BEFORE THE
STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW

I/M/O of the Verified Petition of Rockland Electric Company for Approval of Changes in Electric Rates, Its Tariff for Electric Service, Its Depreciation Rates, and for Other Relief ("Base Rate Filing")	**BPU Docket No. ER02100724** **OAL Docket No. PUCRL 09366-02N**

INITIAL BRIEF ON BEHALF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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TABLE OF CONTENTS

Page No.

TABLE OF AUTHORITIES

Statutes

Texts

PROCEDURAL HISTORY

On July 28, 1999, the New Jersey Board of Public Utilities ("BPU" or "Board") issued a Summary Order in Rockland Electric Company's ("Rockland", "Petitioner" or "Company") Restructuring Proceeding that adopted with modifications a Plan for Resolution of Proceedings ("Plan"), which was incorporated in a stipulation between Rockland and New Jersey Transit. *See I/M/O Rockland Electric Company's Rate Unbundling, Stranded Costs, and Restructuring Filings*, BPU Docket Nos. EO97070464, EO97070464 and EO97070466 ("Summary Order"). In the Summary Order the Board approved unbundled rates, including a separate Delivery charge, to be effective over a four-year "Transition Period" commencing August 1, 1999. The Board's Summary Order also required rate reductions over the Transition Period, including a 5% reduction on August 1, 1999, a 7% reduction effective July 1, 2001 (part of which was funded by a permanent reduction of $1 million in Delivery rates), and a 10% reduction in April 30, 1997 rates, effective August 1, 2002, part of which was provided by a Temporary Credit, scheduled to expire on July 31, 2003.

On July 22, 2002, the Board issued its Final Decision and Order in Rockland's Restructuring Proceeding. *See, I/M/O Rockland Electric Company's Rate Unbundling, Stranded Costs, and Restructuring Filings*, BPU Docket Nos. EO97070464, EO97070465, EO97070466 ("Final Order"). The Final Order directed Rockland to make a filing with the Board by no later than October 1, 2002, with respect to the proposed level of its distribution rates beginning August 1, 2003. On October 1, 2002, Rockland filed the instant petition to change its rates and charges effective August 1, 2003 pursuant to *N.J.S.A.* 48:2-21, and in compliance with the Board's directive. *RECO-10*. In addition to the Company, the parties to this proceeding are the Staff of the Board ("Staff") and the New Jersey Division of the Ratepayer Advocate ("Ratepayer Advocate").

In support of its rate case, concurrent with its filing, the Company filed the testimony of Frank P. Marino (*RECO-30*) (policy, lead-lag study results, and information regarding the Company's income statement, rate base, and revenue), Robert G. Rosenberg (*RECO-20*) (cost of equity capital), Angelo M. Regan (*RECO-26*) (plant additions, capital budget and proposed expanded service reliability program), Kenneth A. Kosior (*RECO-24*) (wages), Richard A. Kane (*RECO-22*) (employee benefits), Donald E. Kennedy (*RECO-14*) (proposed late payment charge, dishonored check charge, and reconnection charge), Charles D. Hutcheson (*RECO-28*) (depreciation study), James O. Clawson (*RECO-13*) (construction charges), Allan S. Cohen (*RECO-17*) (electric cost of service study) and William A. Atzl, Jr. (*RECO-18*) (rate design).

By letter dated October 16, 2002, the Board transmitted this case to the Office of Administrative Law ("OAL") as a contested case. The case was assigned to the Honorable William Gural, Administrative Law Judge, t/a ("ALJ") for evidentiary hearings.

Rockland filed a Motion for *pro hac vice* Admission of John L. Carley on November 27, 2002. ALJ Gural approved the Motion by Order dated December 9, 2002.

On November 6, 2002, Public Service Electric and Gas Company ("PSE&G") filed a Motion to Participate with the Secretary of the Board. On November 12, 2002, Rockland filed a letter with the Board Secretary stating that the Company had no objection to PSE&G's request for participant status. On December 2, 2002, Jersey Central Power & Light Company ("JCP&L") filed a Motion to Participate with the Secretary of the Board. Rockland filed a letter on December 3, 2002 with ALJ Gural stating that the Company had no objection to JCP&L's request for participant status.

A prehearing conference was held at the OAL on December 3, 2002, and a prehearing order was entered on December 6, 2002. By letter dated December 12, 2002, the Ratepayer Advocate requested changes to the prehearing order. Also by letter motion dated December 12, 2002 to the Board Secretary, the Ratepayer Advocate requested, on behalf of all parties, that May 30, 2003 be reserved by the Board as a hearing date with respect to the Company's 12-month actuals, which will not be available until May 20, 2003. A revised prehearing order was entered on December 17, 2002.

On December 23, 2002, the Ratepayer Advocate filed an emergent letter motion seeking to compel Rockland to provide responses to all outstanding discovery. Rockland responded to the motion to compel by letter dated December 30, 2002. The Ratepayer Advocate filed a letter in further support of its motion on January 6, 2003. ALJ Gural granted the Ratepayer Advocate's Motion to Compel by Order dated January 14, 2003.

The Company filed its update to Exhibits P-2, P-3 and P-4 to reflect seven months of actual data ("7 + 5 update") on January 2, 2002, and its update to those same exhibits to reflect eight months of actual data ("8 + 4 update") on January 17, 2002. *RECO-11* and *RECO-11A*, respectively.

The Ratepayer Advocate filed the Direct Testimony of James A. Rothschild (*R-13*) (cost of capital/rate of return), Robert J. Henkes (*R-50*) (revenue requirement), Michael J. Majoros (*R-36*) (depreciation), and David E. Peterson (*R-10*) (cost of service/rate design) on January 13, 2003. The Ratepayer Advocate filed the Supplemental Direct Testimony of Robert J. Henkes on February 7, 2003. *R-51*.

On January 31, 2003, Rockland filed the Rebuttal Testimony of Frank P. Marino (*RECO-31*), Robert G. Rosenberg (*RECO-21*), Angelo M. Regan (*RECO-27*), Kenneth A. Kosior (*RECO-25*), Richard A. Kane (*RECO-23*), Donald E. Kennedy (*RECO-15*), Charles D. Hutcheson (*RECO-29*), George Christ (*RECO-16*), and William A. Atzl, Jr. (*RECO-19*).

Public hearings were held on February 10th and March 19th, 2003 at the Holiday Inn in Montvale. Evidentiary hearings took place on February 20th, 21st, 24th, 25th, 27th and 28th, 2003 at the OAL in Newark.

STATEMENT OF FACTS

Rockland is a public utility corporation of the State of New Jersey and is subject to the jurisdiction of the Board. Rockland's principal offices are located at 82 East Allendale Avenue, Suite 8, Saddle River, New Jersey. Rockland is owned by Orange and Rockland Utilities, Inc. ("O&R"), a New York utility that serves approximately 200,000 customers. O&R, Rockland's parent, and Con Edison Company of New York, Inc. ("ConEd"), are both subsidiaries of Consolidated Edison, Inc. ("CEI").

Rockland is engaged in the retail distribution and sale of electric energy for residential, commercial and industrial purposes within its defined service territory, which includes parts of Bergen, Passaic and Sussex Counties in New Jersey. The Company is subject to the jurisdiction of the Board pursuant to *N.J.S.A.* 48:2-21 *et seq.* Within its service territory, Rockland serves approximately 70,000 customers. The rates and charges for electric service furnished by Petitioner and the conditions upon which the same are furnished are set forth in the Company's tariff designated P.U.C. No. 2 Electricity. The Board, in its July 22, 2002 Final Decision and Order in the Restructuring Proceedings, required Rockland to make a filing with respect to the proposed level of its distribution rates beginning August 1, 2003, by no later than October 1, 2002. Final Order, pp. 59, 65. Rockland's rate petition was filed in compliance with the Board's directive on October 1, 2002. *RECO-10*.

The Company's electric base rates were last increased in January of 1992. The Company is requesting an increase in its rates and charges pursuant to *N.J.S.A.* 48:2-21, effective August 1, 2003. The overall distribution rate increase proposed by the Company is $6.332 million (8+4 Update), which represents a 4.8% overall increase in revenue, which would result in an overall rate of return of 9.41%. *RECO-31*, p. 6. Rockland is also requesting approval to change its electric and general plant depreciation rates pursuant to *N.J.S.A.* 48:2-18. The company claims that the proposed rates are necessary to provide sufficient operating revenues to meet operating expenses, including depreciation, taxes and fixed charges, and provide a reasonable rate of return on investment in electric property.

As set forth more fully in the sections which follow, and in the testimony of the Ratepayer Advocate's witnesses, the Company proposed an unreasonably high rate of return, used a rate base figure which did not accurately reflect the actual assets utilized, understated its projected revenue, and overstated its expenses, including an unreasonably high estimate of its depreciation expense. The Company's overstated claim for rate relief should be rejected. Instead, in accordance with the analyses and recommendations set forth in the testimony of the Ratepayer Advocate's witnesses, a rate decrease of approximately $5,300,000 million is due ratepayers. *R-51*, p. 9. As set forth in the sections which follow, there is overwhelming evidence in the record which supports the Ratepayer Advocate's recommended adjustments to the Company's proposed return on equity, rate base, and pro-forma revenue and expenses. Similarly, there is ample support for the Ratepayer Advocate's recommendations regarding the Company's proposal for its tariff and rate design.

Contrary to the overwhelming evidence calling for a much lower rate of return, Rockland proposes a 12% return on equity. *RECO-20*, p. 44. Based on the analysis of Ratepayer Advocate witness James A. Rothschild, the Ratepayer Advocate is proposing a return on equity of 9.5%. Unlike the 12% return proposed by the Company, Mr. Rothschild's recommended return figure is based on the proper application of sound methodology and is consistent with interest rate trends and expected returns for electric distribution utilities. As discussed herein and in the testimony of Mr. Rothschild, the Company bases its proposal on a flawed application of the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methodologies.

The Ratepayer Advocate also proposes the adoption of rate base adjustments to the Company's proposal, totaling over $23,726,000, as recommended by its witness, Robert J. Henkes. *R-51*, p. 7, Sch. RJH-1. The Ratepayer Advocate recommends other adjustments which properly reflect a reasonable level of expenses and revenues associated with the provision of utility service. Ratepayer Advocate witnesses also challenged many components of the Company's claimed operating expenses, including the Company's accounting for labor operating and maintenance ("O&M") expense, labor cost increases, incentive compensation, pension expense, regulatory expense, and others. The result of the pro-forma revenue and expense changes proposed by the Ratepayer Advocate amounts to an increase of $11,683,000 in pro-forma operating income.

The recommended adjustments also include a significantly larger reduction to the Company's depreciation expense, reducing the pro-forma depreciation expense by $1.9 million versus the $522 thousand decrease proposed by Rockland. *R-36*, p. 5.

In order to equitably benefit the different classes of ratepayers, the rate decrease should be allocated to the various customer classes on an equal percentage basis, as proposed by Ratepayer Advocate witness David E. Peterson. *R-10*, p. 5. Furthermore, the Ratepayer Advocate recommends that the Company's proposed increase to the service charge be rejected. Rockland already has the highest residential monthly service charge of the four regulated New Jersey electric utilities. It is the Ratepayer Advocate's recommendation to maintain Rockland's current service charge. The Company could instead recoup any increase or decrease in class revenue responsibility that results form this proceeding by changing current energy and demand charges by a uniform percentage within each rate classification. Rockland also proposes to extend the applicability of its dishonored check charge to residential customers. The cost data presented in this proceeding supports only a $7.00 flat charge for each dishonored check and that is the Ratepayer Advocate's recommendation. Rockland's proposal to increase its reconnection charge from $7.00 to $27.00 would significantly exceed the existing electric reconnection charges approved in New Jersey. The Ratepayer Advocate recommends that the reconnection charge be raised to $15.00 instead. *R-10*, p.6.

In sum, as set forth in the sections which follow, the Ratepayer Advocate respectfully submits that the recommended adjustments and modifications to the Company's request be adopted by Your Honor and the Board.

POINT 1

THE RATEPAYER ADVOCATE'S RECOMMENDED 9.25% RETURN ON EQUITY IS BASED ON THEORETICALLY VALID AND PROPERLY CALCULATED DCF AND RISK PREMIUM/CAPM METHODS CONSISTENT WITH CURRENT MARKET CONDITIONS AND SHOULD BE ADOPTED BY YOUR HONOR AND THE BOARD.

A. Introduction

The Ratepayer Advocate's witness, Mr. James A. Rothschild adopted the Company's capital structure and embedded cost of debt in this proceeding. *R-13*, p. 6. Therefore, it is only necessary for Your Honor and the Board to determine the appropriate cost of equity. The Company's current authorized return on equity was set over ten years ago, in 1992, at 12%. T80:L18-20 (2/21/03). The Company's cost of capital witness in this case is Robert G. Rosenberg. He recommends a cost of equity for Rockland that he claims is "… certainly not below 12.0". *RECO-20*, p.44. He also recommends the use of a capital structure containing 50% debt and 50% common equity. *RECO-20*, p.45. Mr. Rosenberg determined the capital structure for Rockland based upon the capital structure for a group of proxy companies. It was noted by Mr. Rothschild that, while the procedure used by Mr. Rosenberg to establish the capital structure in this case is considered flawed, he utilized the capital structure Mr. Rosenberg selected because it is consistent with the actual capital structure being used by both Orange and Rockland, and the consolidated capital structure of Consolidated Edison. Mr. Rosenberg then quantified the cost of equity through a DCF method and CAPM, two different risk premium methods and comparable earnings methods. *RECO-20*, p.1. Mr. Rosenberg's recommendation of 12% contains serious errors in the implementation of the equity costing methods he presented, which has the effect of significantly overstating estimates of the cost of equity.

The Ratepayer Advocate's expert witness, Mr. Rothschild, provides the basis for an appropriate return on equity. The Ratepayer Advocate's position was set forth in the testimony of Mr. Rothschild, (*R-13*, p.13), who used two orthodox DCF methods: the single stage, or constant growth method, and the multi-stage method, or complex or non-constant growth method, as well as two different Risk Premium/CAPM methods.

Mr. Rothschild's cost of equity position may be summarized as set forth in the following chart:

Rockland Electric Company
Cost of Equity Summary

	Based Upon Average for year Ended 10/31/02 Stock Prices	Based Upon Stock Prices on 10/31/2002
DCF		
SIMPLIFIED, OR CONSTANT GROWTH DCF (D/P+g) RESULTS:		
COMPANY WITNESS GROUP	9.21%	9.31%
ALL EASTERN ELECTRIC COMPANIES COVERED BY VALUE LINE	9.68%	9.87%
CONSOLIDATED EDISON	9.42%	9.17%
	9.44%	9.45%
COMPLEX, OR MULTI-STAGED DCF RESULT FOR COMPARATIVE ELECTRIC COMPANIES:		
Based upon HIGH End of Range for future return on book	9.67%	9.80%
Based upon LOW End of Range for future return on book	8.95%	9.07%
Average of high-low results	9..31%	9.43%

Risk Premium/CAPM:

Based upon analysis of historic returns from 1926-1999: Adjusted for Electric Utility Specific Risk	8.36%
Recommended Equity Cost Rate	9.50%
Capital Structure Risk Adjustment	-0.25%
Cost of equity net of tax effect	9.25%

Source: *R-13*, Sch. JAR 2.

Mr. Rothschild's results were based on the proper application of the DCF and Risk Premium/CAPM methods. Mr. Rothschild proved that current capital market conditions simply do not justify Rockland's requested return on equity.

In his testimony, Mr. Rothschild stated that there is currently much discussion in Washington, D.C. about changing the tax code to exclude the double taxation on corporate dividends. Mr. Rothschild's cost of equity recommendation has not been adjusted for this possibility because the potential change in the tax law is speculative. T137:L11-25 and T:138:L1-11 (2/21/03). The Ratepayer Advocate points out, however, that should corporate dividends become tax free, this could have a material impact on the cost of equity. For example, an investor in the 30% bracket who owns stock in a company that is currently paying a 5% dividend (the approximate dividend level being paid by the comparative electric companies being examined in this case), making the dividends tax free would have the effect of lowering the cost of equity by about 1.5%, or from 9.25% to 7.75%. If the dividend should become partially tax-free, then the reduction in the cost of equity would be proportionately less.

This is such a material change, the Ratepayer Advocate is recommending that the Board include a mechanism to lower rates, concurrently with the passage of the new tax legislation, in its decision. *R-13*, pp. 4 and 5.

Mr. Rosenberg, on rejoinder, asked Your Honor and the Board to accept that investors had already priced in the tax elimination on stock dividends based upon one small article on the 4th page of the Wall Street Journal that merely stated President Bush was in favor of such a proposal. *RECO-71;* T105:L25, T106:L1-25 and T107:L1-5 (2/27/03). Mr. Rosenberg should know that the stock market does not produce a significant reaction to the early seeds of a new idea that might or might not come to pass. If the date marked by the newspaper article was a significant landmark turning point in the minds of investors, the article would have been a first-page headline followed by numerous other articles discussing the stock market's reaction to what would be such a major change in the investment prospects for common stock.

Mr. Rothschild's testimony shows that Rockland's cost of equity is no more than 9.25%. Mr. Rothschild's 9.25% recommendation is, as it should be, somewhat lower than what the Board has allowed in recent years – 10% being the return the Board most recently allowed *In the Matter of the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell Atlantic-New Jersey, Inc.,* BPU Docket No. TO00060356 (Order dated March 6, 2002).

Since that Board decision, numerous cases have been stipulated using the 10% cost of equity, including *I/M/O The Petition of Public Service Electric & Gas Company for Approval of an Increase in Gas Rates and for Changes in the Tariff for Gas Service,* BPU Docket No. GR01050328 (Order dated January 9, 2002). T147:L17-23 (2/21/03).

In addition, since long–term Treasury bond interest rates have dropped dramatically, the fact that Mr. Rothschild's cost of equity recommendation is lower than recently allowed returns simply confirms the accuracy of his position.

This recommendation is, on its face, more reasonable than Mr. Rosenberg's recommendation, which appears to give scant recognition to the changes in the market that have occurred since 1992.

B. The Cost Of Equity Should Be No Higher Than Required By Investors To Buy Or Hold the Stock.

The ratemaking process is designed to give a utility the opportunity to recover prudently incurred costs of providing utility service to its customers, including a return on its used and useful utility property. The Board's regulation of a utility's rate of return is intended to identify the fair and reasonable cost of capital invested in the utility's rate base, and to approve rates that give a soundly managed utility an opportunity to recover those costs. A utility's rate of return should be "reasonably sufficient to assure confidence in the financial soundness of the utility and should be adequate, under efficient and economical management, to maintain and support its credit and enable it to raise the money necessary for the proper discharge of its public duties." *Bluefield Waterworks and Imp't. Co. v. Public Svc. Comm.,* 262 *U.S.* 679, 693 (1923); *accord Public Svc. Coord'd Transport Co. v. State,* 5 *N.J.* 196, 225 (1950). In this process, the Board must balance the competing interests of the rate paying public and Rockland's investors to arrive at a figure "within the range of reasonableness, the zone between the lowest rate not confiscatory and the highest rate fair to the public." *In re N.J. Power & Light Co.*, 9 *N.J.* 498, 534 (1952).

The cost of equity is the rate of return that must be offered to a common equity investor in order for that investor to be willing to buy the common stock. The rate of return is earned in two different ways. One part of the return is from a dividend. The other part of the return is through the change in the stock price. Investors buy stock to benefit from the total return. Total return is the sum of the dividend income and the profit (or loss) obtained from the change in the stock price. While it is uncommon in the utility industry, many companies do not pay a dividend at all. Yet, investors are willing to buy the stock if they feel that the likely capital appreciation will offset the lack of any dividend income. A fair return on equity for utility investors is the return investors require to hold or acquire that utility's common stock. Any return higher than necessary to meet investors' requirements would provide them with an unexpected windfall at the expense of ratepayers who would be overcharged for utility service. The investors' return requirement would normally be sufficient to permit the utility to maintain its financial integrity and to attract additional capital. The minimum required return on common equity is the cost of common equity. The cost of common equity must be estimated through analyses of capital market behaviors, as investors do not directly specify the return they require on their common stock investments.

C. The Cost Of Equity Recommendation Of The Ratepayer Advocate Is Properly Calculated And Based On Methodologies Accepted By The Investment Community, Whereas The Company's Cost Of Equity Recommendation Is Based On Flawed Methodologies And Improper Calculations.

1. DCF Methods

The basic formation of the DCF method is probably the most widely used approach to return on equity determination in utility rate proceedings. This model states that the percent return expected and, therefore, required by investors equals the expected dividend yield, which is the annualized dividend divided by market price, plus the expected annual rate of growth of dividends per share. It is applied by implementing the following formula:

> Cost of equity = dividend yield + future expected growth
> Where growth refers to the future sustainable growth rate in dividends, earnings, book value and stock price.

