STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW
BEFORE HONORABLE WALTER J. BRASWELL

I/M/O THE PETITION OF	)	
PUBLIC SERVICE ELECTRIC AND	)	
GAS COMPANY FOR APPROVAL OF	)	
AN INCREASE IN ELECTRIC AND	)	
GAS RATES AND FOR CHANGES IN	)	
THE TARIFFS FOR ELECTRIC AND	)	
GAS SERVICE,	)	**BPU DOCKET No. GR09050422**
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B.P.U. N.J. NO. 14 GAS PURSUANT TO	)	
N.J.S.A. 48: 2-21 AND N.J.S.A. 48: 2-21.1	)	
AND FOR APPROVAL OF GAS	)	
WEATHER NORMALIZATION;	)	
A PENSION EXPENSE TRACKER AND	)	
FOR OTHER APPROPRIATE RELIEF	)	

TESTIMONY OF MITCHELL I. SEROTA
ON BEHALF OF THE
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL

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PUBLIC SERVICE ELECTRIC AND GAS COMPANY
BPU Docket No. GR09050422
Direct Testimony of Mitchell I. Serota

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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 Actuarial Consulting.

Q. WHAT IS YOUR REGULATORY EXPERIENCE?

A. As an actuary for CNA Insurance, I filed a rate request to each State to request acceptance of the Major Group Health rate manual I had prepared. The rate manual was approved by all 50 states.

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

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

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I earned a Ph. D. from the University of Chicago Department of History (1976). I also received a Master of Arts from the University of Chicago Division of Social Sciences (1972). In addition, I hold two Bachelors of Science from the Massachusetts Institute of Technology, one in Mathematics (1971), the other in Humanities and Science (1971).

II. SCOPE AND PURPOSE OF TESTIMONY

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 to present testimony regarding the Pension Costs proposed by Public Service Electric and Gas Company ("PSE&G" or "the Company") as part of its combined electric and gas 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 PSE&G's initial and supplemental 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

Q. WHAT IS THE AMOUNT OF PENSION EXPENSE THAT PSE&G IS ASKING TO INCORPORATE INTO ITS BASE RATE DETERMINATION?

A. PSE&G is requesting that its base rate determination incorporate $81,558,680. This figure was set using ten-twelfths of the projected 2010 Pension Expense plus two-twelfths of the projected 2011 Pension Expense. The comparable figure for the 2009 test year is $73,873,000. Both figures are calculated as the share of the Pension Expense attributable to the Gas and Electric Utilities and the Service Company.[1]

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

A. I believe the Pension Expense for PSE&G's qualified pension plans has been forecast at too high a level. At this time, I believe the Pension Expense forecast for PSE&G should be reduced by $37.2 million each year. My opinion may change based upon further analysis and additional discovery responses. Please refer to the testimony of Andrea Crane for the effect of this reduction upon the revenue requirements for Gas and Electric Distribution Rates.

Q. HOW DID YOU ARRIVE AT THE FIGURE OF $37.2 MILLION? PLEASE EXPLAIN HOW PENSION EXPENSE IS DETERMINED.

[1] MGK-23 Entries for Pensions shown in tabs labeled "Rate Year" and "Test Year" respectively.

A. My testimony from this point through page 8 is rather technical. I have therefore structured it to present the reader with the important points necessary to understand pension expensing and pension funding. I first address the actuarial methods and assumptions that are used in determining an appropriate amount to expense on corporate books and then compare and contrast them to the actuarial methods and assumptions used in determining a cash contribution within the confines of the Employee Retirement Income Security Act of 1974 ("ERISA").

Q. WHAT IS THE DIFFERENCE BETWEEN PENSION EXPENSE AND PENSION CASH CONTRIBUTIONS FOR A GIVEN PLAN YEAR?

A. Pension Expense is an amount that is put in the corporate books to indicate the cost of maintaining a pension plan according to Generally Accepted Accounting Principles ("GAAP") and the Financial Accounting Standards Board ("FASB") *Statements 35, 87, 88, 132* and *158*. Pension Cash Contributions are the actual cash amounts which the Corporation deposits in a Qualified Trust for the pension plan each year. These contributions are calculated by the plan actuary in accordance with ERISA. Each year the actuary calculates a Minimum Funding Requirement and a Maximum Tax-deductible Contribution. The Pension Expense and the Pension Cash Contributions for a Plan Year need not be equal. As will be demonstrated later, the Pension Expense and the Pension Cash contributions have not been the same for PSE&G for the last decade, at least.

