**BEFORE THE STATE OF NEW JERSEY**
**BOARD OF PUBLIC UTILITIES**
**OFFICE OF ADMINISTRATIVE LAW**

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| **I/M/O THE PETITION OF PUBLIC SERVICE** | ) | |
| **ELECTRIC AND GAS COMPANY FOR** | ) | **DOCKET NO. ER02050303** |
| **APPROVAL OF CHANGES IN ELECTRIC** | ) | **OAL DOCKET NO. PUC 5744-02** |
| **RATES, FOR CHANGES IN THE TARIFF FOR** | ) | |
| **ELECTRIC SERVICE, CHANGES IN ITS** | ) | |
| **ELECTRIC DEPRECIATION RATES AND FOR** | ) | |
| **OTHER RELIEF** | ) | |

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# REPLY BRIEF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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## INTRODUCTION

In this Reply Brief, the Division of the Ratepayer Advocate ("Ratepayer Advocate") will respond to those parts of the Initial Briefs of the other parties that require further discussion. The Initial Briefs of the other parties will be cited as follows:

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|---|---|
| Public Service Electric and Gas Company | |
| Revenue Requirements | = PIB |
| Depreciation | = PDIB |
| Cost of Service and Rate Design | = PCSIB |
| Staff of the Board of Public Utilities | = SIB |
| Municipal Utility Authority Intervenors | = MUIB |
| Ratepayer Advocate Initial Brief | = RAIB |

To the extent that our Reply Brief does not respond to arguments and allegations contained in some of the Initial Briefs, this does not signify that the Ratepayer Advocate concedes any of the positions it has taken in our Initial Brief. The Ratepayer Advocate continues to urge Your Honor and the Board of Public Utilities ("Board") to adopt those recommendations.

## POINT I

## THE BOARD SHOULD ADOPT THE RATEPAYER ADVOCATE'S RECOMMENDED 9.5% RETURN ON EQUITY, WHICH IS BASED ON WELL-ESTABLISHED METHODS, RELIES ON VALID RESEARCH, AND IS CONFIRMED BY RECENT MARKET TRENDS.

### A. Introduction

#### 1. Overview

PSE&G in its Initial Brief argues, based on the testimony filed by Dr. Roger Morin, that Your Honor and the Board should permit an 11.6% return on equity. In the Initial Brief of the Ratepayer Advocate, the infirmities of Dr. Morin's approach were analyzed in depth, and the Ratepayer Advocate will continue to rely on those arguments here. This Reply Brief will note Board Staff's positions, particularly Staff's commentary regarding the difference between PSE&G's risk factor versus that of its parent, and the inconsistency of Staff's argument with its return on equity recommendation. This reply brief will also respond to PSE&G's specific critiques of the testimony filed by the Ratepayer Advocate witness Mr. Copeland, and will show that Mr. Copeland's two DCF Models were calculated correctly and are consistent with long- term growth forecasts reflective of investors' expectations. Similarly, this brief will show that Mr. Copeland properly applied the Inflation Risk Premium/CAPM method.

#### 2. Contrary to PSE&G's Assertion, The Return on Equity Does Represent A Profit Element.

The Company again tries to bring up the argument that the return on equity does not represent a profit, but rather, represents a cost. It attempts to validate this argument with the statement that Mr.

Copeland notes that the purpose of his testimony is to "...present evidence concerning the cost of equity capital..." *RA-1*, p. 3, PIB at 100, 114. This is purely a matter of semantics. No matter how it is phrased, the return on equity represents the residual income available to the stockholders of PSE&G after all costs have been subtracted from the Company's revenues. The Ratepayer Advocate would argue that this is profit. Indeed, if the return on equity is not a profit, then no company would ever be able to report a profit.

**3. The Company Presents Unsupported Assertions About Economic Factors.**

At the outset, it is necessary to address PSE&G's arguments that do not relate to the substance of the experts' analyses. The first is the Company's argument that the terrorist events of September 11, 2001 justify a higher rate of return. PSE&G claims, without any supporting evidence whatsoever, that its business risk has increased since the recent tragic events. PIB at 26. Even though the events of September 11 have been harmful to this area and created uncertainty in the business and financial community, it is likely that the effect of this uncertainty is that investors will seek out more secure investments for their money. In such an environment, regulated utilities provide protection to investors, because of their franchise monopoly and the continuing need for the basic services they provide. Thus, the recent tragic events may well decrease the appropriate return on equity for PSE&G.

**4. The Company Unjustifiably Questions the Credibility of Ratepayer Advocate Witness Copeland.**

PSE&G's wholly unjustified attack on Mr. Copeland's qualifications in its Initial Brief is without merit. PSE&G states that Mr. Copeland is "driven by his desire to secure the lowest possible rate without regard to the financial impact on the Company," and appears to denigrate Mr. Copeland's

expert witness career for having been devoted primarily to staffs of utility commissions and consumer advocates. PIB at 34, 27. To the contrary, consumer advocates are vitally interested in assuring the financial integrity of utilities in order for them to be able to provide to their customers the safe and reliable service that is the statutory mandate.

In this proceeding, Mr. Copeland's recommendation is founded on that concern, and despite the Company's unsupported claim to the contrary, Mr. Copeland did not propose the lowest possible return on equity. Mr. Copeland used two DCF methods plus the CAPM/risk premium method, resulting in a range of costs of equity. He chose to rely for his recommendation on the midpoint between the CAPM and DCF methods. *RA-1*, p. 15. Mr. Copeland's motives should be compared to those of the Company, which has no need whatsoever to bring a balanced perspective to this proceeding, and whose sole concern is the interest of its shareholders in the highest possible return on equity. Your Honor and the Board should carefully weigh the motives underlying the recommendations respectively of the Company and the Ratepayer Advocate, and it will realize that it is Mr. Copeland who proposes a cost of equity that balances the needs of the Company and its ratepayers.

Indeed, in several places in its Initial Brief, the Company even takes statements by Mr. Copeland out of context in the attempt to advance its position. For example, at page 43, the Company claims that Mr. Copeland "himself admitted that his recommendation is so low that it, essentially, could not be reduced any further." PIB at 43. This is a disingenuous attempt to misrepresent Mr. Copeland's answer to Board Staff's question. Rather than PSE&G's "interpretation" of that answer, Mr. Copeland made no statement that his recommendation was low in any absolute sense; rather, Mr. Copeland explained quite simply that he would not lower his recommendation without a further substantial

lowering of interest rates.

Another example of the Company's reliance on out-of-context statements occurs when the Company presents return on equity numbers that Mr. Copeland has derived under other circumstances in other cases as certain proof that the number he has recommended for PSE&G must be incorrect. PIB at 43-44. The Company fails, however, to note Mr. Copeland's qualifying response when asked about a number he had at one point derived for Public Service Enterprise Group:

> Well the number is 12.69 percent for that individual observation. And there is a reason why we do a sample of numbers and take the average and not rely on any number that's unusually high or low because those individual numbers are not as reliable as the average for the sample. T90:L6-12

Likewise, the Company points out a base rate case proceeding from three years ago in the state of Colorado in which Mr. Copeland's DCF methodology reveals a 12.55% return on equity for Public Service Enterprise Group. The Company points to Exhibit P-14, Schedule 2 as its proof. However, looking at the Company's proof reveals that Mr. Copeland's first DCF calculation resulted in a 9.38% result (which Mr. Copeland also clearly noted on the stand). T100:L3-4.

PSE&G attempts to impugn Mr. Copeland's credibility because in some recent utility proceedings wherein he testified, the Company asserts the adopted returns on equity propounded by Mr. Copeland are inconsistent and that he "routinely varies his DCF methodology." PIB at 45. The illogic of this statement is easily apparent. The Ratepayer Advocate expert witnesses take into consideration the different facts that are in evidence from case to case, necessitating changes in implementation details. Experts such as Mr. Copeland and Dr. Morin can differ in their interpretation

of any given facts. "If the Board could determine what is a reasonable rate of return simply by looking at what other Commissions have allowed, there would be no need for witnesses like Dr. Morin and [Mr. Copeland] to present independent evidence of the cost of equity. While these may be current allowed rates of return, we do not know when these returns were originally set, or what circumstances prevailed at the time they were set . . . .Unless Dr. Morin proposes to file in this case all of the facts and circumstances that led to those other decisions, there is no way anyone can independently determine whether or not those rates would be reasonable based on the facts and circumstances of this case. Hence, the information is of no probative value and should be ignored." *RA- 3*, pp. 1-2. When facts and circumstances change, so may the effect upon the expert recommendation. Without examining the facts of each and every one of the cases that the Company puts forth, there simply can be no interpretation that one of those results was "more correct" than Mr. Copeland's recommendation for PSE&G.

Finally, the Company points out that there were "errors and inconsistencies" in Mr. Copeland's testimony. However, the alleged "errors" are primarily typographical mistakes, which were corrected by Mr. Copeland on the witness stand, and did not affect the validity of his findings.

### B. The Company Presents An Incomplete Recitation Of The Relevant Legal Standard.

The Company has carelessly cited the *Bluefield* case along with *Hope* as being the litany regarding legal principle associated with investor return. *Bluefield Water Works & Improvement v. Public Service Commission*, 262 *U.S.* 679 (1923); *Federal Power Commission v. Hope Natural*

*Gas*, 320 *U.S.* 591 (1944). Despite being placed together with *Hope*, the legal principles that underlie *Bluefield* were rejected by *Hope*.[1] The true standard of *Hope* of what is "fair and reasonable" is not the one-sided review of investor concerns, but requires a proper balancing of investor and consumer interests. *Hope* states that, "[t]he rate-making process under the Act, *i.e*., the fixing of 'just and reasonable' rates, involves a balancing of the investor and consumer interests." *Hope* at 603. Indeed, consumer protection was not a one-time consideration of the Court; the *Hope* court relied as precedent upon another Supreme Court decision in which the concurring opinion of Justices Black, Douglas and Murphy addressed the question of "just and reasonable" ratemaking from the standpoint of the competing interests of the consumers and investors:

> The requirement of "just and reasonable" embraces, among other factors, two phases of the public interest: (1) the investor interest; (2) the consumer interest. The investor interest is adequately served if the utility is allowed to earn the cost of service. That cost has been defined by Mr. Justice Brandeis as follows: "Cost includes not only operating expenses, but also capital charges". . . . Irrespective of what the return may be on "fair value," if the rate permits the company to operate successfully and to attract capital all questions as to "just and reasonable" are at an end so far as the investor interest is concerned. *Federal Power Commission v. Natural Gas Pipeline*, 315 *U.S.* 575, 606-607 (1942).

Justice Black added:

> One *caveat* however should be entered. The consumer interest cannot be disregarded in determining what is a "just and reasonable" rate. Conceivably, a return to the company of the cost of service might not be "just and reasonable" to the public. The correct principle was announced by this *Court in Covington & Lexington Turnpike v. Sandford*, 164 *U.S.* 578, 596: "It cannot be said that a corporation...is

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[1] Basil L.Copeland, Jr. & Walter W. Nixon, III, *Procedural Versus Substantive Economic Due Process for Public Utilities*, Vol. 12, No. 1 ENERGY LAW JOURNAL 81, 94 (1991).

> entitled as of right, without reference to the interest of the public, to realize a given percent upon its capital stock... ." It reemphasizes...that the investor is not the sole interest for protection. The investor and consumer interests may so collide as to warrant the rate-making body in concluding that a return on historical cost or prudent investment, though fair to investors, would be grossly unfair to the consumers. *Id*. at 607-608.

Over two decades after the *Hope* case, the Supreme Court re-emphasized the necessity of balancing the interests of ratepayers and shareholders in the *Permian Basin Area Rate Cases*. *Permian Basin Area Rate Cases*, 390 *U.S.* 747 (1968).[2] Here, the Court stated that "regulation may, consistent with the constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." *Permian Basin Area Rate Cases* at 769. The agency would certainly have to have good reason and justification – but the language clearly states that something less than the interest of the investor may be allowed, implying that the more important interest lies with that of the general public.

**C. The Ratepayer Advocate's Witness Properly Calculated An Appropriate Return On Equity.**

Both witnesses in this proceeding used more than one approach to arrive at a recommended cost of equity. Mr. Copeland used two DCF approaches and the risk premium/CAPM methods. He exercised his professional judgment and chose to rely primarily on the DCF method, which produced a higher return than his CAPM analysis, for his recommendation of 9.5%. He stated that he relied on the DCF method because, in his judgment, under current circumstances the risk premium/CAPM methods understate the required cost of equity. Mr. Copeland notes that "the CAPM is much more sensitive to

[2] *Id*. at 98.

the changes in interest rates than the DCF is....Right now, we have the monetary policy which has kept interest rates very low. That's not showing up all that much in the DCF but it's showing up dramatically in the CAPM." The CAPM should not be discounted as a method, however, for it corroborates the utter reasonableness of Mr. Copeland's 9.5% recommendation.[3] T123:L16-25. The Ratepayer Advocate's Initial Brief explains in detail the reasons why Mr. Copeland's methodology results in a reasonable estimate of the cost of equity. The following discussion will address the Staff's and the Company's criticisms of certain aspects of Mr. Copeland's analyses.

**1. Staff Utilizes Facts Not In Evidence In Its Argument That Mr. Copeland Did Not Use the Correct Proxy Companies For His Recommendation.**

Staff clearly notes that "the estimates of the cost of equity for PSE&G derived by Mr. Copeland appear to be in the right order of magnitude." SIB at 73. However, Staff argues that "Mr. Copeland failed to provide any justification for using the sample companies selected by Dr. Morin" and that he "fail[ed] to explain how he translated a market cost of equity for the various parent holding companies into a cost of equity for the regulated subsidiary PSE&G(E)."

Whether or not there is merit to Staff's arguments is nearly irrelevant at this point. At no time during Staff's cross examination of Mr. Copeland did Staff raise the question to Mr. Copeland regarding his choice of proxies. Therefore, Staff's argument is being made on the basis of facts that have not been presented.

Staff rejects Mr. Copeland's (and Dr. Morin's) methodology, and chooses a 9.75% return on

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[3]The Company oddly notes that "Mr. Copeland has placed (albeit quietly) primary reliance on the CAPM." PIB at 48. Indeed, had Mr. Copeland truly relied primarily on the CAPM, his recommendation would have been far lower (his CAPM result was 8.12%).

equity, stating that:

> The overall range of recommendations is Mr. Copeland's 9.5% and Dr. Morin's 11.6%. Given that the two gas cases recently settled at 10% for the riskier gas industry, it is difficult to support a recommendation above 10%. (citations omitted) Thus, Staff will use 9.75% for the cost of equity to calculate the overall cost of capital in its brief. SIB at 74-75.

However, no support is given for how this number was chosen, other than a rationale that "when interpreting the impacts on a utility, some leeway should be recognized for the overhang of the more risky parent." SIB at 64.

