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September 1, 2022

IN THE MATTER OF PUBLIC SERVICE ELECTRIC
AND GAS COMPANY'S REQUEST FOR AN ACCOUNTING
ORDER AUTHORIZING THE COMPANY TO MODIFY ITS PENSION
ACCOUNTING FOR RATEMAKING PURPOSES

BPU Docket No. ______________

VIA ELECTRONIC MAIL

Carmen Diaz, Acting Secretary
Board of Public Utilities
44 South Clinton Avenue, 9th Floor
P.O. Box 350
Trenton, New Jersey 08625-0350

Dear Acting Secretary Diaz:

Enclosed herewith is Public Service Electric and Gas Company's Petition and the supporting affidavit of Joseph McDonald in the above-referenced proceeding.

Consistent with the Order issued by the Board in connection with In the Matter of the New Jersey Board of Public Utilities' Response to the COVID-19 Pandemic for a Temporary Waiver of Requirements for Certain Non-Essential Obligations, BPU Docket No. EO20030254, Order dated March 19, 2020, this document is being filed electronically with the Secretary of the Board and the New Jersey Division of Rate Counsel. No paper copies will follow.

Very truly yours,

Matthew Weissman

Matthew M. Weissman

cc
Stacy Peterson
Michael Kammer
Benjamin Witherell
Brian Lipman

STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

IN THE MATTER OF PUBLIC SERVICE	)	
ELECTRIC AND GAS COMPANY'S	)	P E T I T I O N
REQUEST FOR AN ACCOUNTING	)	
ORDER AUTHORIZING THE	)	BPU Docket No. ____________
COMPANY TO MODIFY ITS PENSION	)	
ACCOUNTING FOR RATEMAKING	)	
PURPOSES	)	

Public Service Electric and Gas Company, a corporation of the State of New Jersey, having its principal offices at 80 Park Plaza, Newark, New Jersey, 07102 ("Public Service", "PSE&G", "Petitioner" or the "Company"), respectfully petition the New Jersey Board of Public Utilities ("Board" or "BPU") pursuant to *N.J.S.A.* 48:2-16, 48:2-21, *et seq*., and *N.J.A.C.* 14:6-5.1, as follows:

INTRODUCTION AND SUMMARY OF REQUEST FOR RELIEF

1. PSE&G is a public utility engaged in the distribution of electricity and the provision of electric Basic Generation Service ("BGS"), and in the distribution of gas and the provision of Basic Gas Supply Service ("BGSS"), for residential, commercial and industrial purposes within the State of New Jersey.

2. PSE&G is subject to regulation by the Board for the purposes of setting its retail distribution rates in New Jersey and to assure safe, adequate and proper electric distribution and natural gas distribution service pursuant to *N.J.S.A.* 48:2-23. The Company, like all other public

utilities in New Jersey, is also subject to regulation by the Board concerning its system of accounts. *See N.J.S.A.* 48:2-16, *N.J.A.C.* 14:5-6.1, 14:6-5.1.

3. PSE&G by this Petition seeks an Accounting Order authorizing a change to the methodology currently used by the Company for determining the market-related value of assets for purposes of calculating pension expense. Specifically, PSE&G seeks the authority to use a calculated value that recognizes changes in fair value in a systematic and rational manner, to "smooth" returns on assets in the Company's pension trust for purposes of calculating the amortization of net gain or loss component of pension expense, using the methodology outlined in 1985 by the Financial Accounting Standards Board ("FASB"). This methodology change results in a timing difference between PSE&G's recognition of the impact of changes in the market-related value of assets in calculating its pension expense for ratemaking purposes versus its current methodology. PSE&G will record a regulatory asset or regulatory liability to account for the difference between its current methodology and the requested methodology.

4. Adopting a calculated method for determining the market related value of plan assets in PSE&G's pension trust for purposes of calculating pension expense, like the majority of PSE&G's peer companies and the State of New Jersey itself, will reduce the volatility of PSE&G's income statement and customer rates; improve the usefulness of the information presented to financial statement users; and improve comparability of results for PSE&G and its peers.

5. The statements in this Petition are supported by the attached Verification of Bradford D. Huntington, Vice President and Treasurer for PSEG Services Corporation and the

Treasurer of PSE&G. Additional factual support is set forth in the affidavit of Joseph McDonald ("McDonald Aff."), Senior Partner with PSE&G's actuary Aon, provided herewith.

