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

I/M/O THE PETITION OF PUBLIC SERVICE ELECTRIC AND GAS COMPANY FOR APPROVAL OF AN INCREASE IN ELECTRIC AND GAS RATES AND FOR CHANGES IN THE TARIFFS FOR ELECTRIC AND GAS SERVICE, B.P.U. N.J. NO. 14 ELECTRIC AND B.P.U. N.J. NO. 14 GAS PURSUANT TO N.J.S.A. 48: 2-21 AND N.J.S.A. 48: 2-21.1 AND FOR APPROVAL OF GAS WEATHER NORMALIZATION; A PENSION EXPENSE TRACKER AND FOR OTHER APPROPRIATE RELIEF	))))))))))))))	BPU DOCKET No. GR09050422 OAL DOCKET No. PUC-7559-09

DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL
INITIAL BRIEF

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PROCEDURAL HISTORY

On May 29, 2009, Public Service Electric and Gas Company (the "Company", or "PSE&G") filed with the Board of Public Utilities ("Board" or "BPU") a Petition (*P-1*) and testimonies in support of its request for an increase in its electric and gas distribution rates effective July 1, 2009 and July 2, 2009 respectively. In its initial filing, the Company sought an increase in electric revenues of $133.72 million or approximately 1.93%, and a gas revenue increase of $96.92 million or approximately 2.95%.

In addition to the increase in base rates, the Company requested the establishment of a Weather Normalization Clause ("WNC") for its gas utility, a Pension Expense Tracker, and an expansion of its Capital Adjustment Charge ("CAC") to include essentially all non-revenue producing plant additions between rate cases. The Company is also requesting a change in its Margin Adjustment Charge ("MAC").

In support of its base rate case, concurrent with its filing, the Company filed the testimony and exhibits of Ralph LaRossa (*P-2*), David Daly (*P-3*), Jorge Cardenas (*P-4*), Michael Vilbert (*P-5*), Daniel Furlong (*P-6*), Mark Kahrer (*P-7*), and Stephen Swetz (*P-8*).

On June 19, 2009, the Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel") filed a letter with BPU Secretary Izzo asking that the Board suspend the Company's proposed effective date of the increase because it violated the provisions of the 2006 PSE&G Electric and Gas stipulations. Rate Counsel requested that the Board amend the petition to reflect November 15, 2009 as the date upon which the Company's proposed rate increase could become effective. On July 1, 2009, the Board issued an Order suspending increases, changes or alterations in rates and charges.

The matter was transmitted to the Office of Administrative Law ("OAL") for evidentiary hearings and assigned to the Honorable Walter Braswell, Administrative Law Judge ("ALJ"). New Jersey Large Energy Users Coalition ("NJLEUC") filed a Motion to Intervene on August 7, 2009.

On August 12, 2009, the ALJ held an in-person pre-hearing conference. At the request of Judge Braswell, the parties negotiated the terms of the Pre-hearing Order by establishing a proposed procedural schedule, a list of contested issues, and the number of witnesses expected to file testimony. A Pre-hearing Order was issued on August 21, 2009.

On September 23, 2009, Bayonne Plant Holding, LLC, Camden Plant Holding, LLC, Newark Bay Cogeneration Partnership, LP and Elmwood Park Power, LLC (collectively known as the "Morris Energy Group" or "MEG")[1] filed a Motion for Intervention. Both NJLUEC's and MEG's Motions were granted by ALJ Braswell.

On September 25, 2009 the Company updated its Revenue Requirement Schedules to reflect six months of actual data and six months of projected data ("6+6 Updates"). In that update, the Company increased its electric rate increase request to $147.02 million and its gas rate increase request to $105.95 million. On October 16, 2009 the Company filed its Updated Cost of Service schedules and Rate Design schedules reflecting six months of actual data and six months of projected data.

On November 19, 2009, Rate Counsel and MEG filed their Direct Testimony. Rate Counsel submitted the testimony and exhibits of Matthew I. Kahal (*RC-31*), Richard W. LeLash (*RC-22*), Michael J. Majoros, Jr. (*RC-110*), David Peterson (*RC-90*), Brian

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[1] The discovery propounded and the exhibits submitted by MEG at the hearings were marked as ECG.

Kalcic (*RC-112*), Charles Salamone (*RC-36*), Dian Callaghan (*RC-21*), Robert Henkes (*RC-65*), Mitchell Serota (*RC-53*), Andrea Crane (*RC-131*) and the joint testimony of Michael J. McFadden, John Peters and A.E. Middents (*RC-35a* -Gas Reliability and *RC-35b*- Infrastructure Issues).

Public hearings were held on December 14, 2009 in Hackensack, December 15, 2009 in Mt. Holly and December 18, 2009 in New Brunswick.

On December 30, 2009, PSE&G filed the Rebuttal Testimony and exhibits of David Daly (*P-3-RB*), Jorge Cardenas (*P-4-RB-A- Gas and P-4-RB-B- Capital Economic Stimulus Infrastructure*), Daniel Furlong (*P-6-RB*), Mark Kahrer (*P-7-RB*), Joseph Forline (*P-10-RB*), Robert Krueger (*P-11-RB*), Joseph McDonald (*P-12-RB*), Earl Robinson (*P-13-RB*), Gerald Schirra (*P-14-RB*), Michael Vilbert (*P-15-RB*), James Warren (*P-16-RB*), Stephen Wreschnig (*P-17-RB*) and Stephen Swetz (*P-18-RB*). In addition, the Company filed revised direct testimony of Messrs. Daly, Cardenas, Furlong and Kahrer on January 29, 2010.

Evidentiary hearings, which included oral surrebuttal testimony on behalf of Rate Counsel, were held at the OAL on February 1, 2, 18, 19, 24 and March 2, 3 and 4, 2010.

On February 12, 2010, February 16, 2010, February 23, 2010 and March 1, 2010 the Company filed the revised direct testimony and the supplemental rebuttal testimony and exhibits of Stephen Swetz (*P-8-R-1electric and P-9-R-1gas*), David Daly (*P-3-RB*), Joseph McDonald (*P-12-RB Supplemental*), Robert Krueger (*P-11-RB Supplemental*) and Stephen Wreschnig (*P-17-RB-1*) all updated to reflect twelve months of actual data.

According to the schedule set in the Pre-hearing Order, initial briefs are due on March 19, 2009 and reply briefs are due on April 5, 2010. In an effort to resolve as many issues as possible prior to submitting briefs, the parties participated in numerous conference calls and in-person meetings. The following is a list of the issues that were agreed upon by the parties:

1. Severance expense
2. Severance - Payroll Taxes
3. Supplemental Executive Retirement Program expense
4. Rate Case expense
5. Management Audit
6. Insurance expense
7. Postage expense
8. Meals & Entertainment
9. Dues/Lobbying expense
10. Gains on Sale of Property
11. Real Estate tax expense
12. Vegetative Mgmt. expense
13. Advertising expense
14. Uncollectible expense
15. Solar Loan Administrative Costs
16. Wages
17. Wages – Payroll Taxes
18. Customer Care System
19. Revenue Annualization
20. Interest Synchronization
21. Plant Held For Future Use
22. Cash Working Capital

The following issues are not in dispute:

1. Company Owned Life Insurance Interest expense
2. BPU/Rate Counsel Assessment
3. Cost of Removal
4. TSGNF Margin Sharing
5. Depreciation Annualization
6. Capital Stimulus Revenue
7. Energy Master Plan Clauses

Based on the above, Rate Counsel's revenue requirement increase for electric operations changed from $1.981 million for electric operations (*ACC-1E Corrected 3/12/10*) to $21.379 million (*ACC-1E Brief*). Rate Counsel's revenue requirement decrease for gas operations changed from ($15.5) million for gas operations (*ACC-1G Corrected 3/12/10*) to ($1.2) million (*ACC-1G Brief*).

The following are the contested issues that are being addressed in the parties' brief:

- Capital Structure (all components: return on equity, long term debt, debt-to-equity ratio, customer deposits)
- Rate Base (Plant In Service, post-test year adjustment)
- Expanded Capital Infrastructure Clause
- Current Capital Infrastructure Stimulus Clause: Post-test year additions
- Consolidated Taxes
- Pension Expense and Pension Tracker Mechanism
- Incentive Compensation
- Weather Normalization Adjustment
- Gas Weather Normalization Clause
- Customer Operations Performance metrics
- All Cost of Service Study/Rate Design issues except those noted above
- Morris Energy Group issues
- NJLEUC issues

ARGUMENT

POINT I

RATE COUNSEL'S PROPOSED OVERALL RATE OF RETURN OF 8.06 % SHOULD BE ADOPTED REFLECTING ADJUSTMENTS TO THE COMPANY'S PROPOSED CAPITAL STRUCTURE THAT REMOVE CUSTOMER DEPOSITS, ALLOW 49.73% EQUITY AND A 10.0% RETURN ON EQUITY.

The parties have presented testimony in this case setting forth their disputed positions regarding Capital Structure, which includes debt/equity ratio, long-term debt rate, and return on equity. The debt/equity ratio relates to the percentage of capital raised by PSE&G that comes from debt versus the percentage that comes from equity. Equity is generally more expensive than debt, as it represents the contribution from shareholders for which they seek a return. Thus, adjustments to the ratio that increase the amount of equity increase the costs to ratepayers. The long-term debt rate is the rate PSE&G is allowed to recover for interest on long-term debt. The return on equity is the percentage PSE&G is permitted to earn on behalf of shareholders to compensate them for their equity investment. An additional issue between the parties is whether the customer deposits, which provide another source of capital for the company, should be included in the Capital Structure.

Rate Counsel witness Matthew I. Kahal originally recommended a return on equity of 10.1% which yields an overall cost of capital of 8.08% %. *RC-31, Schedule MIK-1*. Adjusted to reflect capital cost changes through December 2009 Mr. Kahal's recommendation is currently a 10.0% return on equity with an overall cost of capital of 8.06%. *RC-32, Schedule MIK-1, February 2010 update*. As set forth fully in his testimony and in this brief, Mr. Kahal's recommended return on equity is well supported by recognized methodologies, the Discounted Cash Flow ("DCF") Analysis and Capital Asset Pricing Method ("CAPM"), and results in both a reasonable cost of equity and a reasonable overall rate of return for PSE&G.

In addition, Mr. Kahal initially recommended a Capital Structure with a debt/equity ratio of 49.19% long term debt, 1.08% preferred stock and 49.73% common equity with removal of customer deposits from the Company's proposal. *RC-31, Schedule MIK-1* In a February 2010 update, Mr. Kahal removed preferred stock from his proposed capital structure based on updated information from the Company. *RC-32, Schedule MIK-1, February 2010 update.* This resulted in a Rate Counsel recommended Capital Structure of 50.27% long term debt and 49.73% common equity. *Id.* This recommendation is also fully supported by the record and will allow PSE&G to access capital markets without undue cost to ratepayers.

The Company's witness Dr. Vilbert initially recommended a return on equity of 11.5% that Company witness Mark G. Kahrer incorporated into his recommended overall rate of return of 8.86%. *P-7*, p. 8. Dr. Vilbert's initial recommended return on equity was subsequently modified to 11.25%. *P-15-RB,* p.38. Mr. Kahrer incorporated this 11.25% in his updated capital structure resulting in an overall return of 8.70 %. *P-7-R-3*. Dr. Vilbert also used the DCF and CAPM methodologies but added a "market versus book" capital structure adjustment ("leverage adjustment") to develop his recommended return on equity. As will be shown in this brief, the result of his DCF analysis is similar to Mr. Kahal's but his leverage adjustment is highly improper, contrary to Board practice and should be rejected.

With respect to Capital Structure, the Company presented the testimony of Mr. Kahrer who initially proposed a debt/equity ratio of 46.60 % long term debt, 1.05 % preferred stock, 1.15% customer deposits, and 51.2% equity. *P-7, MGK-6.* With the February 2010 12+0 update filing, Mr. Kahrer updated his initial proposal to 47.8% long term debt, 1.01 % customer deposits and 51.2% common equity. *P-7, MGK-6, R-3.* He removed preferred stock to reflect the Company's planned preferred stock redemption pursuant to the Board's Order in BPU Docket No. EF09120990.

For the reasons set forth in this brief, Rate Counsel respectfully submits that the capital structure, return on equity, long-term debt rate and overall return calculations set forth in Mr. Kahal's testimony are reasonable and should be adopted.

A. Capital Structure

1. Overview

The most recently authorized common equity ratio for PSE&G is 47.4%, as established in its 2006 base rate case. *P-7, RB,* p.53. In this proceeding, PSE&G's witness proposes a "target" 51.2% equity ratio as compared to Rate Counsel's proposed 49.73%. The Company's request for a 3.8 percentage point increase in its authorized equity component is unsupported and, because the cost of equity is higher than the cost of debt, this increase will cost ratepayers over $30 million annually. *T478:L2-5.* Mr. Kahal' proposed debt/equity recommendation includes an increase in equity of over 2% for PSE&G, but represents a more gradual approach that strengthens the capital structure and will allow the Company to satisfy the requirements of financial markets while avoiding an undue burden on ratepayers.

2. Removal of Preferred Stock

Both Rate Counsel and the Company agree to the removal of Preferred Stock from the Company's Capital Structure.

3. Removal of Customer Deposits

Rate Counsel's position is that customer deposits should be removed from the Company's Capital Structure and treated as a test year expense and rate base deduction. This position is contained in the testimony of Rate Counsel witness Andrea Crane. *RC-131,* p. 24. Mr. Kahal's testimony goes further to address the merits of the issue, arguing that customers are entitled to the full benefit of the availability of their deposits to PSE&G and thus the inexpensive capital that their deposits provide should not be diluted by folding them into the general capital structure. .

Mr. Kahrer in his Direct Testimony did not specifically set forth any rationale for the inclusion of customer deposits. *P-7*, p.8-9. Rather he raised general arguments about the Company's need to raise funds and the importance of Capital Structure in allowing them to access the financial markets. *Id*. Mr. Kahrer's Rebuttal Testimony focused mostly on the appropriate equity ratio and his recommended target figure of 51.2%. The only support he offers for including customer deposits in Capital Structure was that one other New Jersey utility had done so. Notably, he was unable to cite to any other New Jersey utility that applied this same method. In fact, according to the testimony of Rate Counsel's witness, PSE&G's proposed inclusion of customer deposits in this case was non-standard. *T480:L18-19*.

Rate Counsel's witness did specifically address customer deposits in his testimony. Mr. Kahal's main concern with including customer deposits in Capital

Structure is that the ratepayer benefits from the low cost capital from customer deposits are "diluted" when customer deposits are included in the Company's Capital Structure. As Mr. Kahal stated in his surrebuttal testimony on February 18, 2010:

> The reason it gets diluted is because the capitalization data that's used to compute capital structure is total company. Since it's total company that means it's including the capital that finances the FERC portion of rate base. That is transmission.
>
> So the result is that in this rate case if we use the company's method of treating customer deposits, we don't get the full benefit of customer deposits. We get kind of a diluted benefit of customer deposits.

T481:L9-17

To avoid this result, Ms. Crane's testimony fully and properly accounts for customer deposits by recommending that they be reflected as a rate base reduction, with the associated interest expense moved "above-the –line." Ms. Crane reasoned that rate base is limited to investment that is financed by investors. As it is the customers that provide customer deposits, any investment funded by customer deposits should be removed from rate base. *RC-131*, p. 24.

Rate Counsel recommends the adoption of the well reasoned positions of Mr. Kahal and Ms. Crane. Ratepayers are entitled to the full benefit of the money raised from their deposits and shareholders should not be unfairly enriched by including those deposits in rate base. Customer deposits should be removed from Capital Structure and addressed as a test year expense.

4. Debt/Equity Ratio

Mr. Kahal's debt/equity ratio should be adopted because it properly and fully addresses the financial needs of the Company without over taxing ratepayers. Mr. Kahrer's "target" of 51.2% equity which is 3.8 percentage points above the last common equity ratio approved by the Board in 2006, is neither required nor needed for PSE&G to satisfy the ratings agencies or access the financial markets. *T470:L4-T480:L3*. While a higher equity ratio (and more expensive capital structure) over time may be justified to support credit ratings, the Company simply has not demonstrated that an increase of this magnitude is necessary or that Rate Counsel's proposed 49.73% is inadequate.

Increasing the amount of equity in the company's Capital Structure to the extent proposed by the company substantially increases the costs to ratepayers. PSE&G's witness, however, has not demonstrated that such an increase is necessary to allow the Company to borrow capital. As Mr. Kahal explains, Rate Counsel's proposed debt/equity ratio is well above the Value Line 2009 Industry-Wide Equity Ratio of 46.5%, and still represents an increase of 260 basis points over the currently-authorized common equity ratio approved by the Board only three years ago. It is more than enough to satisfy the language cited by Mr. Kahrer from the Moody's Report to as necessary to access capital markets. *T479:L4-16.*

B. Interest on Long-Term Debt

Mr. Kahal's updated interest on long-term debt for the Company is 6.15%. This is the Company's actual cost of debt at the end of the test year, December 31, 2009, as reported by the Company in RCR-ROR-41. *RC-29*. It should be adopted in this proceeding. The Company has belatedly attempted to include the effects of a post-test year debt issuance and debt redemption on the cost of debt, increasing the interest rate to 6.34% which is well above what the Company has previously reported in this case. This attempt should be rejected as beyond the test year and unsupported by the record. The

Company did not introduce evidence at the February 18, 2010 hearing to justify these post-test year additions. The parties have been given no opportunity to evaluate this new information or determine if the proposed increase is reasonable.. Indeed, at the February 18, 2010 hearings, the Company expressed no disagreement with Rate Counsel's figure of 6.15%, nor did it provide any indication of an expectation of material change. As the increased interest rate in long-term debt sought by the company is unsupported by the record, it should be rejected ant Rate Counsel's propose rate of 6.15% should be adopted.

C. Return on Equity

Mr. Kahal recommends a return on equity for PSE&G of 10.0%. Mr. Kahal's recommendation is based upon his application of the widely accepted DCF model applied to selected proxy groups of utility companies with similar risk to PSE&G. In his testimony Mr. Kahal explains how he picked his proxy groups, the necessary assumptions he made and why some companies were inappropriate to use in his proxy groups. *RC-32,* p.32-33. After conducting his DCF analysis Mr. Kahal also prepared an analysis using the CAPM. Mr. Kahal's use of these two models, and his recommendation derived from them, results in a return on equity that is reasonable, fully reflects market requirements and fairly compensates PSE&G' shareholders.

In contrast, Dr. Vilbert's 11.25% return on equity, while based on a DCF analysis, is flawed because of his use of a leverage adjustment that serves only to boost the DCF return. This results in an unreasonably high return on equity for the Company, a return that almost 100 basis points higher than the highest equity return approved by the Board for any regulated entity in the last several years. Accordingly, Rate Counsel submits that

Dr. Vilbert's proposed return on equity should be rejected and that Mr. Kahal's 10% return should be adopted.

1. Mr. Kahal's Application of the Discounted Cash Flow and Capital Asset Pricing Methods

The DCF method is based upon the principle that the price of a stock will reflect the discounted stream of cash flows expected by investors. *RC-31*, p. 30. Mr. Kahal used the constant growth DCF model to determine his recommendations. This model is widely accepted and has often been used in setting equity rates in New Jersey. The constant growth DCF model assumes, for mathematical simplicity, that an investor's required return on equity is equal to the dividend yield, plus expected rate of growth, and assumes further that the growth rate is constant for an indefinitely long period. This model is particularly applicable to regulated public utilities, which are more stable than unregulated companies.