Q. WHAT IS AN ACTUARIAL FUNDING METHOD? DESCRIBE THE ACTUARIAL FUNDING METHODS USED FOR DETERMINING EXPENSE AND

HOW THEY COMPARE TO ACTUARIAL FUNDING METHODS FOR DETERMINING CASH CONTRIBUTIONS.

A. An actuarial funding method is a technique to divide the total cost of a pension plan into payments attributable to past service of the plan participants and payments attributable to future service of plan participants.

Under the accounting standard in FASB *Statement 87* (as modified by FASB *Statement 158*), the actuary must use the Projected Unit Credit actuarial method ("PUC") for determining the liability of the pension plan. This is done in the following simplified manner. Using the Plan formula, which may be found in the Plan Document or Summary Plan Description, the retirement benefit is projected to the retirement age for each plan participant. This projection includes an assumption regarding future pay increases over the working lifetime of each active plan participant until retirement. The Present Value of Future Benefits ("PVFB") is calculated for each plan participant. This is the value, as of a specific date (usually the first or last day of the Plan Year), of the projected cash flow, represented by the stream of future retirement payments to the plan participant. The Projected Unit Credit actuarial method ("PUC") then divides this PVFB into future service costs and past service costs by pro-rating the PVFB over the service which that plan participant has given to the Corporation at the time of the calculation.[2] The sum of the Past Service Costs of all plan participants (active, retired, disabled, terminated but vested in a future benefit) is called the Projected Benefit Obligation ("PBO"). The PBO measures

[2] For a very simplified example, if the PVFB for an individual participant is $90,000, the participant has worked 20 years and has 10 years remaining to retirement, the Projected Unit Credit method would assign $60,000 as past service cost ($90,000 x 20/30) and $30,000 as future service cost ($90,000 x 10/30). The Service Cost is the value (or cost) of one year of service of the participant. In this case, the Service Cost would be $3,000 ($90,000 divided by 30).

liability in terms of how much money would theoretically be in the Trust, at a given point in time, if the plan sponsor had funded the retirement benefits of the plan participants on a level basis over each participant's expected working lifetime.

Both the FASB and ERISA require the use of the Unit Credit actuarial method ("UC"), as distinguished from the PUC, for additional, but different, purposes. The UC basically examines the present value of the Accrued Benefits earned to date and ignores benefits that may or may not accrue during the working lifetime of the active participants. It then measures the liability of the retirement benefits earned at the time of the specific date. For FASB *Statement 87*, this liability is called the Accumulated Benefit Obligation ("ABO").[3]

Under the ERISA standard, newly modified by the Pension Protection Act of 2006 ("PPA"), the actuary must use the UC for determining the Target Benefit Liability. [4]

Not only do the accounting methodology and the ERISA methodology employ different actuarial methods with different results; they also have different discounting mechanisms. Discounting is the technique used to assign future payments an equivalent present day value. On the one hand, the concept of an interest rate discount is familiar because it is well accepted that the payment of $100 ten years in the future has much less value than the payment of $100 today. Actuarial techniques and methods also incorporate the likelihood of actually receiving that $100 in the future. Thus, there are actuarial assumptions regarding the likelihood of continuing to work for the Corporation (turnover rates), retiring at an age other than 65 (retirement rates), becoming disabled (disability rates), and living to

[3] In the example above , the ABO for the participant might be in the vicinity of $40,000.

[4] In the example above, the Target Benefit Liability might be in the vicinity of $45,000.

receive the retirement benefits during a given year (mortality rates). Another level of complexity in this calculation comes from the effect of a salary scale, which is used to account for the fact that participants' salaries increase over time.

Under the FASB *Statement 87* standard, the discount rate is established by the auditor and the CFO of the corporation with the advice of the actuary. Under the ERISA standard, the discount rate is set by the Department of the Treasury each month. Under FASB *Statement 87*, the other actuarial assumptions are also set by the auditor and CFO with the advice of the actuary. Under ERISA, the mortality table is also dictated by the Department of the Treasury each year, but the other assumptions are left under the domain of the actuary.

