

BEFORE THE STATE OF NEW JERSEY  
OFFICE OF ADMINISTRATIVE LAW

I/M/O THE PETITION OF NUI UTILITIES, INC     )  
D/B/A ELIZABETHTOWN GAS COMPANY     ) BPU DOCKET NO. GR02040245  
FOR APPROVAL OF INCREASED BASE     ) OAL DOCKET NO. PUC 5744-02  
TARIFF RATES AND CHARGES FOR GAS     )  
SERVICE AND OTHER TARIFF REVISIONS     )

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DIRECT TESTIMONY OF DAVID E. PETERSON  
ON BEHALF OF THE  
NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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Seema M. Singh, Esq.  
Acting Director and Ratepayer Advocate

Division of the Ratepayer Advocate  
31 Clinton Street, 11th Floor  
P. O. Box 46005  
Newark, New Jersey 07101  
(973) 648-2690 - Phone  
(973) 624-1047 - Fax  
[www.rpa.state.nj.us](http://www.rpa.state.nj.us)  
[njratepayer@rpa.state.nj.us](mailto:njratepayer@rpa.state.nj.us)

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**I. INTRODUCTION**

**Q. PLEASE STATE YOUR NAME, OCCUPATION AND BUSINESS ADDRESS.**

A. My name is David E. Peterson. I am currently employed as a public utility rate consultant by Chesapeake Regulatory Consultants, Inc. ("CRC"). Our business address is 6837 Guilford Road, Clarksville, Maryland 21029-1632. I maintain an office in Dunkirk, Maryland.

**Q. WHAT IS YOUR EDUCATIONAL BACKGROUND AND EXPERIENCE IN THE PUBLIC UTILITY FIELD?**

A. I graduated with a Bachelor of Science degree in Economics from South Dakota State University in May of 1977. In 1983, I received a Master's degree in Business Administration from the University of South Dakota. My graduate program included accounting and public utility courses at the University of Maryland.

In September 1977, I joined the Staff of the Fixed Utilities Division of the South Dakota Public Utilities Commission as a rate analyst. My responsibilities at the South Dakota Commission included analyzing and testifying on ratemaking matters arising in rate proceedings involving electric, gas and telephone utilities.

Since leaving the South Dakota Commission in 1980, I have continued performing cost of service and revenue requirement analyses as a consultant. In December 1980, I joined the public utility consulting firm of Hess & Lim, Inc. I remained with that firm until August 1991, when I joined CRC. Over the years, I have analyzed filings by electric, natural gas, propane, telephone, water, wastewater, and steam utilities in connection with utility rate and certificate proceedings before federal and state regulatory commissions.

**Q. HAVE YOU PREVIOUSLY PRESENTED TESTIMONY IN PUBLIC UTILITY PROCEEDINGS?**

A. Yes. I have presented testimony in 77 proceedings before state regulatory commissions in Alabama, Arkansas, Colorado, Connecticut, Indiana, Kansas, Maine, Maryland, Montana, Nevada, New Jersey, New Mexico, New York, Pennsylvania, South Dakota, and West Virginia, and before the Federal Energy Regulatory Commission.

Collectively, my testimony has addressed the following topics: the appropriate test year, rate base, revenues, expenses, depreciation, taxes, capital structure, capital costs, rate of return, cost allocation, rate design, life-cycle analyses, affiliate transactions, mergers, acquisitions, and cost-tracking procedures.

**II. SUMMARY**

**Q. ON WHOSE BEHALF ARE YOU APPEARING IN THIS PROCEEDING?**

A. I am appearing in this proceeding on behalf of the New Jersey Division of the Ratepayer Advocate (ARatepayer Advocate@).

**Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. CRC was asked by the Ratepayer Advocate to review the Petition, testimonies and exhibits filed by NUI Utilities, Inc. d/b/a Elizabethtown Gas Company (AElizabethtown@or Athe Company@) supporting the Company's request for an increase in base rates (i.e., non-gas cost related) for retail gas distribution service in New Jersey. The purpose of my testimony is to present the results of my analyses of Elizabethtown's claimed revenue requirement to Your Honor and the Board. Included in my analyses are my recommendations, and those of other Ratepayer Advocate witnesses, for alternative ratemaking treatments for several items included in the Company's claimed revenue

requirement. Specifically, I made a determination of Elizabethtown's adjusted test year rate base and pro forma operating income under present rates. From this, I calculated the revenue adjustment required to produce Ratepayer Advocate witness Basil Copeland's recommended rate of return.