In any event, Staff may be arguably correct that there is a question of PSE&G's insulation from its parent, as well as the fact that rating actions that affect PSE&G have been attributed to negative developments at the holding company level. However, the fact remains that it may well be impossible to find market-traded companies with the kind of "stand alone" risk that Staff associates with the Company. The previously discussed *Hope* case contains the standard that the rate of return should be commensurate with the return on investments of "comparable risk." Investors do not invest in "stand alone" entities. They invest in shares of consolidated entities. Rate of return witnesses such as Mr. Copeland and Dr. Morin must utilize the share prices of market-traded companies to determine the cost of equity. These share prices never reflect "stand alone" risk *per se.*

Thus, there can be no completely valid criticism of the group of proxies on the grounds alleged by Staff. However, if the "stand alone" risk is, as Staff argues, arguably less than the risk reflected in the share price of market-traded entities, logically, the adopted rate of return should be at the lower end of the range of "reasonableness."

**2. The Company's Criticisms Of Mr. Copeland's Discounted Cash Flow**

**("DCF") Analyses Are Unfounded.**

The Company continues to rehash the same points that were already clearly refuted in Mr. Copeland's rebuttal testimony.

First, the Company claims that Mr. Copeland used "stale dividend yield data." PIB at 51. Dr. Morin's calculations incorrectly tabulate the average dividend yield for the companies in Mr. Copeland's sample at 6.1%, based on data from mid-October 2002. *Id*. at 52. However, as the table in Mr. Copeland's rebuttal testimony shows, the dividend yield calculation is 4.7%, based on the Value Line Report from December 2, 2002. *RA-3*, pp. 3-4. The Company's claim that the data is "stale" is simply erroneous.

Next, the Company incorrectly criticizes Mr. Copeland's reliance on dividend growth rates as a DCF growth proxy rather than earnings growth rates, upon which Dr. Morin relied. By focusing on the earnings growth rate, Dr. Morin patently ignores the impact of short-term declining payout ratios and low dividend growth on investor expectations. *R-3*, p. 9. Dr. Morin also attempts to dismiss dividend growth as "outlier." PIB at 53. This erroneous argument (also addressed in Mr. Copeland's rebuttal) ignores the fact that utilities are increasing their earnings ratios, and reducing dividend payout ratios. Dividend yields are expected to grow more slowly until payout ratios stabilize. Dr. Morin, however, would prefer to ignore dividend growth altogether, rather than acknowledge the fact that the changing payout ratio has an impact upon a DCF analysis. *RA-3*, pp. 6-7.

The Company continues its arguments that have already been refuted by again trying to argue that Mr. Copeland's DCF model underestimates the return expected by the investor because Mr. Copeland multiplies the spot dividend yield by one plus one half the expected growth rate (1 + 0.5g)

instead of by one plus the expected growth rate (1 + g). PIB at 53. Mr. Copeland explained in his rebuttal that Dr. Morin's proposed functional form is analogous to the use of a beginning-of-year rate base. This has the effect of overstating the projected return. In order to properly match earnings, the flow of dividends must be divided by the average value of the stock that produces it. The correct way to do this, as Mr. Copeland did, was to take one-half of the growth of the coming year's dividends and relate to today's stock price. *RA-3*, pp. 5-6.

Regarding the issue of flotation costs, the Company again tries to argue what has been done in other rate cases with different fact patterns and evidence. The Company argues against a very simple proposition. Mr. Copeland clearly stated that flotation costs or their amortization are not the actual issue. Indeed, amortization recovers a ratable allocation to a current operating expense. Rather, the issue lies with Dr. Morin's treatment of them. Rather than using real numbers based on a real stock issuance – such as the one actually done during the test year – Dr. Morin chose to use purely hypothetical numbers that far exceed anything the Company is likely to experience on an annualized basis. Dr. Morin appears to propose a form of retroactive ratemaking in order to recover past flotation costs, in direct contradiction to a basic ratemaking principle. *RA-3*, pp. 16-17.

### 3. The Company's Criticisms of Mr. Copeland's CAPM Analyses Are Unfounded.

The Company again doggedly drags out arguments already refuted by Mr. Copeland. It remains unclear why Dr. Morin believes that natural gas betas are a better proxy for electric utilities than electric utility betas. One only needs to examine the natural gas utilities in New Jersey to question the validity of this statement. Indeed, assuming the correctness of Staff's arguments regarding its

reservations about riskier holding company versus safer subsidiary stock, Mr. Copeland's use of a .55 beta is further validated. Even without this assumption, Dr. Morin continues to fail to present convincing evidence that there is any downward bias in electric utility betas. As Mr. Copeland explains, all raw betas below one have a downward bias, and all raw betas above one have an upward bias. No evidence is presented that electric utilities have any special anomaly that excepts them from this bias. Finally, the Value Line betas are already adjusted for bias. Mr. Copeland has been estimating cost of equity capital for over twenty-five years, and notes that there has been no indication of any general upward trend in utility betas. *RA-3*, p. 11.

PSE&G continues to argue against the use of the geometric mean in order to determine a market risk premium as part of the CAPM analysis. There is little left to say, other than to note that again the Company attempts to take partial statements, out of context, in order to validate its weak positions. The Company's Initial Brief points to a sentence from a scholarly article[4] used by Mr. Copeland that supposedly actually "ratifies the position contra" to that of Mr. Copeland. PIB at 58. Had the Company chosen to include the rest of the statement, Your Honor and the Board would have read that the article actually argues for the use of the geometric mean. The rest of the statement provided by the Company at page 58 of its Initial Brief reads:

> We argue that the expected wealth relative for the holding period is the relative metric. If the holding period of concern is of such length that more than one non-overlapping investment horizon exists within the data base of periodic returns, then more than one holding period wealth

[4]Russell J. Fuller and Kent A. Hickman, "A Note on Estimating the Historical Risk Premium," *Financial Practice and Education*, Fall/Winter 1991, Vol. 1, No. 2, 45-48. This article describes the correct procedure for computing a long horizon equity risk premium using the geometric mean for periods matching the investment horizon for which the risk premium is being computed. *RA-1*, p. 18.

> relative can be estimated. In this case, there exists a sample of wealth relative, and the arithmetic mean of this sample should be used as the best estimate of the expected wealth relative of the expected horizon of a given length. <u>The risk premium may then be estimated as the difference between the stock and bond holding period returns, computed as the geometric means of their expected wealth relatives</u>. (Emphasis added.) Fuller & Hickman at 48; T158-159:L10-5.

Trying to help its case on a partial statement taken out of context is at best disingenuous and at worst, an attempt to misdirect Your Honor and the Board.

Finally, the Company claims that Mr. Copeland used "raw" betas in his CAPM calculations. To the contrary, as he stated in his rebuttal, Mr. Copeland used Value Line betas, "which are adjusted for the tendency of betas to regress toward the mean." *RA-3*, p. 12. Mr. Copeland does, however, argue against the use of Value Line betas in Dr. Morin's ECAPM analysis. As Mr. Copeland noted, "[i]f one is going to use the results of the ECAPM to 'adjust' a CAPM result, one must begin in the same place that the ECAPM begins - with 'raw betas.' When one uses the 'adjusted' betas of Value Line in a CAPM analysis, one is implicitly approximating an ECAPM result. These adjusted betas make the risk-return tradeoff flatter than it would be using unadjusted betas. No further adjustment is necessary, and to explicitly do an ECAPM analysis using adjusted betas rather than raw betas double-counts the empirical effect of historical betas. Nothing in Dr. Morin's Rebuttal Testimony actually answers this fundamental criticism." *RA-3,* p. 13. Nothing in the Company's Initial Brief answers this criticism.

## POINT II

## PSE&G HAS PRESENTED NOTHING WHICH REFUTES THE RATEPAYER ADVOCATE'S RECOMMENDATIONS REGARDING THE COMPANY'S DEPRECIATION EXPENSE.

As set forth below, in its Initial Brief the Company has not provided any convincing argument against the adoption of the depreciation adjustments advocated by the Ratepayer Advocate. For the reasons set forth below and its Initial Brief and testimony of its witness, Mr. Michael J. Majoros, Jr., the Ratepayer Advocate respectfully submits that its depreciation recommendations should be adopted.

### A. General and Common Plant

The Ratepayer Advocate does not object to the use of the Company's proposed depreciation rates for its electric General and Common Plant. However, as noted in its Initial Brief, the Ratepayer Advocate does not concede to any underlying methodology or the calculations underlying the Company's proposed depreciation rates for General and Common Plant, noting that those rates were the product of an earlier Stipulation. RAIB at 26. Board Staff also does not oppose the Company's proposed rates for its electric General and Common Plant. SIB at 50.

### B. Electric Distribution Plant

At issue is the proper depreciation rate for PSE&G's electric Distribution Plant. The depreciation rate is a product *inter alia* of the service lives of the underlying assets. PSE&G argues that the depreciation rate for its electric distribution assets should not be changed, notwithstanding the fact a lower rate was used in calculating its excess depreciation reserve in its Restructuring Case.[5] The

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[5] *I/M/O PSE&G's Rate Unbundling, Stranded Costs and Restructuring Filings*, BPU Docket Nos. EO97070461, EO97070462 and EO97070463 ("*Restructuring Case*").

Company's proposed rate, 3.52 percent, is based on a 28-year service life for the assets. The Ratepayer Advocate recommends that a rate of 2.49 percent be used for the electric Distribution Plant, reflecting a service life of 45 years. RAIB at 26-33. Board Staff and the MUA interveners also support the use of the 2.49 percent depreciation rate for the Company's electric Distribution Plant. SIB at 49-54; MUIB at 2-8. As set forth below, in its Initial Brief the Company has offered nothing which refutes the Ratepayer Advocate's recommendation.

### 1. Reasonableness of the 2.49 Percent Depreciation Rate

As set forth below and in the Ratepayer Advocate's Initial Brief and testimony of its witness, contrary to the assertions of PSE&G, there is ample basis in the record for the adoption of the 2.49 percent depreciation rate, which is supported by the Ratepayer Advocate. RAIB at 26-32; *See RA-6, RA-7*. In contrast, the only support proffered by PSE&G for continuation of the 3.52 percent rate is a utility comparison study performed by its witness and a partial analysis. PDIB at 15-16.

A key factor in the determination of the depreciation rate percentage at issue is the service life of the underlying assets. The Company's proposed rate of 3.52 percent is based on a service life of 28 years. The 2.49 percent depreciation rate recommended by the Ratepayer Advocate, Board Staff, and the MUA interveners is based on a service life of 45 years. As noted in the Ratepayers Advocate's Initial Brief, perhaps the most compelling argument for the use of a longer service life comes from the Company's own witnesses. RAIB at 28-29. In testimony filed in PSE&G's Restructuring Case, Company witness Mr. Robert C. Krueger, Jr. specifically requested "that the average service life used to establish depreciation for the Company's distribution plant investment,

identified on the attached Schedule RCK-E2, be extended from 28 to 45 years.'"[6] Furthermore, as noted by Board Staff, Company witness Mr. Bachmura testified at an evidentiary hearing in support of longer service lives for the Distribution Plant assets at issue:[7]

> The 1970s studies showed true need of a life of 28 years. As time went on the lives and new studies showed that the lives were getting longer. And that is correct. Now the lives and asset back in 1997 were around 28 years. Now they would say that the life is, yes around 45 years. T249:L21-T250:5.

Furthermore, Mr. Majoros tested the continued reasonableness of the 2.49 percent rate (which PSE&G calculated based on a 45 year life and zero salvage value) and found it to be a reasonable rate. *RA-7*, p. 5. Mr. Majoros compared the average service lives underlying the 2.49 percent rate to the lives identified by the Company in a partial year 2000 depreciation study. *Id.*, p. 4. Mr. Majoros found that the average lives of the plant assets are getting longer and, therefore, concluded that the 2.49 percent rate continues to be reasonable. *Id*.

Nonetheless, the Company states that its partial analysis indicated that its depreciation rate should be 4.51 percent, which is even higher than its proposed rate of 3.51 percent. *Id*. PSE&G's partial analysis was based on a 75 percent salvage factor. *Id*. However, the Company did not provide any removal cost documentation to support the 75 percent net salvage factor used in its partial analysis. In short, the partial analysis proffered by the Company does not provide any credible support for the 3.51 percent rate.

Additionally, in support of its argument, the Company proffers a four year old study of a sample

[6] *RA-6*, MJM-3 (testimony appended to response to RAR-DEP-53).

[7] SIB at 53.

of overall weighted composite depreciation rates for other utilities compiled by two industry trade groups, the Edison Electric Institute and the American Gas Association. PDIB at 15-16, 25-26; *RA-7*, MJM-8 (response to RAR-DEP-73). However, as noted by Mr. Majoros, the utility comparison study relied upon by PSE&G was fraught with unanswered questions. *RA-7*, pp. 6-8. Mr. Majoros noted the age of the study, the questions surrounding the study's use of weighted composite rates, and regulatory differences among the States represented in the survey as causes of concern. *Id.* Significantly as noted by the MUA intervenors, Mr. Bachmura's use of the utility survey to support the 3.52 percent depreciation rate was based on the depreciation rates of other utilities, not PSE&G's own experience. MUIB at 4. As set forth herein and the Ratepayer Advocate's Initial Brief and the testimony of its witness, the proffered sample does not support the 3.52 percent rate advocated by the Company. RAIB at 31-32.

Contrary to the Company's claims, the $568.7 million excess depreciation reserve computation in its Restructuring Case was more than a " mathematical accounting exercise used to fund the bill discounts...." PDIB at 3. The Ratepayer Advocate respectfully submits that the calculation was something much more than that. The calculation of the excess depreciation reserve of $568.7 million has its genesis in the use of the lower depreciation of 2.49 percent, based on a 45-year service live for Distribution Plant assets. The Board adopted the excess depreciation reserve calculation of $568.7 million and the New Jersey Supreme Court acknowledged the import of lengthening the service (useful) lives of the Company's electric distribution plant assets.[8]

PSE&G's arguments based on the treatment of net salvage are without merit. PDIB at 3-6,

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[8] *Restructuring Case Final Order*, p. 115; *In re Pub. Serv. Elec & Gas Co.*, 167 *N.J.* 377, 388-389 (2001).

23-25. The 2.49 percent depreciation rate does not reflect net salvage because PSE&G itself did not include net salvage when it computed the rate. It is reasonable to assume that if PSE&G anticipated net salvage, it would have included it in its computations to arrive at the 2.49 percent rate. One might conclude that PSE&G either assumed that it would not experience any future net salvage or assumed that it had already collected too much from ratepayers. The latter observation would be consistent with PSE&G's original assumption of a depreciation reserve excess in its Restructuring Case testimony. Moreover, in any case, PSE&G has not supported it net salvage claim with documentation of its actual removal costs. The Company's position is also inconsistent with the parameters underlying its current depreciation rate. As Mr. Majoros testified, the Company's depreciation rate based on a 28-year life was set using a zero percent salvage value. *RA-6*, MJM-3 (response to RAR-DEP-53).