R-13, p. 45

The DCF model has been used for many years, and the constant growth form of the DCF model is more widely used than any other approach to determining the cost of equity. Implementation of the DCF model in utility rate proceedings starts out with the same D/P +g, or dividend yield plus growth formula. Also, most generally agree that the growth rate “g” must be representative of the constant future growth rate anticipated by investors for dividends, earnings, book value, and stock price.

The evidence presented in these proceedings shows that Mr. Rothschild’s DCF results are the product of appropriate methodology and relevant current data. Mr. Rothschild derived his 9.25% return on equity recommendation using the widely recognized DCF methodology and the Risk Premium/CAPM model. As explained by Mr. Rothschild in his Rockland testimony, “ [s]tock analysts and textbooks recognize that generally the most accurate way to estimate the sustainable growth rate in a constant growth DCF method is to use what is usually referred to as the retention growth, or “b x r” method.” *R-13*, pp. 59 and 60.

According to Mr. Rothschild, the “b x r” method is best implemented by multiplying the *future expected* return on book equity by the retention rate that is consistent with both the future expected return on book equity and the dividend rate used to compute the dividend yield. Also, future sustainable growth should include an increment of growth to allow for the impact of sales of new common stock above book value. *Id.*

In the textbook, *Investments*, by Bodie, Kane and Marcus (Irwin, 1989) at page 478, expected growth rate of dividends is described as follows:

> How do stock analysts derive forecasts of *g*, the expected growth rate of dividends? Usually, they first assume a constant dividend payout ratio (that is, ratio of dividends to earnings), which implies that dividends will grow at the same rate as earnings. Then they try to relate the expected growth rate of earnings to the expected profitability of the firm's *future* investment opportunities.
>
> The exact relationship is
>
> $$g = b \times ROE$$

> where *b* is the proportion of the firm's earnings that is reinvested in the business, called the **plowback ratio** or the **earnings retention ratio,** and ROE is the rate of return (return on equity) on new investments. If all of the variables are specified correctly, [the] equation . . . is true by definition, . . .

R-13, p. 61

The Ratepayer Advocate's cost of equity was based upon the application of the DCF method. Mr. Rothschild applied the DCF method two different ways. One way is a single-stage, or constant growth DCF model in which he added a growth rate that was carefully constructed to meet the rigorous requirements of the constant growth formula. The second DCF analysis is a multi-stage method. Both approaches to the DCF method are dependent upon an estimate of what common equity investors expect for future cash flow. *R-13*, p. 54, T144:L4-11 (2/21/03).

a) Implementation of Single-stage DCF

Mr. Rothschild began his examination by first applying the DCF method to both the group of electric companies chosen by the Company and to a group of electric companies consisting of all the companies in the Eastern edition of Value Line. He took the current quarterly dividend rate for each company examined and multiplied it by 4 to arrive at the current annual rate. This number was then converted to a dividend yield by dividing it by the stock price of each company. The stock price used was determined two different ways. One way was to take the actual stock price as of December 31, 2001. The second way was to take the average of the high and low stock price for the year ended December 31, 2001. Then, the dividend yield was increased by adding one-half the future expected growth rate. This upward adjustment to the dividend yield is necessary because the DCF formula specifies that the dividend yield to be used is equal to the dividends expected to be paid over the next year divided by the market price. After this adjustment to increase the dividend yield, the yield is equal to an estimate of dividends over the next year.[1] To each dividend yield result, he added one-half the future expected growth rate.

[1] The complexversion does not directly use dividend yields. Instead, it determines the present value of each dividend payment as a discounted cash flow.

He derived the growth rates used in the constant growth, or k= D/P + G, version of the DCF method from the internal, or retention growth rate, or "b x r" method where "b" represents the future expected retention rate and "r" represents the future expected earned return on book equity. In addition to the "b x r" growth caused by the retention of earnings, he added an amount to recognize that growth is also caused by the sale of new common stock in excess of book value.

b) Implementation Multi-Stage DCF

Mr. Rothschild also performed a multi-stage DCF analysis. In this analysis, Mr. Rothschild performed a DCF analysis in two stages, the first based upon short-term growth projections for the 2001 through 2005 period, and the second based on projections 40 years into the future.

For his first-stage determination, Mr. Rothschild used Value Line's estimates of earnings and dividends per share and earnings per share for 2001 through 2005 for the companies examined. Since Value Line does not show a specific earnings and dividend projection for every year from 2005-2006, Mr. Rothschild interpolated from the available data, and mechanically used Value Line's projections for the period. *R-13*, p. 65. For the second stage of the multi-stage or non-constant DCF model, Mr. Rothschild determined future earnings by multiplying the future book value per share by the future expected earned return on book equity, using the same future expected return on book equity used in the constant growth, single-stage or "simplified" DCF version. Projections were made for 40 years into the future, and relied on a constant dividend payout ration set equal to the payout ratio for 2002. *Id.* at p. 66. Mr. Rothschild derived the estimated future stock price from the projected book value using the same market-to-book ratio at the time of sale as exists today. The stock price used was both the spot stock price as of October 31, 2002, and the average stock price for the year ended October 31, 2002. *Id.* at p. 66. The cost of equity indicated by the DCF method is between 8.95% and 9.80% for the group of electric companies chosen by the company witness. *R-13,* p. 67 and Sch. JAR 2.

Analysis of Company Position

Rockland's witness, Mr. Rosenberg, uses a two-stage DCF model in this case. He begins his detailed discussion of the DCF model by stating that the "DCF model is currently ….suspect…" because the state of flux in the industry makes it more difficult to estimate growth expectations. *RECO-20*, p. 6, T138:L12-25 and T139:L1-16 (2/21/03). Mr. Rothschild agrees that the DCF method, as Mr. Rosenberg has applied it, is suspect because of his heavy reliance on analysts' forecasts. Mr. Rosenberg noted in his Direct Testimony that the credibility of security analysts' recommendations is very much in question, making any method that mechanically relies upon analysts' forecasts likely to contain the same exaggerated bias that is included in the analysts' forecasts on which the computations are based. *R-13*, p. 18.

Mr. Rosenberg also raises the argument that analysts five-year forecast projections might be wrong. He gives reasons such as absorbing non-recurring costs, accelerated depreciation, employee buyouts, etc. These are not valid reasons because these kinds of costs do not impact earnings five years out. He also discusses the reorientation away from dividend yield to growth. Mr. Rothschild points out that this might be correct, but the impact is for an earnings growth rate to therefore be overstated unless the dividend yield portion of the DCF equation is fixed to be consistent. Mr. Rosenberg also interjects that stock buybacks can temporarily escalate stock prices and therefore unduly influence the cost of equity indicated in the DCF method. Stock buybacks are not a cause for concern. Properly managed stock buybacks do not temporarily raise a company's stock price as the effect is permanent. Secondly, as pointed out by Mr. Rothschild, the impact cannot be very great or investors would simply sell into the higher price. *R-13*, p.19.

Finally, Mr. Rosenberg asserts that merger activity can influence stock prices and therefore influence the DCF result. Mr. Rothschild agrees that mergers can influence stock prices, but the effect works both ways and therefore is cancelled out. The stock price of the company being acquired typically increases, and the stock price of the company doing the acquiring typically declines. The net result is zero, especially if Mr. Rosenberg's prior statement on page 10 of his

Direct Testimony, that mergers will not impact the earnings growth rates, is correct. *RECO-20*, p. 10.

In his two-stage DCF model, Mr. Rosenberg uses stock pricing for the six months ended August 2002. He uses the average high and low price for each month. The first stage growth in his two-stage model was determined by using the earnings projections made by Value Line and by the Institutional Brokers Estimate System ("I/B/E/S"). *RECO-20*, p. 12.

For his second stage, he used long-term nominal GDP growth. *RECO-20*, p. 12. Mr. Rosenberg's approach to use GDP growth as the growth rate for the second stage makes no sense whatsoever and is clearly flawed. GDP growth is not a growth in earning, or in earnings per share. The GDP growth understates growth for companies retaining most of their earnings and overstates growth for companies paying a large dividend. *RECO-20*, p. 10. For his second proxy for long-term growth, Mr. Rosenberg employed Value Line projections for 2005-2007 for retention growth. This number is also inconsistent with his dividend yield because he did not reduce the dividend yield proportional to the forecasted increase in the retention rate. This is a blunder and by failing to do this, Mr. Rosenberg has overstated the dividend yield since earnings were forecast by Value Line to be growing more quickly than dividends.

Mr. Rosenberg's third projection of growth is for long-term industry growth. This method is also wrong because it does not relate to earnings per share. It also ignores the fact that these are regulated companies. The earnings growth will equate to the rate of return times book value irrespective of how the industry grows.

Mr. Rosenberg's analysis is seriously flawed and ridden with inconsistent results. His GDP and Industry Average approaches predictably overstate the cost of equity because they are measuring the wrong thing. His retention growth method, which averages 10.0% also overstates the cost of equity because he has mismatched earnings and dividends. He has overly relied upon Value Line's expectation even though Value Line and other analysts are known to be chronically optimistic. Despite the weight of the evidence which appropriately shows that the DCF method is indicating a cost of equity *below* 10%, Mr. Rosenberg concludes it is indicating a cost of equity of 11.0% to 11.5%. To use the DCF model correctly, one must use it in an internally consistent manner. *RECO-20*, pp. 10 –15.

2. Risk Premium/CAPM Method

The Risk Premium/CAPM method estimates the cost of equity by analyzing the historic difference between the cost of equity and a related factor, such as the rate of inflation or the cost of debt. *R-13*, p. 67. While the Risk Premium/CAPM method has most commonly been implemented by adding an historically determined risk premium to the cost of debt, the investment community is now increasingly aware that this method will result in a massive over-estimate of the return on equity investors can rationally expect to obtain. *Id.*

Of critical importance when implementing the risk premium method is to take into account that risk premiums have declined in recent years. Federal Reserve Chairman Alan Greenspan made a speech on October 14, 1999, entitled "Measuring Financial Risk in the Twenty-First Century" supporting this point. Chairman Greenspan stated:

> That equity risk premiums have generally declined during the past decade is not in dispute. What is at issue is how much of the decline reflects new, irreversible technologies, and what part is a consequence of a prolonged business expansion without a significant period of adjustment. The business expansion is, of course, reversible, whereas technological advancements presumably are not.

R-13, pp. 67 and 68

It is evident that the financial investment community shares Chairman Greenspan's view on the reduction in risk premiums. An article that appeared in the April 5, 1999 issue of *Business Week* agreed with this point:

> The risk premium is the difference between the risk-free interest rate, usually the return on U.S. Treasury bills, and the return on a diversified stock portfolio. Over more than 70 years, the return to stocks averaged 11.2%, and T-bills, just 3.8%. The difference between the two returns, 7.4%, is the risk premium. Economists explain this extra return as an investors' reward for taking on the greater risk of owning stocks. **Most market watchers believe that in recent years, the premium has fallen to somewhere between**

> **3% and 4% because of lower inflation and a long business upswing that makes corporate earnings less variable.** (Emphasis added)

R-13, p. 68

Mr. Rothschild used both an "inflation risk premium" approach and a "debt risk premium" approach. The inflation risk premium approach, based on an analysis of the earned total return on equity investments compared to the inflation rate, indicated a cost of equity between 8.60% and 9.20%. *R-13*, p. 17.

The inflation premium method is accepted by the investment community as a valid approach to estimating the cost of equity. A book entitled *Stocks for the Long Run*[2] examined the real returns achieved by common stocks from 1802 through 1997. The conclusion in the book is that equity returns in excess of the inflation rate have been very similar in all major sub-periods between 1802 and 1997, while the risk premium in between bonds and common stocks has been erratic. Page 11 of this book says:

> Despite extraordinary changes in the economic, social, and political environment over the past two centuries, stocks have yielded between 6.6 and 7.2 percent per year after inflation in all major subperiods.

The book then says on page 12:

> Note the extraordinary stability of the real return on stocks over all major subperiods: 7.0 percent per year from 1802-1870, 6.6 percent from 1871 through 1925, and 7.2 percent per year since 1926. Ever since World War II, during which all the inflation in the U.S. has experienced over the past two hundred years has occurred, the average real rate of return on stocks has been 7.5 percent per year. This is virtually identical to the previous 125 years, which saw no overall inflation. This remarkable stability of long-term real returns is a characteristic of mean reversion, a property of a variable to offset its short-term fluctuations so as to produce far more stable long-term returns.

Continuing on page 14, *Stocks for the Long Run* says:

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[2] *Stocks for the Long Run* by Jeremy J. Siegel, Professor at Wharton. McGraw Hill, 1998. According to the book cover, Professor Siegel was "… hailed by Business Week as the top business school professor in the country…".

> As stable as the long-term real returns have been for equities, the same cannot be said of fixed-income assets. Table 1-2 reports the nominal and real returns on both short-term and long-term bonds over the same time periods as in Table 1-1. The real returns on bills has dropped precipitously from 5.1 percent in the early part of the nineteenth century to a bare 0.6 percent since 1926, a return only slightly above inflation.
>
> The real return on long-term bonds has shown a similar pattern. Bond returns fell from a generous 4.8 percent in the first sub period to 3.7 percent in the second, and then to only 2.0 percent in the third.

The book explains some of the reasons why bond returns have been especially unstable. Page 16 says:

> The stock collapse of the early 1930's caused a whole generation of investors to shun equities and invest in government bonds and newly-insured bank deposits, driving their return downward. Furthermore, the increase in the financial assets of the middle class, whose behavior towards risk was far more conservative than that of the wealthy of the nineteenth century, likely played a role in depressing bond and bill returns.
>
> Moreover, during World War II and the early postwar years, interest rates were kept low by the stated bond support policy of the Federal Reserve. Bondholders had bought these bonds because of the widespread predictions of depression after the war. This support policy was abandoned in 1951 because low interest rates fostered inflation. But interest rate controls, particularly on deposits, lasted much longer.

The book then provides a conclusion on page 16 that:

> Whatever the reason for the decline in the return on fixed-income assets over the past century, it is almost certain that the real returns on bonds will be higher in the future than they have been over the last 70 years. As a result of the inflation shock of the 1970's, bondholders have incorporated a significant inflation premium in the coupon on long-term bonds.

Mr. Rothschild determined the cost of equity using the debt risk premium method by separately determining the proper risk premium applicable to long-term treasury bonds, long-term corporate bonds, intermediate-term treasury bonds and short-term treasury bills. Mr. Rothschild, in his approach considered a wide array of data points across the yield curve. Therefore, the results are less impacted by a temporary imbalance that may exist in the debt maturity "yield curve". *R-13*, p. 72, Sch. JAR-10.

Mr. Rothschild's "debt risk premium" analysis indicates a cost of capital of 8.36%. *R-13*, p. 77.

Analysis of Company Position

Rockland implemented a CAPM method by using both a traditional form of the CAPM and a zero beta form. Mr. Rosenberg uses a beta of 0.59 for his proxy companies, based upon the numbers from Value Line adding a risk premium to a 5.5 % "risk free rate." *RECO-20*, p. 22. He theorizes that because common stocks have no maturity date, the long-term treasury is the proper measure to use. This justification is erroneous because one has nothing to do with the other. The theory is that he is comparing the return on a zero beta risk entity to the beta of the stocks he selected. A long-term treasury does NOT have a beta of zero, but he treats it as if it does. Therefore, by using a long-term treasury as a proxy for a risk free security, his method overstates the cost of equity. *R-13*, p. 24.

Mr. Rosenberg estimates the risk premium using two methods. One is based upon the Ibbotson Associates "Risk Premia Over Time Report:2002." The second approach is based upon his use of a DCF approach. To qualify the risk premium, Mr. Rosenberg erroneously uses the arithmetic mean rather than the geometric mean. The arithmetic average of returns is computed by taking the percentage change over a specific period[3] and computing an arithmetic average of those returns. The geometric average is computed by determining the compound annual average return from the beginning of the period to the end of the period being examined.

The coin toss example Mr. Rosenberg gives on page 24 of his testimony is a futile attempt to support his choice of the arithmetic average. His footnote indicates that the results only make sense if "… the coin used is fair…" In other words, the toss of each coin is independent of the prior

[3] Frequently, arithmetic average returns are computed based upon annual results. However, arithmetic returns could be computed using any other time - daily, weekly, monthly, every two years, every 5 years, etc. and then converting that result to an average annual return.

toss. As pointed out by Mr. Rothschild in his testimony, such is not the case for stock market returns; they go in cycles. *R-13*, p. 25. The results are also impacted by changes in trends such as the desirability of mutual funds, pension funds, etc., changes in long-term capital gains rates, and even the growing popularity of the concept that stocks return more than bonds in the long-run. Another critical factor that negates his entire analysis is the assumption that the investment amount associated with each toss of the coin is the same. It is not. When the stock market declines, investors have less money invested than before the decline. When market prices increase, they have more. This means that an investor with a $100,000 portfolio that suffers a market decline to $50,000 only had $50,000 invested if the market should double. If the $50,000 doubles, it again becomes the $100,000 that the investor started with. In this circumstance, the use of the arithmetic average would be wrong because it would naively average the 50% decline in value from $100,000 to $50,000 with the 100% gain from $50,000 to $100,000 and thereby conclude that the return earned was 25% (the average of -50% and +100%) even though in reality the investor would have made absolutely nothing. *Id*.

Mr. Rosenberg, in his rejoinder testimony, addressed the use of the arithmetic verses geometric averaging method of quantifying a risk premium. T127:L7-25 (2/27/03). An analytical look at what he presented shows that his attempt at defending his flawed use of the arithmetic average is analogous to a fast-talking trickster at a carnival side-show act. In his oral surrebuttal testimony, Mr. Rothschild provided yet another proof the arithmetic average method is invalid by showing what was wrong with the coin toss example that Mr. Rosenberg has presented. T153:L9-25 (2/21/03). Mr. Rothschild showed that in all four coin toss case studies presented by Mr. Rosenberg, the geometric average produced a correct result, but the arithmetic average was incorrect in two of the cases. In the cases where the arithmetic average was correct, it got the same answer as the geometric average. Therefore, while the geometric average is always correct, the arithmetic average produces erroneous results. For example, Mr. Rothschild showed that in two of the four cases, the arithmetic average approach, which concluded that an investor did not lose any money, actually measured cases in which an investor started with $1 million, and after two coin tosses had only $75,000 left. Any method that concludes that an investor who lost 25% of his or her capital but measures that situation as a 0% return rather than a negative return must be wrong.T158:L5-25 and T159:L1-9 (2/21/03).

The arithmetic mean has been singled out by numerous sources as a method that will result in an answer that is upwardly biased. The U.S. Securities and Exchange Commission ("SEC") and Value Line have both recognized that the only proper way to measure long-term historic actual earned returns is to use the geometric mean.

In order to protect investors from misleading data, the SEC requires mutual funds to report historic returns by using the geometric average only. The arithmetic average is not permitted. The geometric average, or SEC method, has the compelling advantage of providing a true representation of the performance that would have actually been achieved by an investor who made an investment at the beginning of a period and re-invested dividends at market prices prevailing at the time the dividends were paid. *R-13*, p. 30.

On May 9, 1997, Value Line issued a report entitled "The Differences in Averaging". This report was contained on pages 6844-6845 of the "Value Line Selection & Opinion" portion of its weekly mailings to subscribers. This report says that:

> (t)he arithmetic average has an upward bias, though it is the simplest to calculate. The geometric average does not have any bias, and thus is the best to use when compounding (over a number of years) is involved.

R-13, p.34

The Value Line report then goes on to provide examples that show why the arithmetic average overstates the achieved returns while the geometric average produces the correct result. A complete copy of this Value Line discussion is attached to Mr. Rothschild Direct Testimony as Appendix B.

In addition, from 1928 to 1998, the arithmetic average method produced an indicated risk premium that was about 1.90% higher for public utility stocks versus public utility bonds than the risk premium indicated by using the SEC, or geometric average method. The arithmetic median method produced a 1.85% higher risk premium than is indicated by using the SEC, or geometric average method. *R-13*, p. 40.

Your Honor and the Board should not fall for carnival trickery that uses mathematical trickery to create an illusion that the cost of equity is higher than it really is. The arithmetic average approach put forward by Mr. Rosenberg deserves to be resoundingly rejected. Giving any weight to Mr. Rosenberg's use of the arithmetic mean rather than the geometric mean, it would dramatically further exaggerate the cost of equity. The Ratepayer Advocate submits that, based upon the record evidence, this exaggeration would be added to all of the equity costs overstatements caused by the errors in Mr. Rosenberg's implementation of the Risk Premium/CAPM method.

In sum, the Ratepayer Advocate recommends a 9.25% return on equity and submits that this is the appropriate figure to be adopted by your Honor and the Board for purposes of this proceeding.

POINT II

YOUR HONOR AND THE BOARD SHOULD REJECT ROCKLAND'S UNREASONABLE DEPRECIATION EXPENSE AMOUNT AND ADOPT THE RATEPAYER ADVOCATE'S RECOMMENDED AMOUNT WHICH REFLECTS THE USE OF THE NET SALVAGE ALLOWANCE APPROACH.