PSE&G's SIGNIFICANT PENSION ASSETS ARE PRUDENTLY INVESTED TO MAXIMIZE RETURNS WITHIN THE COMPANY'S RISK TOLERANCES OVER THE LONG TERM, AND ARE THEREFORE SUBJECT TO VOLATILITY IN THE SHORTER TERM

6. Pension plans provide retirement benefits for the lifetime of current and former employees and their dependents, and thus represent very long-term financial commitments, with anticipated payouts often expected to be made over the next 75 – 100 years.

7. PSE&G sponsors an "open" pension plan, meaning newly hired employees and active employees at PSE&G continue to participate and earn benefits in the pension plan. Thus, PSE&G's pension plans continue to be very long-term in nature.

8. PSE&G's parent company Public Service Enterprise Group ("PSEG") sponsors qualified plans covering active employees and retirees for PSEG and its subsidiaries. As of December 31, 2021, PSEG had qualified pension liabilities totaling approximately $7.1 billion with qualified pension assets totaling $6.9B, versus assets of approximately $800M at year-end 1987, the year we adopted our current accounting treatment, and $2.9B at year-end 2009. This significant increase in qualified pension assets has contributed to a funded ratio of approximately 98%. PSE&G accounts for approximately 63% of the pension liabilities. PSE&G pension liabilities represent the projected benefit obligation for active union employees ($1.3B), active management employees ($0.5B) and retirees and other former employees ($2.7B). This projected benefit obligation is growing, with continuing service accruals for new hires and active employees.

9. PSE&G's pension assets are invested in portfolios with significant equity allocations, due to the higher return expectations for equity investments over long-term time horizons, appropriate for investors with a long time horizon.

10. While equity investments do offer attractive returns over the long-term, those higher returns come with significant price volatility in the short-term. As described in detail in the accompanying McDonald Affidavit, while the returns of large capitalization stocks in the United States over the past 30 years have averaged 10.2%, annual returns demonstrate significant volatility, with returns as high as 34.1% in 1995 and as low as minus 38.5% in 2008.

11. In addition, in the current economic climate, fixed income investments are also exposed to volatility due to an unprecedented rise in interest rates in an attempt to dampen significant inflationary pressures.

12. PSE&G maintains the large, well-funded pension plan described above, driven by pension obligations for our active union employees and retirees. As also noted, the Company maintains a well-funded pension plan with substantial assets to fund these liabilities, which exposes the plan to volatility in the financial markets.

PENSION ACCOUNTING PRINCIPLES

13. Pursuant to accounting rules established by the Financial Accounting Standards Board ("FASB"), PSE&G calculates on an annual basis its net periodic pension cost ("NPPC"), which is the annual accounting expense or income a company must recognize in its income statement associated with pensions.

14. The NPPC is made up of several components, which are calculated based on various factors, including assumptions about active employees' retirement dates, life expectancy, and other factors that are subject to uncertainty.

- <u>Service cost</u> – The actuarial present value of the projected benefits attributed by the plan's benefit formula to services rendered by employees during the current period. It can be thought of as the current value of the pension benefits that is being earned this year.

- <u>Interest cost</u> – Interest on the Projected Benefit Obligation ("PBO"). The PBO itself is the actuarial present value of all benefits attributed by the plan's benefit formula to employee service rendered prior to that date in time, and can be thought of as the present value of the pension benefits that were earned in prior years; the annual interest cost is generally the discount rate multiplied by the beginning-of-year PBO, adjusted for current year expected benefit payments.

- <u>Expected return on assets</u> – The expected increase in plan assets associated with the passage of time during the year. This is offset against the other cost items and is generally the expected long term rate of return on assets multiplied by the beginning of year market-related value of the assets adjusted for current year expected benefit payments, contributions and possibly for expected administrative expenses paid from the trust, if applicable.

- <u>Amortization amounts</u> – Systematic recognition of certain changes, such as gains or losses associated with asset or liability experience that differs from expected.

It is the accounting for the fourth expense item – amortization of net gains or losses associated with asset experience - that is the subject of this Petition. This component, which is impacted by the annual investment performance of the assets, is a significant source of volatility of pension expense.

THE PROPOSED CALCULATED VALUE APPROACH TO DETERMINING THE MARKET RELATED VALUE OF PSE&G'S PENSION TRUST ASSETS

15. Financial Accounting Statement ("FAS") 87, "Employer's Accounting for Pensions", at paragraph 30, states the following:

> 30. The expected return on plan assets shall be determined based on the expected long-term rate of return on plan assets and the market-related value of plan assets. The market-related value of plan assets shall be either fair value or a calculated value that recognizes changes in fair value in a systematic and rational manner over not more than five years.