Additionally, the assumption of zero net salvage does not conflict with the depreciation methodologies expressed in the depreciation manual cited by PSE&G. PDIB at 4. The National Association of Regulatory Utility Commissioners ("NARUC"), in its 1996 publication entitled "Public Utility Depreciation Practices" ("NARUC depreciation manual"), recognizes that net salvage need not be reflected in depreciation rates as a matter of course:

> 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. NARUC depreciation manual, p. 158.

The NARUC depreciation 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.*

Here, assuming *arguendo* that PSE&G were to present credible documentation to support a claim for net salvage, exclusion of such removal costs from depreciation rates would not be inconsistent with the various treatments set forth for net salvage in the NARUC depreciation manual.

PSE&G also attempts to fault Mr. Majoros for not conducting a full depreciation study. PDIB at 16, 23. However, PSE&G admits that although it performed a preliminary depreciation analysis, the Company did not conduct a full depreciation study either to support its proposed rates or refute those recommended by Mr. Majoros. PDIB at 15.

While PSE&G proposed a change in rates for its General and Common Plant, it based its proposed depreciation rates on those adopted in its recent gas base rate case. Notably, PSE&G did not submit a full depreciation study using 2002 test year data to support its proposed changes in its General and Common plant depreciation rates, or any of its proposed depreciation rates for that matter. Instead, it proposed to rely on the depreciation rates adopted in its gas base rate case for its General and Common Plant, which were the product of a settlement among the parties to that case and

subsequently approved by the Board.[9]

Here, the depreciation rate for Distribution Plant supported by the Ratepayer Advocate, Board Staff, and the MUA interveners was the product of an earlier Stipulation adopted by the Board and later affirmed by the New Jersey Supreme Court.[10] Moreover, as discussed above and in the Ratepayer Advocate's Initial Brief, there is ample support in the record in the instant case for the 2.49 percent rate for Distribution Plant. RAIB at 26-32.

**2. Burden of Proof**

Contrary to the assertions of PSE&G, as set forth below, PSE&G has the burden of proof to show that its proposed rates are just and reasonable. PDIB at 19-22. In the instant case, PSE&G proposes to change its depreciation expense as part of its base rate increase petition. *P-1*, p. 3-4. The Company proposes a test year depreciation expense of $178.4 million, which constitutes a significant portion of its claimed test year expenses. *See RA-60*, Sch. RJH-18R (12+0), line 10. The relevant New Jersey statute governing rate proceedings clearly provides that "[t]he burden of proof to show that the increase, change, or alteration is just and reasonable shall be upon the public utility making the same." *N.J.S.A*. 48:20-21(d). Clearly, PSE&G ultimately bears the burden of proof to show that its proposed depreciation expense is just and reasonable. In a 1997 case, the Appellate Division recognized the burden placed on the utility in a rate case:

> The burden of proof to show that the proposed rates are just and reasonable is upon the utility. *N.J.S.A*. 48:2-21(d). As part of its proof, the utility must prove: (1) the

[9] *I/M/O PSE&G*, BPU Docket Nos. GR01050328, GR01050297 (Order dated January 9, 2002).

[10] *See Restructuring Case Final Order*; *In re Pub. Serv. Elec & Gas Co.*, 167 *N.J.* 377 (2001).

> value of its property or the rate base, (2) the amount of its expenses, including operations, income taxes and depreciation, and (3) a fair rate of return to investors. *See In re Jersey Central Power & Light Co.*, 85 *N.J.* 520, 529 (1981)].[11]

In its Initial Brief, PSE&G cited the language in the *Petition of Public Service* case which addresses the burden on parties proposing an alternative to the rates proposed by a utility. PDIB at 19-20. Notably, in the *Petition of Public Service* case, the Appellate Division aptly noted that the Board consistently recognized that the Company had the burden of proof for the ultimate issue, that its rates were just and reasonable. *Petition of Public Service* at 274. The Appellate Division in the *Petition of Public Service* case did not find that the ultimate burden of proof shifted to the challenger, only that the party raising a defense to the moving party's claim bears the burden of coming forward with evidence to support its defense. *Id, citing Citibank v. Estate of Simpson,* 290 *N.J. Super* 519, 530 (App. Div. 1996). The Appellate Division noted that the Board found that the challenger did not present sufficient evidence to overcome the evidence presented by the Company. *Id.*

In the instant case, as set forth above, Mr. Majoros proposed an adjustment to the Company's Distribution Plant depreciation rate which was supported by ample evidence in the record. Mr. Majoros' conclusions were supported by clear and convincing evidence, which included Mr. Majoros' testimony and analysis, as well as the prior testimony of the Company's own witness and cross-examination transcripts. *See supra*. Moreover, the Board accepted the lower Distribution Plant depreciation rate calculation (now recommended by the Ratepayer Advocate) in its Final Decision and Order in the Company's Restructuring Case, which was subsequently upheld by the New Jersey

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[11] *Petition of Public Service Electric and Gas Co.*, 304 *N. J. Super* 247, 265 (A.D. 1997, *certification denied* 152 *N.J.* 12) ("*Petition of Public Service*").

Supreme Court.[12] *See supra*. In contrast, PSE&G did not present any studies to support its proposed depreciation rate for Distribution Plant, other than the sample survey presented by its witness and a partial analysis. Here, the evidence in the record supporting the depreciation rate proposed by the Ratepayer Advocate clearly outweighs that presented by the Company.

The instant case may be distinguished from the tax appraisal case cited by PSE&G, *Public Service Electric and Gas Co. v. Township of Woodbridge*, 139 *N.J. Super*. 1 (App. Div. 1976), aff'd in part and rev'd in part on other grounds, 73 *N.J.* 474 (1977) ("*Woodbridge*") PDIB at 21. In the *Woodbridge* case, the testimony of a town's real estate appraiser on the physical life of a structure was weighed against the Board-approved depreciation rate for a structure, which the Court noted was based on an analysis of its functional life. *Woodbridge* at 21. In the instant case there is no such disagreement, both Mr. Majoros and the Company's witnesses testified as to the useful (functional) life of the assets in question. Furthermore, Mr. Majoros followed the same approach - predicated on the useful (*vs.* physical) life of a utility asset - presumably followed by the Board in evaluating the depreciation rate when it was last considered by the Board. Additionally, as set forth in the Appendix to his testimony, Mr. Majoros has significant experience in public utility depreciation issues. *RA-6*, Appendix A.

In the Atlantic City Sewerage Company case cited by the Company, *Atlantic City Sewerage Co. v. Board of Public Utility Com'rs*., 128 *N.J.L.* 359 (N.J. Sup. 1942), aff'd 129 *N.J.L.* 401 (N.J. Err. & App. 1943) ("*Atlantic City Sewerage*"), the Court noted that "there rests upon the company [utility] the burden of establishing that the amounts charged to operating expenses for

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[12] *In re Pub. Serv. Elec & Gas Co.*, 167 *N.J.* 377 (2001).

depreciation are not excessive." PDIB at 22; *Atlantic City Sewerage* at 368. The Court upheld the Board's finding that Atlantic City Sewerage did not sustain its burden to support an increase in its depreciation rates. *Id*. Here, PSE&G, much like the utility in *Atlantic City Sewerage*, proffers support for continuation of its depreciation rate for Distribution Plant in the form of a sample of utilities and a partial analysis. *See supra*. Similarly, in the Mantua Water Company case cited by PSE&G, the Board denied an upward adjustment in a utility's depreciation rates where the utility relied on the accounting records of other companies, instead of a proper study of service lives and other information. PDIB at 22; *Mantua Water Co.*, 67 *P.U.R. 3d* 264 (N.J.B.P.U. 1966). Here evidence presented by PSE&G's witness in the form of a sample of weighted depreciation rates for other utilities seems remarkably similar to the use of the accounting records of other companies to support a proposed depreciation rate.

In sum, the Company bears the ultimate burden of demonstrating that its proposed rates are just and reasonable. As set forth herein and in the Ratepayer Advocate's Initial Brief and testimony of its witnesses, the Company has failed to substantiate a depreciation expense incorporating a depreciation rate for Distribution Plant based on a 28-year service life. RAIB at 32-33. In contrast, contrary to the assertions of the Company, the Ratepayer Advocate has presented substantial evidence in the record supporting its depreciation recommendation.

### 3. Amortization Period for the Excess Depreciation Reserve Balance

Board Staff recommends that the excess depreciation reserve be amortized over a five year period. SIB at 54. The Company recommends that if it is determined that a excess depreciation

reserve exists, that it be returned over the remaining life of the assets. PDIB at 31.

As set forth in its Initial Brief and the testimony of its witness, the Ratepayer Advocate recommends that the excess depreciation reserve be amortized over a two-year period. RAIB at 32-33. Mr. Majoros recommended that the excess depreciation reserve which developed since December 31, 1998, be amortized to base rates over the remaining two years of the original amortization period set forth in the Board's Final Decision and Order in the Company's Restructuring Case. *RA-6*, p. 9.

Board Staff's argument that a shorter amortization period would hasten the filing of a base rate case is not persuasive. SIB at 54. The Ratepayer Advocate submits that many factors influence the timing of utility base rate case and such concerns should not be controlling in this instance.

**C. Conclusion**

As set forth above and in the Ratepayer Advocate's Initial Brief and testimony of witness Michael J. Majoros, Jr., the Ratepayer Advocate respectfully submits that Your Honor and the Board should adopt the following recommendations:

(1) The depreciation rate for electric distribution plant should be set at 2.49 percent and the expense allowance for depreciation should be adjusted accordingly; and

(2) The excess depreciation reserve which developed since December 31, 1998 should be amortized to base rates over the remaining two years of the original amortization period set forth in the Board's Final Decision and Order in the Company's Restructuring Case.

## POINT III

## PRO FORMA UTILITY OPERATING INCOME

### A. Fiber Optic Construction Revenues and Pole and Duct Revenues

PSE&G attempts to rationalize its proposal to reject long-standing Board policy and deprive ratepayers of the net revenues from the use of the utility plant and employees for the above services by saying these are wholesale services. PIB at 82. The utility implies that since these are wholesale services, they are outside the Board's jurisdiction and that is a reason to place the net revenues "below the line." On the other hand, as stated in our Initial Brief, PSE&G's witness, Mr. Stellwag admitted that these services use the plant and employees of the utility and that the costs of the plant and employees are paid for by the ratepayers. RAIB at 35. That fact alone places these services squarely within the Board's policy to keep the net revenues "above the line" to defray some of the utility's revenue requirements as required in the Board orders for Gordon's Corner Water Company and Jersey Central Power and Light Company ("JCP&L") mentioned in our Initial Brief. *Id.* That policy also applies whether the services are retail or wholesale. PSE&G has not sufficiently distinguished these revenues to place them outside the Board's policy.

PSE&G also argues that the net revenues are speculative because of alleged financial distress of the users of the services. PIB at 82. As mentioned at the evidentiary hearing, the revenues were sufficiently certain that PSE&G's Board of Directors included them above the line in account 456 in the Company's 2002 Operating Plan. T1229:L7-20; *RA-34*. The utility claims this was an inadvertent error, but that explanation would be more persuasive if it had been made outside a base rate case where PSE&G would be required to credit ratepayers with these net revenues. *Id.* Furthermore, the

purported financial distress of the users of these services was never proven by PSE&G, only alleged, and PSE&G never provided any evidence that the Chapter 11 filings by any users prevented them from paying for these services on an ongoing basis. T1385:L2-20. Despite the Ratepayer Advocate's invitation for the Company to provide such proof, it has never done so. The allegation that these net revenues are speculative should be rejected.

PSE&G also cites *N.J.S.A.* 48:3-55(b) for the alternate proposal that if Your Honor and the Board should recognize these revenues for ratemaking purposes, then only 50% of the net revenues should be credited to ratepayers and that this credit should not pass through base rates, but through the Societal Benefits Charge ("SBC"). PIB at 82; T1215:L5-11. *N.J.S.A.*48:3-55 applies to an electric public utility offering retail competitive services that are outlined in section (f) therein. PSE&G has denied that the instant services are retail. Therefore, based on the Company's argument, this statute would not apply.

PSE&G's alternate proposal should be rejected in favor of the Ratepayer Advocate's proposal that is not based on whether these services are competitive or not, and does not depend on the retail or wholesale nature of the services, but simply follows Board precedent and policy that fairly treats these revenues above the line since they are wholly derived from the use of utility plant and employees that ratepayers are funding. Staff also "fully agrees" with the Ratepayer Advocate's position and supports our $3,413,316 adjustment. SIB at 23-27.

**B. Year End Customer Revenue Annualization Adjustment**

PSE&G comments that a revenue adjustment based on the number of customers should also account for customer usage. PIB at 83-85. The utility believes it can support this theory by citing to

Mr. Henkes' testimony that the current weakened economy could harm customers' ability to pay their utility bills, apparently arguing that Mr. Henkes implied that the economy will cause the average usage per customer to decline. *Id.,* p. 84. Mr. Henkes' statement was actually made in response to PSE&G's request to add its bonus incentive plans onto the burdens of already-strapped ratepayers. *RA-49*, p. 46. It is clearly an indication that customers may have trouble paying utility bills that include unreasonable expenses, but it does not signify that customers will use less electricity or that the average usage per customer will decline. PSE&G points to no record evidence that customers will use less in 2003 and beyond. This contention is completely unsupported.

The Company also endeavors to bolster its argument by relying on alleged evidence in the record that rests entirely on its witness' opinion with no facts to support it. In addition, PSE&G's Initial Brief misstates the witness' testimony. PSE&G says that Mr. Cistaro testified "that the level of new construction required to accommodate new housing was not expected to continue at current levels" due to the current state of the economy. PIB at 85. However, a review of the actual text of Mr. Cistaro's testimony reveals that he relied on last year's mild winter rather than the economy as a reason for his statement.[13] In fact, Mr. Cistaro testified that "record low interest rates sparked a recent boom in residential housing construction" in the Company's territory. *P-2*, p. 3, line 19 to p. 4, line 1. It cannot be denied that the record low interest rates are continuing, so there seems to be ample reason to expect continued higher activity than PSE&G has stated. Therefore, PSE&G's justification for its argument is refuted by its own witness' testimony. Even if one considers that last year had a relatively mild winter,

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[13]Also, Mr. Cistaro's qualifications attached to his direct testimony do not reveal an expertise in economic analysis that would support such a statement in any case. *P-2*, Sch. PAC-1.

Mr. Henkes' calculation of this adjustment takes into account that one year might be unrepresentative of the prospective period. Mr. Henkes specifically declined to base his adjustment on one year and calculated a three-year average annual compound growth rate for various customer classes that takes into consideration this complaint by PSE&G. *RA-49*, pp. 33-34. Mr. Henkes' review of Company data also revealed a "general upward tend" in the number of customers that PSE&G has failed to refute. *Id.,* p. 32, lines 15-18. Further, as stated in Mr. Henkes' testimony, his calculation applies the number of customers to the "weather-normalized test year consumption per customer," so he has indeed considered customer usage in his calculation. Also, it is fair to make a revenue adjustment using an updated number of customers, since the Company's proposed test year revenues are based on the average number of customers. *Id.*, p. 30, lines 8-9.