17. ARE YOU FAMILIAR WITH ELIZABETHTOWN'S FILING IN THIS PROCEEDING?

1. Yes, I am. I have carefully reviewed the direct testimonies, exhibits and workpapers, of the Company's twelve witnesses relating to the issues that I address. I have also reviewed Elizabethtown's responses to requests for additional data and information from the Board Staff and the Ratepayer Advocate relating to the issues that I address herein.

**Q. BEFORE DISCUSSING YOUR SPECIFIC FINDINGS AND RECOMMENDATIONS, PLEASE SUMMARIZE THE COMPANY'S RATE REQUEST.**

A. Elizabethtown's witness Mr. Victor Fortkiewicz, Vice President of Distribution Services, explains in his direct testimony that the last time the Company's revenue requirement was subject to a comprehensive review was in connection with the base rate proceeding in BPU Docket No. GR88121321 wherein the Board authorized a \$3.51 million increase effective February 1, 1990. A little over a year later, by an order issued on September 30, 1991 in Docket No. GR90121391J, the Board reduced Elizabethtown's base rates by \$500,000 annually. Base rates that were established in September 1991 remain in effect today.

On April 16, 2002, Elizabethtown filed a Petition requesting Board authority to implement a 9.3 percent increase in total annual revenue. Since purchased gas costs are not at issue in this proceeding, it is more appropriate to characterize Elizabethtown's request as a 22.3 percent increase in annual non-gas revenue. If approved as proposed, Elizabethtown's rates would generate \$28,633,000 in additional annual revenue and are designed to yield an 11.75 percent return on common equity and a 8.95 percent on adjusted test-year end rate base.

17. HAVE YOU PREPARED AN EXHIBIT SUMMARIZING YOUR FINDINGS AND RECOMMENDATIONS?

1. Yes. Exhibit\_\_(DEP-1) attached to my testimony summarizes my revenue requirement study. Schedule 1 of this exhibit summarizes the cumulative effect of my recommendations and adjustments, as well as those of other Ratepayer Advocate witnesses, on Elizabethtown's claimed cost of service. From this schedule, I calculated that Elizabethtown's current base rates produce a 6.58 percent return on test year-end rate base. Mr. Copeland testifies for the Ratepayer Advocate in this case that Elizabethtown requires a 7.68 percent overall rate of return on rate base. Therefore, revenue should be increased \$7,469,000 or 2.3 percent to produce the rate of return that Mr. Copeland recommends, rather than \$28.6 million that Elizabethtown proposes. Elizabethtown's proposed base rates will generate revenue far in excess of that required to produce an adequate rate of return. The Company should be directed to file revised rate schedules consistent with the Ratepayer Advocate's revenue requirement determination.

Exhibit\_\_(DEP-1), Schedule 2, is a multi-page schedule detailing my determination of Elizabethtown's adjusted test year-end rate base. Schedule 3 shows my calculation of pro forma operating income under current base rates.

The top sheet in both schedules begins with Elizabethtown's original filing information, which includes seven months of actual operating results and five months of forecast operating results. Subsequent to the original filing, Elizabethtown supplied actual operating results for the entire 12-month test period. The adjustments that bridge the change from the original forecast filing to the update (i.e., the Company's 12<sup>th</sup> filing) are shown on the top sheet of Schedules 2 and 3. The Ratepayer Advocate's recommended adjustments to Elizabethtown's 12<sup>th</sup> filing are then shown on these schedules. The bases for the Ratepayer Advocate's recommended adjustments are set forth in the following sections of my testimony and in the testimonies of the other Ratepayer Advocate witnesses.

Later in my testimony I discuss the Ratepayer Advocate's opposition to the Company's proposed System Improvement Adjustment Clause (SIAC).

In the final section of my testimony I briefly discuss the proper ratemaking treatment for costs incurred under the Company's automatic meter reading program.

### **III. RATE BASE**

#### **1.1 TEST PERIOD**

#### **17. WHAT TEST PERIOD DID ELIZABETHTOWN REFLECT IN ITS FILING?**

1. Mr. Clancy's revenue requirement study is premised on a 12-month test year ended May 31, 2002. Because Elizabethtown filed the Petition in April 2002, actual operating results for the entire twelve months of the test period were not available when the Petition was filed. Elizabethtown's original revenue

requirement study was developed using seven months of actual data (June through December, 2001) and five months of estimated data (January through May, 2002). On July 31, 2002, Elizabethtown supplemented its original filing with an updated revenue requirement analysis replacing the forecast data with actual operating results for the months January through May, 2002.