Q. HOW DOES PSE&G FUND ITS PENSION PLAN?

A. Every year, PSE&G makes a cash contribution to the four qualified pension plans it sponsors. The four plans must follow the specifications of ERISA as regards a Minimum Funding Requirement and a Maximum Tax-deductible Contribution. PSE&G has hired an Enrolled Actuary to calculate the range of acceptable contributions under ERISA and to certify that PSE&G has indeed contributed an amount within the specified range for a given plan year. Mr. Kahrer has testified that the Funding Policy of PSE&G is "to fund enough to meet or exceed 100% PBO (Projected Benefit Obligation) funded level over a period of several years."[5]

Q. WHAT IS THE PROJECTED BENEFIT OBLIGATION AND ITS RELATIONSHIP TO THE REQUIREMENTS UNDER ERISA?

[5] S-ECON-19

A. The PBO is an accounting concept. While it is based on generally accepted actuarial techniques for measuring the liability of a pension plan, it differs importantly from the generally accepted actuarial techniques used for determining minimum required contributions and maximum tax-deductible contributions under ERISA.

Once the PBO is established under FASB *Statements 87/158*, it is compared to the Fair Value of the Plan Assets to determine the Funded Status of the Plan. Under ERISA, the Target Benefit Liability is compared to the Actuarial Value of Assets to determine the Funding Shortfall. While there is no accounting requirement for the plan sponsor to bring the assets up to the level of the PBO (per Mr. Kahrer's testimony), there is an ERISA requirement to eliminate the Funding Shortfall over roughly seven years.

FASB *Statements 87/158* set forth rules for determining the Pension Expense for a given year. The Pension Expense is comprised of a Service Cost, an Interest Cost, an offsetting Investment return credit, and an amortization of actuarial gains and losses and of the impact of any plan amendment.

ERISA, under PPA, sets forth rules for determining the Minimum Required Contribution ("MRC") and the Maximum Tax Deductible Contribution. The components of the MRC are the Target Normal Cost (which is comparable to the Service Cost under FAS87) and an amortization of the Funding Shortfall over 7 years. The MRC may be reduced by any Funding Standard Carryover Balance from pre-PPA years or by any Prefunding Balance from PPA years. The Maximum Tax Deductible Contribution concept may be simplified for this testimony as an additional buffer of 50% greater than the Funding Target.

To summarize, the annual Pension Expense is determined by the actuary under the direction of the corporate CFO and the auditor. The annual cash contribution to comply with ERISA is a range determined by the actuary under strict IRS guidelines, but the plan sponsor may choose the actual amount of cash contribution within the range calculated by the actuary.

Q. HISTORICALLY, HOW HAS PSE&G's EXPENSE DIFFERED FROM THE CASH CONTRIBUTION?

A. The following table shows the FAS87 Pension Expense for the years 2001 through 2013 (projected). The Cash Contribution for the Plan Year is shown next to the Expense when such number is available.

Year	Pension Expense[6]	Charge to O&M[7]	Actual Cash Contribution[8]	Total Contribution[9]
2001	48.7	27.5		50.1
2002	77.1	31.3		137.8
2003	146.6	52.5	70.0	118.3
2004	101.9	35.2	113.1	52.6
2005	109.2	41.8	120.0	89.3
2006	97.2	37.2	8.3	29.3
2007	43.5	16.0	70.8	9.1
2008	37.1	13.3		35.6
2009	216.0	73.9		209.8
2010	247.1	81.5		
2011	216.5			
2012	188.0			
2013	158.0			

The presumed difference between Actual Cash Contribution and Total Contribution is timing. The Actual Cash Contribution, provided by Hewitt Associates, appears to be

[6] RCR-POL-13, RCR-PT-1, RCR-PT-3
[7] RCR-PT-23, RCR-PT-22, MGK-23
[8] Hewitt Associates Valuation Reports, 2007 and 2008
[9] RCR-A-28

attributable to a *plan* year, even if the Trust receives the cash in the next fiscal year. The Total Contribution from PSE&G appears to be cash contributions during the *fiscal* year.

