BEFORE THE STATE OF NEW JERSEY

BOARD OF PUBLIC UTILITIES

I/M/O THE PETITION OF PUBLIC SERVICE	)	
ELECTRIC AND GAS COMPANY FOR	)	
APPROVAL OF A SOLAR ENERGY PROGRAM	)	**BPU DKT. NO. EO07040278**
AND AN ASSOCIATED COST RECOVERY	)	
MECHANISM	)	

SURREBUTTAL TESTIMONY OF MATTHEW I. KAHAL ON BEHALF OF THE NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE, DIVISION OF RATE COUNSEL

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I. <u>Introduction</u>

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Matthew I. Kahal. I am employed as an independent consultant retained in this matter by the Department of Public Advocate, Division of Rate Counsel (Rate Counsel). My business address is 5565 Sterrett Place, Suite 310, Columbia, Maryland 21044.

Q. HAVE YOU PREVIOUSLY TESTIFIED IN THIS CASE?

A. Yes. On September 21, 2007, I submitted Direct Testimony on behalf of Rate Counsel that addresses the appropriate rate of return that Public Service Electric and Gas Company ("PSE&G" or the "Company") should receive and charge its electric ratepayers under its proposed Solar Program.

Q. WHAT WAS YOUR MAIN RECOMMENDATION IN YOUR SEPTEMBER 21, 2007 DIRECT TESTIMONY?

A. PSE&G envisions a Solar Program involving an investment of about $100 million, to be recovered from electric distribution ratepayers on a dollar-for-dollar basis through the Societal Benefits Charge ("SBC"). As part of PSE&G's proposed cost recovery, ratepayers would be charged a 12.11 percent return on net investment (including associated income taxes). This is based on the authorized return approved in the Company's last gas distribution base rate case <u>plus</u> a 100 basis point return on equity "bonus."

My Direct Testimony expresses the view that the 12.11 percent return request is inappropriate and overstated. There is no reason to rely on a <u>gas</u> base rate case decision to set the rate of return charged to <u>electric</u> customers, and the 12.11 percent return on net investment (and the requested 11.0 percent equity return) fails to account for the very low-risk nature of this program, given the proposed SBC recovery mechanism. I am recommending a 10.11 percent pre-tax return, which reflects a 60 percent debt/40 percent equity capital structure, a 6.0 percent prospective cost of debt and a 9.75 percent cost of equity (PSE&G's currently authorized equity return for electric service). This recommendation assumes that Rate Counsel's cost recovery and ratemaking recommendations are adopted.

Q. DID PSE&G SUBMIT REBUTTAL TESTIMONY CONTESTING YOUR RECOMMENDATION?

A. Yes. PSE&G responded to my recommendations in the Rebuttal Testimony of Mr. Morton Plawner. He disputes my use of the currently authorized electric return, the 6.00 percent cost of debt (although this differs only very slightly from the Company's figure) and my recommended capital structure.

Q. WHAT ARE THE MAIN POINTS IN MR. PLAWNER'S REBUTTAL TESTIMONY?

A. Mr. Plawner addresses each of the three rate of return components (i.e., capital structure, cost of debt and equity return) separately, although his emphasis is on the equity return since that is the component most in dispute. First, he argues for the use of the gas service equity rate of return (established by settlement) rather than the authorized electric distribution figure because the gas decision is more recent. (Plawner Rebuttal Testimony, page 3) He criticizes the electric figure as being "out-of-date" and therefore should be disregarded. (*Id.*) He further defends the gas return figure as being reasonable for an electric program because the risks associated with electric and gas distribution are similar. (*Id.,* pages 3-4) However, the largest area of disagreement is with the 100 basis point bonus. His argument is that the New Jersey Board of Public Utilities ("Board") has the authority to award this bonus and its decision should have nothing whatsoever to do with the risks that PSE&G investors would face under this program.

The second component, the cost of debt, is a very minor issue since my 6.0 percent figure is very close to the Company's figure of 6.19 percent. However, Mr. Plawner argues that market evidence today provides more support for the Company's proposed slightly higher cost rate.