To apply the model, Mr. Kahal selected proxy groups of utilities with attributes and a risk profile similar to PSE&G. He chose his proxy groups from companies, "that are predominantly utility delivery services (i.e. "wires and pipes"), and therefore reasonably comparable to PSE&G." *RC-31, p.32* For his first proxy group Mr. Kahal selected nine of the twelve companies in the Value Line data base that are classified as gas distribution utilities. The second proxy group consisted of seven companies, " classified as electric utilities that (like PSE&G) operate in Mid-Atlantic or Northeastern restructured markets and function primarily as electric delivery service companies, *i.e.*, are not vertically integrated." *Id.* Mr. Kahal also considered other risk indicators in his selections including Safety Ratings, Financial Strength, Beta statistics and Common Equity Ratios. Id**,** at 33, *Sch. MIK-3*.

Mr. Kahal used his gas proxy group to measure the dividend yield component of the DCF formula over the six month period from May through October 2009. The average for this period was 4.49%. In order to properly predict investor expectation Mr. Kahal then used the standard "half year" growth adjustment technique to calculate a DCF adjusted yield of 4.6%. *RC-31, p. 34.*

The next step in applying the DCF method was to estimate the growth rate. Mr. Kahal used four sources for projecting earnings growth rates. In Schedule MIK-4 to his Direct Testimony, Mr. Kahal showed his calculations which resulted in an average of 5.23% within a range of 5.0% to 5.5%. Mr. Kahal also considered additional information as outlined in his Schedule MIK-4 page 4 of 4. Based upon his analyses Mr. Kahal reached the following conclusions for his gas proxy group:

> The adjusted dividend yield for the six months ending October 2009 is 4.6 percent for this group. Available evidence would support a long-run growth rate in the range of approximately 5.0 to 5.5 percent (or less), as explained above. Summing the adjusted yield and growth rates produces a total return range of 9.6 percent to 10.1 percent, and a midpoint result of 9.9 percent. I use these results in conjunction with my second DCF study and my CAPM results to develop a final recommendation of 10.1 percent.

RC-31, p. 38.

This was later updated to a range of 9.5% to 10.0% with a midpoint of 9.75% based on more recent market data. *RC-32, Sch. MIK-4, February 2010 Update*.

> Mr. Kahal's electric proxy group consisted of seven companies that as a whole had, "risk measure averages are very close to those of the gas utility proxy group." *RC-31,* p. 42. Mr. Kahal used a similar method to do his DCF calculation for the electric proxy group resulting in a dividend yield of 5.8%, a growth rate range of 4.0 to 5.0 percent

> resulting in a DCF cost of equity of 9.8 to 10.8 percent, with a midpoint of 10.3%.[2] This was later updated to a range of 9.5% to 10.5% with a midpoint of 10.0% based on more recent market data. *RC-32, Sch. MIK-5, February 2010 Update*.

Mr. Kahal also employed the CAPM to derive a return on equity reference point as a check on his DCF results. The CAPM is the method most used after DCF for deriving cost of equity in utility rate cases. *RC-31*, p.44 The CAPM is "risk premium" approach, where the cost of equity is equal to the yield on a risk-free asset, plus a market risk premium multiplied by the company's "Beta," a measure of the firm's risk relative to the market. The risk premium is the amount by which the expected return exceeds the yield on a risk-free asset.

Mr. Kahal's application of the CAPM methodology resulted in a cost of equity range of 7.75% to 9.9%, with a midpoint of 8.8%. *RC-31*,p. 46. Mr. Kahal testified that even though the 8.8% midpoint is below his proposed return on equity it does confirm that his recommendation is not too low. Accordingly, Mr. Kahal's use of both DCF and CAPM confirm that his proposed return on equity of 10.0% will provide PSE&G with sufficient opportunity to earn the necessary overall return to attract equity capital and is fair to investors.

2. Dr. Vilbert's Recommended Return on Equity

Dr. Vilbert originally recommended a return on equity for PSE&G of 11.5% that Mr. Kahrer incorporated into his recommended overall rate of return of 8.86%. *P-7,* p.8. Dr. Vilbert subsequently revised his cost of equity to 11.25%. *P-15-RB,* p.38. Mr. Kahrer

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[2] Mr. Kahal's detailed analysis is contained in his direct testimony on pages 41 – 44 and Schedule MIK-5.

incorporated the revised cost of equity with his updated capital structure resulting in a new proposed overall return of 8.70%. *P-7-R-3.*

Dr. Vilbert used both the DCF and CAPM methods to develop his recommendations and for each method he employed two variants. For DCF he used the "Simple" or "constant growth" version as well as a more complex "Multi-Phase" version. For CAPM, he used the "Standard" CAPM formula and the Empirical version or ECAPM formula. He applied both methods and variants to a proxy group of electric companies. *RC-31, p.50.* In response to criticism from Mr. Kahal, he presented gas distribution proxy group results in his rebuttal testimony. However, while both Mr. Kahal and Dr. Vilbert both used DCF and CAPM methods to develop their recommendations their conclusions are significantly different, *i.e.*, 10.1% vs. 11.5% in their initial recommendations, and 10.0% vs. 11.25% in their updated recommendations. Rate Counsel believes that these differences are based on a number of flawed assumptions and interpretations in Dr. Vilbert's analyses that will be set forth below. If only one of the results were to be removed from Dr. Vilbert's DCF analyses, his cost of equity finding would be fairly close to Mr. Kahal's, 10.3% for Dr. Vilbert versus 10.0% for Mr. Kahal. *T487:L3-13.*

Dr. Vilbert's initial DCF proxy group calculations were 13.1% using the "Simple" DCF and 11.9% using the "Multi-Stage" DCF. Dr. Vilbert adapted these results to PSE&G's regulatory capital structure (which is a "book value" capital structure) resulting in a decline of 0.5 percent to 12.6% and 11.4%, respectively. *RC-31, p.51.* This decline is significant, because, as will be set forth in the discussion of Dr.Vilbert's CAPM analysis, using the same adaptation to PSE&G's regulatory structure Dr. Vilbert raises his

CAPM calculations by 70 basis points. Moreover, in his rebuttal update, the adjustment balloons to average nearly a full percentage point. That is, his cost of equity finding for PSE&G is nearly a full percentage point higher than his proxy group cost of equity estimates.

Mr. Kahal raised a number of issues with Dr. Vilbert's DCF analysis. First, Dr. Vilbert's used a quarterly compounding version of the DCF. This formulation recognizes that dividends are paid quarterly, not annually at the end of the year. The use of quarterly compounding is both unnecessary and over-compensates the utility as the ratemaking process already compensates the utility by providing the utility with a stream of earnings on a more or less continuous basis throughout the year. The "0.5 x g" dividend adjustment factor, which has been accepted by FERC and numerous state Commissions, properly compensates investors. The added return from quarterly compounding is unnecessary and excessive.

Second, Dr. Vilbert's selected an electric proxy group that is unquestionably riskier than PSE&G. As stated by Mr. Kahal,

> He selects no natural gas utility companies despite the fact that the task in this case is to determine the cost of capital for *both* gas and electric distribution operations. He selects 18 companies with only 3 of his 18 being companies that are principally delivery service. All others have substantial generation assets. In selecting the proxy companies Dr. Vilbert accepted the Edison Electric Institute ("EEI") category of "mostly regulated". However, this definition permits a company to have up to 50 percent non-utility assets. In my opinion this sets the bar too low and allows inclusion of companies with substantial merchant generation or other non-regulated activities.

RC-31, p.56.

Third, and most important of all, Dr. Vilbert's uses the market capital structures of his proxy group and compares this with PSE&G's book or regulatory capital structure, in an improper attempt to reach a finding regarding PSE&G's risk (and therefore cost of equity) compared to the proxy groups. As noted by Mr. Kahal, a comparison of the proxy group market capital structure and PSE&G's book capital structure (*i.e*., the capital structure used for ratemaking purposes) has nothing to do with the return on equity. The proxy group DCF and CAPM studies purport to measure the cost of equity of the proxy group. The next step would be to determine whether PSE&G is equal in risk, less risky or more risky that the proxy group. PSE&G's capital structure is only one factor to be considered in making that comparison. Moreover, even if one chooses to focus on capital structure, it makes no sense to compare one company's book capital structure with the market capital structure of other companies. *RC-31, p.59.* As noted by Mr. Kahal and readily conceded by Dr, Vilbert, , this market versus book adjustment method generally has not been accepted as part of cost of equity setting by state or federal regulatory commissions in this country, including New Jersey's BPU. *T431:L10 – T432:L25.*

Fourth, Dr. Vilbert improperly applied his market versus book capital structure adjustment by using a number of incorrect data inputs. For example, he used a grossly excessive debt cost rate for PSE&G; he ignored short-term debt and customer deposits, and he imputed PSE&G's income tax rate for all proxy companies. *RC-31*, pp.59-61.

Mr. Kahal also raised a number of issues with Dr. Vilbert's CAPM Analysis. First, Dr. Vilbert's adaptation of his CAPM calculations to PSE&G's regulatory capital structure resulted in a 70 basis point increase rather than the 50 basis point decrease to the DCF analysis. Second, Dr. Vilbert arbitrarily changed a number of key inputs to his CAPM model, for example, he increased the "risk free rate" by 1.1 percent, he chose a 1.5 percent equity risk premium and he added 0.7 percent to his proxy group's market based capital structure. None of these adjustments are warranted. Dr. Vilbert also improperly added 35 basis points to his ECAPM study. *RC*-31 p. 61-63.

In his Rebuttal Testimony, P-15-RB, Dr. Vilbert discusses in great detail his after-tax weighted-average cost of capital ("ATWACC") method. The record clearly demonstrates that this adjustment methodology is both contrived and an improper departure from cost-based ratemaking. Your Honor and the Board should stand with all other state and federal regulatory bodies and reject it on its merits. *T460:L3 – T461:L10.* As stated by Mr. Kahal on February 18, 2010;

> My objection to the ATWACC methodology is not that it's complicated. That is not what bothers me. It's that it's flatly wrong. Because in this case it's claiming that PSE&G is more leveraged than these proxy companies which is not true, they are not more leveraged. And secondly, it's claiming that they have higher overall investment risks than these proxy companies which is also not true. We know PSE&G is less risky.

Transcript 2-18 p. 489, lines 9-17

The overwhelming evidence shows that PSE&G in fact is a financially sound Company, well regarded by credit rating agencies As a low risk "wires and pipes" delivery service utility, PSE&G also has far less business risk than Dr. Vilbert's proxy group, nearly all of whom are vertically integrated and burdened with generation or commodity risk. If any adjustments are made to Dr. Vilbert's proxy group estimates, to adapt to PSE&G, a reduction should result – not an increase. Dr, Vilbert's novel methodology quite simply produces an adjustment that goes in the wrong direction when setting PSE&G's cost of equity. It should be rejected.

D. Summary of Capital Structure, Return on Equity and Overall Rate of Return

For the reasons set forth in this brief, in Mr. Kahal's filed testimony and in his testimony at hearing on February 18, 2010, Rate Counsel respectfully submits that a debt/equity ratio of 49.73% equity, with a 10.0% return on equity and overall return of 8.06% is reasonable and should be adopted. Customer depostis should be removed from PSE&G's Capital Structure, and a long-term debt rate of 6.15% should be applied. These recommendations are reasonable, fully supported by the record, and will allow PSE&G a fair return and access to capital.

POINT II

AN ELECTRIC RATE BASE OF $3.5 BILLION AND A NATURAL GAS RATE BASE OF $2.2 BILLION SHOULD BE ADOPTED AS RECOMMENDED BY RATE COUNSEL IN THIS PROCEEDING.

The Company selected the twelve month period ending December 31, 2009 as the test year in this proceeding. *P-7,* p.2. The Company's initial filing reflected actual results for three months and projected results for the last nine months of the year. On September 25, 2009, PSE&G updated its filing to reflect six months of actual and six months of projected data (6+6 Update). Then again on January 29, 2010, PSE&G filed an update to reflect twelve months of test year data. Rate Counsel witness Andrea C. Crane, in her testimony filed on November 19, 2009, and in her subsequently filed Updated Schedules recommended numerous rate base adjustments, some of which were settled among the parties. In this brief, Rate Counsel is recommending a total electric rate base adjustment of $379,870,000 resulting in a rate base for the Company's electric operations of $3,514,953,000. *RC-132, Sch. ACC-1E update*. Rate Counsel is recommending a total gas rate base adjustment of $90,947,000 for a total gas rate base of $2,216,357,000. *RC-132, ACC-1G update*. The rate base recommended by Rate Counsel included three adjustments to the Company's rate base claims in Exhibit P-7, Schedule MGK-3. These include adjustments relating to the post-test year plant additions (including plant-in-service, accumulated depreciation, and accumulated deferred income taxes), consolidated income taxes, and customer deposits. In addition, Rate Counsel's recommended rate base also reflects the agreements reached among the parties with regard to plant held for future use and cash working capital. Schedules ACC-3E (brief) and ACC-3-G (brief) attached to this brief in Exhibit A. Rate Counsel's proposed rate base adjustments are as follows:

A. Utility Plant in Service – Post Test Year Plant Additions

The Company's claim for electric utility plant in service is based on actual plant balances as of December 31, 2009 of $5,895,397. *P-7, Sch. MGK-5 R-3*. In addition, the Company has proposed to include post test year electric plant additions through February 28, 2010 of $33,113,000. ($5,928,510,000 - $5,895,397,000). *P-7- Sch. MGK-5, R-3*. The Company's claim for gas utility plant in service is based on actual plant balances as of December 31, 2009 of $ 4,643,224,000. *P-7, Sch. MGK-4 R-3*. In addition, the Company has proposed to include post test year gas plant additions through February 28, 2010 of $20,576,000. ($4,663,800,000 - $4,643,224,000). *P-7- Sch. MGK-5, R-3*.

Rate Counsel witness Andrea Crane recommended these post test year plant additions be rejected and that no post test year additions into the rate base be approved in this proceeding. In her testimony, Ms. Crane recognized that the proposed post test year plant additions resulted in "a mismatch among the components of the regulatory triad used to set rates in this case." *RC-131*. Ms. Crane pointed out that while the Company had used projected plant in service balances as of February 28, 2010, claimed revenues were based on test year customer levels. In addition, the Company's expense claim consisted of a mixture of actual test year costs for some expenses, while other expenses were selectively projected as far out as 2011 for other claimed expenses. This imbalance becomes even more lopsided when we recognize that the Company has not included known and measurable reductions in expenses beyond the test year. For example, the

Company had included 2010 and 2011 projected wage increases in its requested revenue requirement and yet has failed to include known and measurable savings that the Company will see in 2010 due to the recent implementation of reduced Company contributions to employee 401K plans. T1393:L22 – T1395:L20. Thus, the Company has selectively included certain post test year items while ignoring others.

Rate Counsel urges Your Honor and the Board to reject the Company's effort to add certain costs to rate base that were incurred after the end of the test year. The imbalance that results from the inclusion of only certain Company-selected post test year items is unfair to ratepayers who will not be credited with contemporaneous savings. Accordingly, Rate Counsel recommends that Your Honor and the Board recognize the importance of the regulatory matching principle and not allow the inclusion of these post test year plant additions into rate base to maintain the careful balancing of rate base with revenues and expenses.

Indeed, the Board has a long standing policy regarding post-test year adjustments. In the <u>Elizabethtown Water Company Rate Case Decision on Motion For Determination of Test Year and Appropriate Time Period For Adjustments</u>, Docket No. WR8504330 (May 23, 1985), the Board established the general policy that the test year to be used in a base rate proceeding must be fully historical prior to the close of record in the proceeding. *P-56.*

The Board in the Elizabethtown Water case specified that only "known and measurable" changes occurring outside the test year would be allowed into rates. The Board defined the "known and measurable" standard as follows:

> Known and measurable changes to the test year must be (1) prudent and major in nature and consequence, (2) carefully quantified through proofs

> which (3) manifest convincingly reliable data. The Board recognizes that known and measurable changes to the test year, by definition, reflect future contingencies; but in order to prevail, petitioner must quantify such adjustments by reliable forecasting techniques reflected in the record.

Id.

It is clear that the Company has not met the criteria specified by the BPU for the inclusion of post-test year projects in rate base. PSE&G has not limited its post-test year plant in service claim to projects that are "major in nature and consequence." Furthermore, these post test year plant additions have not been "carefully quantified through proofs which manifest convincingly reliable data." The Company failed to provide any quantitative support for its claim in this filing beyond a schedule provided to the parties on the next to last day of hearings with numbers purporting to be actual January updates. As noted by Ms. Crane, Rate Counsel has had not opportunity to do any review of these updated numbers. There has been no prudency review and no review to determine if the proposed plant additions are revenue producing. *T1616:L1 –T1617:L2.*

Accordingly, the Company's post-test year plant in service claims do not meet the BPU's standard for inclusion in rate base. They are not known and measurable and do not include operation savings and increased revenues for the same time period. Rate Counsel therefore recommends that Your Honor and the Board affirm the importance of regulatory matching and disallow all post test year plant additions proposed by the Company in this proceeding. Rate Counsel recommends rate base be determined based on the actual December 31, 2009 utility plant in service balances as set out in Schedule ACC-3E (brief) and Schedule ACC-3-G (brief) included as Exhibit A in the Appendix to this brief.

B. Rate Base – Post Test Year Capital Infrastructure Expenditures

The Company is also proposing to roll into base rates its projected cumulative expenditures at February 28, 2010 associated with its Capital Infrastructure Investment Program ("CIIP"). The CIIP was established in response to an Economic Stimulus initiative announced October 16, 2008 by then Governor Corzine. In April, 2009, the BPU approved a stipulation which set forth the ratemaking treatment for a total of 38 CIIP projects ("Qualifying Projects"). *RC-85* That stipulation (the "PSE&G CIIP Stipulation") contained a cost recovery mechanism (Capital Adjustment Clause or "CAC") that allowed PSE&G to recover costs associated with the CIIP through a surcharge mechanism that would be subject to periodic review and true-up. The CIIP stipulation further provided that during the Company's next base rate case

> . . . the net capitalized amounts for the Qualifying Projects that are deemed to be reasonable and prudent, will be rolled into the Company's rate base and the associated revenue requirements will be recovered through base rates. … Any Qualifying Project expenditures and CACs not included in base rates at the conclusion of the required base rate case will be included in the recalculation of CACs based on the methodology set forth in Appendix B.

RC-85

Consistent with her testimony on other rate base additions, Rate Counsel witness Ms. Crane recommended that only CIIP expenditures at the end of the test year, December 31, 2009, should be rolled into rate base. *RC-131*, p. 12 and p. 15-19. Accordingly, Ms. Crane recommended an adjustment of $35.6 million to the Company's claimed rate base to remove post-test year adjustments associated with CIIP projects. *RC-132*, *Schedule ACC-5E*. PSE&G, on the other hand, proposes to include all expenditures as of the end of February 2010, including CIIP expenditures as of that date. *T1369*; *P-7-R3*, *Schedule MGK-5-R3*.

Significantly, as Ms. Crane testified, the Company will continue to recover its revenue requirement for the CIIP projects not rolled into base rates at this time through the operation of its CAC. *RC-131*, p. 17. PSE&G will have the opportunity to add post-test year CIIP projects to its rate base when the instant case is reopened, as provided by the terms of the PSE&G CIIP Board Order and PSE&G CIIP Stipulation. *RC-8, p. 8-9* Rate Counsel respectfully submits that Ms. Crane's proposed adjustment is reasonable and should be adopted.

C. Depreciation Expense

While the parties are not, in this proceeding, disputing the Company's claimed depreciation rates, the depreciation expense allowed in rates will be determined based on Your Honor and the Board's decision regarding the post test year plant additions and the final determination of plant in service.

POINT III

RATE COUNSEL'S PROPOSED CONSOLIDATED TAX ADJUSTMENT FULLY CONFORMS WITH BOARD PRECEDENT AND PROVIDES A BENEFIT TO RATEPAYERS IN EXCHANGE FOR THE ENTERPRISE GROUP'S USE OF RATEPAYER FUNDS TO SUBSIDIZE UNREGULATED AND UNPROFITABLE ENTITIES.