PSE&G also completely misstates the Board's policy on this type of revenue adjustment. The Company would have Your Honor believe that the customer growth revenue adjustment "is contrary to the use of a year-end rate base. . . ." PIB at 84. As stated by Mr. Henkes, the Board has stated that this policy to use year-end customer growth is important because it serves the matching principle that if a utility's rates are set using its year-end rate base, then matching that with the use of year-end customer figures is also necessary. Staff recognizes the correctness of the Ratepayer Advocate's position on this adjustment:

> Staff concurs with the argument that in order to properly match revenues with the use of test year-end rate base and annualized depreciation expenses based on year-end plant, revenues should reflect customer growth up to the end of the test year. The Board has adopted this argument in previous base rate cases.

SIB at 28.

The Board approved exactly this principle when it approved the text below from the Initial Decision in PSE&G's base rate case in Docket No. 837-620:

> …a normalization adjustment should be made for test year-end customers. It is a proper adjustment because it matches the (test) year-end plant with the (test) year-end level of customers, and thus is consistent with the Board's clearly enunciated "matching" principle.

As stated in our Initial Brief, the Board has repeatedly rejected PSE&G's argument that it should be granted an attrition allowance in rates. RAIB at 37-38. Yet, PSE&G appears to request just such an allowance again in this case. PIB at 84. That argument should once again be disregarded and the Ratepayer Advocate's customer growth revenue adjustment should be accepted. Staff recommends continuing with the Board's long-standing policy and agrees with the Ratepayer Advocate's revenue adjustment. SIB at 29.

**C. Reversal of Labor O&M Ratio Normalization Adjustment**

In its Initial Brief, PSE&G reiterates its argument that its test year 2002 labor O&M ratio should be adjusted upward because 2002 was an allegedly aberrational year. PIB at 87. The Ratepayer Advocate has refuted this argument in our Initial Brief, pages 39 to 41. Our witness' testimony and our legal argument present Your Honor and the Board with ample reason to reject the Company's adjustment. On the other hand, Staff recommends adopting the Company's adjustment. However, Staff relies entirely on the faulty arguments propounded by PSE&G.

Staff fails to give sufficient recognition to the fact that PSE&G's proposal is based entirely on estimates while Mr. Henkes' recommendation uses the Company's actual experience. PSE&G's witness, Mr. Stellwag, admitted during cross-examination that the labor O&M expense ratio has

generally been a few percent lower than the average fringe benefit O&M ratio and that PSE&G's planned O&M ratio for pension and fringes for 2003 was 60.8 percent. T1259:L6 to T1273:L7 and T1210:L5-7. The figures admitted by Mr. Stellwag average to a labor O&M ration that is 2.7% lower than the fringe benefit O&M ratio. If 2.7% is subtracted from the 2003 planned fringe benefit O&M ratio of 60.8%, the result is 58.1% for the labor O&M ratio. 58.1% is very close to the 57.6% experienced in 2002 and recommended by Mr. Henkes. In this way, it is clear that Your Honor and the Board should adopt Mr. Henkes' recommendation rather than rely on Staff's acceptance of the Company's adjustment.

Staff also seems to give some credence to PSE&G's claim about the mild winter in the early part of the test year 2002. SIB at 32. Mr. Henkes refuted that claim when he testified that any effects of the mild winter in the early months of 2002 should likely be offset by the colder than normal weather experienced late in the year. T1412:L14 to T1413:L10. Therefore, for the same reasons that the Ratepayer Advocate recommends rejecting the Company's arguments, the Ratepayer Advocate also recommends rejecting Staff's agreement with those faulty arguments.

**D. Removal of Incentive Compensation Expense**

PSE&G relies heavily on the testimony of its witness Richard Meischeid to support its request to add $3,378,000 to ratepayers' bills for the incentive compensation plans. PIB at 88-93. As much as Mr. Meischeid's testimony may support reasons for PSE&G shareholders to pay for the incentive compensation plan, his testimony does not support ratepayer funding for the plans. Virtually all the benefits cited by PSE&G for its incentive compensation plans relate to increasing shareholder value and not improvements in the provision of safe, adequate and reliable utility service at the lowest possible

cost. Therefore, Mr. Meischeid's testimony provides no reason to charge ratepayers for this expense.

PSE&G also mischaracterizes one of Mr. Henkes' citations to Board policy on this issue. The utility claims that Mr. Henkes' citation to the 2001 Middlesex Water Company base rate case only quotes Staff's argument in a brief and does not represent Board policy. PIB at 10. However, a review of the order in that case shows that the Company's characterization is incorrect. In fact, the Board order repeats the language from the Staff brief and adopts it entirely in disallowing 100% of the requested incentive compensation plan expenses.

> The Board HEREBY ADOPTS the Staff and the Ratepayer Advocate position that the incentive compensation expenses in the amount of $324,057 should not be included in expenses. The Board is not persuaded by the recommendations made by the ALJ, nor by the arguments made by the Company in this matter and, therefore, REJECTS the ALJ's recommendation that these incentive compensation expenses should be shared fifty/fifty.

*I/M/O Petition of Middlesex Water Company for Approval of an Increase in its Rates for Water Service and Other Tariff Changes*, BPU Docket No. WR00060362, OAL Docket No. PUC 4879-00S, Order Adopting In Part/Modifying In Part/Rejecting In Part Initial Decision (Order dated June 6, 2001) p. 24. Therefore, PSE&G's argument can be completely disregarded as erroneous.

PSE&G once again attempts to tie in its request for the incentive compensation plans with its request for financial advertising expenses. PIB at 12. However, as stated by Mr. Henkes in his surrebuttal testimony, there is no logical connection between the two issues and this argument should be rejected. Mr. Henkes also stated:

> Mr. Stellwag is apparently not aware of the fact that in both cases[14] where

[14]JCP&L rate case, BPU Docket No. 91121820J, dated 2/25/1993 and Middlesex rate case, BPU Docket No. WR00060362, dated 6/6/2001.

> the Board explicitly disallowed a utility's incentive compensation for ratemaking purposes, the Board disallowed the incentive compensation in part because the incentive compensation was significantly impacted by the utility's achievement of financial performance goals.

*RA-51,* pp. 4-5.

PSE&G also attempts to distinguish its incentive compensation plans from the plans that the Board rejected in the JCP&L case cited by Mr. Henkes. PIB at 11-17. Mr. Henkes also completely refuted this argument in his prefiled testimony wherein he outlined in detail the great similarities between the JCP&L plans the Board rejected and PSE&G's plans in this case. *RA-52*, pp. 2-4. The Ratepayer Advocate also described these details in our Initial Brief and will not repeat them here. Suffice it to say, that the plans are so alike as to compel the rejection of PSE&G's plans in base rates.

Staff completely agrees with the Ratepayer Advocate recommendation.

> Staff's position is that the $3.378 million designated for incentive compensation should be removed from test year expenses. When financial goals are part of the incentive compensation formula, which is a factor in all three of the Company's incentive pay programs, pursuing these goals can jeopardize a utility's commitment to providing safe, reliable, economical service over the long term by emphasizing short-term, bottom-line performance. Maximizing shareholder profits is not necessary to the provision of utility service; safety and reliability do not rise and fall with the market. Ratepayers do not benefit by focusing the attention of employees on earnings per share. The Company did not provide evidence that any of these programs produced measurable direct, or even indirect, savings or benefits to the ratepayers.

SIB at 34-35.

Your Honor and the Board have considerable justification to continue Board policy on this issue and reject PSE&G's proposal.

### E. Reversal of PSE&G's Restructuring Cost Amortization

PSE&G proposes to include in base rates a four-year amortization of $50,025,000 in restructuring expenses and associated carrying charges.[15] *P-4 (U 12+0)*, Sch. ANS-11; PIB at 97, 101. This would decrease its pro forma operating income by an after-tax amount of $7,397,000 and increase its requested revenue requirement by an annual amount of $12,506,000. *Id.*

It is undisputed that EDECA contemplates rate recovery for incremental operating costs that would not be incurred but for the statute. However, PSE&G's citation to these sections of EDECA does not prove that a mere allegation of these costs is enough to increase customers' bills by $12,506,000 per year for four years. Much more is legally mandated before such a charge can be just and reasonable. *See Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 218-219 (1950); RAIB at 45-47.

The costs requested included costs to allow customers to choose an alternate electric supplier, to divest its generation plant to its unregulated affiliate (PSEG Power), and other costs allegedly related to restructuring. PIB at 93. While the costs to implement customer choice would be due to EDECA, PSE&G's costs for divesting its generation plant were not required by the Board under EDECA. The utility implies that it involuntarily divested its generation plant, when it says that the Board "directed" it to do so. However, PSE&G omits the fact that the Board's Restructuring Case Final Order approved (with modifications) PSE&G's own proposal to divest this generation plant. That is hardly an involuntary decision.

PSE&G makes the mistaken claim that, because of EDECA, it was under an "obligation" to

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[15]The Ratepayer Advocate's Initial Brief originally contained an outdated figure of $49.4 million for these costs. RAIB at 45. The expenses for these items amounted to $37,179,000 by December 2002 with the balance comprised of interest requested on these costs.

divest its generation plant, but cites to no language in that statute to support this claim. PIB at 96. Despite PSE&G's allegation to the contrary, divestiture was a business decision that the utility voluntarily undertook. EDECA did not require it. Any expenses PSE&G incurred due to that entirely voluntary choice were undertaken at the utility's risk if it should not be able to prove the prudence of spending those dollars and the reasonableness of the expense amounts. EDECA provides no guarantee of recovery for costs that do not meet the legal burden of proof on the utility.

Also, PSE&G has not proved that EDECA permitted, let alone required, the utility to unilaterally apply deferred accounting treatment to these costs. The utility claims that the EDECA's rate cap justifies deferred accounting for these costs, but can point to no language in that statute that specifies this. PIB at 95. PSE&G alludes to the deferred accounting treatment given to SBC costs as justification for its request here, but there was obviously a specific BPU Order allowing deferred accounting for the SBC costs as quoted by the Company. *Id.,* pp. 98-99. No such Order exists for the alleged restructuring costs, so that argument does not support PSE&G's request.

PSE&G also cites the Board Order in the generic docket examining the issue of allowing alternate, non-utility parties called Third Party Suppliers ("TPSs") to provide ratepayers with Customer Accounts Services ("CAS")[16] as support for its request for approval of the restructuring costs in this base rate case. PIB at 97. The Company alleges that this is an example of the Board permitting restructuring costs in rates and quotes a small portion of the Order that says "it is reasonable for utilities to recover known and measurable restructuring costs in connection with providing additional customer

[16]EDECA defines these services as "metering, billing, or such other administrative activity associated with maintaining a customer account." *N.J.S.A.* 48:3-51.

account services...." *Id.* However, PSE&G omits the complete discussion of this topic in that Order. That discussion shows that the Board did not simply "rubber stamp" any utility's request for deferred accounting or rate treatment, as can be seen below:

> Finally, paragraph 12 of the Sipulation [sic] provides that costs incurred by the utilities as a result of the Stipulation, not otherwise recovered from TPSs, subject to review for reasonableness, shall be subject to deferred accounting treatment. There is no estimate, at this time, of the extent of such possible costs. While the Board believes it is reasonable for utilities to recover known and measurable restructuring costs in connection with providing additional customer account services, the Board believes that the proposed language needs to be modified to exclude the possibility for double recovery of implementation costs. Therefore, with respect to the recovery of any incremental costs reasonably and prudently incurred by the [sic] Conectiv, GPU and PSE&G as a result of the Stipulation and identified in paragraph 12, the Board permits Conectiv, GPU and PSE&G to petition the Board for recovery of such costs to the extent such costs are not otherwise recovered.
>
> To ensure that the Board is aware of the potential for any deferred accounting associated with any start-up costs and/or Market Development Costs, as delineated in Attachment E, the Board DIRECTS Conectiv, GPU and PSE&G to report quarterly, beginning April 15, 2001 for the period from the date of this Order through March 31, 2001, a detailed breakdown of the start-up and Market Development Costs incurred and the funds remaining to cover these costs. Each subsequent quarterly report should include quarterly and cumulative data. As part of the report for the third quarter of 2001, the electric utilities should also file projected costs through July 31, 2003. In this way, the Board could initiate a proceeding, if necessary, to address any deferred accounting issues.

*CAS Order,* p. 8.

In the above text it is clear that before granting rate treatment for costs to implement this portion of EDECA allowing TPSs to provide CAS, the Board would require (1) a "review for reasonableness," and (2) that these costs must be "known and measurable" and "reasonably and prudently incurred" before rate treatment, and (3) that these costs be "incremental", *i.e.*, that they be in

addition to other costs already included in rates, and (4) that no rate treatment would be permitted until the utility proved there would be no "double recovery of implementation costs" due to those costs already being recovered elsewhere in rates, and (5) that a utility could only petition the Board for rate recovery "to the extent such costs are not otherwise recovered."

The Board also stated as quoted above that there is only the "potential for any deferred accounting associated with any start-up costs and/or Market Development Costs," (emphasis added), so it is clear the Board did not give pre-approval for deferred accounting as PSE&G seems to allege and that the Board would at some later time "address any deferred accounting issues." From this more complete citation of the Order, it is evident that PSE&G has overstated what the Board decided in that *CAS Order*. The utility's claim that this Order supports its arguments should be rejected.

PSE&G also may not unilaterally decide what is a regulatory asset that may be charged through rates, despite its allegation to the contrary. PIB at 97. This regulatory treatment requires approval by the BPU first.

The utility recently admitted as much when it filed a petition requesting BPU approval of regulatory asset treatment for its minimum pension liability. *I/M/O Public Service Electric and Gas Company's Application for an Accounting Order Permitting it to Record a Portion of its Minimum Pension Liability as a Regulatory Asset on its Balance Sheet,* BPU Docket No. EO02110853, Order dated January 23, 2003 ("*Minimum Pension Liability Order*").

As stated by the Board in that matter:

> In order for the Company to record the regulatory asset, it must meet criteria set forth in another accounting statement issued by the FASB [Financial Accounting Standards Board], Statement of Financial Accounting Standards

> No. 71, *Accounting for the Effects of Certain Types of Regulation* ("FAS 71"), which requires that the recovery of the asset through future rates must be probable, i.e., "can reasonably be expected or believed on the basis of available evidence or logic but is neither certain nor proved." As represented by the Company and its outside auditors, Deloitte & Touche, LLC ("Deloitte & Touche" or "D&T"), the requested regulatory asset treatment would meet this requirement as long as the Board issues an accounting or rate order supporting the probability of continued inclusion of pension costs in future rates.

*Minimum Pension Liability Order*, p. 3 (footnote omitted).