In 2009, FASB approved the accounting standards codification ("ASC") as the single source of authoritative U.S. accounting and reporting standards other than guidance issued by the SEC. The codification superseded all then existing SEC accounting and reporting standards by reorganizing existing literature. Through that reorganization, FAS 87 has been codified and is now referred to as ASC 715-30 (US GAAP Codification of Accounting Standards Codification Topic 715-30: Defined benefit plans – pension).

16. PSE&G currently uses the fair value of plan assets in determining the market-related value of assets for all asset classes in its pension trust. "Fair value of assets", in this context, means the market value of the trust assets at year-end. The Company adopted this approach in 1987 when FAS 87 "Employer's Accounting for Pensions" was implemented and is unable to change the approach under U.S. GAAP.

17. While the accounting standards indicate that measuring plan investments at fair value provides relevant information, the standards also note "that measuring investments at fair value could introduce volatility into the financial statements as a result of short-term changes in fair values" and that some view "that volatility as meaningless or even misleading, particularly in

view of the long-run nature of the pension commitment and the fact that pension investments are often held for long periods, thus providing the opportunity for some gains or losses to reverse."[1]

18. As detailed in Mr. McDonald's affidavit, given the long-term nature of pension plans, the year-to-year fluctuations of equity and overall portfolio returns can be misleading to financial statement users by introducing spurious volatility to the income statement associated with pensions that are inconsistent with the underlying long-term financial performance of the plan and cash contribution requirements.

19. Fortunately, the accounting standards applicable to pensions specifically allow for the use of a "calculated value that recognizes changes in fair value in a systematic or rational manner" – or "smoothed" for purposes of calculating the market-related value of plan assets as part of calculating pension expense. Indeed, the response to Q28 of the ASC 715-30 implementation guide indicates that "[t]he use of a market-related value of plan assets was developed as a response to suggestions to reduce the asset-related volatility of net periodic pension expense".

20. Upon adoption of FAS 87, when PSEG's pension assets were almost 90% smaller than they are today, PSEG opted to use fair value of assets for purposes of determining pension expense. However, if approved by the Board, PSE&G can partially mitigate the volatility of its now-significant and volatile pension expense by modifying the amortization of its actuarial gains and losses for rate-making purposes, and apply the rules under ASC 980-10 (US GAAP Codification of Accounting Standards Codification Topic 980-10: Regulated Operations - overall). This accounting standard notes that "[r]egulators sometimes include costs in allowable

[1] See FAS 87 (basis for the Board's conclusions, paragraph 120).

costs in a period other than the period in which the costs would be charged to expense by an unregulated entity."

21. PSE&G is proposing that for rate-making purposes, the amortization of the net gain or loss component of pension expense be determined utilizing the "calculated" or "smoothed" market-related value of assets instead of fair value. The difference between these two methods would be recorded as a regulatory asset or liability. For this purpose, the market-related value is calculated by adjusting the fair value of assets by the following:

a. 80% of the difference between the actual asset return minus the expected return for the preceding year,
b. 60% of the difference between the actual asset return minus the expected return for the second preceding year,
c. 40% of the difference between the actual asset return minus the expected return for the third preceding year, and
d. 20% of the difference between the actual asset return minus the expected return for the fourth preceding year.

22. In this way the calculated market-related value "phases-in" excess/under-performance over a period of five years, such that the calculated market-related value is significantly less volatile than the fair value, while gains and losses associated with excess/under-performance prior to the five-year period are fully reflected.

23. PSE&G is proposing that this methodology for purposes of determining the net gain or loss amortization component of pension expense be effective January 1, 2023.

24. Finally, PSE&G proposes that the resulting difference in the amortization of the net gain or loss component of pension expense (or income) between its current methodology and this alternative methodology for purposes of income statement reporting will be recorded as a regulatory asset or regulatory liability. The resulting regulatory asset or liability from this timing difference will be included in net pension expense submitted for cost recovery or return in future rate cases as it is amortized pursuant to the above methodology.