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 ("the Enterprise Group"). *RC-131, p.27*. Rate Counsel witness Andrea Crane has calculated a rate base Consolidated Tax Adjustment, fully consistent with BPU precedent, of $281.935 million for the PSE&G's electric utility and of $38.3 million for the PSE&G's gas utility. *RC-132, ACC-13E (Update 2/25/10) and ACC-12G (Update 2/25/10).* This Consolidated Tax Adjustment results in a revenue requirement adjustment of approximately $38.7 million for electric operations and of $5.3 million for gas operations. *RC-132, ACC-43E (Update 2/25/10) and ACC-39G (Update 2/25/10).* This revenue requirement adjustment is well below PSE&G's claimed income tax expense of $111.5 million for electric operations and $67.8 million for gas operations. *P-7-R-3, MGK-26, R-3*.

By filing a consolidated return, the tax loss benefits generated by one group member can be shared by the other consolidated members, resulting in a reduction in the effective federal income tax rate. PSE&G has not passed these savings on to ratepayers. Rather, according to the Tax Sharing Agreement PSE&G has entered into with the Enterprise Group, PSE&G pays to the parent the amount of tax liability calculated on a stand alone basis. *RC-131,* p.30. Any funds that exceed the tax liability of the Enterprise

Group are then given to the members of the consolidated group that incurred tax losses. *Id.* Thus, the regulated and profitable utility subsidiaries subsidize the unregulated and unprofitable ventures.

In order to address this subsidy and to partially compensate ratepayers for this subsidization, the BPU has, since 1991, used a consolidated tax adjustment when setting rates for New Jersey utilities. *RC-116*, (hereafter "*ACE Consolidate Tax Decision")*[3]. The consolidated tax adjustment adopted by the Board is referred to as the rate base method, that is, when a utility belongs to a consolidated tax group, the utility's rate base is reduced by the accumulated tax benefits allocated to the utility based on the utility's share of total positive taxable income. *RC-117,* (hereafter "*JCP&L Consolidated Tax Decision"*).[4]

This rate base method as approved by the Board does not directly reduce the income tax expense included in a utility's revenue requirement, but rather provides for the treatment of these accumulated benefits as cost free capital. Rate Counsel witness, Ms. Crane, used the Board's rate base methodology to calculate her recommended consolidated tax adjustment in this proceeding. *RC-131*, *p. 33*. Fully consistent with the methodology adopted by the Board in the Rockland Electric case, Ms. Crane first aggregated from 1991 through 2009 taxable income or loss for each PSEG affiliate. *RC-118,* (hereafter *RECO Consolidated Tax Decision*).[5] For each year, the taxable income or loss for the group of companies that had an aggregated (1991-present) taxable loss was

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[3] 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, Order Adopting in Part and Modifying in Part the Initial Decision, BPU Dkt No. ER90091090J, (Oct. 20, 1992).
[4] I/M/O Verified Petition of Jersey Central Power and Light Company, BPU Dkt. Nos. ER02080506, et.al, Final Order (May 17, 2004).
[5] I/M/O the Verified Petition of Rockland Electric Company, BPU Dkt Nos. ER02080614, ER02100724, Final Decision and Order, (April 20, 2004_.

then multiplied by that year's annual federal income tax rate, in order to determine the annual income or loss for the year. The annual tax benefit for those companies that had aggregated net losses was then aggregated. Adjustments were made for any alternative minimum tax ("AMT") paid by the group. The resulting aggregate benefit was then allocated among all the companies that had a 1991-present aggregated positive taxable income, based on each entity's share of the aggregated positive taxable income. This resulted in an allocation of 55.20% to PSE&G's electric operations and 7.51% to PSE&G's gas operations. *RC-132, ACC-13E (Update 2/25/10) and ACC-12G (Update 2/25/10).*

PSE&G did not include a consolidated tax adjustment in its direct case but presented two rebuttal witnesses on this issue. Mr. James I. Warren, a tax partner with the law firm of Winston & Strawn LLP, in Washington D.C. and Robert C. Krueger, employed by PSEG Services Company as Vice-President and Assistant Controller – Tax.

A. Ms. Crane's Calculation Of A Consolidated Tax Adjustment Fully Complies With Long Standing Board Precedent.

Mr. Krueger, in his rebuttal testimony, argued that the Consolidated Tax Adjustment made by Rate Counsel witness Andrea Crane was "less rational" than the adjustment made by Rate Counsel witness Robert Henkes in the Company's previous cases. *P-11-RB,* p.2. Mr. Krueger asserted that the Company "has in fact relied on the consolidated tax position presented in past PSE&G cases by Rate Counsel through Mr. Henkes" and "it would be inequitable, in light of PSE&G's reliance, to adopt Ms. Crane's new proposal in this case." *Id.* Despite the Company's claims to have "relied upon" Mr. Henkes method of calculating a consolidated tax adjustment, the Company has consistently rebutted Mr. Henkes' adjustment in the prior cases and did not, in this case, file a consolidated tax adjustment using Mr. Henkes' method or any other method. As testified to by Ms. Crane:

> It looks like the Company has said that they rely on Mr. Henkes' testimony and they also said they have never filed a consolidated tax adjustment. They said they filed rebuttal against Mr. Henkes in virtually all his cases and yet the Company at the same time is basically ignoring or seems to be ignoring the long-standing BPU policy and Board Orders on this issue.
>
> This is a sophisticated company, they have a lot of attorneys so I assume that they were aware and/or should have been aware of the BPU policy.

T1300:L16-17

In fact, both the Company's consolidated tax adjustment witnesses admitted that they were familiar with New Jersey Court rulings, Board policy and the rate base methodology used by Ms. Crane. *See*, *P-16-RB*, p.6, lines 12-17; p. 7, line 16; *T1257:L12-24*; *T1261:L16-21*. *P-11-RB*, p.20; *T1301:L10*, *T1303:L5*, *T1307:L25-T1308:L2*.

Ms. Crane's adjustment should therefore not have been unexpected, as the BPU has consistently applied the rate base method used by Ms. Crane in this proceeding when making a consolidated tax adjustment. PSE&G was certainly aware of how this adjustment has been calculated for the other electric utilities in the state. Similarly, PSE&G was certainly aware that the courts in this state have upheld such adjustments by the Board "indicating generally that a utility is not entitled to collect a certain amount of tax expense from ratepayers merely because that amount may have been paid to the holding company based upon the statutory income tax rate applied to the utility income." *RC-116*, p.5. The Company's claim that it relied on Mr. Henkes' testimony rather than Board precedent is without merit.

Indeed, the same arguments made by PSE&G in this proceeding were made by Atlantic Electric in the ACE Consolidated Tax proceeding. In the ACE Consolidated Tax Decision, the Board recognized the "substantial tax benefits" realized by the holding company, ("AEI") "by virtue of its major subsidiary, Atlantic Electric Company. *RC-116, p.5.* Like PSE&G in this proceeding, ACE argued that utility rates should be set as though the utility were on a stand-alone basis for tax purposes. Here, PSE&G has argued that shareholders assume the risk associated with these investments and are therefore entitled to the tax benefit. ACE made the same argument. And, as does PSE&G, ACE asserted that crediting tax benefits to ratepayers would undermine investments strategies that rely on tax benefits. The Board rejected all of these arguments:

> We concur with the ALJ that, but for [ACE's] taxable income in 1987 through 1991, AEI would have been unable to realize any tax savings from the losses on the non-utility side in each year, which losses totaled $153.3 million. Had these subsidiaries been on a stand alone basis for tax filing purposes, there would have been no current value to these losses, they would have had to be carried forward to potentially be used to offset future positive taxable income. It is only the offset of the current taxable income of the utility, by virtue of a consolidated tax return, which created current benefits for AEI. Clearly, at least with respect to tax filings, the wall of separation between the utility and non-utility side has been breached.
>
> The rate base method endorsed in this proceeding by Staff and Rate Counsel essentially treats the tax benefits derived by the holding company as cost free capital contributed by ratepayers. By providing a rate base adjustment, ratepayers are credited with the carrying costs of those contributions, prospectively, reflecting the present value benefits of being able to use the tax losses sooner rather than later or never because of [ACE] income. We concur with the ALJ that this does not represent retroactive ratemaking. Moreover, this method represents a sharing approach, since only the carrying costs are credited to ratepayers, while the contributions or savings themselves are retained by AEI. Moreover, the adjustment is self-correcting, and would turn around in future years if the subsidiaries achieve positive taxable income. . . .

RC-116, p.6

Subsequently, in the JCP&L rate base proceeding, JCP&L proposed that tax savings should have been flowed through first to the loss affiliates. *RC-117,* p.44. JCP&L argued in that case, as PSE&G has done in this case, that any tax savings could have been produced by offsetting the tax losses by the positive income of the unregulated affiliates. *RC-117,* p. 44. As does PSE&G in this case, JCP&L argued that loss affiliates would have operated differently had the benefits of consolidation not flowed to the benefit of non-utility operations." *Id.* Staff responded:

> [C]onsistent with law, and long-standing Board policy, the tax savings should be shared with JCP&L's customers, because JCP&L contributed to the tax savings with its positive taxable income, which was provided by ratepayers. Staff asserts that the Company's argument that tax savings could have been produced by offsetting the tax losses by the positive income of only unregulated companies is as arbitrary and unfair as it would be to say that the losses could have been offset by the positive income of only regulated companies and, therefore, all the savings should have be allocated to regulated companies.

Id.

The Board found that Staff was correct and "that allocating all of the savings to the unregulated affiliates, as proposed by JCP&L in this proceeding, would be as arbitrary and unfair as it would be to allocate the entire savings to the regulated companies." *RC-117,* p.46.

Similarly, in the RECO base rate case the Board approved a consolidated tax adjustment based on the well established rate base method. *RC-118.* In the RECO proceeding the Board found that the 1991-2001 time period used by BPU Staff was consistent with prior BPU Orders and appropriately compensates ratepayers for the value of money that has essentially been lent cost-free to the parent holding companies in the form of currently used tax advantages. *RC-118,* p.64. The Board recognized that while there may have been a period of time where investors might have reasonably expected that the Board would not make consolidated tax adjustments because of certain IRS private letter rulings, "it is clear that at some point during the 1988-1991 time frame, investors should reasonably have expected that prospective consolidated tax adjustments would or at least could be made." *Id*. The Board concluded:

> The Board continues to believe that if a utility is part of a conglomerate which profits by consequential tax benefits from the utility's contributions, the utility customers are entitled to have a computation of their fair share of those benefits reflected in their utility rates.

RC-118, p.64

Thus, the arguments made by PSE&G in this case have already been made by the three other electric utilities in this state and have been rejected by the Board each time. The Board's position on the sharing of tax benefits is long standing and well documented. The Company's claimed "reliance" on Mr. Henkes' testimony in the face of such clear Board precedent is unreasonable. PSE&G is not entitled to a different consolidated tax adjustment than the other utilities in this state and PSE&G ratepayers should not subsidizing affiliate losses through a Tax Sharing Agreement without receiving some benefit in return. If, as claimed by PSE&G, a consolidated tax adjustment would leave Enterprise "no choice but to exit the leasing business," that is a decision the Enterprise Group must make. At this point, it is clear that there is a benefit to the Enterprise Group in filing a consolidated tax return or The Enterprise Group would not be doing so. Ratepayers are entitled to share in that benefit.

B. The Board's Methodology is Sound and Should Not Be Changed.

Mr. Warren in his rebuttal testimony found fault not with Ms. Crane's calculation but with the Board's use of a consolidated tax adjustment in any form. In fact, at the hearing, Mr. Warren conceded that, although he couldn't be sure, Ms. Crane's calculation of a consolidated tax adjustment appeared to be consistent with the calculation used by the Board in the RECO Board Order. *T1262:L11 – 23*. Mr. Warren then stated that he had "criticism of the RECO methodology" (*T1265:L7-8*) and argued that, in his opinion, any consolidated tax adjustment was inappropriate and "amounts to confiscation of shareholder property." *T1255:L8*. On the stand, Mr. Warren took the position that "[t]he imposition of a CTA is in my view never just and reasonable" and argued that "it should be illegal per se . . . . " *T1258:L20-22*. Mr. Warren suggested that Ms. Crane and the Board were confused about the nature of consolidated tax benefits (*T1268:L13*) and that Ms. Crane's "fundamentally erroneous premise" was "that taxes exist in a vacuum. They just happen." *T1254:L19-20*.

In her surrebuttal testimony, Ms. Crane countered:

> I agree completely with Mr. Warren, I believe with regard to that statement that taxes do not just happen, in fact companies make very deliberate choices to influence income taxes.
>
> In this case, what are the choices that were made? PSE&G joined the Consolidated Income Tax Group, number 1. By doing so, PSE&G became liable for the taxes due not only from utility operations but PSE&G became liable for the taxes due by any member of the Consolidated Income Tax Group.
>
> Finally, PSE&G entered into a tax sharing agreement, by which it agreed to pay a certain level of taxes to its parent company, and to the extent that those amounts were not used to make payments to the IRS that tax sharing agreement provides that those excess payments be distributed to those companies with tax losses.
>
> In my view that is called a subsidy and PSE&G has agreed to that in the tax sharing agreement.

T1588:L14 – T1589:L9.

In sum, while Mr. Warren may believe that the Board is "confused," to the contrary the Board has a long standing reasonable policy of ensuring that if a utility's tax expense, collected from ratepayers, is used to subsidized affiliate losses, then ratepayers providing that subsidy are entitled to recover some of the benefit of the consolidated tax filing.

The Company has admitted that from 1993 to 2007, the cumulative federal tax payments paid by PSE&G to the Enterprise Group exceeded the Enterprise Group's cumulative tax payments to the IRS. *RC-131, p.31, App. C, response to S-PREV-91.* While this situation finally ended in 2008, even through 2008 almost 95% of all taxes paid to the IRS by the Enterprise Group, were funded by the utility and its ratepayers. While it is understandable that the Company would prefer not to share tax benefits with its customers, Mr. Warren has not provided Your Honor or the Board with any compelling new argument to support a departure from Board policy.

C. The Company's Proposed Adjustments To Ms. Crane's Consolidated Tax Adjustment Are Not Consistent With The Board's Prior Consolidated Tax Decisions.

Mr. Krueger then argued that if the Board were to calculate a consolidated tax adjustment using the Rockland methodology used by Ms. Crane in this proceeding, certain adjustments should be made.

1. Transmission assets

Mr. Krueger first argued that the Board should not include in its consolidated tax adjustment an allocation of tax benefits attributable to the income of transmission assets that are not included in PSE&G's rate base. Mr. Krueger argued that if such an adjustment were to be made, it should be made by the Federal Energy Regulatory Commission ("FERC"), not the New Jersey BPU.

While Ms. Crane acknowledged that this adjustment may have some validity after rates were unbundled, she noted that Mr. Krueger had "overstated the impact" by making this adjustment as far back as 1991 when in fact rates were not unbundled until 1999. *T1596:L20-23*. Ms. Crane also noted that this adjustment did not impact the total consolidated tax adjustment, only how much should be allocated to PSE&G's electric operations. *T1596:L25 –T1597:L1*. On cross, Ms. Crane clarified:

> I did address the transmission issue and I think what I said with regard to the transmission issue is that I didn't make the adjustment, that the Board has not made the adjustment in the RECO case, and so there's no indication or precedent that any such transmission adjustment should be made. I said that if you were going to make a transmission adjustment it should certainly in any case only be limited to the period of time after rates were unbundled, but my primary recommendation would be that no transmission adjustment be made and I'm not sure [if] that's a yes or no to your question.
>
> . . .
>
> [I] think that ratepayers should receive that transmission piece because that's the way that the Board has indicated it should be done in the RECO case, number one. Number two, transmission is still a regulated service. Now, you know, the company will claim – well, FERC regulates transmission. Well, you know, in fact, FERC regulates in a totally different way than the New Jersey Board of Public Utilities regulates or basically most state regulatory commissions. In fact, ratepayers are not going to ever have the opportunity to receive those benefits if they're not given back to them through the distribution rates here in New Jersey.

T1725:L23 – T1727:L19.

Thus, the Company's proposed transmission adjustment has not been adopted by the Board in the previous proceedings. The Company has not claimed that the rates imposed by FERC include a consolidated tax adjustment, only that the BPU is not the proper authority to make such an adjustment. Rate Counsel disagrees. Although transmission rates are set by FERC, the rates are paid by New Jersey ratepayers. It is certainly within the Board's authority to include in its calculation of a consolidated tax adjustments the tax benefits afforded to the Enterprise Group through regulated transmission rates. The Board has held that rate payers are entitled to share in the benefits of the consolidated tax filing, if transmission assets are removed from this calculation, then regulated rates are subsidizing unregulated and unprofitable ventures with no benefit to New Jersey ratepayers.

2. Generation Income

Mr. Krueger next argued that Ms. Crane's Consolidated Tax Adjustment improperly included income from the generation assets for tax years prior to 2000, before the generation business was "structurally separated from PSE&G." *P-11-RB*, p.7. Mr. Krueger argued that the allocation of tax benefits was "an asset of the generation business" and was therefore transferred along with all the other assets of that business. Mr. Krueger testified that "[t]he utility received fair value for all assets and liabilities transferred." *P-11-RB*, p.8.

Initially it should be noted that Rate Counsel does not believe that the value received by ratepayers as a result of the transfer of PSE&G's electric generation assets to its affiliate included ratepayer compensation for the loss of the consolidated income tax benefits as a result of this transfer. Nothing in the PSE&G Restructuring Order reflects any compensation to the ratepayers for loss of consolidated income tax benefits. [6] Since PSE&G ratepayers have not been shown to have received any value for the transferred

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[6] I/M/O PSE&G Company's Rate Unbundling, Stranded Costs and Restructuring Filings, BPU Docket Nos. EO97070461,et al., Final Decision and Order, pp. 99-101 (Aug 24, 1999); *See also*, Joint Stipulation of Settlement of Stranded Costs Restructuring and Unbundling Proceedings, Better Choice Settlement Proposal, BPU Dkt No. EO97070461 *et al*. (Filed March 30, 1999).

consolidated income tax benefits associated with the electric generation asset transferred to the electric generation affiliate, Mr. Krueger's pro forma adjustment to remove all consolidated income tax benefits estimated to be related to the electric generation business from Ms. Cranes' consolidated income tax adjustment calculation is inappropriate and inequitable to the Company's ratepayers.

As pointed out by Ms. Crane in her surrebuttal testimony, the generation assets were only included for the years when rates were bundled and, in Ms. Crane's calculation, the generation assets were not included with the utility after unbundling. Ms. Crane explained that the consolidated tax adjustment looked back and examined what happened in the prior years. The "structural separation" of the generation assets in 2000 did not erase the income tax benefit associated with the generation assets from prior years and therefore any tax benefits associated with the generation assets were allocated to the utility during the period of bundled rates and are appropriately included in Rate Counsel's consolidated tax adjustment. PSE&G's recommendation shows a misunderstanding of the "look back" perspective of the Board's rate base consolidated tax benefit.

3. Treatment of Businesses Dissolved or Sold

Mr. Krueger then argued the Ms. Crane had failed to properly account for entities that have been dissolved by liquidation. Mr. Krueger cited to the 2002 liquidation of the loss company, Energy Holdings. At the time of liquidation, according to Mr. Krueger all tax attributes of Holdings carried over to PSEG Enterprise Group, a tax positive entity. Similarly, Mr. Krueger argues that Ms. Crane should not have included the tax losses and the taxable income of entities that have been sold to third parties.

In her surrebuttal testimony, Ms Crane rejected this argument, noting that in the RECO decision and the supporting schedules, there are companies that have been dropped since 1991 but were still included in the consolidated tax adjustment calculation for RECO. Ms Crane further explained:

> We are looking at what kind of benefit did the utilities provide to these unregulated entities. The fact that the unregulated entities may not be there any longer does not negate the fact that [a benefit] was provided to them by the utilities, whether they were sold or not, the utilities didn't get the benefit back when a business was sold, that money wasn't reimbursed to the utility when the business was sold. So, the utility is still out essentially as to those payments.

T1598:L5-13.

