) have allowed a rate mechanism to deal with Pension and OPEB expenses.

PENSION LIABILITY TRENDS

Unlike other "hot button" issues such as aging infrastructure, lead service lines, and climate change, the nation's pension crisis has not gained much media attention, even though 48 out of 50 states have underfunded pension plans and five states have funded less than 50 percent.[2] According to Moody's Investor Services (Moody's) , as of the end of FY 2017, the nation's adjusted net pension liabilities (ANPL) is about $1.6 trillion. Moody's estimates that the nation's unfunded public pension liabilities (the amount by which the present value of the liabilities exceeds the current assets) is about $4.4 trillion. To put this into perspective, the American Society of Civil Engineers estimates that America needs to spend approximately $4.5 trillion thru 2025 to fix our failing infrastructure systems.

For the past several years, Pennsylvania has ranked in the top five states with the largest unfunded pension liabilities with an estimated shortfall of $68.8 billion, which represents a funding level of approximately 64 percent.

The Commonwealth of Pennsylvania has more than 3,200 public pension plans, the largest number of all 50 states. The state plays an active role in local pensions by mandating minimum funding requirements and providing contribution assistance. Factors that make solving the pension funding gap difficult include:

[2] Wisconsin and South Dakota are fully funded.

- Three of the four largest plans in Pennsylvania have fewer active members than retirees and other inactive members.
- State and local governments are increasingly susceptible to contribution volatility and funding challenges stemming from negative plan cash flows as the growing portion of retirees increases.
- Some plans are having trouble making "tread water" contributions, the funding level that Moody's refers to as needed to prevent the ANPL from growing.

As noted in the Department's recent Official Statement dated August 6, 2019, in Philadelphia, the City's pension system provides service to approximately 66,000 of which approximately 28,800 make contributions to the plan. The City faces significant ongoing financial challenges in meeting its pension obligations, including an unfunded actuarial liability (UAL) of approximately $6.1 billion as of July 1, 2018. In Fiscal Year 2018, the City's contribution to the Municipal Pension Fund was approximately $782 million of which the Water Fund's share was $62 million. The Water Fund's aggregate pension costs, consisting of payments to the Municipal Pension Fund totaled $62.7 million in FY2018. These costs have increased roughly 72 percent from Fiscal Year 2009.

The Water Fund's contribution is not only influenced by overall number employees' but also the performance of the pension plan itself. The annual rate of return experienced by the pension fund has varied from a 19.9 percent loss in FY 2009 to a 19.4 percent gain in FY 2011. The 5-year and 10-year annual average returns as of June 30, 2018, were 6.73 percent and 5.30 percent, respectively, on a market value basis.

The City has taken a number of steps to address the funding of Municipal Pension Plan including:

- Reducing the assumed rate of return on a gradual and consistent basis, which results in the City making larger annual contributions.
- Adopting more conservative mortality rates in response to experience studies performed by the Municipal Pension Plan actuary.
- Changing from a level percent of pay amortization schedule to a level dollar amount schedule (in conjunction with the revisions to the amortization periods that occurred in Fiscal Year 2009). This results in producing payments that ensure that a portion of principal on the UAL is paid each year.
- Funding consistently an amount greater than the MMO (subject to the authorized deferrals for Fiscal Years 2010 and 2011).
- Negotiating collective bargaining agreements by which additional contributions are being made (and will be made) by certain current (and future) members and by which benefits will be capped for certain future members of the Municipal Pension Plan.
- Securing additional funding, including funds required to be deposited by the City to the Municipal Pension Fund from its share of sales tax revenue.
- Adopting a Revenue Recognition Policy, by which sources of anticipated additional revenue that will be received by the System are specifically dedicated toward paying down the unfunded pension liability and not to reducing future costs of the City.
- Changing the investment strategy to increase the use of passive investment vehicles, which has resulted in increased returns and decreased fees.

Even with the above steps, 100 percent funding levels are not anticipated to reach 100 percent until the 2030s (based upon the actuarial projections referenced in the above noted official statement).

ALTERNATIVE RATE STRUCTURE MEETING NO. 3 – POTENTIAL PENSION RIDER

Based upon the above-cited reasons, the Department is interested in assessing whether recovering pensions costs (or a portion thereof) via a reconcilable rate rider would enable the Department to more accurately reflect actual experience in establishing rates and charges as well as address under/over-performance in a more timely and transparent fashion between full rate proceedings.

During the third Alternative Rate Structure meeting, the Department's consultants will present the following to participating stakeholders:

1. Background information on the Department's current pension-related expenses and challenges associated with projections;
2. An overview of Pension and OPEB cost recovery mechanisms currently in use by other utilities;
3. Associated industry trends;
4. The overall applicability of a pension rider approach to the Department; and
5. Alternative pension rider approaches along with factors for consideration.