I have adopted the test period ended May 30, 2002 in my analysis in this case and I have incorporated Elizabethtown's actual operating results into my revenue requirement determination.

17. DID THE COMPANY PROPOSE ANY ADJUSTMENTS TO THE TEST YEAR RESULTS?

1. Yes. Actual results were adjusted to include accounting, Board required and pro forma adjustments for a post-test period.

17. IS IT APPROPRIATE TO ADJUST ACTUAL TEST YEAR OPERATING RESULTS?

- A. Yes, under certain conditions. It is necessary to conform Elizabethtown's financial statements to the Board's ratemaking practices and accounting requirements and to eliminate abnormal and nonrecurring events occurring during a test year. It is also appropriate to annualize significant changes that occurred during the test year and to recognize post-test year changes provided that they have a continuing effect on operations and are known, measurable, and do not distort the test period matching principle. These types of adjustments make an actual test year reasonably representative of the conditions that are likely to exist when the revised rates become effective. They also provide the utility a reasonable opportunity to earn its authorized rate of return.

Most agree that adjustments to actual operating results are necessary to make rates reasonably reflective of pro forma operating conditions. Analysts and regulatory bodies often disagree, however, on the types of adjustments that should be permitted. I have been advised by counsel that the Board has already adopted a policy for using year-end rate base, for requiring corresponding year-end annualizing adjustments to revenues and expenses, and for allowing post-test year adjustments to rate base, revenue and expenses under the conditions, and subject to the limitations, set forth in the test period policy statement contained in the Board's 1985 Decision in the *Elizabethtown Water Company* rate case referenced on page 14 of Mr. Clancy's Direct Testimony in this case.<sup>1</sup> Therein, the Board held that all major New Jersey Public Utilities could reflect known and measurable changes to income and expense items for a period of nine months beyond the end of the test year, known and measurable changes to rate base for a period of six months beyond the end of the test period subject to further conditions, and changes to capitalization for a period three months past the end of the test period. I have applied the Board's policy in my review of the Company's claimed revenue deficiency and in developing my own revenue requirement study.

While the Company claims to have followed the same Board policy on post-test year adjustments as I have, I take issue with several of the Company's proposed revenue and expense adjustments because they do not meet the Board's known and measurable requirement. My objections to the Company's adjustments are discussed throughout the remainder of my testimony.

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<sup>1</sup>*In Re: Elizabethtown Water Company Rate Case*, BPU Docket No. WR8504330, May 23, 1985.



1.2 CUSTOMER DEPOSITS

**Q. HOW HAS MR. CLANCY TREATED CUSTOMER DEPOSITS IN HIS REVENUE REQUIREMENT STUDY?**

A. Mr. Clancy included the test year average customer deposit balance (\$5,969,000) in the capital structure along with interest at the Board-ordered level (4.42 percent).

1. IS THIS THE PROPER TREATMENT FOR CUSTOMER DEPOSITS?

2. No, it is not. A utility's rate base is a measure of physical (plant and equipment) and monetary (working capital) assets supported by investor-supplied funds and dedicated to public service. Customer deposits, as the name indicates, represent funds provided by customers, rather than investors. Therefore, it is more appropriate to reduce rate base by all non-investor supplied capital, including customer deposits. In that way, the capital structure is restricted to investor-supplied capital and is better matched with the investor-supplied funds that have been used to finance rate base.

17. DOES IT MAKE A DIFFERENCE IN THE ULTIMATE REVENUE REQUIREMENT WHETHER CUSTOMER DEPOSITS ARE INCLUDED IN THE CAPITAL STRUCTURE OR ARE DEDUCTED FROM RATE BASE?

1. Yes, it does, where there is a mismatch between total capitalization and the rate base. When, as here, total capitalization exceeds rate base, a portion of the customer deposits end up being allocated to the utility's non-rate base assets when customer deposits are included in capitalization. This is inappropriate since all customer deposits arise from Elizabethtown's regulated utility operations. Exhibit\_\_\_(DEP-2) provides a hypothetical example showing how the mis-

allocation of customer deposit funds to non-rate base assets occurs when customer deposits are included in the capital structure. In this simplified example, ratepayers end up paying \$44 more when customer deposits are included in the capital structure, rather than being deducted from rate base as I recommend.