Similar to the generation assets, these assets were only included for the years when the unregulated entity was part of the consolidated tax group, the assets were not included with the utility after sale or liquidation. As Your Honor and the Board are aware, consolidated tax adjustments look back and examine what happened in the prior years, the sale or liquidation of assets does not erase the income tax benefit associated with these assets from prior years.

4. Removal of Losses at the Expiration of the Net Operating Loss Carry Forward Period

Mr. Krueger next argued that Ms. Crane did not account for the expiration of Net Operating Loss carry forward periods. Mr. Krueger testified that the tax loss carry forward period has expired for tax years 1991 through 1993 and those years should be removed from the computation. *P-11-RB,* p.11. As explained by Ms. Crane in her surrebuttal testimony:

> Similarly, the idea that we should somehow limit some period of time associated with the expiration of the net operating losses, there is nothing in any decision that I have read that would indicate that the Board expected to limit the time period over which these occur to a fifteen or a twenty year period, in fact, the RECO decision says 1991 onward, so I think that is pretty clear as well.

T1598:L6-23.

5. Adjustment of Taxable Income for IRS Disputed Leasing Transactions

Mr. Krueger also stated that the Internal Revenue Service has proposed to disallow the deductions with respect to 20 particular types of leasing transactions known as LILO and SILO transactions. (LILO stands for Lease-In/Lease-Out and SILO stands for Sale-In/Lease-Out). *P-11-RB,* p.12. These leasing transactions entered into by the Enterprise Group's non-regulated businesses are the subject of an on-going dispute with the IRS. Mr. Krueger argued that because of the significant risk of loss associated with these transactions, the Enterprise Group has been required to provide a reserve for the potential loss in its financial statements. *P-11-RB,* p.13. According to Mr. Krueger, these leasing transactions should not be included in a consolidated tax adjustment, or if they are included, they should be included "net of the financial statement reserve that has been set up." *P-11-RB,* p.13.

After the filing of this rebuttal testimony, the Company filed the "supplemental rebuttal testimony" of Mr. Krueger on February 23, 2010. *P-11-RB.,* In addition to various changes to the original rebuttal testimony that the witness supporting the testimony characterized as "inadvertent" or did not remember making *(T1326:L10-25)*[7]. This "supplemental" testimony raised for the first time a $320 million payment to the

[7] These changes included changing pronouns, re-arranging paragraphs and sentence structure, deleting headings and changing references from "Rate Counsel" to the "Advocate."

IRS, purportedly to avoid any future interest costs associated with the pending LILO/SILO transactions. The Company did not explain why it waited until one week before the last hearing in this proceeding to advise the parties about payments made to the IRS that dated back to 2007. To include these claimed payments, made in anticipation of a potential future tax assessment, in any calculation of a consolidated tax adjustment is premature and patently unfair to ratepayers.

Ms. Crane testifed that it would be premature at this time to re-calculate the consolidated tax adjustment to incorporate the disputed tax losses and associated interest payments made to the IRS. As testified to by Mr. Krueger, the LILO/SILO dispute is still in the administrative appeals process stage. *T1313:L11-12*. The Company has indicated that the IRS has not yet sent a statutory notice of deficiency and, according to Mr. Krueger, no determination has been made as to whether the Enterprise Group will litigate this matter. *T1314:L16-20*. The Company expects that it will be three to four years before this dispute is finally resolved. *T1567:L1-9*. Presumably, the Company intends to prevail in this litigation and when it does, the claimed deposit is fully refundable with interest. *P-50, T1565:L7.* As testified to by Mr. Krueger, once a final determination has been accepted by the Company, and, if necessary, amended tax forms filed with the IRS, "we would adjust our taxable income amounts" in the next base rate case. *T1315:L5-6*. Thus, considering those disputed tax losses before a final determination has been made as to the amount of the losses, if any, is pre-mature at this time.

As Ms. Crane testified:

> Once the issue is resolved, hopefully by the time of the Company's next base rate case, the parties will know whether an adjustment needs to be made and we can adjust it at that time.
>
> In my view I don't believe we should consider the three hundred and twenty million dollars at this time.

T1594:L18-24

6. The IRS Interest

The Company finally argues that PSE&G is owed interest from ratepayers on the disputed LILO and SILO tax benefits passed on to ratepayers in prior rate cases. This argument is the same as for the claimed $320 million payment and Rate Counsel will not repeat those arguments. Any adjustment at this time is premature and should be addressed by Your Honor and the Board once a final determination has been made by the IRS. At this point, any adjustment is speculative at best.

D. Conclusion

PSE&G has claimed in this case federal income tax expense of $111.5 million for electric operations and $67.8 million for gas operations, calculated on a stand alone basis. PSE&G files as part of the Enterprise Group's consolidate income tax filing pursuant to a tax sharing agreement. To share with ratepayers the benefits of this tax sharing agreement, Rate Counsel witness Andrea Crane has calculated a rate base Consolidated Tax Adjustment, fully consistent with BPU precedent, of $281.9 million for the Company's electric utility and of $38.3 million for the Company's gas utility. This Consolidated Tax Adjustment results in a revenue requirement adjustment of approximately $38.7 million for electric operations and or $6.4 million for gas operations.

POINT IV

PSE&G'S REQUEST THAT RATEPAYERS COMPENSATE FULLY FOR THE PENSION PLANS' LOSSES IS INEQUITABLE AND DISCOURAGES PRUDENT INVESTMENT.

Rate Counsel maintains that the appropriate 2010 pension cost should be $113,657,426 for all qualified pension plans ("Pension Plans").[8] This amount of pension cost was calculated by Rate Counsel's expert witness, Mitchell I. Serota by examining the actuarial valuation reports of the Pension Plans and applying the Pension Plans' calculated discount rate, but eliminating that portion of the pension cost attributed to losses due to excessive pension portfolio risk assumed by the Pension Plans.[9] Historically, the Board has determined that it is "unreasonable to assess the full charge against the consumers" for funding an actuarial reserve. <u>Bell Telephone v. BPU</u>, 12 <u>N.J</u>. 568, 593 (1953).

PSE&G offered the direct testimony of Mark G. Kahrer, Vice President-Finance for PSE&G, to explain the need for the exorbitant increase of over $80 million in pension expense sought by the Company. Mr. Kahrer stated, "The collapse of the financial markets has resulted in a substantial increase in the Company's pension expense;" because "[a] significant driver of future pension cost is asset performance, which is subject to the uncertainty of the financial markets." *P-7*, p.17 In other words, Mr.

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8 Pension Plans means all qualified pension plans offered by PSEG and its companies including PSE&G.

9 Supplemental Testimony of Mitchell I. Serota, p. 7. Mr. Serota's Supplemental Testimony actually recommended a pension allowance of $96,213,907. In converting that recommendation to the revenue requirement schedules, Ms. Crane reflected an adjustment of $96,213,907, instead of an allowance of $96,213,907. This resulted in Rate Counsel including more in its revenue requirement recommendation for pension expense than it had intended. Nevertheless, Rate Counsel is willing to retain its recommendation of $113,657,426 instead of reducing its recommendation to $96,213,907 in this Brief.

Karher's testimony is that poor performance by the assets chosen by the Pension Plans' Pension Committee coupled with future uncertainty in the financial markets requires ratepayers to cover recent losses and increase payments for future pension requirements.

PSE&G's 2006 pension expense was included when the last gas base rates were set. Rate Counsel's current pension expense calculation for the PSE&G portion of the Pension Plans overall requirement approximates that amount. In 2008, the financial markets experienced a substantial downturn, thereby increasing PSE&G's pension expense in the test year, 2009. The Pension Plan's 2008 experience, and PSE&G's increased expense resulting from that experience, were amplified by the level of high risk assets the Pension Plans chose for investments. In 2009, the minutes of the Pension Investment Committee admitted that the Committee had accepted more "unintended (and potentially unrewarded)" *RC-63, p.32* risk in the portfolio than they desired and that they voted to accept yet more risk by increasing the level of equity in the Pension Plans. In the years when the financial markets performed well, the high risk assets performed better. This reduced pension expense, which allowed PSE&G to keep the money and lower its costs. When the financial markets performed poorly, the value of the high risk assets fell significantly, increasing the pension expense. In other words, the more risk the Pension Plans assumed the greater potential reward or "return." However, the opposite is also true, more risk also exposed the Pension Plans to greater losses, losses that PSE&G has asked ratepayers to make up in this case. Essentially, PSE&G is now asking ratepayers to insulate it from bad investment decisions.

The issue of what is a reasonable pension expense was considered directly by the Board and its judgment was affirmed on appeal by the Supreme Court in <u>Bell Telephone</u>, supra., 12 N.J. 568. After initially noting that, in New Jersey, the utility bears "the burden of proving the reasonableness of proposed rate increases" (Id. at p. 585, citations omitted), the Supreme Court found the Board acted reasonably in "disallowing 50% of a so-called 'freezing charge' or a payment into the pension fund to decrease unfunded actuarial reserve[s]." *Id.* at p. 593. As the Court stated; "The Board held that although the amount of the payment was proved and the Company had to pay the "freezing charge," it was unreasonable to assess the full charge against the consumers." *Id*. at p. 593. This decision makes clear that the Board has the authority and responsibility to determine the reasonableness of the amount sought by PSE&G in this case based upon the record before it.

In January 2008, the actuarial goal or actuarial value of the Pension Plans was 96.8% or almost fully funded. *RC-53*, p. 12 As the actuarial value neared 100%, the Company could have exchanged the higher risk assets in the Pension Plans for more secure, less risky investments. Doing this would have been consistent with sound investment advice and would have mitigated the losses suffered in 2008. *RC-52*, p. 3 , footnote 5. Since the Pension Plans chose not to pursue the prudent course, it is Rate Counsel's position that ratepayers are neither responsible for nor equipped to subsidize or underwrite a guarantee for PSE&G's share of the the Pension Plans's choice of investment assets.

All pension funds, including ratepayer 401ks and other retirement investments suffered losses as a result of the financial market meltdown that occurred in 2008. The reality of this meltdown is that for many, these losses will not be made up, or for some these losses will only be replaced after many years. Yet in this case PSE&G is asking ratepayers to bail out its pension fund by seeking the full cost of the impact of the 2008 investment loss it suffered. Ratepayers, who may have suffered similar losses in their own pensions and investments, should not be required to make PSE&G whole when there is no one to compensate them for their losses. Ratepayers certainly contribute to PSE&G's pension funding and a portion of the cost has been allowed by Rate Counsel in this proceeding. However, ratepayers should not be asked to compensate the Company fully for the losses from poor investment decisions especially when the Pension Plans' funding approached 100% funding levels, as was the case here. This is especially true when, the Pension Committee did nothing to mitigate the risk of loss in its investment decisions.

A. General Determination of Pension Cost

In order to fully understand Rate Counsel's position regarding the pension expense that should be allowed for PSE&G it is necessary to understand how pension expense was calculated by PSE&G, how it was calculated by Rate Counsel's witnesses, and the difference. The pension cost booked by the PSE&G for financial reporting purposes was determined according to Generally Accepted Accounting Principles ("GAAP") and the Financial Accounting Standards Board ("FASB") Statements 35, 87, 88, 132 and 158.

Under the accounting standard in FASB Statement 87 (as modified by FASB Statement 158) when calculating the annual amount to be contributed to a pension plan, an actuary must use the "Projected Unit Credit actuarial method" for determining the liability of the pension plan, also referred to as the Projected Benefit Obligation ("PBO"). The PBO represents the present value of the amount needed to fully fund the anticipated needs of those covered by the pension plan based on service and pay earned by the plan participants ("employees") through the date of the determination. The PBO is a theoretical measurement of what the retirement benefits for the plan participants would be if the plan sponsor had funded those retirement benefits evenly over their expected working lifetimes.

The present value of the PBO is calculated using a discount rate that mimics the prevailing long term corporate bond rate, which is regarded to be a rate of return with low risk of loss. Under the FASB Statement 87 standard, the discount rate is established annually by the auditor and the Chief Financial Officer of the company with the advice of the actuary. The PBO is then compared to the Fair Market Value of the Assets to reveal the Funded Status of the pension plan.

The annual pension cost, which is ultimately the amount that may be incorporated in rates, is also part of the FASB Statement 87 process. The annual pension cost is made up of four essential components that vary each year: 1) service cost, which is the cost of pension benefits earned by active employee-participants during the year, this figure is driven by the age, service and salaries of the participants; 2) interest cost on the PBO, which is basically the PBO liability multiplied by the discount rate; 3) expected return on investment, which is the Fair Market Value of Assets multiplied by an actuarial assumption of how much those assets will return during the year ; and, 4) amortization of gains and losses, which represent the difference between what the actuary's assumptions predicted at the beginning of the year and what the actual results were at the end of the year.

When the total losses over time exceed 10% of the PBO, a portion of that excess is added to pension cost. When the actuarial assumption for Expected Return on Investment overstates the return on investment in a given year (they expect a greater return on assets than they actually attained) a "loss" will occur that also increases the following year's pension expense.

Rate Counsel has accepted PSE&G's calculations for the first three components of the pension cost discussed above. The dispute between the parties centers on the fourth component.

B. PSE&G's Determination of Pension Cost

PSE&G pays pension expense into the Pension Plans. In January 2008, the Pensions Plans' PBO was set at $3.448 billion and the Fair Market Value of Assets was $3.338 billion, or 96.8% of the goal. However, a year later, in January 2009, the PBO was $3.406 billion and the Fair Market Value of Assets had dropped to $2.316 billion or 68% of the goal. PSE&G's pension expenses are based on its share of the Pension Plans funding requirements.

The PSE&G's pension claim was based on 10/12th of its projected 2011 pension costs and 2/12th of its projected 2012 pension costs. The Pension Plans had originally projected 2010 costs (total Public Service Enterprise Group) of $213,826,000 and 2011 costs of $190,098,000. *RC-131, Appendix C* This resulted in a total rate year claim of $209,871,333, which was then allocated among the various entities, including PSE&G. Pension costs of $81,559,000 were allocated to electric and gas operations, including that portion allocated to the electric and gas utilities from the Service Company. *P-7, Schedule MGK-31 R-1*

Mr. Serota's Supplemental Testimony reduced the total Public Service Enterprise Group Pension Plans' claim by $96,213,907 based on additional information provided to him by the Company after his initial testimony was filed. Mr. Serota's revised adjustment of $96,213,907 resulted in a total Public Service Enterprise Group Pension Plans' expense of $113,657,426, given the Pension Plans' claim for total rate year costs of $209,871,333 ($209,871,333 - $96,213,907). A portion of Mr. Serota's recommended pension expense of $113,657,426 would then be allocated to each entity, including PSE&G electric and gas.

In determining the recommended pension expense, Mr. Serota reviewed the components of pension expense for each qualified plan in the Pension Plans. The actuarial valuation reports presented for the qualified plans contained a line item showing the loss of assets for each of the three plans. The loss in asset value, net of all other considerations, amounted to $882.6 million. The actuarial assumption was that the assets would grow by $289.8 million. This was incorrect and is treated as a loss. The combination of the two amounts, a loss of $882.6 million and a failure to earn $289.8 million, is $1,172.4 million, which is considered an actuarial asset loss.

The Pension Plans assumption was that the assets would grow by $289.8 million was based on the expectation that the assets would return 8.75%. This assumption incorporated a degree of risk greater than the low risk discount rate of 6.8%. According to industry practice as the Fair Market Value of the pension fund approached 100% of the PBO, the assets should have been more conservatively invested in less risky securities with a return approaching the discount rate or the long-term rate of investment grade corporate bonds. *RC-53*, p. 12-13. Mr. Serota recalculated the pension expense assuming a rate of return on assets in the pension fund approximating the discount rate. *RC-52*, p. 7 Mr. Serota used this calculation to arrive at his adjustment. The adjustment is reasonable and appropriate as it encourages prudent investment decisions by the Pension Investment Committee and protects ratepayers from extreme market shifts.

In its 12+0 update, PSE&G revised its' electric and gas pension claim from $81,559,333 to $61,982,000. *P-7, R-3.* Workpapers supporting this allocation were not provided until immediately prior to the hearing at which Mr. Serota testified, when the Company provided a second update to its response to S-PREV-71 ("Update 2"). In Update 2, the Company indicated that it had again revised its 2010 pension estimate from $213,826,000 to $164,071,000. It also revised its 2011 pension estimate from $190,098,000 to $144,718,000. Based on 10/12th of the estimated 2010 costs and 2/12th of the estimated 2011 costs, the Company's revised rate year claim (total Public Service Enterprise Group) is $160,845,500, which for PSE&G becomes $61,982,000.

C. Pension Expense Summary

Thus, the difference between Rate Counsel's position and that of PSE&G is that Rate Counsel's expert has permitted only a portion of the Pension Plans' losses to be recovered in rates. If PSE&G's position were adopted, and all of the losses recovered, ratepayers would be insulating the Pension Plan from the consequences of the Pension Investment Committee's decision to keep its investments in high risk assets even if the pensions were fully funded. This is contrary to sound pension investment advice, including that of PSE&G's own expert, Joe McDonald,[10] and would remove any incentive for the Investment Committee to ensure prudent investment. It is simply unfair to ask ratepayers, many of whom have suffered their own pension losses, to make PSE&G's Plan beneficiaries whole. A sharing of these losses, as recommended by Mr. Serota, should be required.

Given Mr. Serota's recommended pension allowance of $113,657,426, the Pension Plans' revised claim is overstated by $47,188,074 ($160,845,500 - $113,657,426). Rate Counsel's Revenue Requirement witness, Ms. Crane, has reflected this adjustment by reducing the total Public Service Enterprise Group Pension Plans' rate year pension cost by $47,188,074. *RC-131 and RC-132*, Schedules ACC-21E and ACC-20G Ms. Crane then allocated the adjustment of $47,188,000 to the Company's electric and gas operations and to the portion of costs allocated to the Service Company and then reallocated to electric and gas operations. *RC 133*

As these adjustments are equitable and supported by the evidence, they should be adopted.

D. Pension Tracker

In addition to requesting full recovery of the market losses experienced by PSE&G's pension fund in 2008, PSE&G proposed a Pension Tracker that would allow PSE&G to recover its annual pension expenses on a guaranteed, dollar-for-dollar basis. Rate Counsel strongly opposes such a mechanism as inappropriate single-issue

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[10] Joe McDonald, "Riding the Pension Rollercoaster – Tracking Surplus Volatility," May 1, 2008 at 32:10; *RC-66*; "Proper risk management is assessing and being aware of the potential downside events and preparing yourself for them." and "Worst case scenarios seem to be happening every day."

ratemaking, as a violation of accepted ratemaking matching principles, as inconsistent with traditional Board policy, as an extraordinary remedy not warranted by the record, and, as encouragement for inefficient management of the PSE&G pension fund. Fundamental tenets of utility ratemaking are the avoidance of single issue ratemaking and matching expenses and revenues.

> It is a long-standing Board policy that issues of expense which are related to base rate proceedings are not normally subject to review in other than a base rate proceeding. … The Board and courts have wisely found that to review specific cost items would be counterproductive, and that only in the confines of the general base rate case, when all of the Company's expenses are reviewed, should such base rate adjustments be counted. I/M/O the Petition of Atlantic City Electric, OAL Docket. No. PUC 2525-97, BPU Docket No. ER97020105, Initial Decision, (12/23/97) at p.5.

Judge McAfoos's decision was affirmed by the Board, with respect to the treatment of the "single-issue" ratemaking issue in an Order adopted June 8, 1998 where the Board stated; "this [expense recovery sought] would be a base rate issue rather than a LEAC issue under traditional ratemaking…" I/M/O the Petition of Atlantic City Electric, BPU Docket No. ER97020105, Order Accepting Initial Decision with Modification, (6/498) at p.8.

Adoption of the Pension Tracker would represent an unwise, major policy shift by the Board. The Board should retain the current regulatory process, where the risks and rewards of the efficient operation of a company remain with the utility, providing the utility the opportunity to recover its costs and earn its authorized rate of return. The Board should not make the ratepayers a bank, guaranteeing dollar for dollar recovery of costs, in this instance pension costs, regardless of the decisions of utility management.

