

**STATE OF NEW JERSEY  
OFFICE OF ADMINISTRATIVE LAW  
BEFORE THE HONORABLE RICHARD MCGILL, ALJ**

**I/M/O THE VERIFIED PETITION OF  
ROCKLAND ELECTRIC COMPANY  
FOR APPROVAL OF CHANGES IN  
ELECTRIC RATES, ITS TARIFF FOR  
ELECTRIC SERVICES, ITS  
DEPRECIATION RATES, AND OTHER  
RELIEF**

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) **BPU DOCKET No. ER09080668**  
) **OAL DOCKET No. PUC-11407-2009N**  
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**DIRECT TESTIMONY OF MITCH I. SEROTA  
ON BEHALF OF THE  
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE,  
DIVISION OF RATE COUNSEL**

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**I. STATEMENT OF QUALIFICATIONS**

**Q. WOULD YOU STATE YOUR NAME AND ADDRESS?**

A. My name is Mitchell I. Serota and my business address is 5215 Old Orchard Rd., Suite 750, Skokie, IL 60077.

**Q. WHAT IS YOUR PRESENT OCCUPATION?**

A. I am President and founder of Mitchell I. Serota & Associates, Inc., a consulting actuarial firm. I am a subcontractor to NovaRest, Inc.

**Q. WHAT IS YOUR REGULATORY EXPERIENCE?**

A. I have prepared and presented testimony in the rate proceedings involving Public Service Electric & Gas Company, BPU Docket No. GR09050422.

**Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?**

A. Currently, I am one of 24 actuaries nationwide on the Pension Committee of the American Academy of Actuaries. The committee addresses actuarial issues affecting public and private pension plans, while monitoring federal tax, PBGC, and other ERISA-related developments. It consults with Congress and relevant regulatory agencies on the effect of regulation on employer pensions and retirement security, and comments on pending legislation and regulations. I am a Member of the American Academy of Actuaries and a Fellow both of the Society of Actuaries

1 and the Conference of Actuaries in Public Practice. I am an Enrolled Actuary under  
2 ERISA.

3  
4 Prior to the establishment of Serota & Associates in 1988, I was Vice President of  
5 Alexander & Alexander Consulting Group and Vice President of Johnson &  
6 Higgins, Inc., both international consulting actuarial firms. As a Consulting  
7 Actuary, my responsibilities have included meeting with clients, understanding their  
8 Human Resource needs and their financial goals, and tailoring employee benefits  
9 programs to fit their specific circumstances. I also perform pension valuations for  
10 United States corporations with domestic or foreign pension plans; analyze and  
11 immunize investment portfolios, research markets for asset management; analyze  
12 self-funded group medical and long-term disability programs; value liabilities for  
13 post-retirement medical plans; train and supervise employees.

14  
15 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**

16 A. I earned a Ph. D. from the University of Chicago, Department of History (1976). I  
17 also received a Master of Arts from the University of Chicago Division of Social  
18 Sciences (1972). In addition, I hold two Bachelors of Science from the  
19 Massachusetts Institute of Technology, one in Mathematics (1971), the other in  
20 Humanities and Science (1971). I am a Visiting Professor of History at Carthage  
21 College in Kenosha, Wisconsin.

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**II. SCOPE AND PURPOSE OF TESTIMONY**

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**Q. WHAT IS THE SCOPE AND PURPOSE OF THIS TESTIMONY?**

A. I was engaged by the New Jersey Department of the Public Advocate, Division of Rate Counsel (“Rate Counsel”) to conduct a review and analysis and present testimony regarding the Pension Costs proposed by Rockland Electric Company (“RECO” or “the Company”) as part of its electric base rate filing.

The purpose of this testimony is to present to the New Jersey Board of Public Utilities (“BPU” or “the Board”) Rate Counsel’s recommended position regarding an appropriate level for the expense of the Company’s Pension and OPEB Plans.

In developing this testimony, I have reviewed RECO’s filings, supporting testimonies and exhibits, and responses to initial and follow-up data requests issued by Rate Counsel and the BPU Staff with regard to Pension Expense.