The third issue is capital structure, for which I propose a 40 percent common equity ratio versus the 47 percent obtained from the most recent gas case. Mr. Plawner argues that the 40 percent is "egregious" since PSE&G targets a 50/50 capital structure. (*Id.,* page 5) He argues that a 60/40 capital structure would cause a credit downgrade from A- to triple B and therefore is improper. (*Id.)* He also argues that the Company does not identify separate capitalizations for individual assets and the Company instead would "finance all our utility investments with our corporate pool of capital." (Rebuttal testimony, page 5)

Finally, Mr. Plawner argues that my recommendations (and those of Ms. Crane) would "send a negative signal to investors." (*Id*., pages 5-6) He further argues that my proposed return would be "negatively perceived by investors" and could increase PSE&G's future cost of capital. (*Id*., page 2)

Q. ARE YOU ALTERING YOUR RECOMMENDATIONS IN RESPONSE TO MR. PLAWNER'S REBUTTAL TESTIMONY?

A. No, I continue to believe that my rate of return recommendation is appropriate. Updated information just received in response to Rate Counsel data requests provides added support for my 6.0 percent debt cost rate. However, in response to Mr. Plawner's criticism of my 60 percent debt/40 percent equity imputed capital structure, I suggest an alternative that would fully address his concern. This alternative is described later in my testimony.

II. Response to Mr. Plawner's Arguments

Q. DO YOU AGREE WITH MR. PLAWNER THAT THE 9.75 PERCENT RETURN IS OUT OF DATE?

A. No. While PSE&G's gas case is more recent than its electric case, Mr. Plawner has presented no evidence that the last electric decision on cost of equity is out of date. The pure passage of time does not, by itself, render a Board decision out of date. Moreover, the most recent electric case decision in New Jersey that I am aware of is for Rockland Electric Company (Docket No. ER06060483, March 22, 2007), in which the Board approved a 9.75 percent return on equity for electric service.[1] This result was part of a comprehensive settlement accepted by the Board (as is the case for the PSE&G gas case), and it is <u>not</u> the basis of my recommendation. My return on equity recommendation is based on PSE&G's currently authorized electric figure.[2] However, the Rockland result clearly contradicts Mr. Plawner's unsubstantiated assertion that PSE&G's currently authorized electric return on equity is "out of date."

Q. MR. PLAWNER SEEMS TO ARGUE THAT THE RISKS OF GAS AND ELECTRIC DISTRIBUTION ARE SIMILAR. DOES THIS SUPPORT HIS POSITION?

A. While I agree with him that, in general, the risks associated with gas and electric utility distribution operations do not differ greatly, his point is academic. The fact is that in the last PSE&G gas base rate case both the Company and Rate Counsel relied

[1] The Company's response to RCR-FIN-22 erroneously states that the most recent New Jersey electric distribution return on equity award was in May 2005.
[2] BPU Docket No. ER02050303, April 22, 2004.

upon gas distribution industry market data to estimate the return on equity, not electric distribution market data.[3] Moreover, Mr. Plawner's risk arguments cannot change the fact that the Company's authorized <u>electric</u> return is 9.75 percent.

Q. DOES MR. PLAWNER PRESENT ANY PERSUASIVE ARGUMENT SUPPORTING THE 100 BASIS POINT BONUS?

A. In my opinion, he does not. He simply states that it is a policy issue and that the Board has authority to provide the requested bonus. From these observations he reaches the conclusion that arguments regarding investment risk are irrelevant to the equity return bonus award issue. (*Id.*, page 6)

Q. YOUR TESTIMONY FINDS THAT THE INVESTMENT RISK FOR PSE&G UNDER THIS PROGRAM IS FAR LOWER THAN THE REST OF THE UTILITY OPERATIONS. DOES MR. PLAWNER TAKE ISSUE WITH YOUR FINDING?

A. No, he does not dispute my finding that the proposed Solar Program is very low risk for PSE&G. Rather, Mr. Plawner argues that risk assessments should not factor into setting the return on equity or evaluating the bonus request.

Q. WHAT IS YOUR RESPONSE?

A. I do not contest Mr. Plawner's assertion that the requested bonus is a policy issue, nor do I dispute the Board's authority to decide this matter. However, such statements by themselves do not support the Company's request. Certainly I do not agree with his contention that the investment risk is irrelevant to the setting of a fair return in this matter. The very low risk associated with PSE&G's proposed dollar-for-dollar SBC cost recovery argues strongly for not increasing the currently authorized 9.75 percent by adding a bonus. As a matter of policy, I believe the Board should recognize that

[3] See the Direct Testimony of Matthew I. Kahal in BPU Docket No. GR05100845 for a description of both the Rate Counsel and PSE&G cost of equity studies.

this Solar Program will be heavily subsidized by ratepayers (not the Company) at a time when customers already are burdened by very high market prices for generation. PSE&G's proposed ROE bonus would only serve to exacerbate that rate burden.