The foundation of utility regulation is that it was designed as a substitute for a competitive marketplace. If a utility's cost recovery is guaranteed it has no incentive to operate efficiently as if it were in a competitive industry. Traditional ratemaking principles allow a utility the opportunity to recover its costs and to earn a reasonable rate of return on investment. They do not guarantee the utility's return.

PSE&G is proposing extraordinary relief based on the recent economic downturn. Adjustment clauses, such as the proposed Pension Tracker, are generally used for expenses that are volatile, beyond the control of the utility and that have a significant impact on the utility's financial condition. *T665-T666*. PSE&G's proposed Pension Tracker does not meet these requirements. As noted in the testimony of Rate Counsel witness Mr. Henkes *RC-65, p.10* pension expense, as a percentage of PSE&G's total actual gas and electric distribution O&M expenses from 2001 through the 2009 test year (6+6 basis), ranged from a low of .18% (2008) to a high of 1.07% (2009 6+6). These percentages demonstrate that this issue is not material enough to warrant extraordinary rate treatment such as the Pension Tracker proposed by PSE&G.

Pension expenses are not the type typically recovered through a reconciliation mechanism such as the Pension Tracker proposed by PSE&G. As noted by Mr. Henkes *T665-T667* in a prior case the Board, in disallowing special treatment for pension expenses determined that there is no reason to treat "pension expenses differently from any other expense item included in the cost of providing service to customers." *Id.*

For the reasons set forth in this brief, and in the testimony of Mr. Henkes, Rate Counsel opposes the Pension Tracker as an inappropriate departure from sound regulatory policy. Proper rate regulation allows the utility the *opportunity* to recover its costs and earn its authorized rate of return rather than *guarantee* it. PSE&G's expenses should be considered in total rather than allowing it to get dollar for dollar recovery on selected items.

POINT V

PSE&G'S RATEPAYERS SHOULD NOT BE SADDLED WITH THE ADDITIONAL BURDEN OF PAYING FOR OVER $26 MILLION IN EXECUTIVE INCENTIVE BONUSES.

The Company has included costs for three incentive compensation plans in its revenue requirement claim. These plans are available only to non-union employees. T1399:L 10-11. First, PSE&G has included approximately $2.3 million for costs of the Management Incentive Company Plan ("MICP"). *S-73, RCR-A-20 Update 2*. Second the Company has included in this case approximately $14.5 million for the Performance Incentive Plan ("PIP") which is available to salaried employees. *Id*. And third, the Company has included costs of approximately $9.5 million relating to the Long-Term Incentive Plan ("LTIP") which is a stock award and option plan available only to select executive level employees, the officers and directors of the Company. *Id.*, *T1401:L3-4*. In total, in the present case, PSE&G is proposing to charge ratepayers approximately $26.30 million for incentive compensation expenses. *P-45, S-73, RCR-A-20 Update 2* Rate Counsel witness Andrea Crane recommended that Your Honor and the Board remove these costs from the Company's revenue requirement.

A. The Company's Incentive Compensation Programs

1. Management Incentive Company Plan

The MICP is an annual cash incentive program "for our most senior officers." *NJLEUC-4*. The stated purpose of the Company's MICP is to "foster attainment of the financial and operating objectives of the Company and its participating affiliates, which are important to customers and stockholders by providing incentives to certain key officers and executive level employees who contribute to attainment of these objectives." *Id.* The MICP is based on four performance criteria: corporate, financial, business unit scorecard and individual. The Corporate Factor, in 2008, was based on a comparison of PSEG's return on equity measured against the median return on equity of a peer group. Corporate and financial goals appear to be much more heavily weighted than either the business unit or the individual goals, although specific weightings can vary from year to year. *RC-131, p. 54.*

According to the PSEG Form 10K, in 2009, PSE&G's Named Executive Officers received the following MICP awards:

Izzo	$1,000,000
O'Flynn	$384,800
Selover	$370,900
LaRossa	$286,100
DiRisio	$146,500

NJLEUC-4, p. 208.

Financial goals for the recipients include achieving earnings targets, improved credit ratings, and reducing costs. Operational goals vary significantly among the award recipients. For example, Mr. Izzo's operational goals "addressed continuous improvement in operation performance through management and workforce development and assisting the PSEG Board in the recruitment of two additional PSEG Board members (weighted @ 25%). *Id.* at 198. Mr. O'Flynn's operational goals include "closings of assets sales to minimize post closing adjustments, reduction of Sarbanes Oxley control failures, improved earnings and cash forecasting accuracy (weighted @ 15%) and investor relations effectiveness (weighted @ 15%). *Id.* at 199. Mr. Selover's operational goals in 2008 included "improving the operations of PSEG's public affairs, internal auditing and law function organizations (weighted 50%). *Id.* Mr. LaRossa's operational goals "included employee training, development and availability (weighted at 10%), customer service satisfaction measures (weighted 10%) and electric and gas reliability and safety measures (weighted at 10%). *Id.* Finally, Mr. DiRisio's operational goals included "timeliness and quality of accounting results (weighted @25%) timeliness and quality of results and controls in connection with Sarbanes – Oxley Act section 404 compliances (weighted at 20%) and accuracy of earnings and case forecasting results (weighted at 15%). *Id.* Thus, even the operational goals are based in part large on earnings and financial goals.

2. Long-Term Incentive Plan

The LTIP "is designed to attract and retain qualified personnel for positions of substantial responsibility, motivate participants toward goal achievement by means of appropriate incentives, achieve long-range corporate goals, provide incentive compensation opportunities that are competitive with those of other similar companies and align participants' interests with those of stockholders." *NJLEUC-4*, p. 200. Awards approved in December 2008 were based on Total Shareholder Return ("TSR") relative to peers (weighted 50%) and Average Return on Invested Capital. *Id.* at 202.

Under the LTIP, non-qualified options to acquire shares of PSEG common stock may be granted to officers and other key employees of PSEG and its subsidiaries selected by the Organization and Compensation Committee of PSEG's Board of Directors. *NJLEUC-4*, p. 155. At the hearing, Company witness Mr. Kahrer was unable to identify the number of employees that typically receive awards under the LTIP plan but conceded that "It is not a large population." The Company agreed to provide the exact number of employees receiving awards under this plan but to date has failed to provide this number.

According to the Company's form 10K the following LTIP awards[11] were granted to the Named Executive Officers. *NJLUEC-4*, p. 205.

Izzo	$2,734,220 Performance Units $2,537,424 Stock Options
O'Flynn	$522,144 Performance Units $483,472 Stock Options
Selover	$462,168 Performance Units $429,872 Stock Options
LaRossa	$433,944 Performance Units $403,072 Stock Options
DiRisio	$116,424 Performance Units $106,607 Restricted Stock Units

3. Performance Incentive Plan

The PIP is available to salaried employees who "foster attainment of the financial and operating objectives of the Company and its subsidiaries." *RC-131, SPREV-59*. The plan is administered by the PSEG Employee Benefits Policy Committee ("Committee") and participation is limited to eligible employees selected by the Company or a participating subsidiary. Participation in one plan year does not guarantee participation in any other plan year. The Committee has the sole discretion with respect to "whether to suspend operation of this Plan for any period of time." *Id.* p.25.

[11] The amounts presented represent the fair value at the grant date of the equity awards granted in 2008.

For PSE&G employees, the PIP incentive payment is based on four factors, the Corporate Factor, the Business Unit Financial Factor, Business Unit Scorecard Results, and Strategic Goals. *P-52.* The Corporate Factor is based on earnings per share, the Business Unit Financial Factor is an earnings based financial measure and the Business Unit Scorecard Goals are stated as top quartile performance "in everything we do" and "to improve continuously." *Id.* at 2-3. The fourth consideration, Strategic Goals will, for PSE&G "focus on customer perception" while the other subsidiaries, including PSEG Services Corp. "will focus on achieving a combined $40 million O&M reduction in actual results." *Id.* at 4.

The PIP is self funded, so total monetary increases and decreases must balance the total PIP award pool. *Id.* at 1. Although the total PIP award pool cannot be modified, the CEO, along with senior leadership, determines how the award pool is distributed. "Therefore, highly successful business areas and/or individuals who contribute greatly to enhance PSEG shareholder value will be rewarded through a pay differentiation in their final PIP payout." *Id*. at 4. Thus, the PIP program, like the MICP and the LTIP, emphasizes earnings and shareholder value.

B. Rate Counsel's Position

In filed testimony, Rate Counsel objected to ratepayer funding of these incentive plans. As detailed above, the MICP and the LTIP are limited to a small group of officers and executives. These executives are already adequately compensated, as the Company has claimed $2.1 million in base salaries for these officers. The employees eligible for the PIP, have consistently received annual increases of 3.0 to 4.0%. Rate Counsel has not objected to rate recovery of these base compensation levels for these executives but strongly objects to the request that ratepayers pay executive bonuses of more than $26 million. If PSE&G chooses to reward its already highly paid executives through these incentive bonuses, that cost should be borne by the shareholders, not the ratepayers who are already struggling to get by in these difficult economic times.

Second, all three of the plans are heavily weighted toward shareholder value and Company profitability. Providing employees with a direct financial interest in the profitability of the Company is an objective that would benefit shareholders, but it does not benefit ratepayers. Compensation awards that are based on earnings criteria violate the principle that a utility should provide safe and reliable utility service at the lowest possible cost. This is because these plans require ratepayers to pay higher compensation costs as a consequence of high corporate earnings, a spiral that does not directly benefit ratepayers, but does benefit shareholders, as well as the management responsible for establishing such programs and to whom most of the incentive compensation is granted.

Incentive compensation plans tied to corporate performance result in greater enrichment of company personnel as a company's earnings reach or exceed targets that are predetermined by management. It should be noted that it is the job of regulators, not the shareholders or company management, to determine what constitutes a just and reasonable rate of return award to shareholders in a regulated environment. Regulators make such a determination by establishing a reasonable rate of return award on rate base in a base rate cost proceeding. Allowing a utility to charge for additional return that is then distributed to employees as part of a devised plan to divide extraordinary profits violates all sense of fairness to the ratepayers of the regulated entity. It is certain to result in burdensome and unwarranted rates and violates the principles of sound utility regulation particularly with regard to the requirement of just and reasonable rates.

Rate Counsel's position in this proceeding is fully consistent with Board policy. In the Board's Final Decision and Order in I/M/O of the Petition of Jersey Central Power & Light, Docket No.ER91121820J, (2/25/93) at p.4., the Board disallowed all of the costs associated with the utility's incentive compensation plans from its cost of service. The Board found:

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

Similarly, the Board denied a utility's request to include incentive compensation costs in rates in the 2001 Middlesex Water Company base rate case. In rejecting the ALJs recommendation to share incentive compensation costs 50%/50% between ratepayers and shareholders, the Board reiterated its JCP&L position by stating: "The language in the Board's JCPL 1993 Order is especially appropriate today when consumers are still faced with increasing energy costs, as well as other increased costs." Id. at 25.

As correctly observed by the Board in the Middlesex case, denial of PSE&G's incentive compensation recovery request is especially appropriate today when the state is faced with record unemployment levels and stagnant or decreasing wage levels. The Company itself has claimed a sharp increase in uncollectibles and has cited the "economic crisis that has unfolded over the past year" and the "collapse of the financial markets" as justification for some of its requests for extra-ordinary recoveries in this case *P-7, p.4, 17.* Given rising energy costs and current economic conditions ratepayers should not have to shoulder the additional burden of over $26 million in executive bonuses included in rates.

Accordingly, for the above reasons, Rate Counsel recommends that the Company's proposed pro forma test year incentive compensation expenses of $26.30 million be disallowed for rate making purposes in this case.

POINT VI

A THIRTY YEAR PERIOD SHOULD BE USED TO DETERMINE NORMAL WEATHER.

Rate Counsel recommends that the Board adjust the sales projections of Petitioner's pro forma revenue claim based on a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its original test year revenue forecast. Weather normalization using the thirty-year standard for normal weather is based on several objective scientific and statistical reasons.[12]

"The purpose of a weather normalization adjustment is not to forecast or predict weather for a particular year. ... The purpose … is instead to determine what customer usage would be, assuming 'normal' weather." *RC-131*, p. 45, lines18-21. A standard using thirty years of normal weather is more appropriate because it is based upon and consistent with the meteorological science used by the National Oceanic and Atmospheric Administration ("NOAA")[13] and other weather experts. In particular,

> The thirty-year normal has been established by [NOAA], the government organization charged with establishing and recording the climatic conditions of the United States. The thirty-year standard is the objective standard, established by the government body responsible for determining normal weather conditions. Moreover, the thirty-year standard is the international standard adopted by the United Nation's World Meteorological Organization ("WMO"). The thirty-year normal is used for a wide range of applications and it

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[12] In fact, Petitioner itself filed its last electric and gas base rate cases using a thirty-year weather normalization, *P-17-RB-1*, p. 4 -5 and *RC-131*, p. 40, lines 15-16.

[13] NOAA, an agency with the U.S. Department of Commerce, is responsible to collect, forecast and distribute "meteorological information in the interests of agriculture and commerce." 15 U.S.C. § 313; see 33 U.S.C. §§ 311, 1101: 15 U.S.C. § 1503b, Reorganization Plan No. 4 of 1970; http://www.noaa.gov/about-noaa.html (last viewed 3/15/10).

> has served as the standard in utility regulation for some time. *RC-131*, p. 40-41[14]

Petitioner failed to rebut the fact that the WMO relies on thirty years of normal weather data, but merely objected that Ms. Crane did not provide a copy of any WMO documents or their terms.

The WMO is a specialized agency, the United Nations' "authoritative voice" on the Earth's atmosphere and climate.[15] It was established by an international agreement, the Convention of the World Meteorological Organization, adopted at the Washington Conference in 1947.[16] In fact, the United States was one of the original signatory countries to the WMO Convention,[17] and joined the WMO by treaty.[18] The WMO Convention, the United States treaty adopting it and the WMO regulations are matters of law, of which this court may take judicial notice. N. J. R. Evid. 201(a).

The use of the NOAA standard is consistent with the principle that each administrative agency should exercise its delegated authority within its area of expertise. *See*, City of Newark v. Natural Resource Council, 82 N.J. 530, 539, cert. denied, 449 U.S. 983, 101 S.Ct. 400, 66 L.Ed.2d 245 (1980) (agency exercise of its statutorily delegated duties presumed reasonable). "In the United States, th[e] agency [with expertise and responsibility for tracking, analyzing, and reporting weather statistics] is

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[14] *See,* http://www.crh.noaa.gov/grr/climate/normals/ (explaining NOAA calculation and use of 30-year normal climate calculations) (last viewed 3/15/10); *see also* Secretariat of the WMO, Technical Regulations, Volume I, "General Meteorological Standards and Recommended Practices," Geneva, 1988 edition, WMO No. 49, at xiii ("climatological standard normals").

[15] http://www.wmo.int/pages/about/index_en.html (last viewed 3/15/10).

[16] available at ftp://ftp.wmo.int/Documents/MediaPublic/Publications/Policy_docs/wmo_convention.pdf (last viewed 3/15/10).

[17] *Id.* at 27.

[18] Convention of the World Meteorological Organization, done at Washington Oct. 11, 1947, entered into force Mar. 23, 1950. TIAS 2052; 1 UST 281; see 22 U.S.C. § 288.

NOAA, which has determined that normal weather should be defined as the arithmetic mean computed over a thirty-year period of time." *RC-131*, p.41, lines 12-16. Using this objective standard ensures consistency by avoiding case-by-case litigation of the appropriate standard. *Id.* at 42 lines16-18.

For several important statistical reasons, longer time periods, such as 30 years, are preferable for weather normalization data. Andrea Crane explained that

> longer time periods tend to average out weather and temperature extremes much better than shorter periods. [O]ne particularly cold or warm winter … has a much greater effect upon a twenty-year average than it does upon a thirty-year average. In fact, a single data point has a 5% impact on a twenty-year average, but only a 3.3% impact on a thirty-year average. Therefore, the effect of a single data point is 50% greater with a twenty-year average than with a thirty-year average. [A] shorter time period may fail to include extreme weather in computing average degree days. It is normal and customary to have a very cold or a very warm winter every so often, and the data base should include these extremes. *RC-131*, p. 41-42.

Statistical measures of central tendency, such as an average, require thirty data points for a normal distribution.

> The use of thirty data points has its basis in the central limit theorem … if the sample size has at least thirty data points, then the distribution of sample means is normal, resulting in a normal distribution centered around the mean with a standard deviation that decreases as the sample size increases. Essentially, the population sample of at least thirty data points will result in a bell-shaped curve. *RC-131*, p. 43 lines 9-13.

Rate Counsel advises use of thirty rather than twenty annual data points to determine average weather. While Petitioner agrees that a statistically normal "bell" curve is necessary; *P-17-RB-1*, p. 3, the proposal to use only 20 data points will not achieve that statistical objective.

It is important to use good standard weather data. As Ms. Crane testified:

> Utility rates are based upon normal operating conditions. If revenues are based on an accurate, consistent and widely-accepted standard for

> normalizing weather, in some years the Company's revenues will be less than normal, in some years the Company's revenues will be greater than normal, but over time, the Company's revenues will reflect normal weather and the Company will receive the opportunity to earn its fair rate of return. *RC-131*, p. 42,lines 12-16.

While NOAA has explored increasing the frequency of updating its thirty-year average data, Crane Direct 43:17-44:9, NOAA has not adopted the twenty-year standard advocated by Petitioner. *Id.* at p. 44 lines10-15. Petitioner has offered no sound, reliable reason to adopt its proposed rubric. In fact, as Mr. Wreschnig admitted on cross, Petitioner did not base its position on some trend in New Jersey weather data. *T1344:L13-1345:1*. Petitioner proposes a statistical method ("Optimal Climate Normals"), *P-17-RB-1*, p. 8-9, that is both experimental,[19] and developed for short-term forecasts rather than the long-term normal weather averages used in revenue projections.[20] The Board should reject the use of that proposed experimental model to support a pro forma revenue claim, for both those reasons. WMO and NOAA have not found a scientific basis to change their calculation of average weather to the method that would support Petitioner's claim.

In summary, Rate Counsel recommends that the Board adjust the sales projections of Petitioner's pro forma revenue claim based on a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its original test year revenue forecast.

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[19] Arguez, Anthony, "Alternative Normals, Version 1.0 Readme File" (June 2009), available at http://www1.ncdc.noaa.gov/pub/data/aarguez/alternative-normals/readme.txt, ("Alternative Normals is a suite of experimental products that are intended to supplement NOAA's official Climate Normals") (emphasis added) (last viewed 3/15/10). Rate Counsel supports continued use of NOAA's official Climate Normals.

[20] *Id.* ("'Optimal Climate Normals' ... is a technique developed at NOAA's Climate Prediction Center (CPC) ... CPC scientists use OCN as an ingredient in their short- term forecasts.") (emphasis added).

POINT VII

PSE&G'S WEATHER NORMALIZATION CLAUSE PROPOSAL SHOULD BE REJECTED AS AN UNJUSTIFIED AND UNREASONABLE DEPARTURE FROM ESTABLISHED BOARD POLICY AND, IF ADOPTED, WOULD RESULT IN INEQUITABLE RATEMAKING TREATMENT FOR RATEPAYERS.

PSE&G requested approval to implement a weather normalization clause ("WNC") as part of its base rate petition. *P-1, Schedule 5, Tariff p. 45.-47. See* also, *P-7, p.7 and P-9, p 52-53*. Since 1991, the BPU has approved other recovery mechanisms as a means for gas utilities to "levelize" or account for the difference between gas usage and weather variations and the effects on utility revenues during winter heating seasons. [21] However, as outlined in its proposed WNC tariff, the Company seeks to distort the revenue-neutrality of the clause by imposing an additional element not adopted by any other gas utility in the state. In direct contradiction to the ratemaking principle that utilities are allowed the 'opportunity' to earn a fair rate of return, PSE&G introduces a condition within its WNC that it "… will not refund any portion of a WNC margin revenue excess that will cause the Gas Utility to earn less than its allowed rate of return on common equity of 11.5% for the Annual Period*." P-1*, *Schedule 5, Tariff Sheet 47*. Such a condition within a WNC is unprecedented and should be rejected by Your Honor and the Board as it is in direct conflict with well established Board precedent and regulatory principles.