Depreciation expense is included in Rockland's revenue requirement and is passed on to ratepayers on virtually a dollar-for-dollar basis. Annual depreciation expense is determined by applying depreciation rates to plant investment. Depreciation rates are determined in depreciation studies. Typically, there are two components associated with the recovery of investment in plant. One is to recover invested capital, that is, money that has already been spent. Another component recovers estimated future net salvage, an expense that has not yet been incurred. At issue in this proceeding is the ratemaking treatment of estimated future net salvage, specifically as it pertains to the Company's annual depreciation expense and the proper level of its depreciation reserve excess.

A. Estimated Future Net Salvage Should be Removed from The Company's Depreciation Rates.

Net salvage is the difference between gross salvage and the cost of removal of the plant. Gross salvage is the amount recorded due to the sale, reimbursement, or reuse of retired property. The cost of removal is connected to disposing of retired depreciable plant. Net salvage is positive when gross salvage exceeds cost of removal. Net salvage is negative when cost of removal exceeds gross salvage. A positive net salvage ratio reduces the depreciation rate and depreciation expense, while a negative net salvage ratio increases the depreciation rate and depreciation expense. *R-36*, p.14.

In this proceeding, Rockland's estimated future net salvage ratios result in an unreasonably large mismatch between what the Company proposes to collect for negative net salvage in its test year depreciation expense, and what it has actually expended for net salvage. Rockland has incorporated $897,000 of annual negative net salvage recovery in its test year depreciation expense for transmission, distribution, and general plant. *R-36*, p. 15, Exhibit MJM-1,Sch. III-1. However, the Ratepayer Advocate's depreciation witness, Mr. Michael J. Majoros, found that over the five-year period ending 2001, Rockland had only experienced $43,000 of annual negative net salvage on average. *Id*., Exhibit MJM-1,Sch. III-2.

Mr. Majoros testified that the mismatch between the Company's actual net salvage experience and the net salvage amount included in its test year depreciation expense for transmission, distribution, and general plant results from Rockland's inclusion of future inflation in estimating net salvage expense. *R-36*, p. 15. Future inflation is included in the cost of removal estimates incorporated in the Company's depreciation rates. *Id.* Mr. Majoros found: "[t]he net salvage procedure proposed by RECO relates cost of removal in current dollars to retirements in very old historical dollars, thus resulting in very high cost of removal estimates." *Id.*, lines 11-13. Rockland's approach extrapolates inflation into the future, and then charges current ratepayers for that inflation.

The approach recommended by Mr. Majoros avoids the pitfalls inherent in the Company's proposal. Mr. Majoros recommends the use of a five-year average salvage expense allowance, which he calls the "net salvage allowance approach." *R-36*, p. 19. Under this approach, net salvage ratios are not calculated or included in depreciation rates. Instead, a separate calculation of the average annual net salvage expense is done by averaging the past five years of actual net negative salvage expense. This five-year average is then added to the annual depreciation expense and included in the reserve. The use of a multi-year average is similar to a normalized expense included in a utility's revenue requirement.

The principle underlying Mr. Majoros' recommended net salvage allowance approach was recognized by the National Association of Regulatory Utility Commissioners ("NARUC") in its publication entitled "Public Utility Depreciation Practices" ("NARUC depreciation manual"):

> Some commissions have abandoned the above procedure [gross salvage and cost of removal reflected in depreciation rates] and moved to current-period accounting for gross salvage and/or cost of removal. In some jurisdictions gross salvage and cost of removal are

> accounted for as income and expense, respectively, when they are realized. Other jurisdictions consider only gross salvage in depreciation rates, with the cost of removal being expensed in the year incurred. *R-35*, p. 158.

The NARUC manual further opines on the underlying rationale for treating removal cost as a current-period expense, instead of incorporating it in depreciation rates:

> It is frequently the case that net salvage for a class of property is negative, that is, cost of removal exceeds gross salvage. This circumstance has increasingly become dominant over the past 20 to 30 years; in some cases negative net salvage even exceeds the original cost of plant. Today, few utility plant categories experience positive net salvage; this means that most depreciation rates must be designed to recover more than the original cost of plant. The predominance of this circumstance is another reason why some utility commissions have switched to current-period accounting for gross salvage and, particularly, cost of removal. *Id.*, p. 158.

Here, Rockland falls within that group of utilities that will experience negative net salvage. Rockland's proposed depreciation expense includes an amount for negative net salvage, where its cost of removal will exceed its gross salvage. *R-36*, p. 15, Exhibit MJM-1, Sch. III-1.

As set forth more fully below, Rockland's proposed approach to the ratemaking treatment of net salvage is also at odds with current accounting thinking regarding net salvage. In his rebuttal testimony, Mr. Hutcheson cited a New Jersey Natural Gas Company case decided by the Board to support Rockland's position on the treatment of net salvage. However, the case cited by Mr. Hutcheson was decided in 1986, over 17 years ago.[4] Since that time, new developments have occurred in the treatment of obligations attendant to the removal of assets at the end of their service life.

Notably, in 2001 the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standards ("SFAS") Number 143 ("SFAS 143"or "FAS 143"), setting forth the treatment of Asset Retirement Obligations ("AROs") for financial statements issued for fiscal years beginning on or after June 15, 2002. *R-37*. Both Ratepayer Advocate witness Mr. Majoros

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[4] *RECO-29*, p. 3; *Re New Jersey Natural Gas Company*, BPU Dkt. No. GR851097 (Order Adopting and Modifying Initial Decision dated July 30, 1986); OAL Dkt. Nos. PUC 7317-85 and PUC 4993-85 (Initial Decision dated June 23, 1986).

and Company witness Mr. Hutcheson agree that SFAS 143 constitutes Generally Accepted Accounting Principles ("GAAP") at this time. *R-36*, p. 15-16; T120:L7-18 (2/25/03).

As Ratepayer Advocate witness Michael J. Majoros testified, the issuance of SFAS 143 supports a new look at how net salvage is treated for ratemaking purposes. "I believe that the regulatory paradigm has changed as a result of FAS 143." T190:L1-3 (2/25/03). Mr. Majoros went on to further explain the significance of the adoption of SFAS 143 as it pertains to the treatment of future costs of removal:

> It's [regulatory paradigm] changed because the concept underlying FAS 143 is that ... future costs will not be included in costs charged to current operations or costs charged to ratepayers unless the company can demonstrate a legal obligation to incur those costs. T190:L5-11 (2/25/03).

As demonstrated below and in the record, the net salvage allowance approach recommended by Mr. Majoros is consistent with the principles set forth in SFAS 143. *R-36*, p. 19.

For long-lived assets, SFAS 143 requires companies to determine whether they have "legal obligations" to remove retired assets. *R-36*, p.16, citing *R-37* (SFAS 143), paragraph 2. Such obligations are referred to as AROs in SFAS 143. *Id*. As Mr. Majoros testified, if a company has AROs, the ARO is considered to be a part of the cost of the asset and recorded as such. *Id*. But only the net present value, not the inflated future value, may be treated as such. *Id*. If a company does not have any AROs associated with assets, Mr. Majoros testified that any cost of removal would likely be expensed, pursuant to the terms of a comment draft of an American Institute of Certified Public Accountants Statement of Position ("AICPA SOP") on Property, Plant and Equipment. *Id*.

Rockland has not claimed any AROs in its books for its transmission and distribution assets, pursuant to SFAS 143. *RECO-59*. Although Rockland has indeed implemented SFAS 143 effective January 1, 2003, it acknowledges that it does not have any AROs for its transmission, distribution and general plant categories. *R-36*, pp. 17-18; *RECO*-29, p. 13; T112:22-T113:L1 (2/25/03). The absence of AROs for transmission, distribution and general plant categories means that Rockland does not have any legal obligations to incur any negative net salvage either now or in the future for those assets. Nevertheless, Rockland has increased its depreciation rates to collect future negative net salvage even though it does not have any legal obligation to incur such costs. Furthermore, Rockland has further increased its depreciation rates to include future inflation in those amounts. Rockland's approach is inconsistent with SFAS 143. As Mr. Majoros testified, these excess amounts will be treated as liabilities to ratepayers on Rockland's GAAP financial books. T141:L1-24 (2/25/03). Alternatively, under Mr. Majoros' proposal, consistent with SFAS 143, no retirement obligations would be reflected in the cost of assets, or the related depreciation rates. Instead, Mr. Majoros proposes the use of a five-year average to establish the proper expense level.

Mr. Majoros' net salvage allowance approach to measuring the net salvage allowance is also consistent with the measurement of the removal obligation found in SFAS 143. Mr. Hutcheson agreed that the net present value would be the proper measurement to value an ARO under SFAS 143. T95:L7-21 (2/25/03). In contrast, as discussed above, Rockland's proposed approach includes future inflation in its removal estimates. Here, Mr. Majoros' net savage allowance approach uses a five-year average of actual removal expenses. In testimony, Mr. Majoros succinctly laid out how his use of a five-year average is consistent with the use of net present value to measure removal costs:

> The net salvage approach ensures that the Company recovers the net present value of its actual costs, but eliminates the inclusion of future inflation in depreciation rates. In my opinion, this approach is consistent in substance with the principals of SFAS No. 143. *R-36*, p. 19.

Mr. Majoros' net salvage allowance approach is also consistent with the treatment set forth in a recent FERC Notice of Proposed Rulemaking ("NOPR") proposing to adopt SFAS 143 for the purpose of its Uniform System of Accounts and for ratemaking. Mr. Majoros testified on the position taken by the FERC in its NOPR: "[o]verall, FERC has taken the position that if a company does not have a legal asset retirement obligation, such costs are not included in current depreciation rates or expenses." T129:L13-17 (2/25/03).

In summary, Mr. Majoros' net salvage allowance approach is consistent with current GAAP and regulatory accounting principles as expressed by the FERC regarding the accounting and ratemaking treatment of net salvage. Other state regulators have also adopted the averaging approach advocated by Mr. Majoros. The Pennsylvania Public Utility Commission, Kentucky Public Service Commission, and Missouri Public Service Commission have accepted the five-year average approach advocated by Mr. Majoros.[5] *R-36*, p.19.

Furthermore, the net salvage allowance approach advocated by Mr. Majoros would not put the Company at risk of a shortfall. It would allow the Company to recover its actual current net salvage costs, just as any other operating expanse. In his direct testimony, Mr. Majoros explained how the Company is further protected from underrecovery:

> Using the whole-life technique, the Company is protected from underrecovery by virtue of its depreciation reserve level. The lower the reserve, the higher the resulting rate base and revenue requirement. *R-36*, p. 8, l. 2-4.

For the reasons set forth above, Your Honor and the Board should reject Rockland's proposed expense. Rockland's proposed depreciation rates will produce excessive depreciation expense and unnecessarily increase revenue requirements. *R-36*, p. 3, lines 4-5. Since depreciation expense flows dollar-for-dollar into the revenue requirement, excessive depreciation expense results in an excessive revenue requirement. *Id*., p. 4, lines 29-30. Instead, Your Honor and the Board should adopt the ratemaking treatment of net salvage recommended by Ratepayer Advocate witness Michael J. Majoros for both the Company's annual expense levels and the level of depreciation reserve excess.

Rejecting Mr. Majoros' recommendations would directly benefit Rockland and simultaneously impose an unjustified cost on its ratepayers. Although Rockland proposes a decrease

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5 *See Penn Sheraton et al. v. Pennsylvania Public Utilities Commission*, 198 *Pa. Super.* 618, 184 *A. 2d.* 234 (1962); *I/M/O Jackson Energy Cooperative Corporation for an Adjustment of Rates*, Ky. PSC Case No. 2000-373 (Order dated May 21, 2001); *I/M/O Adjustment of Rates of Fleming-Mason Cooperative*, Ky. PSC Case No. 2001-00244 (Order dated August 7, 2002); and *I/M/O Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules*, Mo. PSC Case No. GR-99-315 (Second Report and Order dated June 28, 2001).

in its annual depreciation expense, it should be much greater, as Mr. Majoros explains. Rockland proposes a $522,000 decrease in its annual expense for depreciation. Rockland's proposed test year depreciation expense is a net figure, comprised of a $66,000 increase in depreciation expense, offset by a proposed $588,000 annual amortization of it's calculated depreciation reserve excess. *RECO-30,* Exhibit P-2., Sch. 14. Mr. Majoros explains, however, that Rockland has understated the calculated reserve excess. It is actually $22.1 million. Consequently, Rockland has understated that amortization amount. It should be $1.1 million, and ratepayers would be harmed by acceptance of Rockland's overstated amount.

B. Rockland's Proposed Depreciation Expense Should Be Adjusted To Remove Net Salvage, And A Net Salvage Allowance Based On A Five-year Average Should Be Adopted.

Rockland has incorporated $897,000 of net salvage in its test year depreciation expense for transmission, distribution, and general plant. *R-36*, p. 15, Exhibit MJM-1,Sch. III-1. However, over the five-years ending 2001, the Company has only experienced $43,000 of net salvage on average. *Id.*, Exhibit MJM-1,Sch. III-2. The difference between the Ratepayer Advocate's and Rockland's positions is due to the Company's unsupportable and unreasonable net salvage request.

Mr. Majoros accepted the Company's changes in plant service lives and additions, which increased the annual depreciation expense by $66,000. However, Mr. Majoros reduced the Company's proposed depreciation expense to remove the expense attributable to net salvage, for a net decrease of $827,000 in the Company's test year depreciation expense. *Id.* Mr. Majoros also recommended that the Company be permitted to recover an amount equivalent to a five-year average of its net salvage expense, $43 million. *Id.*, p. 20.

C. Rockland's Proposed Amortization Of Its Depreciation Reserve Excess Should Be Adjusted To Reflect The Removal Of Net Salvage.

As recommended by Mr. Majoros, future net salvage should also be removed from the Company's calculation of its depreciation reserve excess. The Company calculated a depreciation reserve excess of $11.8 million, which it proposes to credit to its ratepayers over a 20-year amortization period. *RECO-28*, p. 5. Mr. Majoros removed net salvage for the reserve and computed a depreciation reserve excess of $22.1 million. *R-36*, p. 21, Exhibit MJM-1. Furthermore, Mr. Majoros' recommended adjustment to the depreciation reserve excess is very conservative. Although he accepted Mr. Hutcheson's estimates of service lives, Mr. Majoros found evidence that several of the service lives proposed by Rockland were too short. *R-36*, p. 14. Hence, Mr. Majoros further testified that the reserve excess might actually be even greater than $22.1 million. T125:L24-T125:L17 (2/25/03).

Mr. Majoros does not object to the Company's proposed 20-year amortization period for the excess. *Id*. Mr. Majoros' recommended adjustment for net salvage would increase the annual amortization credit associated with the depreciation reserve excess from $588,000 to $1.1 million. *Id*. The recommended increase in the amortization credit will provide an immediate benefit to Rockland's ratepayers and should be adopted.

POINT III

THE APPROPRIATE PRO FORMA RATE BASE AMOUNTS TO $106,304,000 WHICH IS $23,726,000 LOWER THAN THE PRO FORMA 8 + 4 RATE BASE PROPOSED BY ROCKLAND ELECTRIC COMPANY OF $130,030,000.

This section of the brief presents the Ratepayer Advocate's recommended overall position regarding the Company's revenue requirement. In the determination of the recommended revenue requirement for Rockland in this case, the Ratepayer Advocate relies upon the recommendations made by several other Ratepayer Advocate expert witnesses. Specifically, the Ratepayer Advocate relies upon the return on equity number recommended by James A. Rothschild, the Ratepayer Advocate's return on equity expert, and the depreciation rate and resulting depreciation expense recommendations made by Michael J. Majoros, the Ratepayer Advocate's depreciation expert.

The Company selected the twelve month period ending April 30, 2003 as the test year. *RECO-10*. The Ratepayer Advocate's witness, Robert J. Henkes, recommended numerous rate base adjustments in his testimonies in this proceeding. The adjustments recommended herein are based upon the "8+4" filing (*RECO-11A),* as further reflected in the schedules attached to the Supplemental Direct Testimony of Mr. Henkes. *R-51*. The Company's proposed pro forma rate base is $130,030,000, based on 8+4 filing data.[6] The Ratepayer Advocate recommends a pro forma rate base of $106,304,000 by making various rate base adjustments with the net effect of decreasing the Company's proposed rate base by a total amount of $23,726,000. Each of these recommended rate base adjustments are discussed in detail below.

The difference between the Company's and Ratepayer Advocate's positions, after the 8+4 update, is significant: the Company's latest 8+4 filing position is that it can justify a rate increase of approximately $6.3 million. By comparison, the Ratepayer Advocate's current 8+4 updated position is that the Company's distribution rates should be decreased by approximately $5.3 million. This is a difference of approximately $11.7 million.

6 The 12 + 0 will be provided by the Company after the Initial Decision is submitted on May 1, 2003.

The Ratepayer Advocate witnesses, Majoros' and Rothschild's adjustments for the rate of return and depreciation rate issues, taken together, make up approximately $3.7 million of the total difference of $ 11.7 million. That leaves approximately $8 million worth of remaining issues in the rate base and operating income portions of the case. The largest of these rate base and operating income issues that result in a $77 million revenue requirement reduction are the following:

		Revenue Requirement Impact
- Removal of post-Test Year plant additions:		$3.7 million
- Removal of Incremental Reliability adjustment		$1.4 million
- Removal of 25% Stockholder Share of Alleged Merger Savings		$0.7 million
- Pension and OPEB expense adjustments		$0.5 million
- Removal of Incentive Compensation expenses		$0.4 million
- Removal of Common Exp. Allocator adjustment		$0.4 million
- Lead/Lag Study CWC adjustment		$0.3 million
- Other Operating Revenues and Late Payment Rev. adjustment		$0.2 million
- Miscellaneous Other rate base and expense adjustments		$0.4 million
	Total	$8.0 million

Additionally, once the Company files its 12+0 update, the 8+4 filing will similarly be updated based on the Company's 12+0 updates. It is currently anticipated that the 12+0 update of this testimony will be filed at the Board sometime during the third week of May, 2003.

A. Rate Base And Expense Adjustments.

1. Electric Plant in Service

As shown in the first column of Schedule RJH-5 (8+4 Update), the Company started out with the actual electric plant in service balance as of December 31, 2002. *R-51.* It then added projected test year net plant additions in order to arrive at the projected test year-end electric plant in service balance as of April 30, 2003. *R-51*, Sch. RJH-5, lines 1 - 3. Next, it added proposed electric plant in service additions for the Hourly Energy Pricing Billing and Enhanced Service Reliability Program projects. *R-51*, Sch. RJH-5, lines 4 - 5.

Finally, the Company added projected post-test year plant that, under current projections, is expected to come on line between May 2003 and May 2004. The resulting pro forma adjusted test year-end electric plant in service balance proposed by Rockland is $201,614,000.

The projected "within-the-test-year" plant additions will eventually be restated on an actual basis as of April 30, 2003 in the 12+0 filing. While the Company has reflected "within-the-test year" net plant[7] growth from December 1, 2002 through April 30, 2003 of approximately $1,886,000.00, it is additionally claiming approximately $25.4 million of projected plant additions that, under current proposals, are projected to come on line between May 2003 and May 2004. These proposed post-test year plant additions are discussed in the Direct Testimony of Company witness Angelo M. Regan and are shown in detail on Rockland filing Exhibit P-3, Schedule 16. *RECO-1*. Rockland witness Frank Marino states on page 13 of his Direct Testimony that, "[t]hese projects are either underway or will commence during or shortly after the test year." *RECO-30*. The Darlington Substation project has a projected cost of almost $16 million and makes up over 60% of the total projected post-test year plant additions of $25.4 million. This project is not scheduled to commence until after the April 30, 2003 end of the test year and is not expected to be completed until May 2004 at the earliest, a point in time that extends 13 months beyond the end of the test year. Based upon the cross examination of Mr. Regan, transcript request responses, and the live surrebuttal testimony of Mr. Henkes, the record shows that the Darlington Project, in the best case, can not be completed until 2005. *RECO-55*; see Exhibit A, pp. 1-3, and 9, attached hereto. As noted by Mr. Henkes on live surrebuttal, and Mr. Marino on cross examination, no requisition forms have been issued, no vendor quotes or requests for bids have issued, no bid specification packages including construction drawings have been prepared, and no contracts awarded.

> Q. Now, with respect to Darlington, isn't it true that no requisition forms have been issued by the Company; is that correct?
>
> A. I believe I remember Mr. Regan saying that, yes.

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[7] Net plant represents gross plant net of plant retirements.

> Q. And the practice is before you can issue bid and proposals, you have to have a requisition form internally, right, authorizing the issuance of bid and proposals; is that correct?
>
> A. I'm not familiar with the ins and outs of getting authorization, but generally that's my understanding.
>
> Q. That's your understanding? And no bid and proposals have been issued with respect to any of the items that were shown for the Darlington projects on the spreadsheets that were discussed with Mr. Regan on Tuesday; is that correct?
>
> A. And I think Mr. Regan said that the packages are being prepared as we speak. If I remember correctly, that was talking about Darlington and that those were going to be released in the near future.
>
> T217:L24-T218:L22 (2/28/03).