The Company has presented no evidence in testimony or data responses demonstrating that it requires a return bonus as an incentive to undertake this program. Indeed, it seems clear that shareholders will benefit from the allocation of a substantial share of the solar credits to PSE&G's unregulated generation affiliate at zero cost, as proposed under the program.

Q. MR. PLAWNER USES RECENT MARKET DATA TO SUPPORT THE PROPOSED 6.19 PERCENT COST OF DEBT. IS THIS INFORMATION USEFUL?

A. It is useful to some degree. However, his market data support a cost rate only slightly higher than my 6.0 percent, so the difference is very modest and does not materially change the overall return on rate base. While Mr. Plawner claims that the market data support 6.21 percent, it should be pointed out that this cost rate is for very long-term utility debt with terms of 20 to 30 years. In contrast, the Solar loan amortization period is 15 years, with a declining balance. Given the present upward slope in the yield curve (i.e., higher yields for longer-term debt), Mr. Plawner's market data would imply a slightly lower cost of debt for the Solar program than his 6.2 percent. Therefore, my 6.0 percent cost of debt clearly is a reasonable estimate.

While my estimated 6.0 percent debt cost is reasonable, I do not object to using PSE&G's current actual embedded cost of debt. Indeed, it would be better to use the latest actual value (e.g., at September 30, 2007, excluding securitization debt) rather than the older embedded cost of debt from the Company's last gas rate case.

In fact, PSE&G reports that its embedded cost of debt at September 30, 2007 (excluding securitization debt) is 5.9662 percent, and the Company's most recent long-term debt issue (in May 2007) carries a 5.80 percent cost rate. (Responses to RCR-FIN-14 and 16) This information fully supports the reasonableness of my 6.0 percent figure.

Q. MR. PLAWNER OBJECTS TO YOUR 60/40 CAPITAL STRUCTURE RECOMMENDATION. ARE HIS CRITICISMS REASONABLE?

A. No, they are not. While he agrees with me that the 60/40 capital structure is within the range of an investment grade credit rating, he expresses concern that this capital structure on a total company basis would lead to a downgrade from the current A- to triple B.[4] He further argues that it is improper to employ an imputed or target capital structure for a discrete asset or group of assets that differs from the mix of capital that is used on a total company basis. He also recognizes that securitization is an exception to this principle since it employs a completely dedicated source of capital directly linked to a specific asset.

Mr. Plawner's criticisms are not correct and miss the point. There is no issue of credit downgrading because I am making no recommendation concerning capital structure on a total company basis. Imputing greater leverage to Solar Program assets (which would be a very minor part of PSE&G's total capital) will have no detectable effect on PSE&G's credit metrics or the credit rating. Moreover, imputing a different capital structure for the Solar Program is entirely proper and consistent with the modern financial theory of a "project" or "divisional" cost of capital, if that project or

[4] The response to RCR-FIN-23 reports a Standard & Poor's Business Profile of "3" for PSE&G. Standard & Poor's publishes a triple B benchmark debt ratio of 55 to 65 percent for this Business Profile. Hence, my 60 percent debt ratio is the midpoint of that range, not the lower end.

division has risk attributes that differ significantly from the total corporate risk profile.

Financial theory holds that a reduction in investment risk makes possible the use of greater debt leverage in capital structure. In this case, the risk profile for the Solar Program would be fundamentally different than that of the rest of PSE&G's electric delivery service operations since the Company proposes to recover all Program costs and the authorized return on investment, dollar-for-dollar, through the SBC[5]. Principles of finance recognize that the appropriate (or "optimal") capital structure for the Solar Program differs from the total Company capital structure. If the Company were to propose a cost recovery method for the Solar Program similar to that of its electric distribution operations, then I would agree that the total Company capital structure should be employed, not the 60/40. But that clearly is not the Company's proposal.

Q. MR. PLAWNER SUGGESTS THAT YOUR 10.11 PERCENT RATE OF RETURN WILL BE VIEWED NEGATIVELY BY INVESTORS AND MAY INCREASE THE COMPANY'S COST OF CAPITAL. DO YOU FIND THESE ASSERTIONS TO BE PLAUSIBLE?