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[21] *See,* I/M/O Elizabethtown Gas Co. Petition for Base Tariff Rates, BPU Docket No. GR90121391J, Decision and Order, September 30, 1991; I/M/O New Jersey Natural Gas Co. Base Tariff Rates, BPU Docket No. GR91081393J, Decision and Order, June 24, 1992; and I/M/O South Jersey Gas Co. Petition for Base Tariff Rates, BPU Docket No. GR91071243J, Decision and Order, August 10, 1992.

As defined in the respective tariffs of New Jersey Natural Gas ("NJNG"), Elizabethtown Gas (E'Town) and South Jersey Gas ("SJG"), a "weather or temperature normalization rate or charge" is applied between the months of October to May based on the differences between 'actual' and 'normal' weather during the prior winter period [22] as measured in 'degree days' or 'heating degree days' ("HDD"). [23] A "normalized" level for HDD is calculated by using a 20 to 30-year average of weather recorded by NOAA at various regional weather stations. The weather normalization rate is derived for the total winter period within the clause year (or, Annual Period) [24] by applying a calculation consisting of: (1) actual monthly calendar degree days and normal calendar degree days; (2) a "degree day dead band", which is used as a measurement for determining monthly normal degree days; (3) average consumption factors for individual tariff classes; (4) the revenue margin factors derived for each rate class (as adjusted in each base rate case); and (5) state and energy taxes.[25] Simply, the WNC will operate as a charge to or credit for ratepayers depending upon the amount margin revenues differ from what would have been considered normal weather. If applied appropriately, ratepayers will receive a credit in colder than normal years and be charged for revenue deficiencies in warmer than normal years. As clearly stated by Rate Counsel witness, Richard LeLash, in his direct

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[22] The 'winter period' is defined as the eight consecutive months from October to May of the following calendar year. *See, New Jersey Natural Gas Company Tariff, Sheets 166-169*, eff. October 3, 2008; *Elizabethtown Gas Company Tariff, Sheets 103-107*, eff. December 17, 2009; and *South Jersey Gas Company Tariff, Sheets 75-78*, eff. July 8, 2004 (see tariff pages in Appendix attached to this brief**).**

[23] Degree days are defined as the difference between 65 degrees F and the mean of 24 hourly temperature measurements for a day. *See,* New Jersey Natural Gas Company Tariff, Sheet 166; Elizaabethtown Gas Company Tariff, Sheet 103; and South Jersey Gas Company Tariff, Sheet 77. However, PSE&G proposes to use 60 degrees F versus 65 degrees F for its measurement. *P-1, Schedule 5, Tariff Sheet 45.* (see tariff pages in Appendix attached to this brief**).**

[24] *See,* New Jersey Natural Gas Company Tariff, Sheet 168; Elizabethtown Gas Company Tariff, Sheets 106-107;and South Jersey Gas Company Tariff, Sheets 75-77.

[25] *See,* New Jersey Natural Gas Company Tariff Sheets168; Elizabethtown Gas Company Tariff Sheets 106-107; and South Jersey Gas Company Tariff Sheets 75-76.

testimony "… the weather normalization should be revenue neutral over time, that is, increases to certain years' revenues should be offset by decreases in other years." *RC-22, p.* 15.

The established WNC tariffs for NJNG, E'Town and SJG also contain critical components for the prevention of utility abuses. For instance, there is no recovery of revenues in excess of the authorized rate of return or recovery of any revenue shortfall of more than 3% of the total residential service rate. Also, the WNC is not applied if at the conclusion of the winter period the calculation of the difference between actual and normal weather is less than the degree day dead band. *See,* the appendix attached to this brief. Lastly, each gas utility files a WNC petition every year with the Board to reconcile the prior Annual Period revenues and weather data.

In its proposed WNC tariff, PSE&G explicitly states that "… the Company will not refund any portion of a WNC margin revenue excess that will cause the Gas Utility to earn less than its **allowed** rate of return on common equity of 11.5% for the Annual Period." *P-1, Schedule 5, Tariff p. 47.* (emphasis supplied.) This is unprecedented and an impermissible application of the WNC. As Rate Counsel expert Mr. LeLash appropriately responded in his direct testimony:

> This WNC provision, to a certain degree, would enforce the concept of a guaranteed return… The Company is not guaranteed equity return in excess of its authorized level and thus any normalization revenue in excess of that level is not warranted. Additionally, to ask ratepayers to forfeit their portion of normalized revenue because the Company's stockholders are not earning their authorized return is unreasonable. Ratepayers, through a normalization clause, are not obligated to make up shortfalls for shareholders. The normalization clause should only address shortfalls related to weather.

RC-22, p. 18. As correctly pointed out by Mr. LeLash, allowing PSE&G to use the WNC to make up non-weather related shortfalls in shareholder earning would pervert the purpose of the WNC.

In his rebuttal testimony, PSE&G witness, Mark Kahrer, argues that ratepayers should not receive any revenue credits or refund if the Company is under-earning but weather is colder than normal. *P- 7-RB,* p 61. He further states that Mr. LeLash "…would change the rules proposed by the Company…." under this scenario to the detriment of its shareholders. *Id.* at p. 61-62. To the contrary, it is PSE&G that seeks to change the rules of long established Board WNC regulatory policy designed to protect the interests of captive ratepayers. It must also be noted that the WNC programs currently in operation by NJNG, E'Town and SJG have been functioning in harmony with their shareholders and ratepayers for the past 20 years. PSE&G has not demonstrated in its petition or rebuttal testimony that the Board should deviate from established regulatory policy in favor of its version of a WNC in order to guarantee its rate of return on common equity.

It is within the jurisdiction of the Board to establish just and reasonable rates, with a fair rate of return for utilities after proper notice and hearing. *See,* I/M/O Revision of Rates by Toms River Water Co., 82 N.J. 201, 208-210, (1980) (Legislature has granted broad powers to Board to fix just and reasonable rates and address regulatory lag). However, it is not the responsibility of the Board to ensure that regulated utilities are guaranteed their allowed rate of return. The burden is upon the utility to demonstrate that rates need to be adjusted to achieve a perceived fair rate of return. *See,* I/M/O/ Revision of Rates Filed by Toms River Water Co., 82 N.J. supra, 212-214. A weather normalization clause should only be used to address revenue shortfalls due to weather, not to ensure full earnings for shareholders. Accordingly, the Board should reject PSE&G's alternative WNC as filed.

POINT VIII

EXPANDED CAPITAL ADJUSTMENT CLAUSE IS AN UNREASONABLE DEPARTURE FROM SOUND RATEMAKING PRINCIPLES AND WOULD SHIFT RISK TO RATEPAYERS.

The Company's proposed expansion of its Capital Adjustment Clause mechanism ("CAC") to encompass its ongoing capital additions ignores the factual circumstances and policy underlying the CAC and represents an unreasonable departure from fundamental ratemaking principles.[26] In contrast, the Board-approved CAC found in PSE&G's current tariff only affords such treatment for a well-defined set of 38 discrete capital infrastructure projects intended to stimulate the economy and create jobs in the midst of a severe nationwide economic downturn.[27]

Using projections supplied by the Company, the effects of the Company's CAC expansion proposal on ratepayers can be quantified. In response to RCR-CAC-8, the Company identified electric capital expenditures of $1.086 billion from 2010 to 2013 that it is proposing to recover through an expanded CAC, and $513.5 million of natural gas capital expenditures. *RC-131*, Appendix C. These amounts are in addition to the Capital Infrastructure Investment Program ("CIIP") costs that have already been approved for recovery through the present CAC mechanism. Assuming the cost of capital requested by the Company in this case, Rate Counsel witness Ms. Crane found the Company's CAC expansion proposal would result in further rate increases of approximately $140

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[26] The CAC expansion proposed by PSE&G would not extend to capital additions resulting in increased revenue, i.e. "non-new business investments." *RC-131*, Appendix C (Response to RCR-CAC-8)

[27] *RC-85*, PSE&G CIIP Order. The utility infrastructure economic stimulus program approved by the Board is referred to variously as the Capital Infrastructure Investment Program ("CIIP") and in the Company's testimony as the Capital Economic Stimulus Infrastructure ("CESI") Investments Program.

million for electric customers and of approximately $66 million for gas customers during this period. *RC-131*, p. 106; *T1571:L21-T1572:L2*. At hearing PSE&G witness Mr. Kahrer testified that the Company's proposed expansion of the CAC would result in annual rate increases "on the order of 1 to 1.2 percent." *T1371:L17-19*. However, as set forth below and in the testimony of Ms. Crane, these additional burdens on ratepayers would not be offset by any increased revenue or expense reductions which might accrue to the benefit of the Company during the same period. *RC-131*, p. 100-107.

For the reasons set forth herein, Rate Counsel respectfully recommends that Your Honor reject PSE&G's proposal to expand the CAC and its proposal to implement an "Infrastructure Tracker."

A. PSE&G's Proposed Expansion of the CAC Is an Unreasonable Departure from Established Ratemaking Principles.

Under traditional rate base/rate of return regulation, expenditures associated with capital additions which enter service after the close of a base rate case are presented for rate recovery in the next base rate case. In contrast, through the use of a clause-type mechanism, the Board-approved CAC found in PSE&G's current tariff effectuates contemporaneous recovery of the revenue requirements associated with a set of 38 capital infrastructure investment projects. However, unlike PSE&G's proposal for an "Infrastructure Tracker" expanding the CAC, the limited exception from traditional ratemaking treatment afforded by the Board-approved CAC was grounded in sound policy reasons reflecting a unique set of dire facts.

The CAC had its genesis in the depths of the worst economic crisis in the recent history of the United States. During the fall of 2008, the State's electric and gas public utilities were encouraged by then Governor Corzine and then BPU President Fox to accelerate capital infrastructure improvements and investments, in a effort to create jobs and stimulate the economy. Early in 2009, the State's electric and gas utilities, including PSE&G, responded by filing petitions proposing new and accelerated capital infrastructure projects together with rate recovery proposals.[28]

After extensive discovery and negotiations, Rate Counsel, Board Staff and PSE&G entered into a stipulation of settlement in PSE&G's CIIP case which was subsequently adopted by the Board in an Order dated April 28, 2009. *RC-85* Pursuant to the terms of the stipulation of settlement approved by the Board, PSE&G is permitted to recover a return on its investment in the 38 CIIP infrastructure projects, the associated depreciation charges, and related administrative costs through a CAC surcharge mechanism. The associated monthly revenue requirement and CAC revenues are subject to a monthly true-up, with interest. Significantly, in addition to a defined set of projects, the CAC surcharge mechanism also had a definite end date. The CIIP stipulation of settlement provided that once the projects were rolled into base rates, the "electric and gas CAC rates and tariffs will be recalculated to bring the balance to zero over a reasonable period of time and such rates and tariffs will terminate upon reaching a zero balance." *RC-85,* stipulation p. 9. In summary, the CAC was established for a very specific purpose over a set period of time.

[28] PSE&G's filed economic stimulus proposal is known as the Capital Infrastructure Investment Program ("CIIP") and is referred to by PSE&G in testimony here as its Capital Economic Stimulus Infrastructure ("CESI") Investments Program.

The significance of the departure from traditional rate base/rate of return ratemaking principles and the extraordinary ratemaking treatment afforded the 38 CIIP projects was not lost on the Board. The Board carefully limited the scope of its ruling adopting the stipulation of settlement. In its Order establishing the CAC mechanism, the Board specifically noted the extraordinary rate treatment afforded the infrastructure projects underlying the CAC as well as the dire state of the economy at the time:

> The Board recognizes that the acceleration of utility infrastructure projects and the treatment of capital expenses on an expedited schedule outside the purview of a rate case is not part of the normal course of utility regulation. However, these are not ordinary times. In his address to the Legislature on October 16, 2008, the Governor called upon the Board to help facilitate job growth and assist in New Jersey's economic stimulus program. The Board, in turn, called upon the State's public utilities to formulate plans for enhanced investments in infrastructure that would both increase reliability and promote employment. The Board takes notice of the fact that the financial markets remain volatile, affecting the utilities' ability to fund incremental infrastructure projects within the usual framework which requires that capital expenditures be recovered through a rate case only after projects are completed. N.J.S.A. 48:2-21. It is within a rate case that the property that is used and useful in the utility's provision of service is evaluated, and the expenses that can become components of just and reasonable rates are determined. In re Investigation of Tele. Cos., 66 N.J. 476 (1975). These difficult economic times require creative responses that respect the law but adapt to extraordinary circumstances**.** In the past, the Board has found that it has the power to act to meet such challenges. N.J.S.A. 48:2-13; In re Implementation of the Two Bridges/Ramapo Water Diversion Project, BPU Docket No. 8011-870 (March 17, 1981). The Board continues to have that power.

RC-85 at 8.

Furthermore, the Board clearly stated that the CAC rate recovery mechanism approved for PSE&G's 38 CIIP projects did not set a precedent: "This [CAC] authorization in no way sets a new framework for future actions; instead, it reflects the realities of today's economic situation." *RC-85*, PSE&G CIIP Order, p. 10 Thus, the present CAC represents a limited departure from traditional ratemaking principles in an effort by the utilities and the BPU to stimulate utility infrastructure investment during a crippling nationwide credit crunch and the worst economic recession since the Great Depression.

Now, PSE&G proposes to expand the CAC with an "Infrastructure Tracker" intended to extend the CAC's clause-type rate recovery to encompass the Company's <u>routine</u> capital expenditures going forward, with the exception of projects designed to accommodate revenue growth. *P-7*, p. 15-17. Notwithstanding the unique nature of the CIIP program and the Board's pronouncements, PSE&G proposes to take the extraordinary ratemaking treatment afforded the CIIP projects and make it routine.

PSE&G's proposed expansion of the CAC to routine capital infrastructure projects would violate one of the most basic principles of rate base/rate of return ratemaking, the matching principle, whereby all elements of the revenue requirement (<u>e.g.</u> expenses and revenue) are matched for a particular period of time. The Company's CAC expansion proposal would result in single-issue ratemaking that will have a significant impact on utility rates. Under PSE&G's CAC expansion proposal, the Company's additional infrastructure costs would be recovered from ratepayers without a corresponding review of revenues and other costs. It is not inconceivable that future revenues might increase as the economy improves, nor is it inconceivable that other utility costs might decrease over time. In addition, there are other rate base components that continually offset increases in plant in service, such as accumulated depreciation and the accumulated deferred income tax reserve. However, such changes would not be captured to offset the increase in CAC charges under the Company's proposal. The effect of such a radical change was noted by Rate Counsel witness Ms. Crane, who recommended that it should be rejected:

> This proposal represents a significant and fundamental change in the manner in which a utility's investment is recovered. Moreover, this proposal only addresses one element of the ratemaking equation. By attempting to charge ratepayers for investment made between base rate cases, including projected investment, PSE&G is dismantling the regulatory process that attempts to match investment, expenses, and revenues. As such, this proposal violates the most basic principle of ratemaking and should be rejected.

RC-131, p. 105

If implemented, PSE&G's proposal to expand the CAC would represent a significant departure from traditional rate base/ rate of return principles. In fact, PSE&G would be alone among New Jersey's electric and gas utilities if its CAC expansion proposal were approved.

B. PSE&G's Proposed Expansion of the CAC Would Shift Risks to Ratepayers and Remove Any Incentive To Control Costs.

PSE&G refers to its CAC expansion proposal as the "Investment Tracker" and it is but one of several clause-type mechanisms proposed by the Company in the instant case. The negative practical effects of expanding the CAC were noted by Rate Counsel witness Ms. Crane:

> The Company's proposal is nothing more than another attempt to shift risk from shareholders to ratepayers and to relieve management of its responsibility to manage the Company appropriately. Furthermore, implementation of a CAC-like mechanism would remove a powerful incentive for utility cost control between rate cases.

RC-131, p. 104

Insofar as capital additions placed in service between rate cases involve utility cash outlays without contemporaneous rate recovery, there is an understandable incentive for utility management to conserve resources. Further, Ms. Crane quantified the extent to which the expansion of the CAC would shift risk to ratepayers:

> Expanding the CAC to include additional distribution plant investment between base rate cases would significantly increase the costs that the Company recovers through tracking mechanisms, thereby further decreasing shareholder risk. At the present time, the Company already collects well over 70% of its revenue requirement on a dollar-for- dollar basis through clause type mechanisms. As shown in Schedule SS-E9 R-1, PSE&G's present distribution revenue is approximately $1.135 billion, yet its electric distribution revenue comprises only 21.5% of its total electric sales revenue, as reflected on Mr. Kahrer's schedule. (Schedule MGK-19 R-1.) Similarly, as shown in Schedule SS-G8 R-1 [PSE&G witness Mr. Swetz], its present gas distribution revenue is approximately $668.874 million, yet its gas distribution revenue comprises only 26.7% of its total gas sales revenue as shown on Mr. Kahrer's schedule. (MGK-19 R-1.) Thus, PSE&G's shareholders are already insulated from the risk for the vast majority of the Company's costs.

RC-131, p. 105

Thus, a large percentage of PSE&G's utility revenue is collected through clause-type mechanisms and the expanded CAC proposed by PSE&G would shift even more risk to utility ratepayers.[29] With respect to only capital project expenditures, Rate Counsel witness Mr. Lelash found that if PSE&G's CAC expansion proposal were adopted, approximately 85% of all of the Company's forecasted capital expenditures through the end of 2010 would receive rate treatment through the CAC, rather than through traditional rate base/rate of return recovery. *RC-22*, p. 22. Both Ms. Crane and Mr. Lelash concluded that PSE&G's proposed expansion of the CAC should be rejected. *RC-22*, p. 10, 22; *RC-131*, p. 107.

[29] Adjusted for updates, as shown in Schedule SS-E9 R-2, PSE&G's present distribution revenue is approximately $1.124 billion, yet its electric distribution revenue comprises only 23.3% of its total electric sales revenue, as reflected on Mr. Kahrer's updated schedule. (Schedule MGK-19 R-3.) Similarly, as shown in updated Schedule SS-G8 R-2 [PSE&G witness Mr. Swetz], its present gas distribution revenue is approximately $677.307 million, yet its gas distribution revenue comprises only 24.9% of its total gas sales revenue as shown on Mr. Kahrer's updated schedule. (MGK-19 R-3.)

In sum, expansion of the CAC to include additional distribution capital expenditures between base rate cases would amount to single-issue ratemaking, and would unfairly shift risk from shareholders to ratepayers. Ultimately, as calculated by Ms. Crane, PSE&G's expansion proposal would cost ratepayers millions of dollars in higher utility bills. For all of the above reasons, PSE&G's proposal to expand the CAC with an "Infrastructure Tracker" should be denied.

POINT IX

PSE&G SHOULD BE REQUIRED TO UTILIZE A STANDARDIZED SYSTEM OF METRICS THAT MEASURE THE QUALITY OF AND IMPROVEMENTS IN ITS CUSTOMER SERVICE.

A. Good Customer Service Is an Essential Obligation of a Public Utility. Service Metrics are the Most Accurate and Efficient Method of Measuring the Quality and Improvement of that Service.