More importantly, the Darlington Substation Planning Team Report ("Darlington Report") shows that the Darlington project is not even needed until 2005, 20 months after the test year ends. *R-26.*

The Darlington Report clearly states that the Darlington project is not needed in the second bullet on page 3 of the report. Mr. Regan confirmed this on cross examination. T20:L9-12, T20:23-T21:3 (2/25/03). Rockland's responses to two transcript requests made by the Ratepayer Advocate on February 25, 2003 do not support the assertion that the Darlington project is needed no later than 2004. T21:L10, T71:L13, T72:L2 (2/25/03); see Exhibit A, pp. 1-3, and 9, attached hereto. The actual load as of 2002 reported for the Allendale circuits is only 2.6 MVA. The Ratepayer Advocate notes that when 2.6 MVA is adjusted to megawatts, the trigger point is in the lower range cited in the Darlington Report. In addition, Rockland has failed to demonstrate how the low end of the range of the Allendale circuits, coupled with the substantial reduction in United Parcel Service demand (5.5 MVA vs. 9.5 MVA), requires implementation of this project prior to 2005. In addition, the response to the second transcript request reveals that the most recent Distribution Planning 2003-2007 Distribution Contingency Analysis and Forecast ("2003-2007 Forecast") shows that construction should begin in 2004, not that it should be completed in 2004. If one looks at the the Darlington Substation milestone report attached to *RECO-55*, the construction stage was to begin in February 2003 and conclude 13 months later. The requisition process and bid package development has not even begun and the requests for bids for the construction and equipment has yet to begin. In the best case, the proposed schedule has a 4 to 6 month slip already. Based upon the 2003-2007 Forcast, if construction was to begin in 2004, it would not be completed until some time in 2005. The Darlington Project should be removed from this rate case, based upon the foregoing, and based upon Board precedent discussed below.

On page 13 of his Direct Testimony, Rockland witness Frank Marino lists the following reasons why he believes the inclusion of all of the Company's projected post-test year plant additions should be approved by the Board:

> Mr. Regan's testimony demonstrates that the capital additions are known and measurable changes appropriate for inclusion in rate base. In addition, this filing is not a typical rate case filing. While the Board has ordered RECO to file this rate case by October 1, 2002, rates will not become effective until August 1, 2003. The additions to rate base will occur during the first twelve months that new Distribution rates are effective…

RECO-30

Rockland's claim that these projected post-test year plant additions can be considered known and measurable is not supported by the record or the facts now in evidence. The Company's statement that the projected post-test year plant additions are "based on known and valid historical costs" falls far short of meeting the Board's "known and measurable" standard, which requires that such projections must be "carefully quantified through proofs which manifest convincingly reliable data." See *I/M/O Elizabethtown Water Company,* Decision On Motion For Determination Of Test Year And Appropriate Time Period For Adjustments, BRC Docket No. WR8504-330, dated May 23, 1985 ("*Elizabethtown Water Company Rate Case*"). *R-16.* It should also be recognized in this regard that the majority of these projected post-test year plant additions will not be verifiable with actual results by the time the record in this proceeding closes.

The Board permits the inclusion in rate base of post test-year plant additions that are "known and measurable" in accordance with the Board's standard set forth in its May 23, 1985 Order in the *Elizabethtown Water Company Rate Case*, BPU Docket No. WR8504-330. *R-16.* The Board policy regarding the criteria for rate recognition of post test year rate base additions, as stated on page 2 of this Board Order, is as follows: "changes to rate base for a period of six months beyond the end of the test year, provided there is a clear likelihood that such proposed rate base additions shall be in service by the end of said six-month period, that such rate base additions are major in nature and consequence, and that such additions be substantiated with very reliable data…" *R-16*, p. 2.

Since the test year in this case ends April 30, 2003, six months beyond the end of the test year in this case would be October 31, 2003. Thus, in accordance with the previously referenced Board policy, rate base additions through October 31, 2003 could receive rate recognition in this case, if the Company can prove with convincingly reliable data that such post-test year plant additions will indeed be in-service at that time, and if the Company's projected costs for these post-test year plant additions can be substantiated with very reliable data. The Company has not met these standards for the great majority of its proposed post-test year plant additions.

As pointed out in the cross examination of Mr. Marino, the policies adopted in the *Elizabethtown Water Company Rate Case*, *supra*, apply to all utilities in New Jersey. T31:L6-15 (2/25/03) and *R-16*.

A closer look at the Company's proposed post-test year plant additions within the context of this Board policy shows that Your Honor and the Board must reject Rockland's proposal for post test year additions to plant in service. The total post test-year plant additions claimed by Rockland in this case are $25.4 million. Approximately $15.7 million of these total post-test year plant additions of $25.4 million concerns the Darlington Avenue project. As discussed above, the Company will not start this project until June 2003, or two months after the end of the test year, and the project is not expected to be completed until May 2004, which is approximately 13 months after the end of the test year in this case. As shown in the schedules attached to Mr. Regan's Rebuttal Testimony, up to today, the Company has performed some preliminary work at a total actual cost of around $100,000. The rest of the total projected cost amount of $15.7 million rests on mere estimates. Therefore, not only does the projected completion date fall 7 months beyond the 6-month post-test year standard deemed reasonable by the Board, but, almost the entire $15.7 million project cost still rests on estimates without any requisitions, approvals or bid drawing prepared for the solicitation of bids and proposals on this project. T24:L12-17, T218:L1-25 (2/28/03), *RECO-55*. Estimates alone do not meet the required standard of convincingly reliable data.

The remaining $10 million in post-test year Upper Saddle River and Oakland projects also fail to meet the Board policy. The total Upper Saddle River project cost is projected to be approximately $7.5 million. As shown in Schedules AMR-1, 2 and 3 attached to Mr. Regan's Rebuttal Testimony, and in *RECO-27* and *RECO-27A*, approximately $3.4 million of the total $7.5 million project cost is currently not scheduled to be in-service until November/December 2003, or approximately 8 months beyond the end of the test year. Only $166,000 of this project portion of $3.4 million has actually been spent to date. Based on this information, the $3.4 million portion of the Upper Saddle River project fails the allowable post-test year rate base addition standards set by the Board. Mr. Regan's Rebuttal Testimony shows that of the remaining Upper Saddle River project cost of $4.1 million, approximately $1.8 million has been spent to date, and the associated projects are expected to be in-service between December 2002 and September 2003. While this Upper Saddle River project cost portion of $4.1 million would appear to be much closer to being in compliance with the Board's post-test year rate base addition policy, there is just no reliable information to support that this project will be complete within 6 months after the end of the test year. Therefore, this project should be excluded.

According to the Upper Saddle River milestone schedule attached to *RECO-54*, construction was to begin on October 29, 2002. In a March 7, 2003 response to a transcript request made by the Ratepayer Advocate, Rockland indicates that the contract for the construction is expected to be awarded on April 29, 2003. T60:L21 (2/25/03). This is a six month slip in the schedule for this project, which pushes completion into 2004.

Finally, there is the proposed post-test year plant addition of approximately $2.4 million for the Oakland project. As shown in the rebuttal schedules of Mr. Regan, *RECO-27* and *RECO-27A*, approximately $900,000 of this $2.4 million has been spent to date, and this project is expected to become plant in service by the end of June 2003. Again, while this Oakland project of $2.4 million would appear to be much closer to being in compliance with the Board's post-test year rate base addition policy, significant portions remain incomplete and unverified. *RECO-53*. Rockland provided a complete milestone schedule for this project in response to a transcript request by the Ratepayer Advocate on February 25. T26:L18 (2/25/03); see Exhibit A, pp. 4-7, attached hereto. In addition, the Ratepayer Advocate made a transcript request on February 25, 2003, as to whether the shipping schedule for the transformer had changed as reflected in *R-29*. T37:L10 (2/25/03). On March 7, 2003, Rockland responded that no other delivery schedule has been received. See Exhibit A, p.8, attached hereto. Based upon the response contained in *R-29*, the dates on the revised schedule have not been met. On cross examination, Mr. Regan committed to update any subsequent reports identified in *R-29*. T43:L15-23 (2/25/03). Based upon the updated milestone schedule for the Oakland project, slippage is occurring in the construction and delivery schedule for the transformer and circuit breakers. Construction completion has slipped to April 13, 2003, the transformer delivery date is slipping with no firm date issued by the manufacturer, and the circuit breaker has slipped from October 2002 until March or April 2003. Lastly, only an estimate of the labor needed from O&R forces is available and no definite milestone schedule is available as to when that work will actually be completed, as opposed to just proposed. Therefore, the Oakland project cost should be excluded from rate recognition in this case.

An additional reason for rejecting all of the proposed plant additions is that Rockland, between 1997 and 2002, completed plant additions of approximately $25.872 million. *R-40*. However, Rockland never thought it necessary to seek a rate increase. Rockland has offered no evidence as to why it needs a rate increase now, when no rate increase for additions to plant in service were requested during the period from 1991 through 2002.

Rockland's reliance on Mr. Marino's argument that this is not a typical rate case filing is misplaced. The Board ordered the filing to be made October 1, 2002 with rates effective August

1, 2003. The rate effective date is 9 months after the initial filing date. This, in fact, is a very typical time frame for processing a rate case in New Jersey. By way of example, consider the pending PSE&G electric rate case.[8] PSE&G filed its rate case on May 24, 2002, based on a test year ending December 31, 2002, and will not have its new rates effective until August 1, 2003, or 7 months after the end of the test year used by PSE&G. Yet PSE&G did not propose any post-test year plant additions in its rate filing. Thus, Rockland has not shown or offered convincing reasons why a filing date of October 1, 2002 combined with a rate effective date of August 1, 2003 should justify rate recognition for the large post-test year plant additions claimed by Rockland in this case.

Even if Your Honor permits the post test year plant in service addition - which Your Honor should not- there is another reason why the Company's proposal should be disallowed. The Company's proposed post-test year approach violates the integrity of the test year and the matching principle. For example, while the Company essentially proposes to include in rate base its proposed plant in service balance as of May 2004, it did not propose the same for the offsetting depreciation reserve account. Specifically, rather than bringing its entire embedded depreciation reserve included in rate base forward to May 2004, the Company reflected the April 30, 2003 embedded depreciation reserve, adjusted only for one year's worth of depreciation on the post-test year plant additions (worth $.7 million[9]). If the Company had brought its entire embedded depreciation reserve balance forward to May 2004 (the same point in time as for the proposed plant in service balance), this would have resulted in an additional depreciation reserve rate base deduction of approximately $4 million[10] rather than the $.7 million recognized by Rockland in this case. The Company's failure to do so represents a serious mismatch in these two rate base components.

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[8] BPU Docket No. ER02050303; OAL Docket No. PUC 5744-02.

[9] See *RECO-10,* Exhibit P-3, Schedule 5; *R-51*, Sch. RJH-6, line 6.

[10] Total annual depreciation accruals of approximately $4.7 million, less estimated depreciation reserve retirements of $.7 million.

In its Decision and Order in a prior New Jersey Natural Gas base rate case,[11] the Board established the rate making policy that if the Company proposes to reflect plant additions projected to be in service 6 months after the end of the test year, the Company should similarly bring its entire embedded accumulated depreciation reserve balance forward to that same point in time, i.e., 6 months after the end of the test year. *R-41*. In this regard, the Board states on page 8 of this Decision and Order:

> The Board FINDS this consistent with the principle of including in plant six months of post-test year additions. Depreciation expense should therefore be calculated in this case for this additional 6-month period, and the **accumulated reserve account should be extended out for the entire plant the additional six months**….(emphasis added)

The Company did not bring its entire accumulated depreciation reserve forward to September 30, 2003. Moreover, the Company did not reflect the incremental revenues from post-test year customer growth up to September 30, 2003. This is why the remaining Upper Saddle River project cost of $4.1 million that is projected to come on line by September 30, 2003 should also be rejected for rate making purposes in this case.

Another mismatch that is inherent in the Company's proposed post-test year ratemaking approach is the fact that Rockland has reflected plant additions from April 30, 2003 to May 2004, but has failed to reflect corresponding electric utility plant retirements during the same period.

Finally, while the Company proposes rate base inclusion and annualized depreciation expenses for plant additions extending to May 2004, it has not proposed to reflect offsetting revenue growth from projected customer growth through May 2004, or offsetting expense reductions resulting from the implementation of these plant projects. In response to RAR-A-14, Rockland claims that the additions for plant in service are primarily required to increase system reliability and are non-revenue producing projects. See cross examination of Mr. Marino, T21:L7013 (2/28/03).

[11] Final Order Adopting in Part and Modifying in Part the Initial Decision, *I/M/O the Petition of New Jersey Natural Gas Company for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions*, BPU Docket No. GR89030335J (dated July 17, 1990). *R-41*.

This is directly contrary to the Darlington Report, which tied the need for the project to increases in customer demand. *R-26* at 7. This is also inconsistent with the Direct and Rebuttal Testimony of Mr. Regan, *RECO 26, RECO-27*, wherein Mr. Regan states that growth in demand, load growth, is driving these projects. *RECO-26* at p. 3 , lines 10- 21, p. 5, lines 6- 21, *RECO-27*, p. 2, lines 9 and 22. As a result, Your Honor and the Board should reject Rockland's proposal for electric plant in service additions in this rate case. Therefore, the post test year additions of $25.4 million do not deserve rate recognition.

2. Enhanced Service Reliability Program

As part of this rate case, the Company is proposing to initiate an Incremental Reliability Program, which it claims will provide Rockland's customers with enhanced service reliability. The program is discussed in detail in Mr. Regan's Direct Testimony. *RECO-26*, pp. 8-11. The program involves (1) incremental distribution automation efforts; (2) enhancements in the existing lightning protection program; (3) incremental transmission line maintenance activities; (4) a 10-year pole inspection and treatment plan; (5) underground cable rebuilding enhancements; and (6) various other incremental system reliability efforts. Mr. Marino's Direct Testimony makes the following statements with regard to this proposed initiative:

> The incremental Reliability Program is over and above RECO's base reliability initiatives and is designed to improve reliability of service to our customers. If the Board does not approve this program, RECO does not intend to implement it.

RECO-30, pp. 26-27.

The program has increased the Company's proposed net rate base by $1.294 million.[12] Furthermore, the test year expenses include $40,000 for depreciation expenses and $1,141,000 for annual O&M expenses associated with this project. All of this is equivalent to a revenue requirement of $1,360,000. This represents almost 22% of the Company's requested updated rate increase of $6.332 million in this case.

[12] $1,490,000 plant in service, net of $40,000 depreciation reserve and $156,000 of accumulated deferred income taxes ("ADIT"), equals net rate base impact of $1,294,000.

The Company is required, under *N.J.S.A.* 48:2-23, to provide "safe adequate and proper service" as part of its obligations as a public utility. As a result, the rates now being charged and the new proposed rates, which permit a reasonable rate of return to the Company, should already include all amounts necessary to meet this statutory obligation. The unadjusted test year rate base and expenses should already include all of the capital expenditures and operation and maintenance expenses associated with rendering safe, adequate and proper service now and in the future. The Company should not be seeking additional funds for doing what it is already required to do. The costs for further improvements in service reliability should already be factored into its proposed rate structure. As mentioned before, the cost of this discretionary program is almost 22% of Rockland's rate increase request in this case. Considering that the ratepayers are already facing a $38.6 million, or 28%, increase in their rates as a result of Rockland's pending Deferral Case,[13] the Ratepayer Advocate believes it would be bad timing and poor rate making practice to permit the Company to qualify its obligations for safe, adequate and proper service by proposing a discretionary program – designed to merely augment what they are now required to do -- that would drive up the cost to ratepayers by another $1.4 million. Therefore, the Ratepayer Advocate recommends that Your Honor and the Board disallow cost inclusion for the Company's proposed Incremental Reliability Program for ratemaking purposes in this case.

Schedules RJH-5, line 5, RJH-6, line 5, and RJH-8, line 5 (8+4 Update), *R-51*, show the reversal of the Company's proposed plant in service, depreciation reserve and accumulated deferred income tax entries associated with this program. Schedules RJH-4, line 6 and RJH-17, line 3 (8+4 Update), *R-51*, show the reversal of the Company's proposed operation and maintenance and depreciation expenses associated with this program.

3. Electric Plant Depreciation Reserve

As shown on Schedule RJH-6, (8+4 Update), the Company started out with the actual plant depreciation reserve balance as of December 31, 2002. *R-51*. It then added projected test year

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[13] Direct Testimony of Mr. Marino, *RECO-30*, p. 6, lines 15 – 19.

reserve additions for the 4-month period 1/01/03 – 4/30/03 in order to arrive at the projected test year-end plant depreciation reserve balance as of April 30, 2003. *R-51*, Sch. RJH-6, lines 1-3. Next, it added one year's worth of amortization/depreciation for the proposed plant projects for Hourly Energy Pricing Billing and Enhanced Service Reliability Programs. *R-51*, Sch. RJH-6, lines 4-5. Next, it added one year's worth of depreciation accruals associated with the projected post-test year plant additions. *R-51*, Sch. RJH-6, line 6. Finally, the Company reflected the impact on its plant depreciation reserve balance of its proposed annualized depreciation expense and theoretical reserve amortization adjustments. *R-51*, Sch. RJH-6, line 7. The resulting pro forma adjusted test year-end plant depreciation reserve balance proposed by Rockland is $67.491 million.

The Ratepayer Advocate's recommended adjustments sponsored by Mr. Henkes and the resulting Ratepayer Advocate recommended pro forma test year-end plant depreciation reserve balance are shown on Schedule RJH-6 as $65,330,000, (8+4 Update). *R-51*. Consistent with the Ratepayer Advocate's recommendation that the Company's proposed Enhanced Service Reliability Program not be reflected for ratemaking purposes in this case, the Company's proposed depreciation reserve impact associated with this program is removed. This is shown on Schedule RJH-6, line 5 (8+4 Update), *R-51*. On line 6 of Schedule RJH-6 (8+4 Update), *R-51*, the depreciation reserve impact of the Company's proposed post-test year plant additions is removed. On line 7, of Schedule RJH-6, (8+4 Update), *R-51*, the depreciation reserve impact of the Company's proposed annualized depreciation expense and theoretical reserve amortization adjustments is removed in order to reflect the depreciation expense positions recommended by Ratepayer Advocate witness Mr. Majoros in this case.

As shown on line 8 of Schedule RJH-6, (8+4 Update), *R-51*, the previously discussed adjustments result in a recommended pro forma test year-end plant depreciation reserve level of $65.330 million.

4. Lead/Lag Study Cash Working Capital

The Company's proposed lead/lag study cash working capital requirement is summarized on filing Exhibit P-3, Schedule 8, page 2 and is described on pages 19 – 24 of Mr. Marino's testimony. *RECO-10* and *RECO-30*. The lead and lag days employed in the lead/lag study have been determined based on study data for the most recent calendar year period, 2001. These leads and lags were then applied to the revenues, expenses, taxes and return on capital for the test year in this case, the 12-month period ended 4/30/03. The Company's lead/lag study indicates a cash working capital requirement of $6.528 million.

The Ratepayer Advocate accepts the lead/lag days proposed by the Company. However, the Ratepayer Advocate disagrees with Mr. Marino's proposal to include in the study non-cash expenses (such as deferred expenses, depreciation and amortization expenses, and deferred income taxes) and the return on invested capital with assumed payment lags of 0 days.

The Ratepayer Advocate recommends that a properly conducted lead-lag study should: (1) *exclude* all non-cash expenses such as deferred expenses, depreciation and amortization expenses, deferred income taxes and deferred investment tax credits; (2) *exclude* the return on equity; and (3) *include* debt interest with appropriate payment lags. In general, the appropriate cash working capital should be based on the timing differences between the payment of cash expenses and taxes and the receipt of cash operating revenues. Deferred expenses, depreciation and amortization expenses and deferred income taxes and investment tax credits simply do not represent or require cash outlays during the lead/lag study period. Therefore, these non-cash expenses should be removed from the lead/lag study.

The policy to remove deferred taxes from the lead/lag study in calculating the appropriate cash working capital requirement was most notably established in a prior PSE&G base rate proceeding, BPU Docket No. ER85121163. The Board reiterated this rate making policy in a subsequent rate case involving Elizabethtown Gas Company, BPU Docket No. GR88121321. On page 7 of its Order[14] in that case, the Board stated with regard to this cash working capital issue:

> Cash Working Capital
>
> ...Petitioner presented a lead-lag study to calculate cash working capital requirements....
>
> With respect to deferred taxes, Petitioner recommended including deferred taxes of $1,259,000 as a component of its cash working capital requirements. Petitioner argued that there was a collection lag in recovering deferred taxes because of the deferred tax liability associated with utility plant. Rate Counsel recommended that deferred taxes be excluded from the lead-lag study since deferred taxes are a non-cash item and do not require investor supplied capital.
>
> Staff recommends that deferred taxes be excluded from the lead-lag study. Staff contends that this recommendation is consistent with prior Board treatment of deferred taxes, most notably in the PSE&G rate case, (Docket No. ER85121163) wherein the Board removed deferred taxes from cash working capital. The ALJ was persuaded by Staff's argument as to the proper rate making treatment for deferred taxes. The ALJ recommended that deferred taxes be deducted from operating revenues in the working capital allowance for purposes of this proceeding. Initial Decision p. 21. The Board FINDS the ALJ's determination on deferred taxes to be reasonable and consistent with Board policy. Therefore, the Board ADOPTS the ALJ's conclusion on this issue...