Customer deposits should be eliminated from the capital structure and instead be used to reduce rate base. The capital structure that excludes customer deposits is shown in my Exhibit\_\_\_(DEP-1), Schedule 1, page 3. On Schedule 2 of this Exhibit, I reduced rate base by \$5,969,000, which represents the test year average customer deposit balance. In Schedule 3, I included interest expense on the test year average balance of customer deposits as an above-the-line operating expense and adjusted the income tax allowance accordingly.

### 3. CASH WORKING CAPITAL

17. WHAT IS THE PURPOSE OF A CASH WORKING CAPITAL ALLOWANCE IN RATE BASE?
  1. Mr. Uffelman, Elizabethtown's witness on cash working capital, and I seem to agree that the intended purpose of a cash working capital allowance is to compensate investors for investor-supplied funds used to provide the day-to-day *cash* needs of the utility.<sup>2</sup> Mr. Uffelman's lead/lag study, however, goes far beyond the measurement of Elizabethtown's actual cash working capital

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<sup>2</sup>Direct Testimony of Bernard L. Uffelman, Exhibit P-3, page 6, lines 15-17.

requirement. The average amount of investor-supplied working cash, however, is \$9.2 million less than what Mr. Uffelman has calculated.

17. WHAT ADJUSTMENTS TO MR. UFFELMAN'S STUDY DO YOU RECOMMEND?

1. I recommend that noncash expenses, principally depreciation, deferred taxes, investment tax credits and the common equity return be excluded from the working capital calculation. My adjustments to Mr. Uffelman's cash working capital claim are detailed on my Exhibit\_\_\_(DEP-1), Schedule 2, page 3. My working capital allowance also incorporates the Ratepayer Advocate's adjustments to pro forma cash operating expenses. This schedule shows that Mr. Uffelman's proposed \$22,056,000 allowance for cash working capital is excessive and should be reduced to \$12,825,000.

17. WHY SHOULD NON-CASH EXPENSES BE EXCLUDED FROM THE LAG STUDY?

- A. Mr. Uffelman included depreciation, deferred taxes, and investment credits in his lag study with an assumed payment lag of zero days. Mr. Uffelman claims that this treatment is appropriate in order to provide investors with an opportunity to earn a return on the total amount of investor-supplied capital required for operations since virtually all utility revenues and expenses are based on accrual accounting...<sup>3</sup> I believe what Mr. Uffelman is trying to say is that the reserve

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<sup>3</sup>Direct testimony of Bernard L. Uffelman, Exhibit P-3, page 12, lines 1-5.

balance for these non-cash items are used to reduce rate base prior to the time that related revenues are received from ratepayers. In essence, Mr. Uffelman is invoking a cash basis for plant in service. Mr. Uffelman candidly acknowledges that these items do not require a current outlay of cash when the cost is recorded.<sup>4</sup> What Mr. Uffelman apparently refuses to concede is that if no periodic cash outlay is required, then no investment in working capital is necessary. Thus, Mr. Uffelman has calculated a cash working capital allowance that does not meet his own stated purpose, i.e., to compensate investors for funds used to provide the day-to-day *cash* needs of the utility. This is particularly true with respect to deferred taxes. Deferred taxes have been collected from *ratepayers*, without being paid to the IRS by the utility. It is ludicrous to believe that deferred tax expenses create a cash working capital requirement, since no investor cash has ever been expended for them.

18. IS THERE ANOTHER REASON FOR NOT INCLUDING NON-CASH EXPENSES IN A LAG STUDY?
  1. Yes. In my previous answer, I mentioned that by including these non-cash expenses in the lag study, Mr. Uffelman is invoking a cash basis for plant in service. In so doing, however, Mr. Uffelman fails to recognize that Elizabethtown's cash investment in plant in service and construction work in progress (ACWIP®) lags recognition of earnings by approximately the same period of time. Investment is included in rate base and is earning a return when it is

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<sup>4</sup>Direct Testimony of Bernard L. Uffelman, Exhibit P-3, page 11, lines 22-23.

placed in service even though actual cash payments to contractors, suppliers and construction workers may not be made until sometime later, perhaps 30 to 45 days. The same is true for Elizabethtown's investment in construction work in progress (ACWIP®). On average, earnings on these investments will be reflected one-half month after inclusion in CWIP, if the Company's allowance for funds used during construction accrual is based on the prior month's ending CWIP balance. Earnings on CWIP, therefore, are likely to be recognized prior to actual cash payments for the related investment. It is inappropriate to consider A payment® lags on noncash expenses without considering lags associated with Elizabethtown's cash investments.