Q. IF THE GOAL IS TO FUND TO THE PBO, HOW WELL HAS THE GOAL BEEN MET?

A. By January 2008, the goal was very close to being met. With the PBO set at $3.448 billion, the Fair Value of Assets was $3.338 billion, or 96.8% of the goal. However, a year later, January 2009, the PBO was $3.406 billion and the assets dropped to $2.316 billion, or 68.0% of the goal.

Q. HAVE THE INVESTMENTS PERFORMED BETTER SINCE THE BEGINNING OF 2009? IF SO, HOW WOULD THAT AFFECT FUTURE EXPENSE?

A. Yes, the assets have rebounded. As of September 30, 2009, the Market Value of assets in the Trust was $2.894 billion. The actuarial assumption called for an annual return of 8.75%. For the remaining one quarter of the year (from October 1, 2009 until December 31, 2009), the Fair Market Value of assets are expected to grow to $2.955 billion. If the corporation actually did contribute $209.8 million, as presented on the previous page, and benefit payouts were approximately the same (they were $204 million in 2007), then the assets would increase by $639.4 million by virtue of investment performance. The Pension Expense for 2009 forecast a $215.5 million investment return. The difference is an actuarial gain of $423.9 million. When divided by the remaining working lifetime of the workforce, 11.4 years, **the gain reduces future expense by $37.2 million for up to eleven years, beginning in 2010.**

Note, the above reductions in pension expense would be expected to continue as a constant amortization for 11.4 years. The fact that base rates are determined using 10 months of one year and 2 months of the next do not affect the amount of reduction.

Q. WHY ARE THE EXPENSES WHIPSAWING THE WAY THEY ARE? HOW ARE THE ASSETS BEING INVESTED?

A. During the last few years, the PSE&G Pension Trust Fund Investment Policy was to allocate 62% of the assets to equity investment, 30% to bonds, and the remaining 8% to other investments. The generic asset allocation in the investment industry is 60% equity and 40% bonds. The PSE&G investment philosophy and portfolio return do not stray far from the norm, all things being equal. The almost 36% downturn in the equity market during 2008 certainly had a severe effect on the asset performance of the PSE&G Pension Trust Fund.

The key or central issue becomes one of alternative investment strategies. The goal of funding the plan to the level of the PBO had been 96.8% achieved by the beginning of 2008. An Asset/Liability Study was performed in August 2007, but the Pension Investment Committee ("PIC") Members chose not to change investment strategies. The minutes of an August 28, 2007 meeting refer to a Watson Wyatt (actuarial) Study entitled, "Spending the Risk Budget." The study suggested changes "that could potentially improve the financial efficiency of the fund."[10] The Study, as well as the PIC, were more concerned with the performance of each individual investment house and who was performing best, rather than with the asset allocation and preservation of the almost 100% PBO.

Following the principles of financial economics, the PIC might well have considered locking in the funding level of 2008 and converting the asset mix to possibly immunize both the assets and liabilities against stock market and interest rate fluctuation. The minutes of the meetings of August 8, 2007 and July 14, 2009 do not indicate any such discussion. In fact, the new Investment Policy increased the level of equity from 62% to 70%, which was an acceptance of *more* investment risk, or "spending" *more* of the "risk budget" on the pension plan rather than elsewhere in the corporation. This increase in risk was minimally mitigated by withdrawing investments from the "enhanced index" and "actively managed" equity sub-classes. If the equity market had performed well enough to maintain the 8.75% actuarial assumption for return on investment, the plan would currently be funded above the level of PBO. In summary, the PIC accepted more "unintended (and potentially unrewarded)"[11] risk in the portfolio than they desired and voted to accept *yet more risk* by increasing the level of equity in the PSE&G Pension Trust Fund.

Let us examine the effect of the PSE&G Pension Trust Fund Investment Policy. At the beginning of 2008, the Fair Value of Assets was $3.338 billion. By the end of 2008, the

[10] RCR-PEN-5, p. 25.
[11] RCR-PEN-5, p. 32.