The above Board ruling clearly establishes the rate making policy that deferred taxes are not to be considered in a lead/lag study for purposes of determining the appropriate cash working capital requirement in a rate proceeding.

Even if one were to assume that there is a cash working capital requirement associated with the return on equity, this effect should already be incorporated in the equity return required by the common stock investor. The Company is essentially taking the position that the common shareholder is entitled to the return on his equity investment at the exact instant that service is rendered. The Ratepayer Advocate disagrees with this fundamental assumption. While it may

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14 Order Adopting In Part And Modifying In Part The Initial Decision, *I/M/O The Petition Of Elizabethtown Gas Company For Approval Of Increased Base Tariff Rates And Charges For Gas Service And Other Tariff Revision*, BPU Docket No. GR88121321, OAL Docket No. PUC228-89 (dated February 1, 1990).

sound appropriate that the common shareholder is entitled to the return on his or her equity investment, it is a fact that the shareholder receives his or her return through the quarterly payments of dividends and any gain in the Company's stock. This is the mechanism by which the common shareholder is compensated in the real world.

The Georgia Public Service Commission ("Georgia PSC") recognized this timing issue, and has held that it is inappropriate to assume that there is a cash working capital requirement associated with the return on equity and thus should be removed from any cash working capital calculation.

> It is error to include recognition of an alleged cash working capital requirement associated with a return on common equity. There is no such requirement. Even if one were assumed, an allowance for this has already been made by virtue of how the Commission sets the cost of equity.

Atlantic Gas Light Company, 119 *PUR* 4th 404, 408 (1991).

For the aforementioned reasons, the Ratepayer Advocate recommends that the return on equity be removed from the lead/lag study. *R-51*, Sch. RJH-7, (8+4 Update).

Interest expenses for long-term debt are included as part of the Company's revenue requirement. Therefore, the rates paid by Rockland's customers are set so as to produce, in addition to other amounts, the sums necessary to pay interest to bondholders. As utility services are used, the Company receives money from its ratepayers that partly serves to enable the Company to pay interest to its bondholders. However, the Company does not have to pay its bondholders interest immediately. It only pays interest to its bondholders twice a year. Thus, while long-term interest expense accrues on a daily basis, it is paid out semi-annually in a lump sum. This means that, on average, interest on long-term debt has a payment lag of 91.25 days (365/4). Stated differently, this means that the Company, from the moment it receives the revenues to cover its long-term debt interest expenses, until the time it actually pays out the interest expenses to its bondholders, has such funds available for general working capital purposes.

There have been several Board decisions holding that long-term debt interest should not be included in a lead/lag study. These precedents hold that a zero (0) day lag should be assigned to long-term debt payments because the return on investment is the property of investors when service is provided. See, *I/M/O Atlantic City Electric Company*, BPU Docket No. 8310-883, OAL Docket No. 8543-83 (1984); *I/M/O Public Service Electric and Gas Company,* BPU Docket No. 837-620 (1984). However, this position is inconsistent with the manner in which other cash flow items are handled in a lead/lag study. Moreover, commissions in other states, such as the Georgia PSC, have held that it is appropriate to include interest on debt and preferred dividends with appropriate payment lags in a lead/lag study:

> As should be abundantly clear, it is error not to include elements of a lead-lag study the net payments of interest on long-term debts and dividends on preferred stock. These two elements are sources of funds utilized to reduce cash requirments.

Atlantic Gas Light Company, 119 *PUR* 4th at 408 (1991).

For example, few would agree that the Company becomes entitled to its revenues on the day that service is provided, or that employees are entitled to their salaries on the day that service to the company is rendered. The lead/lag study examines the actual cash flows, not the incurring of an expense or liability, in determining the Company's cash working capital requirement. Interest expense should be treated in a similar manner.

The interest payments to be made to the bondholders are fixed by contract. They cannot be made earlier or later than the specified date. In this, the bondholders are like the tax collector or any other creditor of the Company. To refuse to consider the source of working capital from the interest payment lag has the impact of penalizing the ratepayers who are providing revenues to pay all expenses, including interest expenses, and it would provide a "windfall return" to the Company's stockholders. The bondholder, who has a fixed interest on his bond, will not receive any benefits from the act of excluding the interest payment lag from working capital considerations. It will be the common stockholder who will be allowed to earn a return on such available funds, collected from the ratepayer through rates, if this interest payment lag is not recognized for rate making purposes. For all of these reasons, debt interest expenses should be included with the appropriate payment lag in the lead/lag study to determine the Company's cash working capital requirement.

The Ratepayer Advocate recommends the adoption of the revised lead/lag study calculations set forth on Schedule RJH-7 (8 + 4 Update), *R-51*. As shown on this schedule, the non-cash deferred expenses, depreciation and amortization expenses, and deferred income taxes are removed, as well as the entire Return on Capital line item, while adjusting the Company's proposed pro forma long term debt interest with a payment lag of 91.25 days.

As shown on Schedule RJH-7 (8+4 Update), *R-51*, the appropriate lead/lag study cash working capital requirement to be recognized for rate making purposes in this case amounts to approximately $4.4 million. As summarized on Schedule RJH-3, line 11a (8+4 Update), *R-51*, this is approximately $1.8 million less than the lead/lag study cash working capital requirement of approximately $6.5 million claimed by the Company.

5. Unamortized Research and Development ("R&D") Expenditures

In the Company's prior rate case, the Board approved a stipulation providing for rate recovery, by way of 20-year amortization, of certain R&D expenditures associated with a canceled coal burning technology project. The annual amortization is included in the test year cost of service as Account 930 -Miscellaneous General expense. The Company has also proposed to include in rate base the unamortized expenditure balance net of associated deferred income taxes. The Ratepayer Advocate recommends that Your Honor and the Board reject this proposal. While the Board allowed rate recovery through amortization, inclusion of the unamortized expenditure balance in the rate base is not provided for in the prior Rockland rate case stipulation or Board Order approving the stipulation. These costs claimed by Rockland concern expenditures that are being written off as a result of an abandoned project which has never been, and never will be, used and useful in servicing the ratepayers. The Board has a long-standing and well-established policy that costs associated with abandoned projects, if prudently incurred, must be shared between ratepayers and stockholders. In the past, the Board has implemented this sharing concept by having the ratepayers pay for the amortization and the shareholders pay for the carrying costs of the unamortized cost balance. Your Honor and the Board should continue this policy with regard to these unamortized

R&D expenditures. As shown on Schedule RJH-3, line 12 (8 + 4 Update), *R-51*, the unamortized cost balance is removed from rate base.

6. Unamortized Board Audit Costs And Ramapo Tax Over-Refunds

In its 3+9 filing, the Company requested rate recognition in this case for certain deferred BPU audit costs and certain over-refunded property taxes. The deferred Board audit costs of $77,000 incurred by the Board's consultant in 2000 for a Competitive Services Audit were charged to and deferred by Rockland at that time. The over-refunded property taxes concern an excess customer refund for $154,000 of Ramapo property taxes through Rockland's former LEAC, which the Company deferred for future rate reimbursement when the LEAC was terminated. The Company proposes to amortize these two deferred items over three years and include the unamortized balance in rate base. A review of page 18 of Rockland's monthly reports, *R-43*, indeed indicates that Rockland currently carries these two deferral balances of $77,000 and $154,000 on its books in its Miscellaneous Deferred Debits account.

The Ratepayer Advocate submits that the Company's proposal to include the unamortized deferral balances in the rate base is contrary to Board policy and that these two unamortized balances be removed from the rate base. In addition, the Ratepayer Advocate recommends that these deferred items be amortized over a 5-year period rather than the 3-year period proposed by Rockland. This recommendation is consistent with the 5-year amortization periods recommended by the Ratepayer Advocate for rate case expenses, the storm damage reserve build-up, and the pension expense over-recovery balance, each of which will be discussed in more detail in subsequent sections of this brief. The Company's position with regard to this issue in its updated 8+4 filing schedules is summarized in the first column of Schedule RJH-16, (8+4 Update), *R-51*. Rockland is still requesting rate recognition (through 3-year amortization and rate base inclusion of the unamortized balances) for the deferred Competitive Services Audit costs of $77,000 and the deferred Ramapo Tax over-refund of $154,000. However, Rockland is now also requesting rate treatment (through 3-year amortization and rate base inclusion of the unamortized balances) for

$353,000 associated with a 1993 Management Audit and $96,000 associated with an Electric System Reliability Audit in its petition.

These represent newly introduced expense adjustments. The Company has provided no testimony explaining the reasons for these costs, whether such costs were indeed deferred and are currently included on its books, and why it is reasonable and appropriate to charge the current ratepayers for costs that presumably were incurred by the Company as far back as 1993, whether or not such costs were related to a Board-mandated Management Audit. Based on review of page 18 of Rockland's monthly financial reports, it does not appear that these deferred costs are currently still on the Company's books. *R-43*. It would be especially inappropriate to charge the ratepayers on a going-forward basis for costs that are no longer carried on the Company's books. For these reasons, the Ratepayer Advocate recommends that Your Honor and the Board remove these proposed costs from rate consideration in this case.

Schedule RJH-16 (8+4 Update), *R-51*, shows the reduction to the Company's proposed pro forma test year amortization expenses by $180,000, which has the effect of increasing the Company's proposed pro forma test year after-tax operating income by $106,000. Schedule RJH-3, line 13, (8+4 Update), *R-51*, shows the reduction to the Company's proposed rate base by $295,000.

7. Net Other Post-Employment Benefits ("OPEB") Liability

The Ratepayer Advocate recommends the net Pension/OPEB liability rate base adjustment of $0.5 million be accepted. This adjustment is based upon the Ratepayer Advocate's recommendation to amortize the Company's deferred pension expense over-recovery balance over 5 years rather than over the 3 year period proposed by Rockland, as discussed more fully below.

8. Storm Damage Reserve

The Company has performed an analysis[15] in which it reviewed its total storm damage expenses for the 3-year period 1999 – 2001, broken out between "normalized" and "extraordinary"[16] storm damage expenses. This analysis indicates that during this 3-year period the Company incurred an average normalized annual storm damage expense level of approximately $133,000 and an average extraordinary annual storm damage expense level of approximately $250,000. In this case, Rockland has proposed, first, to include a normalized storm damage expense level of approximately $133,000 in the test year, and second, to reflect an annual extraordinary storm damage expense accrual of $250,000 to be funded in a new Storm Damage Reserve account. This proposal is based on the objective to reach a $750,000 Storm Damage Reserve balance. The Company is also proposing to reduce rate base with the first year's Storm Damage Reserve accrual of $250,000, net of associated income taxes.

While the Ratepayer Advocate does not dispute the Company's storm damage expense history, the Company's storm damage expense analysis that forms the basis for its proposal in this case should not be limited to just 3 year's worth of storm damage experience. Rather, it should be expanded to a longer period of time in order to provide a more reliable analysis basis. In response to RAR-A-25D, the Company provided the same type of storm damage expense analysis it performed for the 3-year period 1999 – 2001, but on an expanded basis for the approximate 6-year period 1997 – 2002. This expanded analysis indicated an average normalized annual storm damage expense level of approximately $137,000 and an average extraordinary annual storm damage expense level of approximately $170,000. Based on this expanded storm damage expense analysis, the Ratepayer Advocate recommends that Rockland be allowed an annual extraordinary storm damage expense accrual of $170,000 for funding in the new Storm Damage Reserve account. With

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[15] This analysis is contained under Tab 11of the filing workpaper book (8 + 4 Update), *RECO-12A*.

[16] Extraordinary storm damage expenses represent incremental expenses associated with major, extraordinary storms that are over and above the normalized annual level of storm damage expenses.

an annual extraordinary storm damage expense accrual level of $170,000, the Company's desired Storm Damage Reserve level of $750,000 can be reached in less than 4.5 years, absent any extraordinary storms during that period.

Schedule RJH-14 (8+4 Update), *R-51*, shows the effect of this change which increases the Company's test year after-tax operating income by $47,000 and the Company's rate base by $52,000.

9. Accumulated Deferred Income Taxes ("ADIT")

As shown on Schedule RJH-8 (8 + 4 Update), *R-51*, the Company's actual ADIT balances for Liberalized Depreciation ("ADR/ACRS"), Contributions In Aid of Construction ("CIAC") and Cost of Removal as of December 31, 2002 is $13.933 million. It then added projected test year additions for these ADIT components in order to arrive at the projected test year-end balances for these three ADIT components as of April 30, 2003. *R-51*, Sch. RJH-8, lines 1-3. Next, it added the ADIT associated with the proposed plant projects for Hourly Energy Pricing Billing and Enhanced Service Reliability Programs. *R-51*, Sch. RJH-8, lines 4-5. Next, it added the ADIT associated with the projected post-test year plant additions. *R-51*, Sch. RJH-8, line 6. Finally, the Company reflected the impact on its ADIT balance of its proposed annualized depreciation expense and theoretical reserve amortization adjustments. *R-51*, Sch. RJH-8, line 7. The resulting pro forma adjusted test year-end ADIT balance proposed by Rockland is $16.944 million.

The Ratepayer Advocate recommends a decrease, as shown on Schedule RJH-8, Line 8 (8 + 4 Update), *R-51*, to $13.673 million for the pro forma test year-end ADIT balance. This adjustment reflects the Ratepayer Advocate's recommendation that the Company's proposed Enhanced Service Reliability Program not be reflected for ratemaking purposes in this case. Therefore, the Company's proposed ADIT component associated with this program is removed, as shown on line 5.[17] On line 6, there is the removal of the ADIT associated with the Company's proposed post-test year plant additions, consistent with the Ratepayer Advocate's recommendation

[17] All references to "lines" in this paragraph refers to the lines in *R-51*, RJH-8 (8+4 Update).

that those projected post-test year plant additions be disallowed for ratemaking purposes. Finally, on line 7, there is an adjustment for the ADIT impact of the Company's proposed annualized depreciation expense and theoretical reserve amortization adjustments in order to reflect the depreciation expense positions recommended by the Ratepayer Advocate's witness, Mr. Majoros, in this case. The resulting pro forma test year-end ADIT balance, currently recommended by the Ratepayer Advocate, amounts to $13.673 million.

The Company has failed to meet its burden of proof, and the Ratepayer Advocate's position should be adopted.

B. Pro Forma Operating Income.

The Company has proposed a total pro forma test year operating income amount of $8,528,000 based on its 8+4 filing data. As shown on Schedule RJH-4 (8+4 Update), *R-51*, the Ratepayer Advocate recommends a large number of operating income adjustments with the effect of increasing the Company's proposed pro forma operating income to a recommended pro forma test year operating income level of $11,683,000. Each of these recommended operating income adjustments will be discussed in detail below.

1. Other Operating Revenue Adjustments

As shown on Schedule RJH-9 (8+4 Update), *R-51*, the Company has proposed the following test year Other Operating Revenue amounts:[18]

Account 451 – Miscellaneous Service Revenues:	$ 6,000
Account 454 – Electric Rent Revenues:	$ 9,000
Account 456 – Other Miscellaneous Revenues:	$ 25,000
Total Other Operating Revenues:	$ 40,000

The Company has significantly understated its projected test year revenues for Account 451 and Account 454. As shown in the top part of Schedule RJH-9, (8+4 Update), *R-51*, the actual Account 451 – Miscellaneous Service Revenues have varied between $14,000 and $45,000 during

[18] These test year Other Operating Revenues represent Rockland's 3+9 test year projections, as presented in the response to RAR-A-70. *R-45*. The Company has not provided any supporting information showing what these 3+9 Other Operating Revenues are on an updated 7+5 basis.

the most recent 4 years, and have averaged approximately $25,000 for this same period. The actual Account 454 – Electric Rent Revenues were $53,000 in 1999, $61,000 in 2000, $64,000 in 2001 and $76,000 in 2002, with a 4-year average of $64,000. The Company has provided no credible evidence, or any evidence for that matter, as to why the projected test year revenue levels for these two revenue accounts should be at such abnormally low levels of $6,000 and $9,000. Based on these facts, the Ratepayer Advocate recommends that the normalized test year revenues levels for Accounts 451 and 454 be set at the actual 4-year average levels of $25,000 and $64,000, respectively.

The top part of Schedule RJH-9 (8+4 Update), *R-51*, also shows that the 4-year average of the Account 456 – Other Miscellaneous Revenues is $113,000 as compared to the Company's projected test year Account 456 revenues of $25,000. However, given the trend in these revenues during the last 4 years, the Company's test year projection of $25,000 is not unreasonable. This revenue forecast is equivalent to the average Account 456 revenues in 2001 and 2002.

In summary, as shown on Schedule RJH-9 (8+4 Update), *R-51*, the recommended total test year Other Operating Revenues are $114,000 as opposed to the Company's projection of $40,000. The recommended total revenue amount of $114,000 is at the same level as actually experienced by the Company in 2001 and 2002. This recommendation increases the Company's test year operating revenues by $74,000 and net after-tax operating income by $44,000.

The Company, in this case, has proposed to implement late payment charges for its commercial and industrial customer classes. The incremental annual revenues to be collected by Rockland from these late payment charges are not reflected on a pro forma basis in the test year in this case. On page 21 of his Rebuttal Testimony, *RECO-31*, Mr. Marino agrees with the recommendation that the pro forma test year revenues should include an estimated annualized Late Payment charge revenue level as a result of the Company's proposal in this case to implement Late Payment charges for its commercial and industrial ("C&I") customers. Based on the actual level of C&I customer arrears in the first 8 months of the test year, from 5/1/02 – 12/31/02, the Company has determined that this would have generated $92,000 worth of incremental revenues had the Late Payment charge been in effect during that 8-month period. Mr. Marino suggests that this $92,000 level of pro forma Late Payment revenues be added to the test year revenues at this time. He further proposes that this 8-month revenue level of $92,000 eventually be updated to include the additional incremental Late Payment charge revenues for the last 4 months of the test year (from 1/1/03 to 4/30/03). It is appropriate to reflect an estimate of a full 12-month Late Payment charge revenue level at this time, to be updated and revised, if needed, once actual arrears experienced for the last 4 months of the test year have become available. For purposes of this recommendation, the Ratepayer Advocate assumed that the estimated Late Payment charge revenues for the last 4 months of the test year equal one half of the $92,000 Late Payment charge revenues for the first 8 months of the test year. This results in a recommended estimated annual Late Payment charge revenue level of $138,000. As shown on line 15 and footnote (5) of Schedule RJH-4 (8+4), *R-51*, this recommendation increases the Company's proposed 8+4 test year after-tax operating income by approximately $81,000.

2. Management Incentive Compensation Adjustment

The response to RAR-A-52, *R-20*, indicates that all management employees allocated to Rockland participate in an Annual Team Incentive Plan ("ATIP") with their awards based on corporate financial and individual performance. This data response further indicates that O&R's consolidated ATIP expenses for the 3+9 test year amounts to $3,025,000, of which $2,625,000 is charged to O&M expenses. The allocated Rockland portion of this O&M expense amount of $2,625,000, based on a Rockland allocation factor of 21.12%, is $554,000. Mr. Marino, in his Rebuttal Testimony, admits that the $544,000 should be reduced to $421,000, consistent with the recommendation of Mr. Henkes in his Supplemental Direct Testimony. *RECO-8*, lines 13-17 and *R-51*, p. 6, lines 18-21. The remaining Rockland-allocated test year incentive compensation expense of $421,000 must then be removed for ratemaking purposes in this case. As shown on Schedule RJH-10 (8+4 Update), *R-51*, the Ratepayer Advocate recommends an increase to the Company's proposed pro forma test year operating income by approximately $249,000, as a result of this recommended expense adjustment.

First, a portion of the awards to be paid out under the ATIP to Rockland's managers are a function of corporate financial performance. The shareholders of Rockland's parent corporation are the primary beneficiaries of such corporate financial performance improvements. For those reasons, the stockholders should be made responsible for these discretionary costs.

Second, it should be recognized that the ATIP awards are paid out to the Company's management in addition to their regular base salaries. The Company's recent (2001 - 2002) salary increases for management employees have averaged 3.5% per year and the Company has proposed pro forma salary increases of a similar magnitude for the year 2003 in this case. These annual salary increases exclude the increases associated with the ATIP. Given the recently experienced and currently continuing low inflation rates, the Company's recent actual and proposed pro forma salary increases for its management employees would appear to be quite adequate already. It is excessive to have the ratepayers additionally fund the incentive compensation expense claimed in this case for these same managers.

Third, the Company has not presented any evidence in this case showing the specific benefits that are accruing to the ratepayers as opposed to the shareholders as a result of these incentive compensation payments for which these same ratepayers are asked to pay 100% of the costs. Nor has the Company presented a shred of evidence in this case showing that there is any appreciable difference in the productivity level of Rockland's allocated management employees as a direct result of the ATIP incentive compensation paid out by the Company.