New Jersey law requires that a public utility provide safe, adequate and proper service to its customers. N.J.S.A. 48:2-23; N.J.A.C. 14:3-3.1(a). PSE&G's customer service has deteriorated over the past few years, particularly since the installation of its new computer system ("System X")[30] in early 2009. *T24:L25*; *T25:L1-20*; *T29:L17-25*; and *T30:L1-14*. "System X" is a customer information system, put into service on April 1, 2009. *T18:L21*; *RC-1*. It replaced the Company's previous system with an upgraded interactive voice response unit, and a new service web site. *T19:L2-3*. "System X" included various new technologies to improve collections, information management, scheduling and customer service. *Id.* Joseph Forline, vice-president of customer operations for PSE&G, testified that "the customer care system is to provide customer service personnel with "real-time" information and allow customers to "manage their relations with PSE&G at their convenience via the enhanced self-service web site and interactive voice response unit." *T19:L3-21*. Mr. Forline admits, however, that its service has deteriorated since the installation of the new system. However, the Company refuses to agree to use the performance plan used by other gas companies to improve service. *P-10-RP,* p. 2; *T18:L21-22*. With all the changes in the utility industry in the past few years,

[30] During hearings PSE&G's counsel requested that the Parties refer to their customer care system as "System X".

regulators have increasingly established service quality standards in order to allow them to track Company performance, address performance deficiencies and require utilities to comply with their statutory obligations. PSE&G should be required to follow such standards.

Historically the Board of Public Utilities required utilities to submit a "Report Card" that tracked company performance of customer service; however, the Report Card was recently terminated. There is currently no transparent comparative process by which the Board can track utility performance. As Company witness Mr. Forline has admitted, PSE&G's customer service has deteriorated in the past year. *P-10-RP,* p. 2. In order to ensure that the Company's service improves, the Board should impose upon PSE&G a performance plan which contains customer service metrics or benchmarks to track performance and ensure service improvement.

Rate Counsel has been recommending a performance plan for gas utilities for several years, particularly since the abolition of the Board's Report Card. In its 2007 base rate case, New Jersey Natural Gas Company agreed to submit quarterly reports to the Board and Rate Counsel to demonstrate the performance of its call center, its meter reading and billing, its field operations and overall service. <u>I/M/O Petition of New Jersey Natural Gas Company for Approval of an Increase in Gas Rates</u>, BPU Docket No. GR071100889, p. 6, Decision and Order, October 3, 2008. Since this was the first gas utility ordered to file performance reports, numerical metrics were not set at that time. By the time Elizabethtown Gas Company filed its base rate case in 2009, Rate Counsel's recommended performance plan included service metrics and benchmarks. The parties stipulated, and the Board approved, the proposed metrics. <u>IMO Petition of Pivotal Utility</u>

Holdings, Inc.. d/b/a Elizabethtown Gas for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions, BPU Docket No. GR09030195, p. 6, Decision and Order (12/17/09), Stipulation, p. 8, Appendix A. Since the approval of those Stipulations, the two gas companies have been reporting performance results quarterly to the Board and Rate Counsel.

B. Deterioration of Customer Service Performance

Historically, PSE&G's customer service performance was adequate. *RC-2,* p. 10. The Company has an internal tracking system (the "Balanced Scorecard"), in which it tracks numerous performance measures with specific annual targets to be achieved. *RC-1,* p.8. PSE&G also tracks other performance measures and coordinates a national panel that produces an annual Utility Peer Panel Study with key measures across utilities. *Id.* at 9-10. However, while this is a commendable start, PSE&G's Balanced Scorecard is flawed in several important respects. Although the scorecard tracks a number of important performance measures such as billing accuracy and call abandonment percentage, these measures may not have specific targets or benchmarks. *RC-21B,* p. 9. All measurements, not just a portion of them, must have specific performance targets as they represent the core of customer service performance and determine whether the company is meeting industry service standards.

Although the Company tracks performance, it does not share either the documents or the information with the Board. *RC-1,* p.11. They are essentially internal documents that the Company uses to measure and improve its operations, financial position, employee development and safety, and customer satisfaction, providing an accountability tool for management and employees. *Id* . There is no comprehensive record of

PSE&G's service performance for Board review, which is of particular concern, given the deterioration of service since the installation of "System X".

It is essential that PSE&G be required to adopt and meet certain essential industry standard service metrics and benchmarks, which are not included in its current service metrics scorecard, and it should further report all performance results to the Board and Rate Counsel to ensure regulatory review and the provision of safe, proper and adequate service to New Jersey customers.

The goal of requiring PSE&G to adopt and report on service metrics recommended by Rate Counsel is to further improve the utility's service quality performance as related to its customers. Rate Counsel has not recommended the assessment of penalties should PSE&G fall below the recommended industry metric and benchmark. However, the Board should address a utility's persistently deficient performance in meeting industry standard metrics and benchmarks. PSE&G should be required to monitor and report its service metrics, incorporating the measures recommended by Rate Counsel. Rate Counsel's recommended metrics and benchmarks are generally accepted industry standards and are therefore reasonable. *RC-22*, p. 24. PSE&G should not have a problem meeting any one of Rate Counsel's recommended metrics. PSE&G's implementation of "System X" should further enhance its ability to initiate and track the industry metrics and benchmarks with little, if any, additional hardship or expense to PSE&G. Finally, Rate Counsel strongly urges the implementation of "exception reporting" to allow evaluation of service performance and to assess if remedial action may be required by the Board.

C. Rate Counsel's Recommended Metrics And Benchmarks Should Be Tracked And Recorded On A Monthly Basis And Reported To The Board And Rate Counsel Quarterly.

PSE&G has fallen short of the following benchmarks, which are reasonable, and common industry standards which PSE&G should be able to meet:

1. Service Appointments Met or Appointment Attainment - Rate Counsel notes that PSE&G has only maintained data on service appointments met for its unregulated appliance service activities. Such tracking is irrelevant in a regulatory context. The Company should maintain metrics of its *regulated* activities. The metrics should allow customers to specify an appointment, during one of four intervals on days other than Sundays and holidays as the basis for measurement. The typical benchmark is 95% met. *RC-22,* p. 24-25. This is a measure of percentage of appointments completed on the day scheduled and includes meter installations, disconnects and reconnects, billing investigations, initial and final meter reads. *RC-21B,* p. 1.

2. Safety / Reliability **-** The metric for response time for customer gas leak calls is normally a 95% response within 30 to 60 minutes. *RC-22,* p. 24. PSE&G's response time currently meets this benchmark and should continue to do so. Rate Counsel recommends that PSE&G be required to file exception reports[31] when its 60 minute response time is not achieved. *RC-22,* p. 25. Such reporting requirements are reasonable and consistent with PSE&G's requirements under the "Service call scheduling" section of N.J.A.C. 14:3-3.8 and will disclose any instances where an excessive response time occurred even if PSE&G has achieved excellent response time averages.

[31] "Exception reporting" is a report submitted by the Company when it fails to respond to a leak response call within its 60 minute requirement. Such reporting will disclose instances where response time has been excessive even if the Company has achieved excellent response time averages. *RC-22,* p. 25.

3. Average Speed of Answer ("ASA") at Call Centers **-** A typical target benchmark is 80% of calls answered in 30 seconds. Rate Counsel noted that PSE&G's Scorecard target has varied annually, and has generally been in the 75% range. *RC-21B,* p. 12.

4. Customer Service Representative Response, a companion measure to the ASA Rate, is the average amount of time in seconds it takes to reach a customer service representative. Although Rate Counsel is not recommending a benchmark or target for this measure at this time, Rate Counsel recommends that the metric be reported and monitored. *RC-21B,* p. 13.

5. Abandoned Call Percentage ("ACP") **-** PSE&G Call Centers should have a benchmark of 5% or fewer calls abandoned. ACP is not a PSE&G Balanced Scorecard measure and the Company has no established target. *RC-21B,* p. 13*; RC-22,* p. 28. Although PSE&G met the recommended benchmarks in 2007 and 2008, it has not meet the benchmark for 2009. *RC-21B,* p. 13.

6. Meter Reading - The industry standard is a recommended percentage of meters read, with a benchmark of 95% of meters read on cycle.[32] PSE&G has consistently achieved an average of about 90% meters read, but has failed to meet the industry benchmark. *RC-22,* p. 26.

7. Billing accuracy - The measure for billing accuracy is the number of rebills per 1,000 customers measured as all bills mailed to customers that are later adjusted, cancelled, or re-issued for any amount or reason. The benchmark is 20 or fewer rebills per 1,000 customers. *RC-22,* p. 26. As shown by the data submitted by Rate Counsel,

[32] Utility bills are not billed on a calendar month, but rather on a monthly cycle, such as March 10 to April 9.

there have been quarters when average rebills have exceeded 23 per 1,000 customers. PSE&G should meet the industry benchmark. *RC-22, at Schedule 4,* p.2.

8. Overall Customer Service and Satisfaction - Rate Counsel recommends a fairly common industry benchmark of less than 1 complaint to the BPU per 1,000 customers annually as a good measure of overall performance. *RC-21B*, p. 15. While PSE&G complaints were consistent during the period under review, PSE&G did not meet the industry benchmark. *RC-22, Schedule 6;* RC-21B*, Exhibit DCP-1.*

Rate Counsel strongly recommends that PSE&G continue to track and report complaints by root cause category, such as billing, collections, and so forth in order to bring PSE&G in compliance with industry benchmarks.

D. The Board should require PSE&G to use the Service Performance Format recommended by Rate Counsel as opposed to its internal Balanced Scorecard.

PSE&G has agreed to provide to the Board periodic updates of the Company's performance results. *P-10-RB,* p. 4. However, the Company has rejected Rate Counsel's proposed standards. *Id.* The Company's Balanced Scorecard internally tracks a number of the benchmarks recommended by Rate Counsel. *T13:L8*. Mr. Forline testified that the information tracked by the Balanced Scorecard enables the Company to "have a thorough understanding of its service maintenance level, and is a critical tool for setting the Company's internal service goals and objectives, and is the basis for the evaluation and compensation for Company officers and employees. " Id. at 8. Although the Balanced Scorecard measures internal performance for several purposes, none of those metrics measure customer service. Without the Board's now defunct Report Card, the Board has no comparable method by which to measure Company customer performance.

Mr. Forline admits that the Company collects many of the statistics Rate Counsel recommends. However, he objects to the proposed format because he believes it would be "unnecessary" and would impose "unnecessary burdens" for the Company to reformat the data. *T13:L19-21*. Given the cost of the installation of "Service X", it is difficult to accept that providing such data is overly burdensome, or unjustified given the benefits that would result from analysis of that data. Quarterly reporting based on the proposed plan would allow the Board to track customer assistance performance in order to ensure that an underperforming utility improves from quarter to quarter. It would also allow the Board to take action against a utility whose performance does not improve. These benefits clearly outweigh any "burden" to the Company.

The Board should require PSE&G to adopt a service performance plan, such as that adopted by ETG and NJNG, which has specific, well-defined service metrics and benchmarks for standards that the company should meet. *RC-1,* p. 12. Many of the metrics set forth in that plan, as Mr. Forline has testified, are currently or will soon be tracked by the Company. Even if the Company collects the information, it is essential that all the data, set forth in a Board-approved format, are reported quarterly to the Board and Rate Counsel so PSE&G's performance can be monitored.

Allowing the Company to choose its own format, as well as the statistics it chooses to collect, fails to meet the safe, adequate and proper service required by New Jersey regulation. The Board should adopt the performance plan proffered by Rate Counsel, which is already being used by two other gas utilities.

E. Conclusion

Industry standard service metrics and benchmarks are necessary to ensure quality service. These benchmarks are paramount tools in gauging PSE&G's performance in providing safe, adequate and proper gas and electric service to New Jersey customers. The adoption of Rate Counsel's recommendations will ensure that the Board and Rate Counsel can properly assess PSE&G's performance in these areas of customer service, and will assist the Board in its duty to ensure that PSE&G is meeting industry standards in providing service to its customers. For the foregoing reasons, Rate Counsel respectfully requests that PSE&G be required to utilize the above recommended service metrics and benchmarks and to monitor and report the data to the Board and Rate Counsel on a quarterly basis.

POINT X

RATE COUNSEL RECOMMENDS THAT PETITIONER INVEST IN IMPROVEMENTS THAT ARE COST-EFFECTIVE AND IMPROVE THE RELIABILITY OF ITS POOREST-PERFORMING ELECTRIC CIRCUITS.

Petitioner has failed to establish[33] that it has satisfied the Board's Electric Distribution Service Reliability and Quality Standards by ensuring the reliable performance of all its circuits or improving its distribution reliability. *See,* N.J.A.C. 14:5-8.1(c), -8.2(a), -8.3(b), and -8.5.[34]

Service reliability is among the issues to be determined in this matter, Prehearing Order, ¶¶ 1.B.8, ¶ 9, as it is in any base rate case, Matter of Valley Road Sewerage Co., 154 N.J. 224 (1998); Township Committee of Lakewood Twp. v. Lakewood Water Co., 54 N.J. Super. 371 (App. Div. 1959). Any rate charged for inadequate service is unreasonable. [35]

The undisputed evidence shows that approximately 300, or about 15%, of Petitioner's electric circuits performed below its own reliability standards from 2006 through 2008.[36] Dozens of these circuits under-performed for more than one year. *RC-36-A, p. 4 lines 2-5 (citing Ex. Attachment CPS-C).* Petitioner's use of divisional average

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[33] "The burden of proof to show that the [proposed rate] increase ... is just and reasonable [is] upon the public utility making the same." N.J.S.A. 48:2-21(d); see In re Public Service Elec. and Gas Co., 304 N.J. Super. 247, 265 (App. Div. 1997), certif. den., 152 N.J. 12 (1998); Public Service Coordinated Transport v. State, 5 N.J. 196 (1950).
[34] The Electric Service Reliability Standards, N.J.A.C. 14:5-8.1 to 8.12, mandate that each electric distribution company provide reliable service, improve its distribution reliability, exceed its minimum standards, and ensure the reliable performance of all its circuits. See N.J.A.C. 14:5-8.1, -8.2, -8.3, and -8.5.
[35] Based upon the review by Rate Counsel's witnesses, PSE&G's gas operations appear to function in a safe and responsible manner
[36] Direct Testimony of Mr. Charles P. Salamone of Cape Power Systems Consulting, LLC, 11/19/09, *RC-36-A, p. 3 line 18 to p. 4 line 5*; see *Id.* Ex. Attachment CPS-B, CPS-C; *RC-28.*

statistics obscures the chronic unreliability of some circuits, and under-reports the number of residents and businesses who experience disrupted service.

Petitioner's service area includes the most densely populated areas of this most densely populated state. *P-1, Sched. 1, Orig. Sheets 4-7.*[37] Unreliable service on even a few circuits or for even a few customers can cause disruption for large numbers of ratepayers.

The number of people inconvenienced by unreliable service to a single "customer" varies with the wide variety of Petitioner's customer types, since a "customer" can be a large business or a single family home. *P-1, Sched. 1, First Revised Sheets 16-17, ¶¶ 3.8.1, 3.8.2, 3.8.3.*[38] For example, during the power failures in downtown Newark on Tuesday, June 30, 2009, 248 customers lost electric service for over two hours; one lost power for almost five hours. *RC-26, pp. 4, 9.* The most unfortunate customer that day was the Robert Treat Hotel.[39] *Id.* at p. 4. In another power failure on the previous day, Monday, June 29, 2009, the inconvenienced customers included a busy government office, i.e., the Board itself, in Gateway II. *Id.* at p. 3. Petitioner counted the Robert Treat Hotel and the Board as only two disrupted customers, but those power failures deprived many customers and employees of reliable service.

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[37] See United States Census Bureau, United States -- County by State, and for Puerto Rico, Table GCT-PH1, "Population, Housing Units, Area, and Density: 2000" (e.g., population density of Petitioner's service areas of Hudson, Essex, Union Counties), available at http://factfinder.census.gov/servlet/GCTTable?_bm=y&-ds_name=DEC_2000_SF1_U&-CONTEXT=gct&-mt_name=DEC_2000_SF1_U_GCTPH1_US9&-redoLog=false&-_caller=geoselect&-geo_id=&-format=US-25|US-25S&-_lang=en (last viewed Mar. 2, 2010).

[38] *P-1, Sched. 1, First Revised Sheet Nos. 16-17, ¶¶ 3.8.1, 3.8.2, 3.8.3*, Standard Terms and Conditions for individual residential customer, multi-unit developments, and individual commercial and industrial customers.

[39] The Robert Treat has 170 rooms on 15 floors. http://www.rthotel.com/accomodations.html (last viewed 3/12/10).

Petitioner does not have and does not propose a program to ensure the reliable performance of all of its circuits. Instead, it has tried to improve only that small percentage of its least reliable circuits mandated at the time by the Board's Remediation – Poorest Performing Circuits program. *P-3-RB-A,* p. 4. Each year from 2001 to 2006, Petitioner tried to improve the reliability of only 2% of its worst-performing circuits. *Id.* This averaged 44 circuits each year. *Id.* at p. 4 lines 11-13. Since 2007, Petitioner has complied with the Board's mandate to improve the performance of 4% of its lowest performing circuits, averaging 89 circuits per year. *Id.* at p. 4 lines 18-20.

Petitioner should review and adjust its project selection process to concentrate on improving reliability in specific areas, by considering large-scale projects separately from local area reliability and capacity problems. After reviewing its project selection process, Petitioner should report its proposed revision of that process to Board Staff and Rate Counsel for their review and recommendations for adjustment to the process. Petitioner can thereby remedy the poor reliability that persists on dozens of circuits.

Petitioner should measure the reliability of its network using non-traditional performance metrics that consider the actual number of people and businesses adversely affected by unreliable service. Petitioner should report proposed alternative reliability performance metrics to Board Staff and Rate Counsel for their review and recommendations for adjustment to those metrics.

In summary, Petitioner has failed to show, as mandated by the Board's Electric Reliability Standards, that it has improved the reliability of its least reliable circuits or ensure the reliable performance of all its circuits. *See,* N.J.A.C. 14:5-8.1(c), -8.2(a), -

8.3(b), and -8.5. Rate Counsel recommends that Petitioner invest in improvements that are cost-effective and improve the reliability of its poorest-performing electric circuits.

POINT XI

GRANTS OR EXTENSIONS OF PREFERENCES, INCLUDING THOSE INVOLVING PSEG POWER AND MEG MEMBERS, SHOULD ONLY BE ALLOWED IN LIMITED CIRCUMSTANCES BASED ON EXPLICIT FINDINGS.

The Morris Energy Group ("MEG") is proposing to establish a special tariff to be available to electric generators taking natural gas distribution service from PSE&G. MEG is an independent power producer which operates four electric generation facilities in PSE&G's service territory. Two of these facilities receive natural gas distribution service under Board-approved special contracts with PSE&G. *P-14-RB, p. 6.* The other two facilities receive service under PSE&G's Rate Schedule TSG-NF. *ECG-1A, p. 2*. MEG presented testimony in which it asserts that the two MEG facilities being served under Rate Schedule TSG-NF receive service that is lower in quality, but at a higher price, than the service provided to PSE&G's affiliate PSEG Power. MEG asserts that PSE&G has engaged in undue discrimination, and that such discrimination has resulted in a competitive disadvantage for MEG in New Jersey's wholesale electricity market. *ECG-1A, p. 2-3; ECG-3A, p. 5-6, 8-9.*

MEG is proposing that the Board create a new electric generation tariff, available only to electric generators, that would permit PSE&G to offer discounted rates for natural gas distribution service based on several factors including "whether the discount will further the accomplishment of the energy, environmental, economic and public utility regulatory goals of the State of New Jersey …." *ECG-1A, Exhibit JRR-3, proposed Special Provision (m).* Although N.J.S.A. 48:3-60 discusses the Societal Benefits Charge ("SBC") as a non-by passable, the proposed tariff would further authorize PSE&G to waive the SBC, as well as the Regional Greenhouse Gas Initiative ("RGGI") Recovery Charge, and CAC for customers receiving discounted rates. *Id.*

MEG proposes that PSEG Power and all electric generators presently being served under Rate Schedule TGS-NF be moved to the new tariff. *ECG-1A, p. 3.* Customers receiving discounted rates under special contracts, including the MEG facilities with special contracts, would continue to receive service under those agreements. *Id.*

MEG's proposal to establish a special rate class for electric generators should be rejected based on the present record. As noted above, MEG is proposing a special tariff that would be available only to electric generators, and would permit the granting of rate discounts for reasons that may include broad policy goals such as supporting the development of the wholesale electric market and improving the environment. Such a special tariff would have broad statewide implications that have not been adequately explored in this proceeding. If the Board wishes to consider such a tariff, it should do so only in a proceeding, with notice to all interested stakeholders, in which it can fully evaluate whether a special electric generation tariff such as that proposed by MEG is an appropriate means for furthering the relevant State policies.