The Company's petition requested Board approval "to record a Regulatory Asset on its balance sheet under Statement of Financial Accounting Standards No. 71 (FAS No. 71) resulting from the recognition of a Minimum Pension Liability under FAS No. 87 . . . ." *Petition*, dated November 13, 2002, p. 1. From these documents it is clear that PSE&G may not unilaterally record a regulatory asset without BPU approval and that such a regulatory asset may not be recorded without an accounting or rate order supporting the probability of continued inclusion of the requested costs in future rates. PSE&G's unilateral recording of a regulatory asset would be improper and impermissible.

Without this deferred accounting treatment, PSE&G would have been required to expense these items and they would not be available for recovery in rates due to the prohibition against retroactive ratemaking. The Ratepayer Advocate avers that that should be the ratemaking resolution of this matter. PSE&G has not substantiated its request to begin charging customers for these alleged costs.

PSE&G also complains about the negative impact on its profitability if these costs are not charged to ratepayers prospectively. PIB at 98-99. Nonetheless, the utility's complaint is completely due to its laxity in coming forward with adequate proofs and its own delay in seeking regulatory

treatment for these expenses. Your Honor and the Board are left with nothing more than the utility's naked allegation that these costs were directly related to restructuring, since PSE&G failed to avail itself of the ample opportunity to support these allegations with fact. Despite presenting the testimony of numerous witnesses in this case, none of them provided any factual detail that could justify the utility's allegations. While the incurrence of some incremental costs to implement EDECA could be expected, that does not excuse PSE&G from its legal obligation to provide substantial, credible factual evidence to support its allegations. EDECA passed into law in February 1999, so the utility has had four years to get its accounting for these costs in order. Its failure or refusal to accomplish that relatively simple task should place the consequences of this failure at its own doorstep, not that of the ratepayers.

PSE&G also alleges that it is "currently earning less than 6.5% on its electric distribution investments. . . ." PIB at 99 (emphasis added). However, this statement does not coincide with PSE&G's other statements concerning this alleged current 6.5% return on equity ("ROE"). PSE&G originally said the 6.5% was the ROE for the period ending June 2002 in the middle of the test year, not the current ROE. *P-4-RB*, p. 3; PIB at 3. Then the utility said the 6.5% was the ROE at the beginning of the test year, not the middle of the test year. PIB at 79-80. Now, PSE&G alleges 6.5% is the current ROE. PIB at 99. It would be a great coincidence if all of these statements were actually true and that the utility had a ROE of exactly 6.5% at all times despite the differing time periods being considered. Furthermore, PSE&G never provided any evidence in the record to substantiate how it calculated this alleged ROE. For these reasons, it is simply an unsupported allegation that Your Honor and the Board may safely disregard. Also, even if the claims were true, it does not reflect any dire financial emergency as the utility would have Your Honor and the Board believe. The utility's

admission that it has provided $1.4 billion in restructuring rate reductions over the Transition Period without harm to its financial integrity is only more evidence that it can easily withstand the denial of these alleged restructuring costs in rates without such harm. *Id.*

The Company also criticizes Mr. Henkes' alternative recommendation that if Your Honor and the Board should decide to give any ratemaking treatment to these costs, the amortization should be for ten years without carrying costs. PIB at 102-105. PSE&G attempts to reverse long-standing Board policy denying carrying costs on any amortizations in base rates by claiming that EDECA overrides prior Board policy decisions on this matter. PIB at 104. This statement is made with no citation to portions of EDECA itself to support this claim. It is plain that PSE&G's allegation here cannot stand when the utility fails to cite the language in EDECA that it alleges makes such a sweeping change in ratemaking policy. This claim deserves no consideration whatsoever.

Staff also recommends allowing these costs through PSE&G's four-year amortization, although "subject to the provision of further documentation." SIB at 38. Staff recommends carrying charges at the 7-year treasury rate plus sixty basis points. *Id.,* p. 39. The Ratepayer Advocate urges rejection of Staff's recommendations for the same reasons stated for rejecting PSE&G's request. Also, it is unclear what is meant when Staff requires "further documentation." This may be a requirement that this charge to ratepayers is only interim subject to refund or that the charge begin now and be trued up at a later date. It might also mean that the amortization should be deferred until PSE&G provides this documentation. If the amortization is to begin now, when will the Board require PSE&G to provide the further documentation and in what forum? Will the documentation be in the form of sworn testimony or some other format? Will all interested parties be permitted to complete discovery on the documentation

and provide an analysis and review?

Although Staff seems to be trying to give the utility another chance to prove these costs are prudently incurred and reasonable in amount, the Ratepayer Advocate believes that PSE&G has spurned its previous numerous opportunities to document these costs and that there is no reason to believe it will be forthcoming with any additional documentation now. Further, PSE&G does not deserve another bite at this apple. The claim for these costs should be denied in their entirety.

Staff's recommendation on the interest rate for the amortization does not specify, as it should, that the interest rate be applied only to the net-of-tax unamortized balance. Also, when Staff recommends that any overrecovery be returned to ratepayers, it does not describe when and how this should be accomplished. Given the uncertainties of this proposal and based on the substantial, credible evidence and our legal arguments, the Ratepayer Advocate continues to recommend rejecting PSE&G's proposal and also Staff's alternate proposal.

### F. Rate Case Expense Adjustment

PSE&G argues to overturn the long-standing Board policy that rate case expenses be shared equally between ratepayers and shareholders. PIB at 105-106. The utility would deny the undeniable argument that filing this base rate case will benefit shareholders by increasing the return earned by PSE&G and setting new rates based on updated costs rather than the costs from the utility's last base rate case filed in 1991. This benefit to shareholders more than justifies their 50% contribution to the expense and this reality is recognized by Staff as well. SIB at 40-41. The fact that the timing of this case was set by the Board Order in the Company's restructuring case is irrelevant to this consideration. PSE&G cannot rightfully claim that it would never have filed this case otherwise when one reads the

Company's repeated allegations that current base rates are insufficient to allow a fair return. Even if that were true, it does not rebut the fact that shareholders will likely see an increased return after this case is over. That factor alone would justify the sharing of this expense.

Staff also agrees with the Ratepayer Advocate recommendation to amortize these costs over five years. SIB at 41. Staff gives a different reason for this amortization than the Ratepayer Advocate (*i.e.,* to match Staff's excess depreciation amortization period), but the mathematical effect is the same. The Ratepayer Advocate again urges Your Honor and the Board to adopt our recommendations herein

PSE&G complains that Mr. Henkes' recommendation would also amortize the Ratepayer Advocate's supplemental assessment over five years. PIB at 109. The utility claims that this assessment is in the nature of the "normal" annual assessment that is not amortized and cites a May 30, 2002 letter from the Ratepayer Advocate that the "supplemental assessment was made because the Advocate did not anticipate the volume and duration of proceedings filed before the Board." *Id.* This letter actually supports Mr. Henkes' testimony that this supplemental assessment will not be a regular part of the annual assessment, but is related to the flurry of regulatory activity related to the end of the Transition Period, *i.e.,* the numerous electric base rate cases and deferred balances proceedings currently ongoing. T1360:L5 to 1361:L9. These facts clearly support the amortization.

**G. Basic Generation Service ("BGS") Implementation Costs**

Despite the total lack of substantial, credible evidence in the record, Staff agrees with the Company's unsupported request for costs of $2,467.000 to change its billing system and to install and service interval meters for the new BGS hourly pricing program for large commercial and industrial customers. SIB at 56-57. The revenue requirement impact would increase customers' bills by

$4,179,000.  RAIB at 52.  The only justification for Staff's recommendation is that it is based "upon the timing of the issuance of the Board's [BGS] Order and the language included in the Board [BGS] Order. . . ."  Id., p. 57.  However, as stated in the Ratepayer Advocate's Initial Brief, that BGS Order merely introduced this issue into the base rate case and did not relieve PSE&G of its legal responsibility to provide Your Honor and the Board with sufficient proof that the $2,467,000 is justified.  RAIB at 54.  The Order did not require Your Honor to "rubber stamp" the Company's request without requiring adequate proof that PSE&G had implemented this program in a prudent manner and that $2,467,000 is a reasonable amount to spend on this program.  Despite numerous opportunities to provide the required evidence, PSE&G has utterly failed to do so.

PSE&G alleges that the BGS Order "affirmed the appropriateness of the pro-forma adjustment itself."  PIB at 121.  If PSE&G is attempting to imply that the BGS Order ratified increasing the revenue requirement in this matter by $4,179,000, then the Ratepayer Advocate avers that this is a misinterpretation of the BGS Order. The Ratepayer Advocate does not dispute that the BGS Order permitted the utility to request its BGS implementation costs in the base rate case.  However, as previously stated, the BGS Order cannot circumvent the legal requirement that the Board go behind the utility's alleged books and records concerning these costs and require proof that the costs requested were prudently incurred and reasonable in amount.   The New Jersey Supreme Court has emphatically stated the law on this issue:

> The dangers inherent in accepting the [utility's] books of account at face value in a rate proceeding are apparent. . . . Neither this Court nor the Board can accept the books of account of a public utility at face value in a rate case in which reasonableness is always the primary issue . . .  There must be proof in the record not only as to the amount of the various

> accounts but also sufficient evidence from which the reasonableness of the accounts can be determined. . . . Lacking such evidence, any determination of rates must be considered arbitrary and unreasonable.
>
> . . . No proof was offered by the companies or demanded by the Board to support the items therein included, other than the companies' books of account. The record is thus lacking in sufficient evidence from which this Court can determine whether this rate base is reasonable.

*Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 218-219. (1950).

Because PSE&G has completely failed to provide any evidence whatsoever, substantial or otherwise, to justify this expense, the Ratepayer Advocate urges Your Honor to reject the recommendation of PSE&G and Staff and to disallow these costs in base rates.

**H. Gains on Sale of Utility Property**

The Ratepayer Advocate has recommended rejection of PSE&G's request to overturn Board policy that uses 100% of the five-year average of the net gain on sales of utility property as a credit to base rates and instead only credit ratepayers with 50% of the average net gains. RAIB at 49-51. The Ratepayer Advocate's proposal uses a five-year average rather than simply the test year net gains which, the Company and Staff agree, helps to mitigate the effects of an unusually high or unusually low net gain in any single year. SIB at 41-42. PSE&G's Initial Brief does not raise any new arguments that the Ratepayer Advocate has not already refuted, but it does cite two cases that should be addressed.

PSE&G cites *I/M/O New Jersey Natural Gas Company*, 76 *PUR 4th* 605, BPU Docket No. GR8510974, Order dated July 30, 1986, claiming this case supports its argument. On the contrary, it supports the Ratepayer Advocate's argument for the reasons below. Mr. Henkes testified that the Board has in some instances used a 50/50 sharing in regard with sales of specific utility property in

cases wherein the utility applies for Board pre-approval of the sale. His testimony was that:

> It is very important to recognize, however, that this policy is not applied in combination with a 5-year annual averaging calculation. The Board's policy simply provides that 50% of gains on the sale of utility property accrued during any particular time should flow to the ratepayers for ratemaking purposes. In other words, this Board policy does not take only 1/5th[17] of the gains at issue in a particular proceeding for ratepayer flow-through consideration. Rather, this Board policy takes the full amount of the annual gain at issue in a particular proceeding and then allocates 50% of this full gain to the ratepayers.

*RA-49*, pp. 63-64.

Mr. Henkes carefully explained that this policy is applied to individual sales of property before the Board and not applied when the Board is reviewing a five-year average net gain for base rate purposes. In the *New Jersey Natural Gas Company* case cited by PSE&G, this was exactly the issue. When the Board applied a 50/50 sharing of the net gain, the Board was considering what to do with the net gain on an individual sale of utility property, *i.e.,* the gas utility's sale of its southern territory to South Jersey Gas Company. 76 *PUR 4th* at 609. The Board was clearly not applying the sharing to its general policy of using 100% of a five-year average net gain as a credit to base rates. In this way, it can be seen that this case supports the Ratepayer Advocate's argument, not PSE&G's.

PSE&G also cited the case, *I/M/O Atlantic City Sewerage Company for Authorization to Make, Execute, and Implement an Agreement of Sale, and to Implement a Plan of Distribution of the Net Proceeds Therefrom,* 1999 WL 33178018, BPU Docket No. WM98090790, Order of Implementation, dated January 14, 1999. PIB at 111. This case also supports the Ratepayer Advocate's argument, not PSE&G's, for the same reason discussed concerning the *New Jersey*

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[17] By virtue of a 5-year averaging procedure.

*Natural Gas Company* case. The *Atlantic City Sewerage Company* case also dealt with the sale of a specific individual property that the utility requested for approval. It did not apply a 50/50 sharing of the utility's five-year average net gain as PSE&G is requesting herein. Therefore, this case supports Mr. Henkes' testimony and the Ratepayer Advocate's recommendation.

It should be further noted that the *Atlantic City Sewerage Company* case concerned the implementation of a memorandum of understanding that agreed to the 50/50 sharing. *Atlantic City Sewerage Company*, p. 1. The sharing issue was therefore, a stipulated issue, not a litigated one. It can be argued that this case should not apply to any other matter for that reason. However, if Your Honor and the Board decide to consider the *Atlantic City Sewerage Company* case, it clearly shows the unreasonableness of PSE&G's proposal which should be rejected.

Staff supports the Company's proposal by stating that:

> . . . a 50%/50% sharing of the 5-year average after-tax gain is appropriate in this proceeding given that this methodology fairly treats both the shareholders and ratepayers by providing a representative amount of gains or losses during such period while mitigating any abnormally high or low year within the 5-year period.

SIB at 42.

However, Staff has confused the justification for using a five-year average with a justification for dividing that average in half before applying it to base rates. As stated above, the Company and Staff both acknowledge that the method used to mitigate unusually high or low net gains in any one year is to use a five-year average. That mitigating effect does not justify then cutting the ratepayers' credit in half. That is an unusually severe proposal that the Board has not yet applied and which should be rejected. As stated in our Initial Brief, PSE&G and the Board have both continually applied 100% of the five-

year average net gain against revenue requirements, and there is no factual or policy reason shown here for retreating from that reasonable procedure. RAIB at 49.

### I. Repair Allowance Amortization Adjustment

It is undisputed that PSE&G is permitted to use deferral accounting for the cost of new business extensions as repair allowance property pursuant to the Revenue Requirement Stipulation ("Revenue Requirement Stipulation") adopted by the Board in the Company's last electric base rate case (combined electric and gas).[18] *RA-49*, pp. 67-68. At issue is the interest rate to be applied to the deferred balance for the post-August 1999 period. *See* PIB at 112-115; RAIB at 60-64; and SIB at 43-47. The August 1999 date is significant, since many of the changes set forth in EDECA became effective on August 1, 1999.[19]

While the Revenue Requirement Stipulation provides for the recovery of "interest, and carrying charges," the Revenue Requirement Stipulation places the burden of proof on the Company to show the "reasonableness of the amounts requested."[20] In its Initial Brief and submissions in the record, the Company has not demonstrated the reasonableness of using its after-tax overall rate of return to compute carrying costs.