On page 4 of its *JCP&L 1993 Base Rate Order*[19], the Board stated:

> We are persuaded by the arguments of Staff and Rate Counsel that, at this time, the incentive compensation or "bonus" expenses should not be recovered from ratepayers. The current economic condition

[19] *I/M/O the Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions*, BRC Docket No. ER91121820J (Final Decision and Order dated June 15, 1993) (referred to hereinafter as the "*JCP&L 1993 Base Rate Order*").

> has impacted ratepayers' financial situation in numerous ways, and it is evident that many ratepayers, homeowners and businesses alike, are having difficulty paying their utility bills or otherwise remaining profitable. These circumstances as well as the fact that the bonuses are significantly impacted by the Company achieving financial performance goals, render it inappropriate for the Company to request recovery of such bonuses in rates at this time. Especially in the current economic climate, ratepayers should not be paying additional costs to reward a select group of Company employees for performing the job they were arguably hired to perform in the first place.

The conditions in the instant Rockland electric base rate proceeding are strikingly similar to, or even worse than, the conditions surrounding the incentive compensation issue in the above-referenced JCP&L case. Due to the current economic conditions, it is reasonable to assume that many of the Company's ratepayers are suffering from economic hardships and may have trouble paying their bills and keeping or finding employment. Furthermore, as discussed before, Rockland's ATIP incentive compensation program is partially driven by the Company achieving financial performance goals for the benefit of shareholders of the parent corporation. In addition, ratepayers are facing a proposed rate increase for Rockland's BGS deferred balance filing.

In the recently completed fully-litigated 2001 Middlesex Water Company base rate case, the BPU Staff stated, on page 37 of its Initial Brief, with regard to Middlesex's incentive compensation expenses:

> Staff is persuaded by the arguments of the RPA that, at this time, the incentive compensation expenses should not be recovered from ratepayers. According to the record, incentive compensation expenses have tripled since 1995. In addition, the record also indicated that the bonuses are significantly impacted by the Company achieving financial performance goals. These facts lend strength to the RPA's position that it is inappropriate for the Company to request recovery of bonuses in rates at this time.

While the ALJ in that case ruled that 50% of Middlesex's incentive compensation expenses could be recovered in rates, the Board overruled the ALJ and ordered that 100% of these incentive compensation expenses be removed from Middlesex's rates.

Mr. Marino addressed this ADIT issue in his Rebuttal Testimony. *RECO-31*. However, Mr. Marino fails to mention in his Rebuttal Testimony that the awards paid out under the incentive programs of both JCP&L and Middlesex are partially based on corporate financial performance criteria and partially based on customer service goals. Yet, the Board disallowed the entire incentive compensation program costs that were claimed by JCP&L and Middlesex because the Board noted in part that the incentive compensation programs are partially tied to corporate financial performance goals.

Mr. Marino attempts to limit the effect of the Board's *JCP&L 1993 Base Rate Order*. From his reading of the Board's Order in the referenced JCP&L case, Mr. Marino believes that the incentive compensation program of JCP&L is a "bonus" program and only applies to a select group of employees. He then argues that Rockland's incentive compensation program is distinguishable from the JCP&L incentive program in that Rockland's program is available to all non-union employees, not only selected employees, and Rockland's program is not a "bonus" type incentive compensation plan. Mr. Marino has misread the Order. The Board clearly states in the *JCP&L 1993 Base Rate Order* that JCP&L's incentive compensation program is available to JCP&L's officers, managers and all full-time non-bargaining employees. Furthermore, even though in some instances the Board uses the term "bonus" expenses, the JCP&L Order makes it quite clear that JCP&L's incentive compensation program, similar to Rockland's incentive compensation program, provides for variable compensation that is paid out to the Company's employees in addition to their regular fixed compensation in the form of base salaries and wages. Company witness Kenneth Kosior, on cross examination, admitted that 55% of the Company's incentive compensation program is a function of 2003 earnings and such earnings are based upon Rockland, O&R, and Pike earnings. T46:L1-13, T57:L7-14 (2/24/03). Therefore, the Ratepayer Advocate recommends that Your Honor not permit Rockland to recover any incentive compensation amounts through its rates.

3. Employee Health And Benefit Insurance Expenses

As shown on Exhibit P-2, Schedule 7 (7+5), *RECO-1*, and described on pages 2 – 6 of Richard Kane's Direct Testimony, *RECO-22*, the Company has reflected the projected employee health and benefit insurance expenses for calendar year 2003. On a gross basis, the proposed 2003 costs are $3,350,625. After removing the capitalized portion and contributions from employees/retirees, the net cost chargeable to O&M expense amounts to $2,481,630. As described by Mr. Kane in his Direct Testimony, "[t]he health and benefit insurance policies are renewed with carriers in January of each year, and the Company will update the budget when the final premium rates for 2003 are known." *RECO-22*, p. 3.

Once the final insurance premiums for 2003 are known in January 2003 and have been reflected as updates to the Company's original projections, the Ratepayer Advocate has no objection to the Company's proposal to reflect its 2003 employee health and benefit expenses for ratemaking purposes in this case. However, a number of questions remain regarding the employee health and benefit insurance numbers on Exhibit P-2, Schedule 7 (8+4). *RECO-11A*. These questions are contained in data request RAR-A-105, *R-19*. Mr. Kane, in his Direct Testimony, states that health and benefit premium increases will range from 5% to 18% in 2003. *RECO-22*, p. 3. The Company's response to RAR-A-105(C), *R-19*, shows that $1.452 million was charged to net health and benefit expenses for 2001 and $1.443 million was charged to O& M expenses for the 12 month period ended October 31, 2002. However, the projected net health and benefit expenses charged to O&M per P-2, Schedule 7 (8 + 4) for the unadjusted test year ended April 30, 2003 is $1.425 million. *RECO-11A*. Mr. Kane admits that these numbers were correct. T29:L8-12 (2/ 24/03). The Company's proposed adjusted net health and benefit expenses charged to O&M for the test year are $2.08 million. Mr. Kane confirmed that $2.08 million is 46% higher than the unadjusted test year health benefit O& M expense of $1.425 million. T30:L5-10 (2/24/03). Mr Kane also confirmed that the adjusted cost proposed by Rockland of $2.865 million is 43% higher than the unadjusted test year cost of $2.001 million. T30:L11-22 (2/24/03). When asked to explain this phenomenon, no adequate response was forthcoming. Rockland's proposed net health and benefit expense will require adjustments when the final rates are provided within a few months. Rockland indicated that they would provide the final rates. T32:L2-8 (2/ 24/03). Therefore, the Ratepayer Advocate reserves its right to supplement this brief and/or modify its position on this issue.

4. Pension Expense Adjustment

As shown in the first column of Schedule RJH-11 (8+4 Update), *R-51*, the Company's proposed pension expenses in this case are based on projected Statement of Financial Accounting Standards ("SFAS") 87 pension accruals of approximately $4.2 million for the 12-month period ended 7/31/04. The Company then removed the capitalized portion of this projected pension expense at a capitalization ratio of 17.4%. Comparing the resulting net pro forma pension expense to the pension expenses of approximately $587,000 included in the unadjusted test year operating expenses results in Rockland's proposed pension expense increase of $2,882,000.

The Settlement Agreement in Rockland's prior rate case, BPU Docket No. ER91030356J, dated January 10, 1992, allowed the Company to defer the difference between the pension allowance provided for in current rates and the corresponding book expense recorded under SFAS 87. As a result of this Settlement provision, Rockland will have a projected pension expense over-recovery balance of $1,651,000 as of April 30, 2003. The Company is proposing to amortize this over-recovery balance as a pension expense credit over a 3-year period. The Company then netted this proposed pension expense credit of $550,000 ($1,651,000 / 3) against its proposed pension expense increase of $2,882,000 in order to arrive at its proposed net expense increase amount of $2,332,000. See Schedule RJH-11 (8+4 Update), *R-51*.

The Ratepayer Advocate opposes the Company's proposal to reflect for ratemaking purposes in this case the projected SFAS 87 pension expenses for the 12-month period ended July 31, 2004. Allowing expense projections that extend 15 months beyond the end of the test year is contrary to fundamental ratemaking principles and violates the integrity of the test year concept. In addition, the Company confirms in its response to RAR-A-38(E) and RAR-A-44 (E), *R-17*, that the final actuary calculations of the Company's SFAS 87 pension expenses for 2004 will not be available until sometime during the 2nd quarter of 2004. Mr Kane admitted to this on cross examination. T20:L3-8 (2/24/03). Therefore, the accuracy of the Company's proposed SFAS 87 pension expenses in this case cannot be verified with actual calculations from a final actuary report during this proceeding.

In view of the above, the Ratepayer Advocate recommends that the pro forma pension expenses in this case be based on the projected SFAS 87 pension expenses for calendar year 2003. While this recommendation still involves an expense projection that extends 8 months beyond the end of the test year in this case, the final actuary calculations for this pension expense estimate will become available in the 2nd quarter of 2003,[20] thereby allowing the parties and the Board to update the current expense estimate for actual actuary results prior to the close of record in this case. The Ratepayer Advocate's projected SFAS 87 pension expense for 2003 amounts to $3,464,000, third column of Schedule RJH-11 (8+4 Update), *R-51*. If one uses the same approach as was used by Rockland, this indicates the need for a recommended net pension expense increase amount of $2,274,000.

The next recommended adjustment to Rockland's proposed pension expense increase in this case concerns the amortization of the projected April 30, 2003 pension expense over-recovery balance of $1,651,000. Rather than using the 3-year amortization period proposed by Rockland, the Ratepayer Advocate recommends the use of a 5-year amortization period. This would be consistent with the 5-year amortization that Mr. Henkes used for other issues in his testimony, *e.g.* the amortization of rate case expenses, the build-up period for the storm damage reserve, etc.

As shown on Schedule RJH-11, lines 8 – 10 (8+4 Update), *R-51*, the recommended pension expense adjustments decrease Rockland's proposed pro forma test year pension expenses by $330,000 which, in turn, increases the Company's test year after-tax operating income by $229,000.

An additional pension expense related issue in this case is Rockland's proposal to continue to be able to defer the difference between pension expenses allowed in rates and actual pension expenses. Rockland justifies this proposal based upon the Settlement Agreement in Rockland's prior rate case, BPU Docket No. ER91030356J, dated January 10, 1992, which allowed the

[20] See *R-17*, response to RAR-A-38 D.

Company to defer the difference between the pension allowance provided for in current rates and the corresponding book expense recorded under SFAS 87. There are no compelling reasons why this mechanism should continue. Pension expenses should be treated the same as any other expenses, such as wages, salaries, medical and dental expenses, outside consultants and so on. In other words, Your Honor and the Board should determine an appropriate annual level of rate recovery for any expense (including pension expense) based on the best information available during a rate case. After final rates are established by the Board, a utility should not be allowed to then compare the actual expenses incurred to the expense allowances built into its rates and defer the difference for reconciliation (amortization) in the next base rate case. That would not be proper rate making practice.

As stated in Mr. Henkes Direct Testimony, it is inappropriate for the Company to receive rate recovery for these two types of expenses through what is essentially an adjustment clause mechanism. In Mr. Kane's Rebuttal Testimony, *RECO-23*, he argues that the deferral treatment for its pension and OPEB expenses is appropriate because these expenses are influenced by swings in the stock market or medical trend rates and that the Company has little control over these items. This is a disingenuous argument. The Company's health benefit expenses, which are even larger than the Company's OPEB expenses, are also influenced by the swings in the stock market and medical trend rates. Yet, the Company is not deferring the difference between its actual health benefit expenses and the corresponding health benefit expenses recovered in rates. The Company's overall rate of return is also very much influenced by swings in the stock market and by capital cost trend rates and the cost components of the Company's overall rate of return can go through significant changes because of factors over which the Company has little or no control. In the Company's last rate case, Rockland was allowed an overall cost of capital of 10.17%, including a cost of debt of approximately 9% and a cost of equity of 12%. The Company's current rates include rate recovery for this overall rate of return of 10.17%. However, since the Company's last rate case, Rockland's overall rate of return has decreased. For example, in the current case, the Company's embedded cost of debt is 6.8% rather than the cost of debt of 9% for which it is receiving rate recovery. The Company is not deferring the difference between the actual cost of debt of 6.79% and the cost of debt of 9% that is included in the current rates.

Based upon the cross examination of Mr. Marino, Rockland's parent corporation is no longer using this accounting in New York, which is the basis offered for its use in this rate case. T67:L2-3 (2/28/03). The Ratepayer Advocate asked several questions regarding RAR-A-114 on cross examination. *R-47*. This data request asked if the deferral accounting had been reexamined by the New York Public Service Commission, and whether ConEd is currently using deferral accounting for the difference between the pension and OPEB expenses. Mr. Marino answered the second portion of the question on cross examination by stating ConEd is not currently using deferral accounting for this expense. T65:L2-T67:L12. The entire data request has not been answered by Rockland as of the filing of this brief, and therefore, Rockland has failed to meet its burden of proof on this issue. See *N.J.S.A* 48:2-21(d).

In conclusion, the Ratepayer Advocate submits that Rockland's arguments regarding this issue are off the mark and should be ignored by Your Honor and the Board. Instead, Your Honor and the Board should accept the Ratepayer Advocate's recommendation that the Company's current practice of deferring the difference between its actual pension and OPEB expenses and the pension and OPEB expenses recovered in rates should be discontinued with the rate effective date of this case.

5. SFAS 106 OPEB Expense Adjustment

The Company's proposed OPEB expenses in this case are based on projected SFAS 106 OPEB accruals of approximately $2,125,000 for the 12-month period ended 7/31/04.

The Company's proposal to reflect for ratemaking purposes in this case the projected SFAS 106 OPEB expenses for the 12-month period ended July 31, 2004 is inappropriate and should be rejected for the same reasons discussed *supra* concerning pension expenses. Allowing expense projections that extend 15 months beyond the end of the test year violates the integrity of the test year concept and fundamental ratemaking principles. Moreover, the Company confirms in its response to RAR-A-44(E), *R-17*, that the final actuary calculations of the Company's OPEB expenses for 2004 will not be available until sometime during the 2nd quarter of 2004. Therefore, the accuracy of the Company's proposed SFAS 106 OPEB expenses in this case cannot be verified with actual calculations from a final actuary report during this proceeding.

Instead, the Ratepayer Advocate recommends that the pro forma OPEB expenses in this case be based on the projected SFAS 106 OPEB expenses for calendar year 2003. While this recommendation still involves an expense projection that extends 8 months beyond the end of the test year in this case, the final actuary calculations for this OPEB expense estimate will become available in the 2nd quarter of 2003,[21] thereby allowing the parties and the Board to update the current expense estimate for actual actuary results prior to the close of the record in this case. The projected OPEB expense for 2003 amounts to approximately $2,028,000. As shown on Schedule RJH-12 (8+4 Update), *R-51*, the recommended OPEB expense adjustment decreases Rockland's proposed pro forma test year OPEB expenses by $80,000. Taking into consideration the capitalization ratio of 17.4%, the Ratepayer Advocate's recommendation increases Rockland's proposed test year after-tax operating income by $47,000.

Although the Company currently defers the difference between the OPEB expense allowance provided for in current rates and the corresponding book expense recorded under SFAS 106, the Ratepayer Advocate submits that, for the same reasons discussed in the prior section of this brief regarding pension expenses, Your Honor and the Board should order the Company to cease its current Regulatory Asset treatment for OPEB expenses under which Rockland defers the difference between the OPEB expense allowance provided for in rates and the corresponding book expense recorded under SFAS 106. This Board order should become effective with the rate effective date of this case.

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[21] See *R-17*, response to RAR-A-44 D.

6. Enhanced Service Reliability Expense

This adjustment is a direct result of the recommendations regarding the Enhanced Service Reliability Program that were previously discussed in the Rate Base section of this brief. Rockland has proposed to include estimated operation and maintenance expenses of $1,141,000 associated with the Enhanced Service Reliability Program. As shown in footnote (2) of Schedule RJH-4 (8 + 4 Update), *R-51*, the reversal of this pro forma O&M expense entry increases the Company's proposed after-tax test year operating income by approximately $675,000.

7. Rate Case Expense Adjustment

The Company is claiming estimated rate case expenses of $450,000 for this case, consisting of $400,000 for legal expenses, $40,000 for consulting fees and $10,000 for miscellaneous expenses. The Company incurred actual rate case expenses of $342,000 for its most recent rate case that was filed in 1991. The Ratepayer Advocate takes no exception to the $450,000 expense estimate for the current case, provided that this case is fully litigated. Should this case be resolved by settlement, then the actual rate case expenses incurred up to the approval of the settlement should be reflected (prior to the applications of stockholder sharing and amortization).

However, the total rate case expense amount of $450,000 should be shared on a 50/50 basis between the Company's ratepayers and stockholders. This recommendation is consistent with long-standing Board policy on this issue. *See Re Elizabethtown Water Co.*, 62 *PUR* 4th 613 (1984); *I/M/O Pennsgrove Water Supply Company*, BPU Docket No. WR98030147 (June 24, 1999); and, more recently, *I/M/O Environmental Disposal Company*, BPU Docket No. WR99040249 (June 14, 2000).

As the next step, the ratepayer's share of the estimated rate case expenses should be amortized over a 5-year period rather than over the 3-year period proposed by Rockland. Based on the fact that the Company's last base rate proceeding was more than 11 years ago, the Ratepayer Advocate submits that the use of a 5-year amortization period for the rate case expenses in this case is to be considered conservative.

In summary, it is recommended that the normalized annual rate case expense level to be recognized for rate making purposes in this case should be $45,000, as shown on line 8 of Schedule RJH-13 (8+4 Update), *R-51*. The Ratepayer Advocate's recommendation decreases the Company's proposed test year expenses by $105,000 and increases the Company's proposed test year after-tax operating income by $62,000.

8. Common Expense Allocation Change Adjustment And Double Count

Rockland filed its 8+4 update on February 11, 2003 with modifications to various exhibits and schedules. *R-11A*. Exhibit P-2, Schedule 23, *RECO-11A*, updates the common expense allocations proposed in this proceeding. As stated in Mr. Henkes' Supplemental Direct Testimony, *R-51*, the Ratepayer Advocate recommends that the revisions made to the common expense allocations proposed by Rockland in its 8+4 filing be rejected.

Rockland is proposing a brand-new adjustment, apparently having to do with a change in the common expense allocation factor for the year 2003, that raises the revenue requirement of the Company by almost $400,000. The support for this new issue consists of P-2, Schedule 23 in Rockland's 8+4 update filing. *R-11A*. The Ratepayer Advocate submits that Your Honor and the Board should reject these late-filed adjustments and not consider them for ratemaking purposes. The purpose of the 8+4 update filing is to update 7+5 filing data for another month's worth of actual test year data as applied to *existing* issues for which other parties have had adequate opportunity to conduct proper discovery, review and analysis.

By contrast, the adjustment to change the common expense allocation factor represents a new adjustment, introduced at the eleventh hour, with no support in terms of explanatory testimony or supporting workpapers and source documentation. One would think that the Company would have known, when it filed this case in October 2002, that these allocation factor changes might take place in 2003. Yet, it never proposed this adjustment in its original and 7+5 update filings, and never made any mention in the 3-month discovery phase that this issue might be forthcoming at a later stage of the proceeding. As a result, there is now very little opportunity for the parties to appropriately review and analyze this issue, conduct the necessary discovery on this issue, and investigate whether other "new" issues are currently present that would have an offsetting revenue requirement impact.

In addition, it also appears that the Company's proposed common expense allocation factor adjustment of $388,000, shown on P-2, Schedule 23 (8+4), is incorrectly calculated and, as a result, is overstated by approximately $180,000. *RECO-11A*. The Company has increased its proposed 8+4 updated pension and OPEB expenses by $119,763 and $60,605, respectively, as a result of the same common expense allocation factor adjustment reflected on P-2, Schedule 23 (8+4). It appears, however, that the $388,000 expense adjustment on P-2, Schedule 23 (8+4), includes this same approximate $180,000 pension and OPEB expense adjustment. Thus, the expense adjustment of $388,000 on P-2, Schedule 23 would appear to include a $180,000 double count.

Board Staff, on cross examination of Mr. Marino, raised this double count issue. T109:L14-15 (2/28/03). Mr. Marino's explanation is not persuasive. T109:L18-24 (2/28/03). Looking at account 926 (which includes Rockland's pension and OPEB expenses) on Exhibit P-2, Schedule 23 (8+4), *RECO-11A*, the line item for Account 926 shows a claimed expense increase for Change in Common Expense Allocations of approximately $190,000. Mr. Kane on Exhibit P-2, Schedule 8, and Schedule 9 to his Rebuttal Testimony increased the Company's claimed pension expenses by approximately $120,000 to account for the same Change in Common Expense Allocator and increased the OPEB expenses by approximately $61,000. *RECO-23*, at page 6, line 5 and line 17. The Ratepayer Advocate believes this is a double count.