A. No. There is no evidence to support these statements. It undoubtedly is true that investors always prefer receiving a higher rate of return over a somewhat lower rate of return (i.e., they prefer 11 percent to 9.75 percent), but in this case the total dollar difference from the respective return recommendations is modest, less than $1 million per year in after-tax earnings.[6] While the level of earnings that I am recommending is

[5] Unlike the case for base rate cost recovery and the return portion of base rates, the full cost recovery proposed for this Program will not be at risk of lower than expected sales or variations in program costs. The Company proposes to true up its Solar Program cost recovery retroactively to account for these variables.
[6] The Solar Program average investment balance will be about $50 million over the 15-year Program life, and the after-tax return difference between my recommendation and the Company's is 1.1 percent, translating into about $0.6 million per year in after-tax earnings reduction compared to the Company's request.

somewhat less than the Company seeks, the SBC-assured cost recovery mechanism proposed by PSE&G certainly would be regarded favorably by investors. Moreover, my recommended 9.75 percent equity return is identical to what is presently authorized for the Company's electric operations.

There simply is no plausible basis to argue either investor disappointment or an increase in the cost of capital from my return recommendation.

III. Alternative Financing Approach

Q. YOU STATE THAT IN RESPONSE TO MR. PLAWNER'S CRITICISM OF YOUR CAPITAL STRUCTURE YOU HAVE DEVELOPED AN ALTERNATIVE TO ADDRESS HIS CONCERNS. PLEASE DESCRIBE THIS ALTERNATIVE.

A. Mr. Plawner's concern is that my imputed 60/40 capital structure departs from the manner in which PSE&G actually finances its utility investment, which is closer to a 50/50 capital structure. At the same time, it is my understanding that in PSE&G's pending debt issuance docket (BPU Docket No. EF07080621) the Company has indicated that it intends to use a substantial portion of this planned new debt to finance the Solar Program. Given these facts, it would be reasonable to simply employ this planned debt financing (i.e., at a 6 percent cost rate) as the return on investment that PSE&G could charge its customers for the Solar Program through the SBC mechanism. This return is appropriate because the proposed SBC cost recovery is extremely low risk and dollar-for-dollar, as discussed above.

Q. THIS ALTERNATIVE WOULD LOWER THE COMPANY'S ALLOWED RETURN FROM YOUR RECOMMENDED 10.11 PERCENT TO 6.0 PERCENT. WOULD THIS REDUCED RETURN MAKE PSE&G WORSE OFF?

A. No, it would not. Assigning 100 percent debt financing to the Solar Program would <u>not</u> make PSE&G worse off. This is because the debt supporting the Solar Program net investment would be excluded from PSE&G's ratemaking capital structure at the time of the next base rate case (and in future rate cases over the life of the Program). For example, if at the time of the next base rate case the Solar Program net investment is $75 million, then that $75 million would be removed from the debt portion of the ratemaking capital structure. This adjustment would ensure that the 100 percent debt financing assigned to the Solar Program is not being "double counted" or used twice. This approach also avoids the dispute over the use of an appropriate hypothetical capital structure since it reflects the manner in which PSE&G actually finances its overall electric distribution operations. That is, the sum of the debt-only Solar Program capital structure and the rate case-adjusted capital structure (i.e., adjusted to subtract out the Solar Program debt) should exactly equal the <u>actual</u> total Company capital structure.

This approach reduces the costs to consumers of the Solar Program, reduces the loan interest rate to Program participants and fully addresses Mr. Plawner's concern over the imputed capital structure. Moreover, this approach also would eliminate the dispute over the appropriate return on equity for the Solar Program.

Q. HAS THIS APPROACH BEEN USED PREVIOUSLY BY PSE&G?

A. Yes. This is conceptually similar to the rate treatment for securitization of stranded costs. The stranded costs are financed at low cost with 100 percent debt, and PSE&G

obtains dollar-for-dollar recovery for the securitization debt service through a special rate mechanism. The securitization debt is excluded from the capital structure (and cost of debt) used in the Company's base rate cases. I am suggesting very similar treatment here for the Solar Program, although unlike securitization, the debt financing the Solar Program will not be triple-A rated.

Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?

A. Yes, it does.