For the post-August 1999 period, the Ratepayer Advocate recommends the use of an interest rate equal to the rate of seven-year constant maturity treasuries as shown in the Federal Reserve

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[18] *I/M/O PSE&G*, BPU Docket Nos. ER9111698J, *et al* (Order dated May 14, 1993), Revenue Requirement Stipulation, pp. 16-17.

[19] *See Restructuring Case Final Order.*

[20] Revenue Requirement Stipulation, p. 17.

Statistical Release on, or closest to, August 1 of each year plus sixty basis points ("seven year interest rate"). *RA-51*, pp.16-17. The interest rate allowed by the Board for deferred cost balances in the restructuring cases - based on the seven-year Treasury rate - is currently 4.64%. *RA-49*, p. 70. Board Staff supports the Ratepayer Advocate's recommendation. SIB at 46.

In contrast, the interest rate proposed by the Company is far in excess of the rate recommended by the Ratepayer Advocate and supported by Board Staff. The Company proposes to use its overall rate of return for the entire amortization period. PIB at 113. For the period through the issuance of an Initial Decision in this case, PSE&G proposes to use a rate of 8.42%, which is its after-tax Board-approved overall rate of return from its 1991 base rate case. *RA-49*, p. 69. For the post rate case period, the Company proposes to also use its authorized rate of return, and it requests in the instant case an after-tax overall rate of return of 7.35%. *Id*.

The Company's argument that its after-tax rate of return be used and that the use of the seven-year interest rate is "confiscatory" is clearly without merit for numerous reasons. First, the seven-year interest rate is, by definition, 60 basis points higher than the Treasury seven-year rate. Second, the seven year interest rate was already approved by the Board for use on other deferred balances. The seven year interest rate is the same as that adopted by the Board for deferred cost balances for electric utilities in the restructuring proceedings and used by PSE&G for computing the carrying charges on its SBC and NTC deferred balances. *RA-51*, p. 16; T1449:L9-15. Third, as noted by Mr. Robert Henkes, the use of a rate which does not include an equity return to compute carrying charges is

consistent with prior Board rulings, as set forth in the recent gas cost adjustment clause cases.[21] *RA-49*, p. 69; See RAIB at 62-63.

Finally, Mr. Henkes testified that the use of an overall rate of return is not consistent with a Board policy of sharing amortized deferred items. T1447:L10-24; *See* RAIB at 61. Contrary to the Company's claims, at hearing Mr. Henkes testified the Company's overall rate of return includes a return on equity, which is inconsistent with his position that it would be inappropriate for the Company to earn a profit on unamortized balances. PIB at 114; T1448:L21-T1449:L8; RAIB at 62. Notably, although the Revenue Requirement Stipulation allows the recovery of carrying charges on the deferral balance, it does not specify that the Company is entitled to earn a profit on this deferral balance.

PSE&G characterizes the seven year interest rate recommended by the Ratepayer Advocate as a "short-term" rate. PIB at 113. PSE&G's characterization of a seven-year rate as a "short-term" rate defies common usage of the term. As the Ratepayer Advocate noted in its Initial Brief, the bond rating agency Standard and Poors defines "short term" in the United States as "obligations with an original maturity of no more than 365 days...."[22]

Mr. Henkes computed the carrying charges, using the seven year interest rate for the period after August 1999, and recommends an expense adjustment of $2.062 million. *RA-60*, Sch. RJH-15R (12+0). Mr. Henkes' recommended adjustment reduced the Company's Repair Allowance

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[21]*See I/M/O Elizabethtown Gas Company*, BPU Docket Nos. GR00070470 and GR00070471 (Decision and Order dated March 30, 2001); *I/M/O New Jersey Natural Gas Company*, BPU Docket. Nos. GR99100778, *et al* (Decision and Order dated March 30, 2001); *I/M/O Public Service Electric & Gas Company*, BPU Docket No. GR00070491 (Decision and Order dated March 30, 2001); and *I/M/O South Jersey Gas Company*, BPU Docket Nos. GR00050293 and GR00050293 (Decision and Order dated March 30, 2001).

[22]Standard and Poor's 2002 Corporate Ratings Criteria, p. 7. An excerpt from this document was entered into evidence as *S-57*. The full document is available at www.standardandpoors.com.

Amortization amount from $8.189 million to $6.127 million. *Id.* As set forth above and in the Ratepayer Advocates's Initial Brief and its witness' testimony, the proposed adjustment is consistent with the Board's treatment of similar expenses and should be adopted. RAIB at 60-64.

**J. Institutional Advertising and Public Relations Expense Adjustment**

At issue are the Company's claimed expense for institutional advertising associated with an industry trade group and certain public relations expenditures, amounting to $88,000. *RA-60,* Sch. RJH-16R (12+0). Of the amount at issue, $5,000 represents the advertising portion of Edison Electric Institute ("EEI") fees and $83,000 represents various public relations expenditures. *See* RAIB at 64-66.

In its Initial Brief, PSE&G did not address the $5,000 EEI advertising expense and offered nothing which discredited the Ratepayer Advocate's position that the public relations expenditures at issue have nothing to do with the provision of safe and adequate electric delivery service and are impermissible charitable contributions for ratemaking purposes. PIB at 115-117, RAIB at 64-66. Board Staff supports the position of the Ratepayer Advocate. SIB at 47.

Although the Company poses a number of rhetorical questions concerning public relations and charitable expenditures, it offers no evidence to show that the expenses claimed for ratemaking purposes are not charitable contributions prohibited by the New Jersey Supreme Court's ruling in a recent New Jersey American Water Company[23] case or by the generic advertising Board ruling cited

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[23] *In re New Jersey American Water*, 169 *N.J.* 181 (2001) *("New Jersey American Water Company")*.

by Board Staff.[24] See RAIB at 65, SIB at 47. While the Ratepayer Advocate commends the Company for making charitable contributions, such contributions should be borne by its shareholders, not its ratepayers.

As set forth above and in the Ratepayer Advocate's Initial Brief and the testimony of its witness, the expense at issue should be rejected for ratemaking purposes, which reduces the Company's expenses by $88,000, resulting in a $52,000 increase in its Operating Income. RAIB at 64-66; *RA-60,* Sch. RJH-16R (12+0).

**K. Miscellaneous O&M Expense Adjustment**

At issue are several claimed Operating and Maintenance ("O&M") expense items. *RA-49*, pp. 73-75. The expenses are out-of-period O&M expenses, PSEG expenses allocated to PSE&G, lobbying expenses, and management "perks."

The Company conceded the out-of-period O&M labor expense adjustment recommended by the Ratepayer Advocate and supported by Board Staff. *P-47*; RAIB at 66; SIB at 47. However, in its Initial Brief and in its witnesses' testimony and exhibits, the Company did not provide any evidence to show that the claimed expenses for charitable donations, contributions to the Liberty Science Center, event tickets, and miscellaneous write-offs were necessary to provide safe, adequate and proper electric distribution service. SIB at 118. Furthermore, to the extent that the claimed expenses are charitable contributions, such expenses are prohibited for ratemaking purposes pursuant to the New Jersey Supreme Court's ruling in *New Jersey American Water Company*. RAIB at 66-67. Similarly,

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[24] *I/M/O The Board's Investigation of Advertising Practices of the Telephone, Electric, and Gas Distribution Companies of New Jersey*, BPU Dkt. 7512-1254 (Decision and Order, May 31, 1977).

in its testimony and Initial Brief, the Company has not demonstrated that its claimed expenses for lobbying and financial services for top executives are necessary for the provision of safe, adequate, and proper electric distribution service and, therefore, should be disallowed. PIB at 118. Board Staff concurs with the Ratepayer Advocate's proposed adjustment. SIB at 47-49.

As set forth above and in the Ratepayer Advocate's Initial Brief and the testimony of its witness, the expenses at issue should be rejected for ratemaking purposes. RAIB at 66-68. The recommended adjustments amount to a total of $3.2 million, which has the effect of increasing the Company's proposed after-tax net operating income by $1,897,000. *RA-60*, RJH-17R (12+0).

**L. Pro Forma Depreciation Expense Adjustment**

The differences in depreciation expense arise from substantive differences underlying the depreciation expense. The Ratepayer Advocate's recommended depreciation expense adjustment is premised on the recommendations of its depreciation witness, Mr. Majoros. RAIB at 68. Although Board Staff accepts the Ratepayer Advocate's recommended depreciation rate for electric distribution plant, Staff proposes a longer amortization period for the excess depreciation reserve. SIB at 54, Sch. 5A. Hence, Board Staff's recommended depreciation expense adjustment differs from that recommended by the Ratepayer Advocate.

For the reasons set forth herein and in its Initial Brief and testimony of its witness, the Ratepayer Advocate - adopting Mr. Majoros' proposed depreciation adjustments - recommends that the annual depreciation expense be set at $78,103,000, resulting in an increase of $59,301,000 in the Company's proposed pro forma test year Operating Income. RAIB at 68, 26-33; *RA-60*, Sch. RJH-18R (12+0).

**M. Interest Synchronization Adjustment**

The Company, Board Staff, and the Ratepayer Advocate agree on the proper methodology to follow for computing the interest synchronization adjustment. PIB at 120, RAIB at 68, and SIB at 57-58. However, each party recommends a different interest synchronization adjustment, due to the fact that each party's respective adjustment is the product of its recommended rate base figure and weighted cost of capital figure. The Ratepayer Advocate's recommended adjustment results in an increase of $353,000 in the Company's proposed pro forma test year operating income. *RA-60*, Sch. RJH-20R (12+0), line 7.

**N. Amortization Expense Adjustment**

At issue is the Company's claimed amortization expense related to its Distribution Work Management System ("DWMS") program. The Company proposes a pro form adjustment of $712,000. PIB at 119. In his 12+0 updates, Mr. Henkes rejected the Company's proposed adjustment. *RA-60*, Sch. RJH-4R (12+0), RJH-19R (12+0). In his Supplemental Direct Testimony and Surrebuttal Testimony, Mr. Henkes set forth the rationale for his recommendation. *RA-50*, pp. 5-7; *RA-51*, pp. 16-18. Mr. Henkes found a difference of only approximately $0.5 million between the Company's total 9+3 test year amortization items ($23.990 million) and its total projected 2003 amortization items ($23.498 million), and concluded that the overall level of amortization items in the 9+3 test year can reasonably be expected to continue in the future. *Id*. Board Staff supports Mr. Henkes' recommendation. SIB at 54-56.

Additionally, Board Staff notes that an amortization adjustment should not be made on the basis of only four amortization items selected by the Company. SIB at 56. In his Supplemental Direct Testimony and Surrebuttal Testimony, Mr. Henkes testified that it would be wrong to consider just a

few selected amortization expense projection updates without considering updates for all operating expenses, and recommended that the Company's proposed adjustment should be rejected on this basis alone. *RA-50*, p. 6.; *RA-51*, p. 18. The Ratepayer Advocate concurs with Board Staff on this point.

The Ratepayer Advocate respectfully submits that Your Honor and the Board should adopt Mr. Henkes' amortization expense adjustment recommendations, which would reverse the $421,000 amortization (after-tax) proposed by the Company. *P-4*, Sch. ANS-24 (12+0); *RA-60*, Sch. RJH-4R (12+0), RJH-19R (12+0).

## POINT IV

## PSE&G HAS NOT PRESENTED ANY CONVINCING ARGUMENTS AND, THEREFORE THE RATE BASE RECOMMENDATIONS OF THE RATEPAYER ADVOCATE SHOULD BE ADOPTED.

### A. Accumulated Depreciation Reserve

The Ratepayer Advocate recommends an adjustment to PSE&G's pro-forma rate base to reflect the effect of the Ratepayer Advocate's recommended depreciation expense adjustments on the Company's pro forma depreciation reserve balance. *See RA-49*, pp. 8-9; *RA-60*, Sch. RJH-5R(12+0). Both the Company and the Ratepayer Advocate used the half-year convention to compute the reserve. RAIB at 69-70. However, due to the use of different depreciation figures (namely, the adjustment proposed by Ratepayer Advocate witness Michael Majoros), there is a difference of approximately $50.1 million between the Company's proposed and the Ratepayer Advocate's recommended depreciation reserve balances. RAIB at 70; *RA-60*, RJH-5R (12+0).

The Ratepayer Advocate's recommended adjustment results in a total recommended pro forma depreciation reserve balance of $1,435,535,000 which is $50,127,000 lower than the Company's proposed pro forma depreciation reserve balance of $1,485,463,000. *RA-60*, RJH-5R (12+0). Board Staff supports the methodology used by the Ratepayer Advocate and the Company and recommends an accumulated depreciation reserve balance of $1,452,589,000. SIB at 10, Sch. 4A. Board Staff's figure differs from the adjustments computed by the Company and the Ratepayer Advocate due to differences in the underlying depreciation figures. For the reasons set forth above and in its Initial Brief and testimony of its witnesses, the Ratepayer Advocate recommends that its adjustment for depreciation reserve be adopted.

### B. Accumulated Deferred Income Taxes

The Ratepayer Advocate recommends an adjustment to the Company's pro forma deferred income tax balance which reflects the Ratepayer Advocate's recommended depreciation changes. RAIB at 70; *RA-49*, p. 9. The Ratepayer Advocate recommends an adjustment of $20,477,000, which increases the Company's deferred income tax balance from $254,817,000 to $275,294,000. *RA-60*, RJH-3R (12+0), ln. 5. Board Staff supports the use of the methodology used to compute the adjustment used by the Company and the Ratepayer Advocate. SIB at 11. However, due to differences in the underlying depreciation recommendations, Board Staff's recommended increase of $13.4 million differs from that recommended by the Ratepayer Advocate. SIB at 11. For the reasons set forth above and in its Initial Brief and testimony of its witnesses, the Ratepayer Advocate recommends that its adjustment for deferred income taxes be adopted.

### C. Cash Working Capital

The Ratepayer Advocate notes that Staff supports Mr. Henkes' recommendation for excluding deferred income taxes from the calculation of working capital in this proceeding. Staff supports this recommendation based upon prior Board policy and precedent. SIB at 12-14. Specifically, Staff relies on *I/M/O Public Service Electric & Gas Company for an Increase in Rates*, Order dated April 6, 1987, BPU Docket No. ER85121163. In that case, the Board adopted the treatment of deferred income taxes in a lead/lag study proposed by the Ratepayer Advocate. Staff, in its Initial Brief, notes that the Board adopted that portion of the ALJ's recommendation on this issue and includes the following quote from that case:

> I FIND that deferred taxes should be excluded from the lead/lag study

> because they did not, at any point in time, require investor-supplied capital. It would be unreasonable and inappropriate to force ratepayers to pay a return on funds not supplied by investors. (Initial Decision at 35) SIB at 13-14.