**Q. WAS THIS TESTIMONY PREPARED BY YOU OR UNDER YOUR DIRECT SUPERVISION?**

A. Yes, this testimony was prepared by me.

**III. PENSION EXPENSE**

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3 **Q. WHAT IS YOUR UNDERSTANDING AS TO THE AMOUNT OF PENSION**  
4 **EXPENSE THAT RECO IS ASKING TO INCORPORATE INTO ITS BASE**  
5 **RATE DETERMINATION?**

6 A. RECO is requesting that base rates incorporate \$6,504,000 for the 2010 test year.  
7 This figure was set at 74.3% of the Operations and Maintenance portion of the 2010  
8 Pension Expense. The comparable figure for the 2009 test year is \$6,852,000.<sup>1</sup>  
9 Both figures have been derived from the 2009 Pension Expense and the 2010  
10 Pension Expense of \$37,866,400 and \$35,917,300 respectively.

11

12 **Q. DO YOU AGREE WITH THE AMOUNT THAT HAS BEEN REQUESTED?**  
13 **IF NOT, WHAT IS YOUR ALTERNATIVE?**

14 A. I believe the Pension Expense for the company's qualified pension plan has been  
15 forecast at too high a level. I believe the Pension Expense, for purposes of setting  
16 rates, should be reduced by \$2,463,800 for 2009 and by \$1,823,900 for 2010.  
17 Please refer to the testimony of Dave Peterson for the effect of this reduction upon  
18 the rates for RECO.

19

20 **Q. WHAT IS PENSION EXPENSE AND HOW IS IT DETERMINED?**

21 A. The following explanation offers a basic summary of the computations that the Plan  
22 actuary performs each year. There is much more intricacy involved at each level of

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<sup>1</sup> Exhibit P-2, Schedule 6; 12 + 0 Update, prepared January 29, 2010

1 the process than I describe, but the following description is offered as an overview  
2 to the process.

3 Pension Expense is an amount that is put in the corporate books to indicate the cost  
4 of maintaining a pension plan according to Generally Accepted Accounting  
5 Principles (“GAAP”) and the Financial Accounting Standards Board (“FASB”) *Statements 35, 87, 88, 132 and 158.*

7 Under the accounting standard in FASB *Statement 87* (as modified by FASB  
8 *Statement 158*), the actuary must use what is known as the “Projected Unit Credit  
9 actuarial method” for determining the liability of the pension plan. This liability is  
10 referred to as the Projected Benefit Obligation (“PBO”). It represents the actuarial  
11 Present Value of Future Benefits based on service and pay earned through the date  
12 of the determination. The liability is a theoretical measurement of how much the  
13 retirement benefit for the plan participants would be if the Plan sponsor (RECO)  
14 had funded those retirement benefits evenly over their expected working lifetimes.

15 The Present Value is calculated using a discount rate which mimics the prevailing  
16 long-term corporate bond rate and is generally regarded to be a rate with low risk.

17 Under the FASB *Statement 87* standard, the discount rate is established annually by  
18 the auditor and the CFO of the corporation with the advice of the actuary.

19 The PBO is then compared to the Fair Market Value of Assets to reveal the Funded  
20 Status of the Plan.

21 Annual Pension Expense, which is ultimately the figure that drives the rates, is also  
22 part of the FASB *Statement 87* process. The Pension Expense comprises four

1 essential components that vary each year: Service Cost, Interest Cost on the PBO,  
2 Expected Return on Investment, and Amortization of Gains and Losses.

3 Service Cost is the cost of pension benefits earned by active employee-participants  
4 during the year. This figure is driven by the age, service and salaries of the  
5 participants. The Interest Cost on the PBO is basically the PBO liability multiplied  
6 by the discount rate. The Expected Return on Investment is basically the Fair  
7 Market Value of Assets multiplied by an actuarial assumption of how much those  
8 assets will return during the year. This component serves to reduce the Pension  
9 Expense.

10 Gains and Losses represent the difference between what the actuary's assumptions  
11 predicted at the beginning of the year and what the actual results were at the end of  
12 the year. When the total losses over time exceed 10% of the PBO, a portion of that  
13 excess is added to Pension Expense. Similarly, if total gains exceed 10%, a portion  
14 of that excess serves to reduce Pension Expense. Some of the gains and losses can  
15 be attributed to hiring practices of the corporate plan sponsor. These  
16 "demographic" gains and losses are not being examined in this report.

17 What is of interest in the present case is the instance when the actuarial assumption  
18 for Expected Return on Investment overstates the return on investment in a given  
19 year. In such instance, a "loss" emerges which then increases the following year's  
20 Pension Expense.