Fair Value of Assets stood at $2.316 billion, a drop of $1.022 billion. Benefit payments account for a bit over $200 million of the assets. Although the Investment return credit at the beginning of 2008 was $289.8 million,[12] the assets lost $800 million of value (net of benefit payments), a 24% drop, which resulted in an actuarial loss approaching $1.1 billion. This loss, amortized over 11.4 years, increased the Pension Expense by $100 million per year starting in 2009.[13]

If we assume the non-equity portion of the portfolio returns 4% to 5%, then the equity portion lost 41% of its value during 2008. The equity market lost close to 36% of its value during the same period--the difference being the leveraging effect of the "enhanced index." The first stated Investment Objective was "to maximize total return on Trust assets while maintaining the Trust's capability to meet short and long-term benefit obligations." Short-term obligations are not in jeopardy, but long-term benefit obligations fell back by $800 million. "The Committee [PIC] believes that investment expectations are based on the concept that the risk/reward relationship . . . will remain basic to the investment markets." The strategy, however, was driven strictly by the reward side of the relationship. The cost of the risk, whether accepted explicitly or implicitly, can be measured as $100 million in additional Pension Expense each year for over a decade. This means that PSE&G put funds at risk at a cost to ratepayers of over $100 million in each year over 11 years.

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[12] RCR-PT-1, p. 2. This is a component of the annual Pension Expense as described on page 9 above.
[13] Compare *ibid* with RCR-PT-2, p. 2.

Q. IS PSE&G REQUIRED TO FUND TO THE PBO? WHAT ALTERNATIVES ARE AVAILABLE?

A. PSE&G is annually required by ERISA to pay the Minimum Required Contribution ("MRC"). The 2009 actuarial valuation report is not yet finished and the MRC is not available. However, the MRC for 2008 was zero and my best estimate for the MRC for 2009 is also zero.

Although there may be a list of motives for seeking "to fund to enough to meet the PBO," one favorable result is that when a corporation contributes more than the MRC, it builds up a Carryover Balance (pre-PPA) and/or a Prefunding Balance (post-PPA). These balances may be used to reduce the funding requirements when the corporation faces a period when cash is not plentiful. Therefore, PSE&G does not have to make any cash contribution to the Trust if it cannot or if it chooses not to. The Balances referred to above may be sufficient to keep the MRC (or the cost to ratepayers) at zero for a few years. Note that even though the Pension Expense may exceed $200 million, the MRC can still be zero because they are calculated using entirely different methodologies and assumptions.

Moreover, on October 15, 2009, the Internal Revenue Service issued Final Regulations for IRC §§430 and 436 which deal with the value of assets and liabilities for funding purposes. One of the clarifications of the Final Regulations gives relief to corporations finding it difficult to meet their MRC obligations. By utilizing these Regulations to best advantage, I am confident the Plan's actuary can have the MRC drop to zero for 2009.

Q. IF THE PENSION EXPENSE EXCEEDS $200 MILLION AND THE MINIMUM REQUIRED CONTRIBUTION IS ZERO, WHY DOES THE BASE RATE NEED TO INCORPORATE THE PENSION EXPENSE RATHER THAN THE MINIMUM REQUIRED CONTRIBUTION?

A. Historically, the pension contribution component of base rates has been driven by the accounting Pension Expense rather than by the Minimum Required Contribution under ERISA. On October 15, 2009, the Final Regulations, referred to on the previous page, provided relief to all plan sponsors of Defined Benefit Plans so that they do not have to find themselves strapped for cash in order to fulfill their obligations under ERISA. The Board has the option to accept the relief offered by the Internal Revenue Service to reduce the pension component of the base rate to the Minimum Required Contribution. PSE&G had funded 96.8% of the PBO by 2008 and by so doing, it built Carryover Balances approaching $700 million. The Prefunding and Carryover balances are there to be used during a time of distress. The Board may consider the suitability and implications of drawing down the Prefunding and Carryover balances now.

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

A. The OPEB expenses as shown in RCR-A-29 seem reasonable. I have reviewed the actuarial reports for the determination of OPEB expense and the assumptions seem reasonable. Only employees who have served 35 years or more at retirement are eligible to collect benefits. Therefore, the plan is designed for employees willing to spend their entire careers working for PSE&G.

The cash expenditures (pay-as-you-go) plus the cash contributions to fund the OPEB plan are slightly lower than the expense figures. If the corporation chooses not to make a contribution to the pension plan for 2009 or 2010, then it may not make a funding contribution to the 401(h) account set up for the OPEB plan.

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

A. Yes, it does at this time. I do, however, reserve the right to supplement my testimony based upon additional analysis and additional discovery when and if it is received.