The Board affirmed this policy in BPU Docket No. GR88121321 *I/M/O Elizabethtown Gas Company for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions*, Order dated February 1, 1990, where the Board found:

> The ALJ was persuaded by Staff's argument as to the proper ratemaking 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. 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. *(Final Board Order at 7.)*

Even though both Staff and PSE&G reject the Ratepayer Advocate's proposed exclusion of depreciation, amortization expenses, and return on invested capital, the Ratepayer Advocate submits that Your Honor and the Board should accept Mr. Henkes' recommendations based upon the arguments set forth in the Ratepayer Advocate's Initial Brief at pages 72-77. The Ratepayer Advocate submits that the arguments are, in fact, compelling and warrant a change in policy at this time. Therefore, Your Honor and the Board should accept the lead/lag study cash working capital of $72,464,000 as set forth on Schedule RJH-6R, (12+0), *RA-60*.

### D. Consolidated Income Tax Benefits

PSE&G does not file its federal income tax return on a stand-alone basis, but rather files as a part of its parent company, Public Service Enterprise Group ("PSEG"). *RA-49*, p. 19. Other subsidiaries of PSEG are also included in the consolidated tax filing. *Id*. As set forth more fully below and in the testimony of Ratepayer Advocate witness Mr. Henkes, consistent with Board policy, the Ratepayer Advocate recommends an adjustment to the Company's pro forma rate base to reflect the income tax benefits allocable to PSE&G's regulated operations.

By filing a consolidated return, PSE&G can take advantage of tax losses experienced by its affiliated companies. In fact, as noted by Board Staff, PSE&G witness Mr. Krueger admitted that for the period 1991 through 2001, PSE&G has actually paid approximately $320 million more to PSEG for federal income taxes than PSEG has paid to the IRS for federal income taxes. SIB at 16. The Ratepayer Advocate submits that any allocation of tax savings made to PSE&G should flow-through for the benefit of its New Jersey ratepayers. *RA-49,* p. 19. Mr. Henkes recommended an adjustment to the Company's rate base to properly reflect the consolidated income tax savings allocable to the Company. *Id*. Mr. Henkes' recommended adjustment for consolidated taxes would reduce the Company's rate base by $55,613,000. *RA-60*, Sch. RJH-3R(12+0), line 7, and RJH-7R(12+0). The consolidated income tax treatment recommended by Mr. Henkes and advocated by the Ratepayer Advocate is consistent with recent Board rulings.

Contrary to the Company's argument, it is appropriate to consider the impact of consolidated income tax on rates. PIB at 69-78. In its Initial Brief, the Company has not advanced any argument

which refutes the position taken by the Ratepayer Advocate and Board Staff.

As set forth in the Ratepayer Advocate's Initial Brief, there is ample support and precedent for the Ratepayer Advocate's recommended consolidated tax adjustment. RAIB at 76-79. Contrary to the arguments raised by the Company, the Board has an established policy that any tax savings allocable to a utility as a result of the filing of consolidated income tax returns must be reflected as a rate base deduction in the utility's base rate filing. *See I/M/O The Petition Of Atlantic City Electric For Approval Of Amendments To Its Tariff To Provide For An Increase In Rates And Charges For Electric Service Phase II*, BPU Docket No. ER90091090J, (Order dated October 20, 1992) ("*Atlantic City Electric 1992 Base Rate Case Order*"); *I/M/O Petition Of New Jersey Natural Gas Company For Increased Base Rates And Charges For Gas Service And Other Tariff Revisions: Phase II; Consolidated Taxes*, BRC Docket Nos. GR89030335J and GR90080786J, (Order dated Nov. 26, 1991)("*NJNG 1991 Base Rate Case*"). Furthermore, the Appellate Division affirmed the Board's policy of requiring utility rates to reflect consolidated tax savings. *See In re Lambertville Water*, 153 *N.J. Super.* 24 (App. Div 1977), *reversed in part on other grounds*, 79 *N.J.* 449 (1979) ("*Lambertville Water*").

The rate base adjustment methodology followed by Mr. Henkes was adopted by the Board. *See 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 Modifications*, BPU Docket No. ER91121820J (Final Decision and Order Accepting in Part and Modifying in Part the Initial Decision dated February 25, 1993) ("*JCP&L 1993 Base Rate Case Order*"). Additionally, Mr. Henkes' tracing of the tax benefits accruing in prior years is consistent with prior Board rulings. *See*

*Atlantic City Electric 1992 Base Rate Case Order*, at 8; *JCP&L 1993 Base Rate Case Order* at 8. Furthermore, as noted by Board Staff, the rate base method followed by Mr. Henkes was supported by the IRS. SIB at 13-14. In sum, there is ample precedent for the adjustments recommended by Mr. Henkes and advocated by the Ratepayer Advocate. Board Staff concurs with the rate base methodology followed by Mr. Henkes as well as the appropriateness of adjustments for consolidated tax savings for ratemaking purposes. SIB at 11-18.

Additionally, the instant case may be distinguished from the Middlesex Water Company case and Pinelands Water Company case cited by PSE&G.[25] PIB. at 69. The subject utilities in the Pinelands case are Pinelands Water Company and Pinelands Wastewater Company, which are both regulated subsidiaries of Middlesex Water Company. In *Middlesex Water Company* , the Board acknowledged its policy of flowing through the tax benefits of tax losses to jurisdictional ratepayers:

> The Board HEREBY ADOPTS the ALJ's recommendation that this issue [consolidated income taxes] should be dealt with in the Pinelands Water and Wastewater cases, which are currently pending before the Board. It is the long established Board policy that any income tax savings attributable to the filing of a consolidated income tax return by a parent company should be flowed back to the jurisdictional ratepayers in the State. Since, in this case, the benefits were not reflected in the current filing, and given the record developed, the issues would be better addressed in the pending Pinelands Water and Wastewater cases [BPU Dkt. Nos. WR00070454 and WR00070455]. *Middlesex Water Company* at 20.

Clearly, the Board did not abandon its policy to flow-though tax loss benefits to ratepayers in the *Middlesex Water Company* case. In the *Pinelands* case, where the Board considered the tax loss

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[25] *I/M/O Middlesex Water Company*, BPU Dkt. No. WR00060362 (Order dated June 6, 2001) ("*Middlesex Water Company*"); *I/M/O Pinelands Water Company and Pinelands Wastewater Company*, BPU Dkt. No. WR00070455 (Order dated August 1, 2001)("*Pinelands*").

benefits cited in the *Middlesex Water Company* case, the petitioner argued that the tax losses were attributable to reduced revenues as a result of a Board-ordered rate phase-in, and that benefits of the tax losses had already flowed back to ratepayers in the form of reduced debt costs and an adjustment would result in double-counting. *Pinelands* at 16. The Board accepted petitioner's argument and did not order an adjustment. *Id.* at 16-17. Nonetheless, the Board recognized that the benefits of the tax losses should flow to ratepayers. *Id.* Thus, the Board's ruling in the *Middlesex Water Company* and *Pinelands* cases is consistent with the treatment of tax losses and consolidated taxes recommended by the Ratepayer Advocate in the instant case.

PSE&G also argues that the consideration of transmission income in the computation of the consolidated tax credit is inappropriate. PIB at 70-71. PSE&G contends that to consider the consolidated tax impact of transmission revenue here would result in double counting, arguing that such adjustments would be made at the FERC. *Id.* at 71. The Company's argument has no merit.

First, for the purpose of consolidated taxes, the Company's proffered distinction between its distribution and transmission operations is contrived. The Company has confirmed that its consolidated income tax filings do not distinguish between, and separately report, taxable income for distribution and transmission operations.[26] It only distinguishes between Electric Delivery Operations and Gas Delivery Operations.[27] Furthermore, PSE&G does not officially record and report – for tax filing and financial statement purposes – the taxable income derived from the transmission portion of its Electric Delivery

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[26]*P-34* (response to S-PREV-47), p. 2 of 3 (update); Response to RAR-A-172.

[27]*Id.*

Operations as distinguished from the distribution portion of its Electric Delivery Operations.[28] Thus, in the real world, the consolidated income tax filing does not distinguish between distribution and transmission taxable income.

Mr. Krueger states in his rebuttal testimony that PSE&G's taxable income from its transmission operations can be "easily and rationally apportioned" by using a net plant allocator. *P-3RB*, p. 3, lines 17-18. However, that calculation would represent a totally hypothetical exercise. The result of that exercise, therefore, would not be a known and measurable issue.

Finally, the Company is also inconsistent when it argues that anything having to do with its transmission operations should be disregarded for ratemaking purposes in this case. For example, the BPU/RPA assessments reflected by PSE&G (and the Ratepayer Advocate) in this case include assessments associated with PSE&G's transmission operations because the BPU/RPA assessment revenue base includes transmission revenues. It is inconsistent for the Company to include transmission revenue-related BPU/RPA assessments for ratemaking purposes in this case, but then argue for exclusion of the consolidated income tax benefits associated with transmission-related taxable income that is embedded within the Company's consolidated income tax filing for its Electric Delivery Operations.

Also, as noted by Board Staff, in the instant proceeding there is no evidence that the FERC has, in fact, made an adjustment for consolidated taxes. SIB at 23. Furthermore, as noted by Board Staff, PSE&G could intervene if the FERC were to contemplate making such an adjustment. *Id*.

PSE&G also argues that the Ratepayer Advocate's recommended consolidated income tax

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[28]*RA-27* (response to RAR-A-173).

adjustment in this case "ensures financial ruin for the unregulated leasing business." PIB at 75. PSEG operates its leasing business in the form of PSEG Resources Inc. As set forth below, the Company's argument is without merit. The Company's gloomy projection for its leasing operations is totally unwarranted and refuted by real-world facts. The Ratepayer Advocate's recommended rate base deduction of $55 million for the consolidated income tax adjustment has a revenue requirement impact of approximately $6 million.[29] By comparison, PSEG's 2001 Financial and Statistical Report shows that in 2001, PSEG Resources had income from leasing operations of $206 million.[30] The proposed adjustment of $6 million is less than 3 percent of PSEG Resources' 2001 leasing operating income of $206 million. Furthermore, PSEG Resources' income has grown over the past several years. For the years 1999 and 2000, PSEG Resources' income from leasing operations was $112 million and $163 million, respectively.[31] Given its upward trend in income, it can be expected that PSEG Resources' income from leasing operations for 2003 will be substantially higher than the 2001 income number of $206 million, whereby the proposed adjustment would amount to even less as a percentage of leasing income.

PSE&G has not demonstrated that the Ratepayer Advocate's recommended rate base deduction adjustment for the consolidated income tax benefits (with a revenue requirement impact of $6 million) will materially impact PSEG Resources' leasing operations or cause its ruin.

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[29] *See RA-60*, Sch. RJH-7R (12+0), RJH-1R (12+0). Applying rate of return and revenue conversion factor, etc., to arrive at revenue requirement impact.

[30] PSEG Financial and Statistical Review 2001, dated April 2002, provided in response to RAR-A-1.

[31] *Id*.

In sum, for the reasons set forth above and in its Initial Brief and the testimony of its witness, the Company's rate base should be adjusted to reflect the impact of consolidated taxes on the utility. RAIB at 76-79, *RA-60*. The recommended consolidated tax adjustment would reduce the Company's rate base by $55,613,000. *RA-60*, Sch. RJH-3R(12+0), line 7, and RJH-7R(12+0).

## POINT V

## COST OF SERVICE AND RATE DESIGN ISSUES

### A. The Board Should Reaffirm the Continuing Validity of the Board's Previously Established Cost Allocation Principles as Applied to the Company's Regulated Distribution System.

As noted in the Ratepayer Advocate's Initial Brief, the cost-of-service study included in the Company's Petition is not consistent with the cost-of-service principles stated in the Board's most recent fully litigated base rate case. RAIB at 100, 102-03; *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"*).

The Staff's Initial Brief includes a detailed discussion of the cost-of-service study performed by the Company based on instructions from Staff. SIB at 58-137. The Ratepayer Advocate has not performed a detailed analysis of the Staff methodology. However, based on the discussion in Staff's Initial Brief, the Staff methodology appears to incorporate the two fundamental cost allocation principles stated in the *JCP&L Base Rate Order*– (1) that the allocation of distribution-related costs should reflect the dual demand/energy dimension of distribution system planning and operation, and (2) that customer costs should be limited to those which vary directly and linearly with the number of customers. SIB at 88-89, 112-13. The Ratepayer Advocate concurs with Staff that the restructuring of New Jersey's energy markets does not change the cost allocation principles that apply to the Company's regulated distribution business. SIB at 76-79. To the extent that the Staff methodology reflects the cost allocation principles stated in the *JCP&L Base Rate Order*, the Ratepayer Advocate

supports its adoption by Your Honor and the Board.

### B. The Distribution Rate Increase Resulting from this Proceeding Should Be Allocated Based upon Consideration of the Combined Impact of the Distribution Rate Increase and the Expiration of the Market Transition Charge.

As explained in detail in the Ratepayer Advocate's Initial Brief, the Ratepayer Advocate believes that the rate increase resulting from this proceeding should be allocated among customer classes based on consideration of the combined impact of the distribution rate increase and the expiration of PSE&G's MTC. The Ratepayer Advocate will not repeat those arguments here. However, since the Staff's proposed class revenue distribution methodology was not available at the time the Initial Briefs were filed, the Ratepayer Advocate wishes to provide Your Honor and the Board with a comparison of the rate impacts, by class of the methodologies proposed by all parties. Attachment 1 shows the combined impact of the distribution rate increase, at PSE&G's proposed revenue requirement, and the MTC expiration for these three proposals.

In addition, the Ratepayer Advocate wishes to provide information showing the rate impacts, by class, of the proposals of the three parties that have presented positions as to both revenue requirements and class revenue distribution, that is, the Company, the Ratepayer Advocate, and Staff. Attachment 2 shows the combined impacts of the distribution rate increase and MTC expiration.

The Ratepayer Advocate urges Your Honor and the Board to consider this information in determining the class revenue distribution in this proceeding.

### C. The Company's Curtailable Electric Service Remains Justified in a Post-restructuring Environment.

As explained in detail in the Ratepayer Advocate's Initial Brief, the Company's Curtailable

Electric Service ("CES") Special Provision provides important conservation and load management benefits, which should be preserved. In its Initial Brief, the Company argues that "[i]n a post-electric restructuring environment, as a distribution company," the Company is "unable to support continuation" of its CES program. PCSIB at 18. This argument is based on an incomplete characterization of PSE&G's continuing obligations as a public utility.