17. WHY SHOULD THE COMMON EQUITY RETURN BE EXCLUDED FROM THE LAG STUDY?
  1. Mr. Uffelman's study includes the common equity return in his lag study using a zero-day expense lag. That is, Mr. Uffelman's treatment is as if Elizabethtown compensates its stockholders on a daily basis. The fact is that compensation is received by stockholders in two forms, through quarterly dividend payments, if any, and through capital appreciation, if any, upon the sale of the stock. If one were to measure the actual delay in the cash outlay by the utility to stockholders, one would refer to the quarterly dividends that are being paid, and not simply assume a zero lag. But, because there is no contractual requirement for NUI to pay fixed quarterly dividends to stockholders, the common equity return should not be included in the cash working capital measurement in the first place.

I recommend that Elizabethtown's cash working capital allowance exclude recognition of depreciation, deferred taxes, investment tax credits and the common equity return.

1.1 CONSOLIDATED TAX SAVING

17. DOES ELIZABETHTOWN FILE A SEPARATE CORPORATE INCOME TAX RETURN WITH THE INTERNAL REVENUE SERVICE (IRS)?

1. No. The Company joins with its affiliates in filing a single consolidated income tax return.

17. WHY DO NUI AFFILIATES FILE A CONSOLIDATED TAX RETURN?

1. They do so to minimize their income taxes.

17. HOW DOES FILING A CONSOLIDATED RETURN ACHIEVE TAX SAVINGS?

1. Certain of NUI's affiliates generate recurring tax losses. Losses generated by these companies are used to offset a portion of the taxable income generated by other affiliates, including Elizabethtown, to reduce taxes currently payable. Without a consolidated tax filing, it could take several years under the IRS' carry-forward and carry-back restrictions, if ever, before the recurring loss companies would be able to fully realize the tax savings. By filing a consolidated return,

NUI as a whole is able to realize currently the tax benefits generated by the recurring loss companies.

17. DOES ELIZABETHTOWN'S RATE FILING REFLECT ITS PARTICIPATION IN THE CONSOLIDATED TAX RETURN?

1. No. Mr. Clancy's revenue requirement study in this case is presented as though Elizabethtown files a separate tax return. That is, Mr. Clancy calculated an income tax allowance by applying the 35 percent statutory federal income tax rate to the ratemaking determination of hypothetical stand-alone taxable income.

17. WHAT IS THE IMPLICATION OF MR. CLANCY'S STAND-ALONE RATEMAKING POLICY?

1. Tax benefits realized by NUI and its affiliates are retained within the company and by stockholders while Elizabethtown's customers pay rates that are higher than necessary to compensate the Company for its actual costs.

17. OTHERS HAVE ARGUED THAT IT IS NOT APPROPRIATE TO RECOGNIZE TAX SAVINGS IN RATES IF THE SAVINGS ARE BASED ON LOSSES GENERATED BY UNREGULATED, NON UTILITY AFFILIATES THAT DO NOT TRANSACT WITH THE REGULATED UTILITY. WHAT IS YOUR RESPONSE TO THIS ARGUMENT?

1. Even though ratepayers do not always pay the expenses of non-regulated companies that generate tax losses, it is still appropriate that all companies

generating positive taxable income share equitably in the tax savings. If it were not for regulated companies like Elizabethtown that consistently generate taxable income, the consolidated group would not be able to realize the tax savings to the extent they now enjoy. Tax losses have no value in the absence of taxable income against which companies can offset the losses.

17. ARE THERE RISKS ASSOCIATED WITH ELIZABETHTOWN'S PARTICIPATION IN A CONSOLIDATED TAX FILING?

1. Yes. Treasury Regulation 1.1502-6 provides that each member of a group filing a consolidated tax return is severally liable for the entire tax of the consolidated group. A company's inter-company tax agreement cannot reduce this absolute liability. Thus, Elizabethtown's participation in a consolidated tax filing exposes ratepayers to the total tax liability of all NUI affiliates.

17. DOES RECOGNIZING CONSOLIDATED TAX SAVINGS IN UTILITY RATES VIOLATE IRS NORMALIZATION REQUIREMENTS?

1. No, a properly constructed consolidated tax savings adjustment need not violate the IRS' normalization requirements. In fact, it is for this very reason that my proposed consolidated tax savings adjustment does not include tax losses generated by NUI's regulated utility companies. Had I included regulated utility losses in my proposed adjustment, one could argue that I was improperly flowing through accelerated depreciation tax benefits through the adjustment which is prohibited by IRS normalization requirements. Such is not the case, however.