In summary, for all of the foregoing reasons, the Ratepayer Advocate recommends that Your Honor and the Board to reject this late-filed new adjustment. As shown on Schedule RJH-4 (8+4), line 14, the Ratepayer Advocate's recommendation to reverse the Company's proposed Common Expense Allocation Change adjustment increases Rockland's proposed pro forma test year operating income by $230,000. *R-51*.

9. Shareholder's 25% Of Merger Savings Adjustment

In this case, Rockland is proposing to continue to retain for its shareholders the 25% portion of the merger savings determined in BPU Docket No. EM98070433. On Exhibit P-2, Schedule 19 (7+5), *RECO-11*, the Company has calculated that this 25% shareholder merger savings portion is estimated to be $665,000 on an annual basis. On page 30, lines 21-23 of his Direct Testimony, Mr. Marino describes how the Company is proposing to treat this estimated merger savings portion: "The adjustment of $665,000 is reflected as an increase to expense in order to increase the cost of service in a manner that will result in the preservation of the sharing." *R-30*.

The Ratepayer Advocate opposes this adjustment. Proper ratemaking requires that a utility's rates be set based on the appropriate cost of service for that utility, and this cost of service should not be artificially increased for non-existing expenses. The intent of the regulatory compact is that, in exchange for having received a monopoly franchise, a utility provide safe, adequate and proper service at the lowest possible rates. The Company's proposal to add these non-existing expenses to its costs of service is contrary to this doctrine. By July 31, 2003, the Company's shareholders will have received four years worth of their portion of the merger savings, a total cumulative amount of approximately $2.7 million.[22] Combined with the $200 million premium received by these same shareholders as a result of the merger with ConEd,[23] this additional 4-year merger savings sharing should be more than adequate compensation to the Company's shareholders from the merger. There is no valid reasons why the stockholders should continue receiving 25% of the calculated merger savings from BPU Docket No. EM98070433.

In addition, the Company's proposal assumes that the pro forma adjusted test year expenses in this case would have been higher by the exact amount of $2,660,460 (see *RECO-11A*, Exh. P-2,

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[22] $665,000 x 4 = $2,660,000.

[23] BPU Order, Docket No. EM98070433, page 13: "We are however mindful in the instant proceeding of the substantial windfall which will accrue to the O&R shareholders by reason of a 38.5% appreciation in the value of their investment traceable directly to the consummation of this merger resulting in an approximately $200 million premium…."

Schedule 19, 8+4 update) were it not for the net merger savings that presumably are incorporated in the pro forma test year data. In actuality, however, the Company has provided no evidence whatsoever that would show what the actual net merger savings are that have been built into the test year operating results. In fact, the Company's proposed approach would appear to indicate that it has not been able to track and quantify the net merger savings incorporated in the test year, if any. The Company's assumed test year net merger savings are purely theoretical savings based on "Year 4" merger saving calculations that were determined four years ago in BPU Docket No. EM98070433. Thus, even if one *were* to consider flowing 25% of the test year net merger savings to the shareholders, there is no way of knowing what net merger savings are actually incorporated in the test year results because the Company has not been able to measure and quantify such net savings. The risk of flowing to the shareholders a theoretical level of assumed net merger savings that may in fact not exist in the test year should present enough of a reason for Your Honor and the Board to reject the Company's proposal.

As discussed in Mr. Henkes' Direct Testimony, *R-50,* and in his live surrebuttal testimony, T:131-134 (2/28/03), no one, including Rockland, knows what the actual merger savings are that are built into the test year results, or whether the test year in actuality *does* include any merger savings. Rockland did not first project its test year expenses without merger savings and then make specific journal entries to remove all of the expenses presumed to represent merger savings. The test year includes actual expenses for the 12-month period ended April 30, 2003 and the Company has not provided any evidence as to whether, and if so what level of, merger savings are incorporated in the test year data. Even Mr. Marino acknowledges this when he states on page 16 of his Rebuttal Testimony, *RECO-31* that "quantifying all the merger savings is a difficult task as these benefits come in many forms." So, while the Company claims that the test year includes 100% of the theoretical merger savings estimated in the merger proceeding 4 years ago and wants to retain 25% of these test year savings for its stockholders, one could similarly take the position that the test year contains none of these theoretical merger savings and that, therefore, a pro forma expense reduction adjustment should be made to the test year in order to continue to flow these theoretical merger savings to the ratepayers in this case.

Apparently in response to Mr. Henkes' testimony that the Company has not quantified any merger savings that are actually incorporated in the test year, Mr. Marino prepared his rebuttal Exhibit FPM-6. *RECO-31*. On this exhibit, Mr. Marino has compared the actual expenses booked by Rockland in six selective O&M expense accounts during the pre-merger year 1998 and the post-merger year 2000 and is claiming that the difference between these two expense totals is representative of the actual merger savings incorporated in the test year. This simple cost comparison involving selected expense account data for 1998 and 2000 can be considered indicative and representative of the merger savings that are actually built into the test year ending April 30, 2003. For example, there may be other expense accounts not included in the simple analysis on Exhibit FPM-6, that would have higher 2000 expenses than the corresponding 1998 expenses, and the impact of such higher expenses in 2000 is not used to offset the results in the simple analysis on Exhibit FPM-6. Rockland is simply relying on a total cost approach without any support or analysis as to why costs are different from one period compared to another period. A total cost comparison without more detail proves only that costs changed and does not establish the reasons, or provide the source of why costs changed. Therefore, Rockland's reliance on a total cost approach to show merger savings has no probative value. Mr. Marino's attempt to resuscitate Rockland's position on merger savings in his response to Mr. Henkes's live surrebuttal testimony simply fails. On direct examination by Mr. Meyer on February 28, 2003, Mr. Marino discussed the purported savings associated with his transfer to ConEd's regulatory department, T212:L5-11 (2/28/03), and Rockland's vacated space at its headquarters in Pearl River, New York, T213:L11-17 (2/28/03).

The mere fact that a direct charge employee is transferred to a regulatory department and his resultant cost is now charged as an indirect general and administrative expense to Rockland and that charge is less, simply reflects the difference between a direct charge and an indirect charge. The indirect charge will be less. This does not necessarily mean that Rockland has shown continued merger savings is appropriate. With respect to the lease in Pearl River, Mr. Marino was not able to verify whether the lease, or a portion thereof, expired, whether the space was sublet, or how much space was still under lease. If the lease expired, there are no ongoing savings to Rockland. If a portion of the lease was sublet, then there may be a savings between the lease rate and the sublet lease rate or income, to the extent the sublease rate exceeds the primary lease rate.[24] It is also clear that to the extent the employees were transferred to space in Manhattan, the lease rates in New York City are substantially higher than in Pearl River, a suburb. Therefore, the allocated costs to Rockland may be higher. In any event, no information was presented to support the alleged savings from the Pearl River lease. Mr. Marino could not verify any fact. T227-228 (2/28/03). Again, the Company has failed to meet its burden of proof on this issue.

More importantly, Rockland has not satisfied the condition precedent set by the Board for revisiting merger saving in this proceeding. See *S-17*. Rockland has not shown that the expenses for the test year in fact include $1,995,000 in merger savings, the ratepayer's portion, which is the Company's justification for including a phantom expense increase of $665,000 into the test year, representing alleged merger savings in the amount of 25% for shareholders. Without record support, it is equally appropriate if Your Honor accepts the phantom increase proposed by Rockland, to permit a corresponding credit to expenses in the amount of $1,995,000 to reflect the 75% share of merger savings for ratepayers.

For the foregoing reasons, the Company's proposal to continue to flow 25% of the merger savings to its shareholders should be rejected by Your Honor and the Board. Schedule RJH-4, line 8, (8+4 Update), *R-51,* shows the recommended increase to the Company's proposed test year after-tax operating income by $393,000.

[24] If a sublet was used, then, this is a transfer of an asset which would require Board approval. The Ratepayer Advocate is not aware of any Board order approving a sublet of the Pearl River space.

10. Storm Damage Reserve Accruals

This adjustment represents the test year operating income impact of the storm damage reserve adjustment shown on Schedule RJH-14 (8 + 4 Update), *R-51*, which was previously discussed in the Rate Base section of this brief.

11. Miscellaneous O&M Expense Adjustment

The first adjustment concerns the removal from the test year of above-the-line operating expenses associated with the provision of certain financial services to Rockland's President. As described in the response to RAR-A-53, these financial services involve "…a personal advisor who provides a comprehensive personal financial advisory service in all areas of their personal finances including investments, taxes, estate planning, insurance, employee benefits and retirement planning…" *R-46.*

The second adjustment concerns the removal from the test year of above-the-line results expenses associated with Restricted Stock Unit Awards payable to Rockland's President, which are described in Rockland's response to RAR-A-53. *R-46*. These items should be removed from the test year above-the-line expenses for ratemaking purposes because the Company's ratepayers should be required to fund these types of top officers' compensation "perks". This should be the responsibility of the Company's shareholders. As shown on Schedule RJH-15, (8+4 Update), the recommended expense adjustments increase the Company's proposed test year after-tax operating income by approximately $44,374. *R-51*.

This adjustment represents the test year operating income impact of the amortization expense adjustment shown on Schedule RJH-16, (8+4 Update), which was previously discussed in the Rate Base section of this initial brief. *R-51*.

12. Pro Forma Annualized Depreciation Expense Adjustment

The Company's proposed pro forma annualized depreciation expense positions are shown on Exhibit P-2, Summary, page 1 (7+5), and Exhibit P-2, Schedules 10, 13, 14 and 20 (7+5), *RECO-11*, and have been presented in a somewhat confusing way. What is clear from Exhibit P-2, Summary, page 1 is that the total pro forma annualized depreciation expense amount claimed by Rockland in this case is $5,200,000.[25] In the first column of Schedule RJH-17, (8+4 Update), *R-51*, the Ratepayer Advocate presents its proposal for the correct breakdown of the component parts making up Rockland's claimed total pro forma annualized depreciation expense amount of $5,200,000. Rockland's reflected annualized depreciation expenses based on the application of its proposed new depreciation rates to the test year-end depreciable plant balances amount to $4,757,000 (see line 1). The next component of Rockland's overall pro forma depreciation expense position of $5,200,000 is a negative expense of $588,000 for the proposed 20-year amortization of the Company's identified "Book versus Theoretical Reserve Difference" (line 3). The next three components -- shown on lines 4, 5, and 6 – represent Rockland's proposed annual depreciation/amortization expenses associated with the Enhanced Service Reliability Program, Hourly Energy Pricing Billing project, and post-test year plant additions.

Mr. Majoros, the Ratepayer Advocate's depreciation expert, has recommended appropriate depreciation rates for the Company that are different from the new depreciation rates proposed by Rockland in this case. As shown on Schedule RJH-17, line 1, (8+4 Update), *R-51*, Mr. Majoros' depreciation rate recommendations result in a recommended annualized depreciation expense level of $3.864 million. Mr. Majoros has also recommended that the amortization of the Theoretical Reserve Difference should be $1.103 million rather than Rockland's proposed amortization amount of $.588 million (see line 3).

Next, consistent with the previously discussed recommendation that the costs associated with the Company's proposed Enhanced Service Reliability Program not be included for ratemaking purposes in this case, Rockland's proposed Enhanced Service Reliability Program depreciation expense (see line 4) should be reversed. Finally, the Company's proposed depreciation expenses associated with the projected post-test year plant in service is reversed

[25] Consisting of the sum of $4,697,000, $200,000, ($398,000) and $701,000.

As shown on Schedule RJH-17, lines 6 - 8, (8+4 Update), *R-51*, the Ratepayer Advocate's recommended pro forma annualized depreciation expense level is $2.961 million lower than the Company's proposed pro forma annualized depreciation expense level of $5.200 million. This recommended expense reduction has the effect of increasing the Company's proposed pro forma test year after-tax operating income by $1.271 million.

13. Interest Synchronization Expense Adjustment

As shown in more detail on Schedule RJH-18, (8+4 Update), *R-51*, the only reason the recommended interest synchronization income tax impact is different from the Company's proposed interest synchronization income tax impact is because of the differences in the Company's proposed and Ratepayer Advocate's recommended rate base and weighted cost of debt positions. Because of these differences, the Ratepayer Advocate's pro forma interest deduction for income tax purposes is smaller than the Company's. As can be seen from Schedule RJH-18, line 5, this results in a decrease of $325,000 in the Company's proposed pro forma test year operating income. *R-51*.

C. Conclusion.

For all the foregoing reasons, as well as those set forth in the testimony of the Ratepayer Advocate's witnesses, the Ratepayer Advocate respectfully requests that the following recommendations should be adopted:

<u>Overall Revenue Requirement</u>

- Adopt the overall revenue requirement recommended by the Ratepayer Advocate which decreases the Company's annual revenues by $5,324,000. *R-51*, Sch. RJH-1 (8+4 Update).

<u>Rate Base</u>

- Adopt the rate base adjustments (decreases) recommended by the Ratepayer Advocate which total $23,726,000, resulting in a pro-forma rate base for the Company of $106,304,000. *R-51*, Sch. RJH-3 (8+4 Update).
- Adopt the Ratepayer Advocate's recommended Plant in Service Position adjustments (decreases) of $26,860,000, which reduces Plant in Service from $201,614,000 to $174,754,000. *R-51*, Sch. RJH-3, line 3, Sch. RJH-5 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment of $2,161,000 in Plant Depreciation Reserve Position to reduce the Company's Pro Forma Test Year-End Reserve Balance to $65,330,000 *R-51,* Sch. RJH-3, Sch. RJH-6 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended Lead/Lag Study Cash Working Capital adjustments to reduce the Company's Cash Working Capital Requirement to $4,387,000. *R-51*, Sch. RJH-3, Sch. RJH-7 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended removal of unamortized R&D expenditures, BPU Audit expenditures and Ramapo Tax deferrals from the Company's proposed rate base. *R-51*, Sch. RJH-3 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment to increase the Company's proposed Net Pension/OPEB Liability rate base balance by $143,000 to $874,000. *R-51*, Sch. RJH-3 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment to reduce the Company's proposed storm damage reserve rate base balance by $53,000 to $111,000. *R-51*, Sch. RJH-3 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment for Accumulated Deferred Income Tax Position of $3,272,000 to reduce the Company's Pro Forma Test Year-End ADIT balance to $13,673,000. *R-51*, Sch, RJH-3, Sch. RJH-8 (8+4 Update).

<u>Overall Rate of Return</u>

- C Adopt the Ratepayer Advocate's recommended overall rate of return of 8.04%, including a return on equity of 9.25%. *R-51,* Sch. RJH-1, Sch. RJH-2 (8+4 Update).

<u>Operating Revenues and Expenses</u>

- C Adopt the Ratepayer Advocate's recommended pro-forma test year operating income of $11,683,000, which reflects adjustments amounting to a net $3,155,000 increase over the Company's proposed operating income of $8,528,000. *R-51*, Sch. RJH-1, RJH-4 (8+4 Update).

- C Adopt the Ratepayer Advocate's adjustment to increase the Company's proposed Other Operating Revenues, resulting in an adjustment (increase) of $44,000 to pro forma net operating income. *R-51*, Sch. RJH-4, Sch. RJH-9 (8+4 Update).

- C Reject the Company's proposal to include $421,000 in executive incentive compensation expense for ratemaking purposes, resulting in an adjustment (increase) of $249,000 to pro-forma net operating income. *R-51*, Sch. RJH-4, Sch. RJH-10 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended decrease of $388,000 in Pro Forma net SFAS 87 Pension expenses, resulting in an increase in Net Operating Income of $229,000. *R-51*, Sch. RJH-4, Sch. RJH-11 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended decrease of $80,000 in Pro Forma net SFAS 106 OPEB expenses, resulting in an increase in Net Operating Income of $47,000. *R-51*, Sch. RJH-4, Sch. RJH-12 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment (decrease) for Rate Case Expense Position of $105,000 for an impact on Net Operating Income of $62,000. *R-51*, Sch. RJH-4, Sch. RJH-13 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended removal from test year expenses of all expenses associated with the Company's proposed Enhanced Service Reliability Program, resulting in an increase in Net Operating Income of $675,000. *R-51*, Sch. RJH-4 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended removal from test year expenses of the Company's proposal to retain 25% of estimated Merger Savings alleged to be incorporated in the test year, resulting in an increase in Net Operating Income of $393,000. *R-51*, Sch. RJH-4 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment to reduce Storm Damage Expense by $80,000, increasing Net Operating Income by $47,000 and decreasing Net Rate Base by $53,000. *R-51*, Sch. RJH-3, Sch. RJH-4, Sch. RJH-14 (8+4 Update). The difference in Schedules RJH-3, line 19 (8+4 Update) and Schedule RJH-14, line 7 (8+4 Update) is due to rounding.

- C Adopt the Ratepayer Advocate's recommended Miscellaneous Expense adjustments with the effect of reducing test year expenses by $75,000 and increasing test year Net Operating Income by approximately $44,000. *R-51*, Sch. RJH-4 , Sch. RJH-15 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment (decrease) for Various Amortization Expenses of $180,000, resulting in an increase of Net Operating Income of $106,000. *R-51*, Sch. RJH-4, Sch. RJH-16 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment (decrease) to Depreciation Expense Position of $2,149,000 with an impact on Net Operating Income of $1,271,000. *R-51*, Sch. RJH-4, RJH-17 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended adjustment for Interest Synchronization, amounting to a decrease in the Company's pro-forma test year Net Operating Income of $325,000. *R-51*, Sch. RJH-4, RJH-18 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommended removal from test year expenses of the Company's proposed Common Expense Allocation adjustment, resulting in an increase in Net Operating Income of $230,000. *R-51*, Sch. RJH-4 (8+4 Update).

- C Adopt the Ratepayer Advocate's recommendation to include annualized Late Payment Fee revenues in the test year, resulting in an increase in Net Operating Income of $81,000. *R-51*, Sch. RJH-4 (8+4 Update).

Adoption of the Ratepayer Advocate's recommendations would result in an overall rate reduction amounting to $5,324,000 million. *R-51*, Sch. RJH-1 (8+4 Update).

POINT IV

YOUR HONOR AND THE BOARD SHOULD ADOPT THE RATEPAYER ADVOCATE'S PROPOSED CLASS REVENUE DISTRIBUTION AND RATE DESIGN.

A. The Ratepayer Advocate's Proposed Distribution Rate Decrease Should Be Allocated On A Uniform Percentage Basis To Each Rate Class.

1. The Proposed Distribution Rate Decrease Should be Allocated on an Across-the-Board Basis

Rockland's petition in this matter included a class cost-of-service study, the results of which were presented by Rockland witness Allen Cohen. *RECO-17; RECO-10; Schedule P-7.* However, rather than relying strictly on the results of this study, the Company is proposing to apply its requested distribution rate increase proportionately to each class's current annual distribution service revenue. *RECO-18, p. 2.* The Ratepayer Advocate agrees with this general approach, and accordingly recommends that its proposed decrease be allocated on a uniform percentage basis to each class.

2. Your Honor and the Board Should Reject Rockland's Cost of Service Study Methodology

Given the Ratepayer Advocate's agreement with Rockland's methodology for allocating the distribution rate increase or decrease that results from this proceeding, the Company's cost-of-service study is not dispositive. Nevertheless, the Ratepayer Advocate wishes to note its disagreement with certain aspects of the methodology used in performing the Company's study.

First, the Company's study uses improper allocation procedures for the majority of Rockland's costs related to its transmission and distribution plant. All of the allocation factors used in the study are based solely on measures of maximum demand, giving no recognition to average demands or annual usage. *R-10, p. 8.* This is improper, because transmission and distribution facilities are not designed solely to meet peak load requirements. As Ratepayer Advocate witness David Peterson explained in his prefiled Direct Testimony, electrical facilities must be designed to meet peak load conditions, but these facilities are also designed, operated, and maintained to provide continuous service throughout the year. *Id.* Moreover, the Company's methodology allows some customers to escape cost responsibility entirely if all of their usage is off-peak. For example, the Municipal and Private Lighting classes use Rockland's transmission facilities to provide lighting for streets, parking lots, stadiums, parks, and other facilities. However, Mr. Cohen's cost of service study allocates these customers classes no cost responsibility for Rockland's transmission facilities. This is unfair to the Company's other service classes.