PSE&G is not solely a distribution company. EDECA provides that, for at least three years following the implementation of electric retail choice, "and thereafter until the Board specifically finds it to be no longer necessary and in the public interest, each electric public utility shall provide basic generation service." *N.J.S.A.* 48:3-57(a). No such finding has been made by the Board. In its December 11, 2002 "Year 4" BGS Order, Board determined that it "cannot, at this juncture, find it to be no longer necessary and in the public interest for the electric utilities to provide BGS." *I/M/O the Provision of Basic Generation Service Pursuant to the Electric Discount and Energy Competition Act, N.J.S.A. 48:3-9 et seq.,* BPU Docket Nos. EX01050303 *et al.,* (Decision and Order dated Dec. 11, 2001), p. 18. Thus, as the Board explained the following year in its "Year 5" BGS Order, the Board "determined that for Year 4 of the Transition Period (August 1, 2002-July 31, 2003), the electric utilities should continue to provide BGS, with the procurement of supply to meet the full electricity requirements of BGS customers to be achieved via an auction process." *I/M/O the Provision of Basic Generation Service Pursuant to the Electric Discount and Energy Competition Act, N.J.S.A. 48:3-49 et seq.,* BPU Docket Nos. EX01110754 and EO002070384 (Decision and Order dated December 18, 2002), p. 1. The Year 5 BGS Order continued this same arrangement, authorizing the electric utilities to conduct another auction to procure the supply needed to

meet the requirements of their BGS customers after July 31, 2003. *Id.,* p. 7. The Year 5 Order does not contain any finding that it is "no longer necessary and in the public interest" for the State's utilities to provide BGS service. Thus, PSE&G, like New Jersey's other electric utilities, remains responsible for providing BGS.

Under EDECA, BGS is defined as a service that is "fully regulated by the board." *N.J.S.A.* 48:3-51. Thus, the costs incurred in providing BGS remain subject to the Board's review to assure that only prudently incurred costs are recovered from ratepayers. *N.J.S.A.* 48:3-57(e). As explained in the Ratepayer Advocate's Initial Brief, the Company's CES program should reduce the costs of BGS supply by reducing loads during times of peak demand. RAIB at 110. Thus, for as long as PSE&G remains responsible for BGS, load management programs such as the CES program will remain relevant to the Company's responsibilities as a regulated electric utility.

The Company's Initial Brief argues that it was incumbent upon the Ratepayer Advocate to demonstrate that the current CES credit is justified solely based on potential distribution system savings. PCSIB at 18. As the Company appeared to acknowledge in the prepared rebuttal testimony of its witness Gerald Schirra, to the extent the CES program is related to BGS , the "continuance or discontinuance" of this program should have been addressed in the Board's generic BGS proceeding. *PS-7-RB,* p. 13. Under *N.J.S.A.* 48:2-21(d), it would have been PSE&G's burden to demonstrate the reasonableness of this proposed tariff change. However, the Company neither sought nor obtained the Board's approval to eliminate the CES program in the BGS proceedings. RAIB at 111-112. Under these circumstances, it is not the Ratepayer Advocate's burden to demonstrate that the CES should be continued.

PSE&G's role as a BGS provider remains an important one. According to the Board's most recent electric "switching" statistics, provided as Attachment 3 to this brief, only 1,127 of the Company's 2,028,909 customers–less than one tenth of one percent–are served by competitive suppliers. Thus, it remains important to preserve programs that will help the Company to provide BGS at affordable rates. PSE&G has presented no showing, either in the Board's BGS proceeding or in this matter, that would justify the elimination of a program that benefits over 2 million ratepayers.

For the above reasons, in addition to those set forth in the Ratepayer Advocate's Initial Brief, Your Honor and the Board should reject the Company's proposal to eliminate its CES program.

## CONCLUSION

For the reasons set forth above, and the reasons in our Initial Brief and the testimony of our witnesses, and supported by the substantial, credible evidence in the record, the Ratepayer Advocate respectfully submits that Your Honor and the Board should adopt the recommendations contained therein.

Respectfully submitted,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By:______________________________
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Dated: April 17, 2003

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## Public Service Electric and Gas

Comparison of Proposed Changes in Total Class Revenues (including MTC)
Basis: Parties' Respective Revenue Requirement Positions ($000)

| Class | Present Total Revenue (w/o RRR) | Recommended Bill Impacts including MTC | | | | | |
|---|---|---|---|---|---|---|---|
| | | PSE&G | | RA | | Staff | |
| | | Amount | % | Amount | % | Amount | % |
| | (a) | (b) | (c) | (d) | (e) | (f) | (g) |
| RS | $ 1,371,583 | $ (19,909) | -1.45% | $ (47,495) | -3.46% | $ (880) | -0.06% |
| RHS | 29,248 | (425) | -1.45% | (1,014) | -3.47% | (437) | -1.49% |
| RLM | 33,407 | (485) | -1.45% | (1,157) | -3.46% | (1,862) | -5.57% |
| WH | 880 | (13) | -1.48% | (31) | -3.52% | 213 | 24.20% |
| WHS | 11 | (0.154) | -1.40% | (0) | -3.34% | 4 | 36.36% |
| HS | 3,083 | (113) | -3.67% | (270) | -8.76% | (40) | -1.30% |
| BPL | 54,751 | (2,384) | -4.35% | (5,687) | -10.39% | (4,619) | -8.44% |
| BPL-POF | 1,246 | (50) | -4.01% | (120) | -9.63% | (145) | -11.64% |
| PSAL | 34,530 | (501) | -1.45% | (1,195) | -3.46% | (1,449) | -4.20% |
| GLP | 883,375 | (24,817) | -2.81% | (60,233) | -6.82% | (66,527) | -7.53% |
| LPL-S | 1,034,238 | (40,154) | -3.88% | (97,214) | -9.40% | (62,058) | -6.00% |
| LPL-P | 316,210 | (13,153) | -4.16% | (32,850) | -10.39% | (23,853) | -7.54% |
| HTS-S | 294,220 | (12,721) | -4.32% | (30,565) | -10.39% | (38,843) | -13.20% |
| HTS-HV | 30,118 | (1,312) | -4.36% | (3,130) | -10.39% | (2,577) | -8.56% |
| EHEP | 23,611 | (3,295) | -13.96% | (3,723) | -15.77% | (2,899) | -12.28% |
| Subtotal | $ 4,110,511 | $ (119,331) | -2.90% | $ (284,684) | -6.93% | $ (205,972) | -5.01% |
| Oth Rev. Increase | | 2,476 | | 0 | | 2,476 | |
| Total Bill Impact | | $ (116,855) | | $ (284,684) | | $ (203,496) | |

Note: PS and RA results reflect the elimination of loss factors in SBC and NTC. Staff retains the loss factor adj.

**Public Service Electric and Gas**

Comparison of Proposed Changes in Total Class Revenues (including MTC)

Basis: Company Requested Revenue Requirement ($000)

| Class | NJLEUC Derivation Combined Change (a) | NJLEUC Derivation Distrib. Increase (b) | NJLEUC Derivation MTC Expiration (c) | NJCU Derivation Combined Change (a) | NJCU Derivation Distrib. Increase (b) | NJCU Derivation MTC Expiration (c) | Staff Derivation Combined Change (a) | Staff Derivation Distrib. Increase (b) | Staff Derivation MTC Expiration (c) |
|---|---|---|---|---|---|---|---|---|---|
| RS | $ 98,555 | $ 149,865 | $ (51,310) | $ 46,732 | $ 98,042 | $ (51,310) | $ 26,251 | $ 77,561 | $ (51,310) |
| RHS | (159) | 278 | (437) | (474) | (37) | (437) | (437) | 0 | (437) |
| RLM | (767) | 1,831 | (2,598) | (588) | 2,010 | (2,598) | (1,466) | 1,132 | (2,598) |
| WH | 242 | 259 | (17) | 197 | 214 | (17) | 336 | 353 | (17) |
| WHS | 4 | 3 | 1 | 5 | 4 | 1 | 5 | 4 | 1 |
| HS | (40) | 0 | (40) | (225) | (185) | (40) | (40) | 0 | (40) |
| BPL | (4,619) | 0 | (4,619) | (8,330) | (3,711) | (4,619) | (4,619) | 0 | (4,619) |
| BPL-POF | (132) | 114 | (246) | (68) | 178 | (246) | (90) | 156 | (246) |
| PSAL | 598 | 5,648 | (5,050) | (8,103) | (3,053) | (5,050) | 488 | 5,538 | (5,050) |
| GLP | (52,753) | 65,386 | (118,139) | (34,793) | 83,346 | (118,139) | (38,761) | 79,378 | (118,139) |
| LPL-S | (85,922) | 16,670 | (102,592) | (63,789) | 38,803 | (102,592) | (40,252) | 62,340 | (102,592) |
| LPL-P | (30,125) | 2,984 | (33,109) | (22,770) | 10,339 | (33,109) | (18,873) | 14,236 | (33,109) |
| HTS-S | (38,337) | 4,547 | (42,884) | (21,147) | 21,737 | (42,884) | (36,669) | 6,215 | (42,884) |
| HTS-HV | (2,949) | 0 | (2,949) | (2,615) | 334 | (2,949) | (2,377) | 572 | (2,949) |
| EHEP | (2,964) | 0 | (2,964) | (3,402) | (438) | (2,964) | (2,864) | 100 | (2,964) |
| Subtotal | $ (119,369) | $ 247,584 | $ (366,953) | $ (119,369) | $ 247,584 | $ (366,953) | $ (119,369) | $ 247,584 | $ (366,953) |

(a)= (b)+(c)

| Source: | NJLEUC (b) | NJLEUC (c) | NJCU (b) | NJCU (c) | Staff (b) | Staff (c) |
|---|---|---|---|---|---|---|
| | Exh. __(JP-5) Update 12+0 | Sch. GWS-10 Update 12+0 Pg. 1 of 3 | Exhibit DWG-SR-3 Update 12+0 | Sch. GWS-10 Update 12+0 Pg. 1 of 3 | Rate Design Schedule in Initial Brief (No number) | Sch. GWS-10 Update 12+0 Pg. 1 of 3 |

# Public Service Electric and Gas

## Comparison of Proposed Changes in Total Class Revenues (including MTC)

## Basis: Company Requested Revenue Requirement

| Class | Present Total Revenue (w/o RRR) | PSE&G | | RA | | NJLEUC | | NJCU | | Staff | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Amount | % | Amount | % | Amount | % | Amount | % | Amount | % |
| | (a) | (b) | (c) | (d) | (e) | (f) | (g) | (h) | (i) | (j) | (k) |
| RS | $ 1,371,583 | $ (19,909) | -1.45% | $ (19,580) | -1.43% | $ 98,555 | 7.19% | $ 46,732 | 3.41% | $ 26,251 | 1.91% |
| RHS | 29,248 | (425) | -1.45% | (425) | -1.45% | (159) | -0.54% | (474) | -1.62% | (437) | -1.49% |
| RLM | 33,407 | (485) | -1.45% | (463) | -1.39% | (767) | -2.30% | (588) | -1.76% | (1,466) | -4.39% |
| WH | 880 | (13) | -1.48% | (13) | -1.48% | 242 | 27.50% | 197 | 22.39% | 336 | 38.18% |
| WHS | 11 | (0.154) | -1.40% | (0) | -1.40% | 4 | 36.36% | 5 | 45.45% | 5 | 44.18% |
| HS | 3,083 | (113) | -3.67% | (114) | -3.70% | (40) | -1.30% | (225) | -7.30% | (40) | -1.30% |
| BPL | 54,751 | (2,384) | -4.35% | (2,361) | -4.31% | (4,619) | -8.44% | (8,330) | -15.21% | (4,619) | -8.44% |
| BPL-POF | 1,246 | (50) | -4.01% | (48) | -3.85% | (132) | -10.59% | (68) | -5.46% | (90) | -7.22% |
| PSAL | 34,530 | (501) | -1.45% | (455) | -1.32% | 598 | 1.73% | (8,103) | -23.47% | 488 | 1.41% |
| GLP | 883,375 | (24,817) | -2.81% | (23,873) | -2.70% | (52,753) | -5.97% | (34,793) | -3.94% | (38,761) | -4.39% |
| LPL-S | 1,034,238 | (40,154) | -3.88% | (39,515) | -3.82% | (85,922) | -8.31% | (63,789) | -6.17% | (40,252) | -3.89% |
| LPL-P | 316,210 | (13,153) | -4.16% | (12,968) | -4.10% | (30,125) | -9.53% | (22,770) | -7.20% | (18,873) | -5.97% |
| HTS-S | 294,220 | (12,721) | -4.32% | (12,441) | -4.23% | (38,337) | -13.03% | (21,147) | -7.19% | (36,669) | -12.46% |
| HTS-HV | 30,118 | (1,312) | -4.36% | (1,299) | -4.31% | (2,949) | -9.79% | (2,615) | -8.68% | (2,377) | -7.89% |
| EHEP | 23,611 | (3,295) | -13.96% | (3,300) | -13.98% | (2,964) | -12.55% | (3,402) | -14.41% | (2,864) | -12.13% |
| Subtotal | $ 4,110,511 | $ (119,331) | -2.90% | $ (116,855) | -2.84% | $ (119,369) | -2.90% | $ (119,369) | -2.90% | $ (119,369) | -2.90% |
| Other Revenue | | 2,476 | | 0 | | 2,476 | | 2,476 | | 2,476 | |
| Total Revenue | | $ (116,855) | | $ (116,855) | | $ (116,893) | | $ (116,893) | | $ (116,893) | |
| Source: | Sch. GWS-10 Update 12+0 | Sch. GWS-10 Update 12+0 | | Same as PS, except for Other Revenue | | Exh. __(JP-5) Update 12+0 plus MTC Expiration | | Exhibit DWG-SR-3 Update 12+0 plus MTC | | Rate Design Schedule in Initial Brief plus MTC | |

# NEW JERSEY ELECTRIC STATISTICS

April 8, 2003

Number of Customers/Accounts Served by Competitive Suppliers

| Distribution Company | Residential | Non-Residential | Report Date |
|---|---|---|---|
| Conectiv | 396 | 466 | 02/28/03 |
| JCP&L | 341 | 56 | 01/31/03 |
| PSE&G | 1,017 | 110 | 02/28/03 |
| Rockland | 0 | 0 | 02/28/03 |
| Statewice Total | 1,754 | 632 | 2,386 |

Number of Customers by Distribution Company

| Distribution Company | Residential | Non-residential | Total |
|---|---|---|---|
| Conectiv | 453,477 | 62,319 | 515,796 |
| JCP&L | 924,540 | 116,824 | 1,041,364 |
| PSE&G | 1,751,134 | 277,775 | 2,028,909 |
| Rockland | 62,175 | 8,746 | 70,921 |
| Statewice Total | 3,191,326 | 465,664 | 3,656,990 |

Amount of Load in MW Being Served

| Distribution Company | By EDC | By TPSs | Report Date |
|---|---|---|---|
| Conectiv | 2,361 | 129.6 | 02/28/03 |
| JCP&L | 3,669 | 117.6 | 01/31/03 |
| PSE&G | 9,954 | 28.0 | 02/28/03 |
| Rockland | 452 | 0.0 | 02/28/03 |
| Statewice Total | 16,436 | 275.2 | 16,712 |