1 **Q. WHAT IS YOUR BASIS FOR REDUCING THE AMOUNT OF PENSION**  
2 **EXPENSE FOR RATE PURPOSES?**

3 A. Several times each year, representatives from Consolidated Edison’s Treasury and  
4 Legal Departments meet to discuss the performance and direction of assets in the  
5 Retirement Plan Trusts that they oversee. These meeting are internally called  
6 Named Fiduciary Meetings. I believe the attendees at the Named Fiduciaries  
7 Meetings accepted risk on behalf of the Consolidated Edison Retirement Plan Trust  
8 that resulted in poor performance during 2007 and 2008. Although their decisions  
9 may have been based on good faith, actuarial losses, as described in the previous  
10 section, nevertheless materialized. It is my contention that the ratepayers should not  
11 be required to subsidize the losses associated with the investments in the Pension  
12 Trust. My goal in this testimony is to ascertain RECO’s Pension Expense if the  
13 assets had been invested in a risk-less environment. The calculations supporting this  
14 figure are presented later in this testimony.

15

16 **Q. HOW HAVE THE ASSETS BEEN INVESTED?**

17 A. In January 2008, the Named Fiduciaries were continuing a policy of investing 65%  
18 in Equity (47% in domestic; 18% in international), 27% in Fixed Income and 8% in  
19 Real Estate.<sup>2</sup> The generic asset allocation in the investment industry is 60% equity  
20 and 40% bonds. The RECO investment philosophy and portfolio return do not  
21 stray far from the norm, all things being equal.

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<sup>2</sup> RCR-PEN-12, January 2008, page 18.

1 Even before the downturn, the results of the portfolio were not encouraging. Both  
2 on a 3-year basis and a 5-year basis, the returns on investment were less than the  
3 50<sup>th</sup> percentile, while the risk, as measured by standard deviation, was greater than  
4 the 50<sup>th</sup> percentile for both time spans.<sup>3</sup>

5 The almost 36% downturn in the equity market during 2008 certainly had a severe  
6 effect on the asset performance of the RECO Pension Trust. Domestic equity lost  
7 38.77%, while International Equity lost 34.06%.<sup>4</sup>

8

9 **Q. DIDN'T MANY PENSION PLAN TRUSTS ACROSS THE NATION**  
10 **SUFFER THE SAME DEGREE OF LOSS IN THEIR ASSETS?**

11 A. Absolutely. The issue is not so much the drop in asset value as the attempt by  
12 RECO to have the ratepayers subsidize the loss of asset value in the Pension Trust.  
13 Inclusion of the investment loss in Pension Expense is an attempt by RECO to have  
14 a portion of its Pension Trust bailed out or subsidized by the ratepayers. The  
15 ratepayers themselves, who also might have suffered large losses in the equity  
16 market, have no comparable source of income to bail themselves out: they must re-  
17 build their assets as best they can. My recommendation to the Board is that RECO  
18 be treated in the identical fashion to any other investor, and not be accorded the  
19 special treatment of having the ratepayers subsidize their asset losses. To accept the  
20 level of Pension Expense being requested by RECO would retroactively validate a  
21 perverse incentive: when they gambled and succeeded, there was no rate reduction;

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<sup>3</sup> Ibid., p. 19.

<sup>4</sup> RCR-PEN-11, p.2.

1           now that they have lost, they are asking the ratepayers to recoup their losses.<sup>5</sup> It is  
2           more suitable for the losses to be sustained by the stockholders of RECO than the  
3           ratepayers.

4

5   **Q.   HOW DO THESE LOSSES AFFECT THE PENSION EXPENSE?**

6   A.   As described above, when the actuary calculates Pension Expense every year, she  
7           calculates the Expected Return on Assets. To the extent that the Expected Return  
8           on Assets exceeds the Actual Return, an “actuarial loss” develops. This loss is  
9           recognized over a period of time, in RECO’s case, ten years. The Pension Expense  
10          is thus increased by approximately one-tenth of the actuarial loss.

11       The Corporation’s actuary does not recognize the entire actuarial loss on assets in  
12       one year, but rather smoothes the fluctuations in asset results over five years. This  
13       mitigates the effect on the Pension Expense significantly. The actuary calculated  
14       the investment loss of 2008 to be \$133.0 million. The smoothing process  
15       recognizes 20%, or \$26.6 million each year over five years for purposes of setting  
16       pension expense. Thus, the Pension Expense for 2009 rose only by about \$5.6  
17       million over the 2008 level.<sup>6</sup> If it were not for the smoothing process, the Pension  
18       Expense would have risen about five times as much.

19

20   **Q.   WHAT IS YOUR PROPOSED TREATMENT OF PENSION EXPENSE?**

21   A.   I believe the Pension Expense forecast for RECO should be separated into

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<sup>5</sup> Paraphrase of Nobel Laureate in Economics Joseph E. Stiglitz, “Harsh lessons we may need to learn again”, China Daily, 2009-12-31.