THE PROPOSED CALCULATED VALUE WILL REDUCE VOLATILITY OF PENSION COSTS AND PROVIDE A MORE REPRESENTATIVE VIEW OF THE COMPANY'S FINANCIAL STATUS

25. As discussed in the McDonald Affidavit, using the calculated market-related value of assets will reduce the impact of volatility associated with annual investment returns and the impact on pension costs. Without smoothing, a significant decline in the equity market significantly increases pension costs in the following year. To the extent equity markets rebound, pension expense will decrease significantly the following year. This volatility is to be expected and is inconsistent with the true cost of pensions over the long-term, where equity market volatility is expected to even out. It is for this precise reason the accounting guidance allows for the use of a calculated market-related value. This stability of costs benefits rate-payers and is consistent with other actions taken to reduce volatility such as the use of weather normalization.

26. Reflecting a more stable, representative cost for pensions rather than a particularly high cost of pensions after a year of lower than expected trust performance (or low cost of pensions after a year of better than expected trust performance) allows the Board to have a more accurate portrayal of the company's financial status and the underlying cost structure of PSE&G,

which is crucial to the Board's ability to make prudent decisions and supports rate stability for customers.

A SIGNIFICANT NUMBER OF PSE&G'S PEER COMPANIES SMOOTH EQUITY AND OTHER GROWTH ASSETS IN THEIR PENSION TRUSTS

27. As also discussed in the McDonald Affidavit, PSEG identifies 18 organizations as peer companies in its financial statements and proxy disclosures. All 18 of PSEG's peer entities sponsor defined benefit pension plans, and 14 of the 18 organizations smooth equity and other pension assets.[2] When comparing the financial performance of PSEG with these other organizations, the volatility embedded in pension costs for PSEG impairs the comparability of PSEG's pension costs, cost structure, and overall financial performance to its peers, the majority of whom smooth asset returns for this purpose. Since nearly all of these peer companies are regulated utilities, most of whom use GAAP expense as the basis for rate recovery in the states in which they operate, rate recovery for these utility peers will commonly be based on the less volatile measure of pension expense, with customers benefitting from the more stable cost profile related to pensions. See McDonald Aff., ¶ 12.

28. We note that the State of New Jersey itself utilizes a calculated value to determine the market related value of assets for purposes of calculating its net pension costs. Specifically, the asset valuation method of the Public Employees' Retirement System of New Jersey ("PERSNJ") employs a 5-year smoothing of the difference between market value and expected actuarial value. See PERSNJ, GASB67 Report as of June 30, 2020, prepared by Cheiron (March 2021), at page 16.

[2] See McDonald Aff., at ¶ 11 (based on Aon analysis and research of 10-k filings of PSEG peer companies).

CONCLUSION AND REQUEST FOR APPROVAL

For all the foregoing reasons, Petitioners respectfully request that the Board expeditiously issue an order authorizing PSE&G to:

(a) determine, for rate-making purposes, the amortization of net gain or loss component of pension expense utilizing the "calculated" or "smoothed" market-related value of assets instead of fair value for computing its pension expense pursuant to the calculation set forth in paragraph 21 hereof, effective January 1, 2023; and

(b) record a regulatory asset or regulatory liability to account for the resulting difference in the amortization of net gain or loss component of pension expense (or income) between its current methodology and the alternative methodology for purposes of income statement reporting; and

(c) submit for recovery or return in rates the pension expense or income utilizing the proposed methodology for computing the amortization of net gains or losses.

COMMUNICATIONS

Communications and correspondence related to the Petition should be sent as follows:

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Respectfully submitted,

PUBLIC SERVICE ELECTRIC AND
GAS COMPANY

By Matthew Weissman
Matthew M. Weissman, Esq.

STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

IN THE MATTER OF PUBLIC SERVICE ELECTRIC AND GAS COMPANY'S REQUEST FOR AN ACCOUNTING ORDER AUTHORIZING THE COMPANY TO MODIFY ITS PENSION ACCOUNTING FOR RATEMAKING PURPOSES	)	P E T I T I O N BPU Docket No. ____________

VERIFICATION

I, Bradford D. Huntington, of full age, verifies as follows:

1. I am the Vice President and Treasurer for PSEG Services Corporation and the Treasurer of PSE&G, the Petitioner in the foregoing Petition.

2. I have read the annexed Petition, and the matters and things contained therein are true to the best of my knowledge and belief.

____
Bradford D. Huntington

Sworn and subscribed before me
this 1st day of September, 2022

Caitlyn M. White

CAITLYN M. WHITE
NOTARY PUBLIC OF NEW JERSEY
My Commission Expires 9/19/2024