Rockland's reliance solely upon peak demands is also contrary to the cost allocation principles adopted by the Board in the most recent fully litigated electric company base rate proceeding. *JCP&L 1993 Base Rate Order*. In that proceeding, United States Department of Defense and Federal Executive Agencies had proposed to allocate transmission, subtransmission and distribution costs based solely on non-coincident peak demands, while the Division of Rate Counsel ("Rate Counsel") proposed an "average and excess" method which considered both peak demand and annual energy usage. *JCP&L 1993 Base Rate Order, p. 16.* Noting that "[e]xlcusive demand approaches to the allocation of T&D costs" had been rejected in a previous rate proceeding, the Board adopted the methodology advocated by Rate Counsel. *Id.* Rockland's cost-of-service study, with its exclusive reliance on peak demands to allocate transmission and distribution related costs, is inconsistent with the principles stated by the Board in the *JCP&L 1993 Base Rate Order.*

Another flaw in Rockland's cost-of-service study is that it allocates a portion of the Company's distribution system using a customer-based allocation factor. Mr. Cohen's justification for his use of a customer-based allocation factor is that "the customer component is the cost of the smallest secondary system needed to physically connect all of the existing service points to the line transformers and rectifiers, *if the system were not required to supply any load.*" *RECO-10,* Sch. P-7, p. 4 (emphasis added). However, the system actually installed by Rockland is based on expected loads, not on a specific number of customers. *R-10,* p. 10.

Based on the above defects in Rockland's cost-of-service study, Your Honor and the Board should reject this study, and reaffirm the cost allocation principles stated in the *JCP&L 1993 Base Rate Order.*

B. Your Honor And The Board Should Adopt The Ratepayer Advocate's Proposed Modifications To Rockland's Proposed Rate Design.

1. Your Honor And The Board Should Reject Rockland's Proposed Increases In Its Monthly Service Charges

Rockland has proposed the following increases to the monthly service charges for various customer classes (including sales and use tax):

Rate class	Present	Proposed	% Increase
Residential	$ 3.85	$ 5.30	37.7%
Residential TOU	$ 4.92	$ 7.42	50.8%
GS - Non Demand	$ 6.54	$ 10.60	62.1%
Primary TOU	$130.66	$318.00	143.4%

RECO-18, p. 10, Sch. P-5. These proposed increases should be rejected, as they are not supported by a cost analysis consistent with Board policy.

Rockland witness William A. Atzl, Jr. originally attempted to justify these large percentage increases based on Mr. Cohen's cost of service study which, according to Mr. Atzl, would justify even larger increases. *RECO-18*, p. 3-4. In using Mr. Cohen's study, however, Mr. Atzl did not consider the Board's policies concerning the costs that may be included in the customer service charge.

As stated in the *JCP&L 1993 Base Rate Order,* the customer costs included in the customer charge "should be limited to those costs which are demonstrated to vary directly and linearly with the number of customers on the system, unaffected by either demand or energy consumption." *JCP&L 1993 Base Rate Order,* p. 17. The costs classified as customer-related in Mr. Cohen's study include costs beyond those directly and linearly related to the number of customers on Rockland's system. As Ratepayer Advocate witness Mr. Peterson explained, costs which are classified as "customer-related" for class allocation purposes include costs beyond those allowed in the service charge under the Board's policy. *R-10*, p. 13. Moreover, as noted above, Mr. Cohen's "customer-related" costs include portions of the Company's secondary distribution which should not have been classified as customer costs. *Id.*

In his Rebuttal Testimony, Mr. Atzl presented revised calculations of customer costs, purportedly limited to costs which vary directly and linearly with the number of customers served. *RECO-19*. However, Mr. Atzl's customer cost analysis actually includes many costs which the Board has not permitted to be included in the customer charge, such as various supervision costs, overhead costs, general plant costs, and advertising costs, and all meters, rather than only the minimum size component defined by the Board. T55:L4-21 (2/20/03); *JCP&L 1993 Base Rate Order*, p. 17. During cross-examination, Mr. Atzl acknowledged that he did not consult any Board orders for guidance in preparing his calculations. T31:L13-19 (2/21/03).

Furthermore, Mr. Atzl had only limited knowledge as to the details of the costs included his calculations. On cross-examination, he repeatedly testified that he did no know whether costs reflected in specific accounts were included in his analysis–he testified that he did not know whether his asserted customer costs included collection activities, the costs of computers used for billing and collections, or costs booked to several accounts which the Board has not allowed to be included in the customer service charge under the *JCP&L 1993 Base Rate Order* cited above. T35:L2-5, T35:L22-24, T37:L10-13, T:37:L18-T38:L8, T39:L22-T40:L2 (2/21/03).

The Company's responses to the Ratepayer Advocate's transcript requests confirm that Mr. Atzl's calculations include costs not properly allocable to the customer charge. Their responses confirm that the "Customer Accounting" component of Mr. Atzl's calculations include expenses booked to accounts 901 (Supervision) and 905 (Miscellaneous Customer Accounts Expenses), and that the "Customer Service" component includes expenses booked to accounts 909 (Informational and Instructional Advertising Expenses), 910 (Miscellaneous Customer Service and Informational Expenses), 911 (Supervision), 912 (Demonstrating and Selling Expenses), 913 (Advertising Expenses), and 917 (Sales Expenses). See Exhibit B, pp. 1 and 3, attached hereto. Another transcript request response states that the "Total Rate Base" items included in the "Customer

Accounting" component do not include computer systems–but does not provide any further information that would allow Your Honor and the Board to conclude that these "Total Rate Base" costs were properly included. See Exhibit B, p. 2, attached hereto.

Given Mr. Atzl's lack of knowledge about the costs included in his analysis, and the Company's acknowledgment that this analysis includes costs beyond those permitted to be included in the customer charge, this analysis does not provide a sufficient basis for the Company's proposed customer charge increases.

As an illustration of the unreasonableness of Rockland's proposals, Mr. Peterson's prefiled Direct Testimony included a comparison of the residential service charges currently in effect for all four New Jersey electric utilities, which are as follows:

Rockland Electric Company	$3.85
Atlantic City Electric Company	$2.48
Public Service Electric and Gas	$2.41
Jersey Central Power and Light	$2.18

R-10, p. 14. Rockland's residential service charge is already the highest in the state. Under the Company's proposal, the residential service charge would increase to $5.30–more than double the next highest one in the State. Further, this proposed 37% increase would have a disproportionate impact on low usage customers, and thus is inconsistent with the Company's general approach of applying rate changes proportionately. *R-10*, p. 14. The proposed large percentage increases to the customers charges for other rate classes would have a similarly disproportionate impact on low usage customers in those classes.

The Company's proposed increases in its monthly customer service charges are not supported by a proper analysis of customer costs, and would unduly burden those customers with the lowest electricity usage. Thus, the Company has failed to meet its burden of proof, pursuant to *N.J.S.A.* 48:2-21(d), to support the reasonableness of its request. These proposed increases should be rejected by Your Honor and the Board.

2. The Company Should Be Permitted To Implement A Flat Charge Of $7.00 For Dishonored Checks, Rather Than The Proposed $3.50 Plus Bank Charges

Rockland's current tariff permits the Company to charge non-residential, non-governmental customers a charge of $3.50 plus the amount of the fees charged by its banks for dishonored checks. The Company is seeking to extend this tariff provision to residential customers. *RECO-14,* p. 2-3. The Ratepayer Advocate does not object to implementing a dishonored check charge for residential customers. However, the Company should not be permitted to continue the current "cost pass through" mechanism for bank charges. Instead, based on an analysis of the Company's actual costs, the dishonored check charge should be established at a flat $7.00 for both residential and non-residential customers.

Rockland is currently the only New Jersey electric utility with a cost pass-through included in its dishonored check charge. The three other utilities all have flat charges, summarized below:

Public Service Electric and Gas	$15.00
Atlantic City Electric Company	$ 7.64
Jersey Central Power and Light	$10.00

R-10, p. 15. Rockland witness Donald Kennedy testified that, during the 12 months ended June 30, 2002, the Company received 1,185 dishonored checks, costing the Company $8,295 including the Company's internal administrative costs. *RECO-14*, p. 2-3. The Company's dishonored check charge should be established at the resulting average per-check cost of $7.00.

The flat charge proposed by the Ratepayer Advocate is both consistent with established ratemaking principles and more equitable to customers than the "cost pass through" structure proposed by Rockland. In determining base rates, New Jersey follows the "test year" approach, in which a utility's revenues and cost of service are considered as a whole. Utilities' rates are set based on the test year, subject only to limited "post test year" adjustments. *Elizabethtown Water Company Rate Case Decision on Motion For Determination of Test Year and Appropriate Time Period For Adjustments*, BRC Docket No. WR8504-330 (Order dated May 23, 1985). *R-16*. With the exception of specifically authorized adjustment clauses, utilities generally are not permitted to pass through increases in individual expense items between rate cases. Rockland's current tariff provision for dishonored check fees is at odds with this fundamental ratemaking principle.

The "pass-through" approach is also unfair to customers. According to Rockland witness Donald Kennedy, the dishonored check fees charged by the Company's banks range from $2.50 to $15.00. *R-7;* T22:L15-T36:L14 (2/20/03). Mr. Kennedy testified that Rockland chooses its banks for a "variety of reasons," but that customers have no say as to which bank the Company uses to deposit their checks. T23:L15-T24:L7 (2/20/03). Thus, under the Company's proposal, similarly situated customers could be charged a dishonored check charge ranging from $6.00 to $18.50, with the exact amount beyond the customer's control. The Ratepayer Advocate's proposed flat fee structure would impose the same charge on all similarly situated customers.

In support of Rockland's proposed dishonored check charge, Mr. Kennedy notes that the Board has previously approved the proposed "pass through" rate structure for the Company's non-residential, non-government customers. This is not a sufficient justification and extending the current inappropriate rate structure. The record in this proceeding demonstrates the unfairness of the current structure of the dishonored check charge, and Your Honor and the Board should therefore adopt the more equitable flat charge. Further, the proposed extension of the dishonored check charge to residential customers would greatly expand the potential for customer confusion if the current "pass through" approach were maintained. According to Mr. Kennedy, residential customers accounted for 1,019, or approximately 85% of the 1,185 dishonored checks received by the Company during the twelve months ended June 30, 2002. *R-8.* Since the current charge applies only to commercial customers, the Company actually charged only 166 dishonored check fees during that period. T26:L17-T27:L16 (2/20/03). Many more customers would be subject to the dishonored check charge under the Company proposal. In addition, if the Company is granted an automatic pass-through for fees charged by its banks for all dishonored checks, it will lose its current incentive to attempt to minimize such fees when choosing the banks in which it deposits its customers' checks.

Rockland's current dishonored check charge is contrary to established ratemaking principles and unfair to customers. The dishonored check charge should be set at a flat $7.00 for both residential and non-residential customers, reflecting the Company's average costs of handling dishonored checks.

3. The Company's Reconnection Charge Should Be $15.00, Rather Than The Proposed $27.00

Rockland's current tariff provides for two different charges for customers whose service is restored following a disconnection for nonpayment. If service is reconnected before 3:00 p.m. on a weekday, the charge is $7.00. After 3:00 p.m., or prior to the next working day, the charge is $21.00. Rockland is proposing to increase the reconnection charge to $27.00 at all times. *RECO-14*, p. 4. Rockland, however, has not properly justified its proposed charge of $27.00.

Rockland's purported cost justification for the increased reconnection charge was presented in the Rebuttal Testimony of Rockland witness Donald Kennedy. *RECO-15,* Sch. DEK-1. As Mr. Kennedy acknowledged during cross-examination, the proposed reconnection charge includes charges beyond those caused by accounts for which service was disconnected and then subsequently reconnected. These include the following types of collection visits and other field visits:

- Visits to disconnect service to accounts of customers who may or may not subsequently pay to restore service. *R-9;* T31:L19-T33-5; T38:L8-15 (2/20/03);
- Field visits in which the customer makes payment to avoid disconnection. *R-9;* T34:L9-T36:L13 (2/20/03);
- Field visits in which the Company leaves a card notifying the customer that service is subject to termination if the customer does not make a payment. *R-9;* T36:L8-T37:L20 (2/20/03);
- Visits in which the representative is not able to gain access to the customer's meter. *R-9;* T21:L15 (2/20/03);
- Visits in which service was not disconnected due to weather restrictions. *R-9;* T38:L16-T39:L14 (2/20/03);
- Field visits to locations at which there has been no activity, or unbilled usage. *RECO-15*; Sch. DEK-1, p. 2; T39:L16-T40:L11 (2/20/03);

- Visits to post notice to residents of apartment buildings that they may collectively pay the landlord's overdue bills to avoid disconnection. *RECO-15*; Sch. DEK-1, p. 2; T40:L12-T41:L4 (2/20/03).

Based on Mr. Kennedy's testimony, it is clear that Rockland's proposed $27.00 reconnection charge includes the costs of many collection activities unrelated to the customers whose accounts are disconnected and then reconnected. T51:L9-T52:L19 (2/20/03).

As a justification for imposing these costs on customers whose service is reconnected, Mr. Kennedy testified that the cost analysis he presented in his Schedule DEK-1 was based on system-wide collection activities for Rockland's parent corporation, O&R. T43:L18-T44:L10 (2/20/03). Mr. Kennedy argued that, since Rockland's customers have better bill payment records than customers of O&R as a whole, the Company's proposal would result in lower total costs to Rockland's customers. T44:L19-T45:L22 (2/20/03). However, this is not a valid justification for charging all collection costs to only a portion of the customers who cause them. The appropriate remedy for the asserted disparity between Rockland and its affiliates would be to perform a separate study of "Rockland only" costs. T51:l4 - T53:L20 (2/20/03).

In the absence of proper cost justification for the Company's proposed reconnection charge, the Ratepayer Advocate has proposed a reconnection charge of $15.00. The other three New Jersey electric utilities have the following authorized reconnection charges:

Public Service Electric and Gas	$15.00
Atlantic City Electric	$15.00
Jersey Central Power and Light	$22.00

R-10, pp. 16-17. The Ratepayer Advocate's proposed $15 charge is the same as that authorized for PSE&G and Atlantic City Electric. This proposal should be adopted in the absence of proper cost justification for Rockland's proposed $27.00 charge.

CONCLUSION

For all of the foregoing reasons, the Ratepayer Advocate respectfully requests that an Initial Decision be rendered recommending that the Board find and conclude that:

Rate of Return

- A 9.25% return on equity is the appropriate figure to be adopted for purposes of this proceeding;

Depreciation

- Mr. Majoros' net salvage allowance approach should be adopted, and the Company's test year depreciation expense and depreciation reserve excess should be adjusted accordingly;

- Rockland's test year depreciation expense should be reduced by $827,00;

- The Company's depreciation reserve excess should be increased from $11.8 million to $22.1 million, increasing the annual amortization credit from $588,000 to $1.1 million.

Overall Revenue Requirement

- The overall revenue requirement recommended by the Ratepayer Advocate which decreases the Company's annual revenues by $5,324,000 should be adopted. *R-51*, Sch. RJH-1 (8+4 Update).

Rate Base

- The rate base adjustments (decreases) recommended by the Ratepayer Advocate which total $23,726,000, resulting in a pro-forma rate base for the Company of $106,304,000, should be adopted. *R-51*, Sch. RJH-3 (8+4 Update).

- The Ratepayer Advocate's recommended Plant in Service Position adjustments (decreases) of $26,860,000, which reduce Plant in Service from $201,614,000 to $174,754,000 should be adopted. *R-51*, Sch. RJH-3, line 3, Sch. RJH-5 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment of $2,161,000 in Plant Depreciation Reserve Position to reduce the Company's Pro Forma Test Year-End Reserve Balance to $65,330,000 should be adopted. *R-51*, Sch. RJH-3, Sch. RJH-6 (8+4 Update).

- The Ratepayer Advocate's recommended Lead/Lag Study Cash Working Capital adjustments to reduce the Company's Cash Working Capital Requirement to $4,387,000 should be adopted. *R-51*, Sch. RJH-3, Sch. RJH-7 (8+4 Update).

- The Ratepayer Advocate's recommended removal of unamortized R&D expenditures, BPU Audit expenditures, and Ramapo Tax deferrals from the Company's proposed rate base should be adopted. *R-51*, Sch. RJH-3 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment to increase the Company's proposed Net Pension/OPEB Liability rate base balance by $143,000 to $874,000 should be adopted. *R-51*, Sch. RJH-3 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment to reduce the Company's proposed storm damage reserve rate base balance by $53,000 to $111,000 should be adopted. *R-51*, Sch. RJH-3 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment for Accumulated Deferred Income Tax Position of $3,272,000 to reduce the Company's Pro Forma Test Year-End ADIT balance to $13,673,000 should be adopted. *R-51*, Sch, RJH-3, Sch. RJH-8 (8+4 Update).

Overall Rate of Return

- The Ratepayer Advocate's recommended overall rate of return of 8.04%, including a return on equity of 9.25% should be adopted. *R-51*, Sch. RJH-1, Sch. RJH-2 (8+4 Update).

Operating Revenues and Expenses

- The Ratepayer Advocate's recommended pro-forma test year operating income of $11,683,000, which reflects adjustments amounting to a net $3,155,000 increase over the Company's proposed operating income of $8,528,000 should be adopted. *R-51*, Sch. RJH-1, RJH-4 (8+4 Update).

- The Ratepayer Advocate's adjustment to increase the Company's proposed Other Operating Revenues, resulting in an adjustment (increase) of $44,000 to pro forma net operating income should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-9 (8+4 Update).

- The Company's proposal to include $421,000 in executive incentive compensation expense for ratemaking purposes, resulting in an adjustment (increase) of $249,000 to pro-forma net operating income should be rejected. *R-51*, Sch. RJH-4, Sch. RJH-10 (8+4 Update).

- The Ratepayer Advocate's recommended decrease of $388,000 in Pro Forma net SFAS 87 Pension expenses, resulting in an increase in Net Operating Income of $229,000 should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-11 (8+4 Update).

- The Ratepayer Advocate's recommended decrease of $80,000 in Pro Forma net SFAS 106 OPEB expenses, resulting in an increase in Net Operating Income of $47,000 should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-12 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment (decrease) for Rate Case Expense Position of $105,000 for an impact on Net Operating Income of $62,000 should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-13 (8+4 Update).

- The Ratepayer Advocate's recommended removal from test year expenses of all expenses associated with the Company's proposed Enhanced Service Reliability Program, resulting in an increase in Net Operating Income of $675,000 should be adopted. *R-51*, Sch. RJH-4 (8+4 Update).

- The Ratepayer Advocate's recommended removal from test year expenses of the Company's proposal to retain 25% of estimated Merger Savings alleged to be incorporated in the test year, resulting in an increase in Net Operating Income of $393,000 should be adopted. *R-51*, Sch. RJH-4 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment to reduce Storm Damage Expense by $80,000, increasing Net Operating Income by $47,000 and decreasing Net Rate Base by $53,000 should be adopted. *R-51*, Sch. RJH-3, Sch. RJH-4, Sch. RJH-14 (8+4 Update).[26]

- The Ratepayer Advocate's recommended Miscellaneous Expense adjustments with the effect of reducing test year expenses by $75,000 and increasing test year Net Operating Income by approximately $44,000 should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-15 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment (decrease) for Various Amortization Expenses of $180,000, resulting in an increase of Net Operating Income of $106,000 should be adopted. *R-51*, Sch. RJH-4, Sch. RJH-16 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment (decrease) to Depreciation Expense Position of $2,149,000 with an impact on Net Operating Income of $1,271,000 should be adopted. *R-51*, Sch. RJH-4, RJH-17 (8+4 Update).

- The Ratepayer Advocate's recommended adjustment for Interest Synchronization, amounting to a decrease in the Company's pro-forma test year Net Operating Income of $325,000 should be adopted. *R-51*, Sch. RJH-4, RJH-18 (8+4 Update).

- The Ratepayer Advocate's recommended removal from test year expenses of the Company's proposed Common Expense Allocation adjustment, resulting in an increase in Net Operating Income of $230,000 should be adopted. *R-51*, Sch. RJH-4 (8+4 Update).

- The Ratepayer Advocate's recommendation to include annualized Late Payment Fee revenues in the test year, resulting in an increase in Net Operating Income of $81,000 should be adopted. *R-51*, Sch. RJH-4 (8+4 Update).

Rate Design

- The Ratepayer Advocate's proposed distribution rate decrease should be allocated proportionately to each customer class based on each class's current annual distribution service revenue.

[26] The difference in Schedules RJH-3, line 19 (8+4 Update) and Schedule RJH-14, line 7 (8+4 Update) is due to rounding.

- The Company's cost-of-service study should be rejected, and the cost allocation principles stated in the *JCP&L 1993 Base Rate Order* should be reaffirmed.

- The Company's proposed increases in its monthly customer service charges, ranging from 37.7% for residential customers to 143.3% for Primary Time-of-Use customers, are not supported by a proper analysis of customer costs, and would unduly burden those customers with the lowest electricity usage. These proposed increases should be rejected and the current service charges maintained.

- Rockland's current dishonored check charge, which includes a cost pass through for bank fees, is contrary to established ratemaking principles and unfair to customers. The dishonored check charge should be set at a flat $7.00 for both residential and non-residential customers, reflecting the Company's average costs of handling dishonored checks.

- The Company's proposed increase in its Reconnection Charge, from $7.00 before 3:00 pm on weekdays and $21.00 after hours, to $27.00 at all times, is based on an analysis that includes costs not properly attributable to reconnections. The Company's reconnection charge should be set at $15.00 at all times, consistent with the charges of two other New Jersey electric utilities.

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By: ______________________________
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Dated: March 18, 2003

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