<sup>6</sup> The Pension Expense in 2008 was \$32.24 million; in 2009 it was \$37.87 million.

1 two segments for purposes of developing base rates. The “legitimate segment” of  
2 Pension Expense should be based on all factors unrelated to investment risk. The  
3 second portion, which should be discarded for purposes of ratemaking, is the part  
4 related directly to the risk of the assets in the portfolio.

5 To put a monetary value on the risk of the assets, I compare the actuary’s expected  
6 return on asset assumption, 8.5%, to the discount rate, which is supposed to be  
7 indicative of high-grade bonds. For the 2008 Pension Expense, the actuary used  
8 6.0%; for 2009, 5.75%.

9  
10 **Q. HOW DID YOU ARRIVE AT THE FIGURE OF \$2,463,800?**

11 A. In the attached spreadsheet, I have examined the components of Pension Expense  
12 for the qualified plan to establish and reconfirm the figures offered as Pension  
13 Expense for 2009.

14 Of primary significance, the actuarial valuation reports presented a line item  
15 showing the loss of assets for the plan. For 2008, the loss in asset value, net of all  
16 other considerations, amounted to \$101.5 million. In contrast, the Pension Expense  
17 had built in an assumption that the assets would gain \$30.7 million. The difference  
18 between the two figures, \$132.2 million is considered an actuarial loss due to  
19 assets.<sup>7</sup> This actuarial loss is first smoothed over five years, then amortized over  
20 ten years. It increases the Pension Expense of the Corporation by \$2.7 million per  
21 year.

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<sup>7</sup> We are subtracting the difference between the expected gain and the actual gain. Because the actual gain was a loss, in this case we are looking at subtracting a negative number. Consider that if I expect to receive \$3 and wind up losing \$8 instead, my position is \$11 worse than what I expected it to be.

*Direct Testimony of Mitchell I. Serota*  
*Rockland Electric Company – BPU Docket No. ER09080668*

1 The assumption that the assets would gain \$30.7 million was based on the  
2 assumption that the assets would return 8.50%. This assumption presumes a degree  
3 of risk relative to the rate by which liabilities were discounted, 6.00%. My  
4 contention is that to calculate the risk factor of the portfolio, the rate of return  
5 should be comparable to the long-term rate of investment grade corporate bonds,  
6 which forms the basis for the discount rate. Therefore, I calculated the Pension  
7 Expense assuming that the return on assets would mimic the liability discount rate.<sup>8</sup>  
8 Instead of a \$30.7 million gain, this resulted in a \$21.7 million gain. The actuarial  
9 loss due to assets would then be mitigated somewhat to \$123.2 million. When  
10 smoothed, then amortized as above, the increased Pension Expense due to the risk  
11 level of the assets is \$2.464 million for 2009.

12  
13 To be fair, the assets did rebound somewhat in 2010. The Corporation and its  
14 stockholders deserve the credit for the gain in assets above and beyond  
15 expectations. In a parallel manner, I compared the return on investments, \$53.5  
16 million, to the expected return based on the discount rate of 5.75%. The actuarial  
17 gain on assets using this methodology is \$32.0 million. When smoothed and  
18 amortized, the Pension Expense is reduced by \$640,000. I then combine the  
19 actuarial loss from 2008 with the actuarial gain from 2009 to arrive at the risk  
20 portion of 2009 expense as \$1.824 million.

21  

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<sup>8</sup> The FAS87 discount rate is 5.75% for 2009, and 5.95% for 2010 and beyond. The discount rate is used to determine the PBO, Service Cost and all related components. The higher the discount rate, the lower the liabilities and costs.

*Direct Testimony of Mitchell I. Serota  
Rockland Electric Company – BPU Docket No. ER09080668*

1 To reiterate, I believe the Pension Expense, for purposes of setting rates, should be  
2 reduced by \$2,463,800 for 2009 and by \$1,823,900 for 2010. These figures form  
3 the basis of the proposed reduction found in Mr. Peterson's testimony.

4

5 **Q. DO YOU HAVE ANY COMMENTARY REGARDING THE EXPENSE FOR**  
6 **THE OPEB PLAN?**

7 A. I reserve the right to supplement my testimony regarding the OPEB plan.

8

9 **Q. DR. SEROTA, DOES THIS CONCLUDE YOUR TESTIMONY?**

10 A. Yes, it does.

# **SCHEDULE**