South Jersey Gas Company ("SJG") has an "Electric Generation Service – Large Volume" tariff that was presented at the evidentiary hearing as "similar" to the one being proposed by MEG in this proceeding. *ECG-15;* T955:L4-14. (2/24/10). SJG's tariff was approved by the Board as part of a Stipulation. <u>I/M/O the Petition of South Jersey Gas Company for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions,</u> BPU Docket Nos. GR03080683 & GR00050285, Order Adopting

Stipulation and Initial Decision at 4-5 (July 8, 2004). The SJG tariff has some similarities to, but is not identical to, the one being proposed by MEG in this matter. For example, SJG's tariff includes an explicit requirement for Board approval of negotiated rates, and does not explicitly contemplate the granting of preferences in order to further broad "energy, environmental, economic and public utility regulatory goals …." *ECG-15, Special Provision (e); EGC-1A, Exhibit JRR-3, proposed Special Provision (m).* These provisions differ from the provisions in MEG's proposed tariff.[40]

While Rate Counsel opposes MEG's proposed new tariff provisions, Rate Counsel is in agreement with the proposition that utility service should be provided without unreasonable discrimination or undue preferences. This principle, in effect in New Jersey since the enactment of the Public Utility Act of 1911, L. 1911, c. 195, sec. 18, is currently codified as N.J.S.A. 48:3-1 and 48:3-4. City of Plainfield v. Public Service Electric and Gas Co., 82 N.J. 245, 247, 252 (1980). Utilities may not "[m]ake, impose or exact any … unjustly discriminatory or unduly preferential individual or joint rate" nor may they "[a]dopt or impose any unjust or unreasonable classification" in establishing rates. N.J.S.A. 48:3-1. They may not "make or give, directly or indirectly,

[40] SJG's Firm Electric Service (FES) rate schedule, which is available to large electric generators, also includes "rate flex" language that differs from that proposed by MEG. SJG Tariff for Gas Service, B.P.U.N.J. No. 9, First Revised Sheets 33-39, special provision (j) at Sheet 36. New Jersey Natural Gas Company ("NJNG") and Elizabethtown Gas Company ("ETG") both have Board-approved rate schedules that apply only to electric generators, but these do not include "rate flex" provisions such as those being proposed by MEG. NJNG Tariff for Gas Service, B.P.U. No. 8, Rate Schedules Distributed Generation-Residential (DGR), Original Sheets 54-55, Distributed Generation-Commercial (DGC), Original Sheets 65-68, and Firm Cogeneration (FC), Original Sheets 71-73; ETG Tariff for Gas Service, B.P.U. No. 14, Rate Schedules Electric Generation Firm Service (EGF), Original Sheets 53-55, and Cogeneration Service-Interruptible (CSI) (supply service closed to new customers), Original Sheets 58-60. PSE&G's Rate Schedule CIG – Cogeneration Interruptible Service, a bundled gas distribution and supply service that is closed to new customers, has no "rate flex" provisions. *P-1, Schedule 4,* Original Sheets 101-105; *P-14-RB, p. 4-5.*

any undue or unreasonable preference or advantage to any person" nor may they "subject any particular person … to any prejudice or disadvantage." N.J.S.A. 48:3-4.

Consistent with the prohibitions on unreasonable discrimination and undue preference, it has been the Board's long standing practice to allow special rates only after a contested proceeding, in which the Board makes explicit findings as to the factual justification and legal authority granting the special rate. See, e.g. I/M/O the Petition of PSE&G Company for Approval of an Experimental Hourly Energy Pricing Tariff, and the Joint Petition of SE&G and Co-Steel Raritan for Approval of a Related Service Agreement and Protective Order, BPU Docket No. ER95010005 (Nov. 17, 1995), appeal dismissed, N.J. Super. App.Div., Docket No. A-2513-95T5 (July 23, 1996). Any rate discounts or other preferences granted to MEG or any other PSE&G customers, including any waivers of the SBC, RGGI and CAC charges, should be considered in a contested proceeding. Preferences should be granted only if justified by explicit findings of fact, and with proper legal authority as found by the Board. Your Honor and the Board should further affirm that a contested proceeding and appropriate findings by the Board are required in order to extend the duration of a contract granting a preference. To the extent any of PSE&G's special contracts with MEG or other generators contain "evergreen" provisions that automatically extend the term of the contract in the absence of an objection by either party, the Company should be directed to seek Board approval before continuing in any such automatic extensions.

The same standards that apply to PSE&G's other natural gas distribution customers should also apply to PSEG Power. As acknowledged in the testimony of PSE&G witness Mr. Gerald W. Schirra, PSEG Power receives natural gas distribution service under an arrangement that was first approved by the Board in 1995, when PSE&G was still an integrated utility providing bundled electric distribution and generation service. *P-14-RB, p. 10-11.* When PSE&G's electric generation assets were transferred to PSEG Power as part of New Jersey's energy industry restructuring, the transfer was subject to PSEG Power's agreement to provide the electric power needed for PSE&G to provide Basic Generation Service ("BGS") to its customers who did not purchase generation service from a competitive supplier during the 3-year period when PSE&G remained obligated to provide BGS. *ECG-9* p. 120-122. In order to assure the reliability of BGS following transfer of generating assets to PSEG Power, the Board directed PSE&G to continue to provide natural gas distribution service to PSEG power under arrangement that had been approved in 1995. *Id.*, p. 122, par. 22.

This arrangement was not reviewed further until 2007, when the monthly "reservation fee" paid by PSE&G Power for distribution service was increased from 27.4 cents to 42.5 cents per dekatherm as part of the Board-approved Stipulation in PSE&G's 2006-07 Basic Gas Supply Service ("BGSS") proceeding. That Stipulation provided that the agreed pricing would take effect on the first day of the month following Board approval, and remain in effect for a minimum of three years. *ECG-13, par. 4 of Stipulation.* The Stipulation was approved by Order issued July 12, 2007. *EGC-13.* Thus, the minimum three-year term ends on July 31, 2010 and the arrangement will be subject to review after that date. Any preferential pricing or other terms of service provided to PSEG Power after July 31, 2010 should be considered in a contested proceeding before the Board, and any continued preference should be based on specific factual and legal findings as outlined above.

POINT XII

RATE COUNSEL'S RECOMMENDED ELECTRIC RATE INCREASE AND GAS RATE DECREASE SHOULD BE IMPLEMENTED BASED ON RATE COUNSEL'S RECOMMENDED CLASS REVENUE ALLOCATION AND RATE DESIGN PRINCIPLES.

PSE&G's Petition in this matter included Electric and Gas cost-of-service studies prepared by the Company's witness Mr. Stephen Swetz. *P-8-R-1; P-9-R-1.* However, rather than strictly applying the results of the studies, the Company used the study results only as a general guide in developing its proposed allocation of its proposed electric and gas rate increases. *P-8-R-1,* p. 43-44*; P-9-R-1,* p. 31. While Rate Counsel is not endorsing the Company's studies, Rate Counsel witness Brian Kalcic believes that the Company's studies are adequate as a general guide for allocating Rate Counsel's proposed $17.9 million electric rate increase and $1.3 million gas rate decrease. *RC-113,* p. 7-8, 20.

Mr. Kalcic's prefiled testimony included specific class revenue allocations based on Rate Counsel's "6+6" and "12+0" revenue requirements positions. *RC-112,* p. 2*, RC-113,* p. 2. Since Rate Counsel's recommendations have changed as a result of the parties' settlement of several issues, the discussion below will present Rate Counsel's proposed class revenue allocations based on Rate Counsel's current position as shown in the schedules in the Appendix attached to this Brief.

The illustrative electric and gas rate designs and proofs of revenue presented in Mr. Kalcic's prefiled testimony also were based on Rate Counsel's "6+6" and "12+0" revenue requirements recommendations, which have now changed. *RC-112,* p, 2*; RC-113,* p. 2. Mr. Kalcic's rate designs and proofs of revenue were illustrative only, because

PSE&G did not provide "12+0" billing determinants that would tie to the thirty-year weather normalized weather forecast utilized by Ms. Crane. As a result, Mr. Kalcic was unable to develop a set of recommended electric and gas rates or electric and gas proofs of revenue corresponding to Rate Counsel's "12+0" electric and gas revenue requirements positions. *RC-113,* p. 2. For these reasons, the discussion below will present the general principles that should be applied in developing electric and gas rate designs based on Rate Counsel's current position.

A. Electric Class Revenue Distribution and Rate Design

Rate Counsel's proposed allocation of its recommended electric rate increase is shown on the attached Schedule BK-2E (Brief) in the appendix attached to this brief. This schedule follows the same format, and reflects the same methodology, as Mr. Kalcic's Schedule BK-2E-Update (2/26/10), which is in the record as part of Mr. Kalcic's Revised Direct Testimony (12+0). *RC-113.* As shown on Schedule BK-2E (Brief) in the appendix attached to this brief, Rate Counsel is proposing an increase in electric distribution revenues of approximately $21.4 million. However, as shown on lines 17 through 20 of Schedule BK-2E (Brief) in the appendix attached to this brief , Rate Counsel has agreed to increases in the Late Payment Charge, Field Collection Charge and Reconnection Charge that will produce approximately $3.5 million in revenues, leaving approximately $17.9 million to be allocated among the Company's electric distribution rate classes.

Rate Counsel proposes to allocate this amount in a manner similar to Company's allocation of its proposed rate increase – with rate increases ranging from 0.5 to 1.5 times the system average of 1.59%. *See RC-113,* p. 7-8. Rate Counsel's proposed allocation of the $17.9 million to be allocated to rate classes is shown in column 2, lines 1 through 15 of Schedule BK-2E (Brief) in the appendix attached to this brief. As shown on the schedule, below average increases are allocated to classes shown as over-contributing, including the smaller commercial and industrial rate classes, and above-average increases are allocated to classes shown as under-contributing, including the residential class.

Mr. Kalcic's "12+0" Revised Direct Testimony was based on a proposed electric rate increase of approximately one tenth of one percent. *RC-113,* p. 8. In light of the very small magnitude of this proposed increase, Mr. Kalcic recommended that the rate increase allocated to each class be assigned to each class's fixed monthly service charge. *RC-113,* p. 10, 11, 12. Since Rate Counsel is now proposing a more substantial increase in electric distribution revenues, Rate Counsel proposes to allocate the proposed increase in a manner similar to that proposed by the Company, *i.e.,* the fixed monthly service charges for all rate classes should be increased by 2.39%, which is 1.5 times the system average increase of 1.59%. *See RC-113,* p. 10. Thus, for example, the monthly fixed charge for residential customers would be increased from $2.27 to $2.32, excluding tax. The remaining rate increase for each class should be allocated based on the objectives stated in Mr. Kalcic's original and "12+0" prefiled testimonies.

For residential customers, the increase remaining after the recommended increase in the monthly service charge should be applied toward remedying an anomaly in the residential per-kWh usage charge: the usage charge is currently higher in the winter than in the summer. *RC-113,* p. 10. Under the Company's current Rate Schedule RS – Residential Service the winter distribution charge (excluding tax) is a flat charge of approximately 3.6 cents per kWh while the summer charge (again excluding tax) is approximately 2.9 cents per kWh for the first 600 kWh in a month and 3.2 cents per kWh for usage over 600 kWh in a month. *RC-113, Schedule BK-3E-Update (2/26/10), p. 1 of 2, column 2,* lines 3-6. In order to better align the summer and winter rates, the rate increase remaining after the recommended increase to the residential service charge should be applied proportionately to the summer usage rates. *See RC-112,* p. 11-12*; RC-113,* p. 10.

In addition, as explained by Mr. Kalcic, the Company is eliminating the current "Base Rate Distribution Kilowatt Hour Adjustment" ("BRDKA"). This credit, which was originally implemented in 2003 to amortize an excess depreciation reserve, was extended at a reduced level 2006. <u>I/M/O the Petition of PSE&G Company for Approval of Changes in Electric Rates, for Changes in the Tariff for Electric Service, B.P.U.N.J. No. 14 Electric Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1, for Changes in its Electric Depreciation Rates Pursuant to N.J.S.A. 48:2-18, and for Other Relief</u>, BPU Dkt No. ER02050303, Decision and Order Adopting Stipulation of Settlement, p. 3 (Nov. 9, 2006). Since the BRDKA is being eliminated, an offsetting reduction in another rate component is necessary to reflect the lost credit. In order further reduce the discrepancy between the residential summer and winter rates, the offsetting reduction for the residential class should be applied to reduce the winter usage rate. *RC-113,* p. 11.

For PSE&G's other electric rate classes, the class increase that remains after applying the recommended increase to the monthly service charge should be applied proportionately to the current demand and energy charges. *See RC-112,* p. 13-14*; RC-113,* p. 11-12. Since the current BRDKA credit applies only to energy charges, the elimination of this credit should be offset by commensurate reductions in each class's energy charges, so as to maintain the current relationships between the demand- and energy-charge recoveries for each class. *RC-113*. p. 11-12.

B. Gas Cost of Service and Rate Design

Rate Counsel's proposed allocation of its recommended $1.3 million gas rate decrease is shown on the attached Schedule BK-2G (Brief). This schedule follows the same format, and reflects the same methodology, as Mr. Kalcic's Schedule BK-2G-Update (2/26/10), which is in the record as part of Mr. Kalcic's Revised Direct Testimony (12+0). *RC-113.* As shown on Schedule BK-2G (Brief), Rate Counsel is proposing a decrease in distribution revenues of approximately $1.3 million. However, as shown on lines 6 through 9 of Schedule BK-2G (Brief), Rate Counsel has agreed to increases in the Late Payment Charge, Field Collection Charge and Reconnection Charge that will produce approximately $1.3 million in revenues, resulting in a $2.5 million decrease to be allocated among the Company's gas distribution rate classes.

As explained in Mr. Kalcic's prefiled testimony, The Company does not retain the margins from customers taking gas distribution service under its Rate Schedules TSG-NF – Non-Firm Transportation Gas Service, TSG-F – Firm Transportation Gas Service and CIG – Cogeneration Interruptible Service. *RC-113*, p. 18. Thus, the $2.5 million decrease to be allocated among rate classes is implemented by adjusting the rates for the remaining four gas distribution service rate classes: RSG – Residential Service, GSG – General Service, LVG – Large Volume Service and SLG – Street Lighting Service. *RC-113,* p. 19. Rate Counsel proposes to allocate the decrease in a manner similar to Company's allocation of its proposed rate increase, assigning decreases ranging from 0.5 to 1.5 times the system average decrease of approximately 0.37%. Since Rate Counsel is proposing a gas rate decrease, the relative decreases assigned to each class reflect an approximate "mirror image" of the rate increases being proposed by the Company. *RC-113,* p. 21. Rate Counsel's proposed allocation of the $2.5 million decrease to be allocated to rate classes is shown in lines 1 through 4 of Schedule BK-2G (Brief). As shown on the schedule, above average decreases are allocated to the classes shown as over-contributing, GSG and LVG, and below average decreases are assigned to RSG and SLG.

Rate Counsel further proposes rate decreases to the three rate classes that do not contribute to the Company's base rate recoveries as shown in lines 11 through 14 of Schedule BK-2G (Brief). The TSG-F rate class is shown as under-contributing in the Company's cost-of-service study, and is therefore assigned a rate decrease of approximately 0.19%, half the system average of approximately 0.37%. *RC-113,* p. 21. Rate Schedules TSG-NF and CIG are based on value-of-service rather than cost-of-service considerations, and were not included in the Company's cost-of-service study. *RC-113,* p. 15. Rate Counsel is proposing to assign these classes the system average decrease of 0.37% percent, except for the TSG-NF customers being served under special contracts, whose rates would remain unchanged. *RC-113,* p. 21.

Rate Counsel's proposed gas rate design principles are as set forth in Mr. Kalcic's "12+0" Revised Direct Testimony. Since the Company's cost-of-service study shows that the fixed monthly service charges for each class are below cost, the service charges should remain unchanged, rather than being decreased. *RC-113*, p. 23. For all classes except Rate SLG, the distribution rate decrease for each class should be applied proportionately to the class's volumetric (per-therm) and demand charges, as applicable. *Id.*

For Rate Schedule SLG, which currently includes a fixed charge per lamp or per unit for gas distribution service, the Company is proposing to implement a new volumetric distribution charge. Consistent with this proposal, Rate Counsel proposes to set the volumetric distribution rate at 1.1 cents per therm. The proposed rate decrease for this class should be applied as a proportionate reduction to the existing per lamp or per unit charges. *RC-113,* p. 23.

CONCLUSION

As discussed above and as demonstrated in the testimony, Rate Counsel respectfully requests that Your Honor deny PSE&G's request for an increase in its electric and gas distribution rates. Rate Counsel recommends Your Honor adopt Rate Counsel's revenue requirement recommendation of $21.3 million for electric operations and for a decrease of $1.2 million for its gas operations. Specifically Rate Counsel recommends the following adjustments.

(1) PSE&G's return on equity should be set at 10.0% with an overall rate of return of 8.06%, reflecting Rate Counsel recommended adjustments to the Company's proposed capital structure;

(2) The appropriate capital structure is 51.27% long term debt and a 49.73% common equity with customer deposits removed from capital structure.

(3) The appropriate rate base for electric operations amounts to $3.5 billion and for gas operations $2.2 billion. Rate Counsel is recommending rate base include adjustments made for consolidated income tax benefits passed on to ratepayers and the exclusion of post-test year plant additions.

(4) Post test year electric plant additions of $33.1 million and gas plant additions of $20.6 million should be excluded from the Company's rate case.

(5) Post test year CIIP expenditures of $35.6 million should be excluded for the Company's rate base.

(6) The appropriate Consolidated Tax Adjustment to rate base deducts $281.9 million from the Company's electric utility and $38.4 million from the Company's gas utility.

The appropriate Consolidated Tax Adjustment results in a revenue requirement adjustment of approximately $38.7 million for electric operations and $6.4 million for gas operations.

(7) Rate Counsel recommends a pension allowance of $113,657,426. This translates to an adjustment that reduces PSE&G's pension costs by $47.2 million.

(8) Rate Counsel opposes the Pension Tracker as an inappropriate departure from sound regulatory policy.

(9) Rate Counsel recommends that the Company's proposed test year incentive compensation expenses of $26.30 million be disallowed for rate making purposes in this case.

(10) Rate Counsel recommends that Petitioner's revenue projections should be based on a thirty-year period of normal weather data.

(11) A weather normalization clause should only be used to address revenue shortfalls due to weather, not to ensure full earnings for shareholders. Accordingly, the Board should reject PSE&G's alternative WNC as filed.

(12) Rate Counsel recommends rejection of THE expansion of the CAC to include additional distribution capital expenditures between base rate cases because it would amount to single-issue ratemaking, and would unfairly shift risk from shareholders to ratepayers.

(13) PSE&G should be required to utilize recommended service metrics and benchmarks and should monitor and report the data to the Board and Rate Counsel on a quarterly basis.

(14) Rate Counsel recommends that Petitioner invest in improvements that are cost-effective and improve the reliability of its poorest-performing electric circuits.

(15) Any future preferential pricing or terms of service, including the service provided to PSEG Power and MEG, should be permitted only after a contested proceeding, and based on explicit findings by the Board as to the factual and legal basis for the preference.

(16) The ALJ and the Board should adopt Rate Counsel's proposed Electric and Gas class revenue allocations, and follow Rate Counsel's Recommendations for the design of the Company's electric and gas distribution rates.

Respectfully submitted,

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Dated: March 19, 2010