17. HOW SHOULD THE BENEFITS OF PARTICIPATING IN NUI'S CONSOLIDATED TAX RETURN BE REFLECTED IN ELIZABETHTOWN'S RATES IN THIS PROCEEDING?

1. The Board has previously required other New Jersey regulated utilities to reflect consolidated tax savings as a cost-free source of capital by deducting the accumulated balance of tax savings from rate base. I have been informed by counsel that the Board first established this policy in its Decision and Order (Atlantic Order) in the Atlantic City Electric Company rate proceeding, BPU Docket No. ER90091090J, dated October 20, 1992. In the Atlantic Order, the Board also ruled that the calculation starting point for the consolidated income tax related rate base deduction must be July 1, 1990:

...it is our judgement that the appropriate consolidated tax adjustment in this proceeding is to reflect as a rate base deduction the total of the 1991 consolidated tax savings benefits, and one-half of the tax benefits realized from AEI's 1990 consolidated tax filing..

...This finding reflects a balancing of the interests to reflect the unique period of uncertainty during the period 1987-1991. We hereby reaffirm and emphasize that the Board's policy is to reflect an equitable and appropriate sharing of consolidated tax benefits for ratepayers in future rate proceedings...

The Board reaffirmed its consolidated income tax policy in its Atlantic Order in the most recent Jersey Central Power and Light Company (JCP&L) base rate proceeding, BPU Docket No. ER91121820J, dated June 15, 1993. On pages 7 and 8 of its D&O in that docket the

BPU stated:

The Board believes that it is appropriate to reflect a consolidated tax savings adjustment where, as here, there has been a tax savings as a result of the filing of a consolidated tax return. Income from utility operations provide the ability to produce tax savings for the entire GPU system because utility income is offset by the annual losses of the other subsidiaries. Therefore, the ratepayers who produce the income that provides the tax benefits should share in those benefits. The Appellate Division has repeatedly affirmed the Board's policy of requiring utility rates to reflect consolidated tax savings and the IRS has acknowledged that consolidated tax adjustments can be made and there are no regulations which prohibit such an adjustment.

The issue, in this case, is not whether such an adjustment should be made, but, rather, what methodology should be used to make such an adjustment. In this area, the courts have held that the Board has the power and discretion to choose any approach which rationally determines a subsidiary utility's effective tax rate. Toms River Water Company v. New Jersey Public Utilities Commissioners, 158 NJ Super 57 (1978). Based on our review of the record in this case, the Board **REJECTS** the ALJ's recommendation to accept the income tax expense adjustment proposed by Petitioner and, instead, **ADOPTS** the position of Staff that the rate base adjustment is a more appropriate methodology for the reflection of consolidated tax savings. The rate base approach properly compensates ratepayers for the time value of money that is essentially lent cost-free to the holding companies in the form of tax advantages used currently and is consistent with our recent Atlantic Electric decision (Docket No. ER90091090J). Moreover, in order to maintain consistency with the methodology applied in the Atlantic decision, we modify the Staff calculation and find that a rate base adjustment which reflects consolidated tax savings from 1990 forward, including one-half of the 1990 savings, is appropriate in this case.

Since this is the established practice in New Jersey, I have followed the rate base deduction procedure in developing my proposed tax saving adjustment. I have prepared an analysis of NUI's consolidated tax savings for the years 1991 through 2000 and recommend that Elizabethtown be allocated a ratable share of those benefits, based on the ratio of Elizabethtown's taxable income to all other affiliates that had taxable income. In this way, all affiliates that had taxable income share equitably in the benefits gained by filing the consolidated return. I have reduced Mr. Clancy's rate base claim by \$3,882,000 reflecting Elizabethtown's accumulated share of the consolidated tax benefit. My adjustment is detailed on Exhibit\_\_\_ (DEP-1), Schedule 2, page 4.

**1.1 RATE BASE SUMMARY**

17. PLEASE SUMMARIZE THE IMPACT OF THE RATEPAYER ADVOCATE'S ADJUSTMENTS ON THE COMPANY'S PROPOSED RATE BASE.
  1. As detailed on Schedule 2, page 1, the Ratepayer Advocate's recommended rate base adjustments reduce Elizabethtown's proposed \$413.8 million rate base (12&0 update) by \$19,082,000. I recommend that Elizabethtown's pro forma rate base be set at \$394,752,000 in this proceeding.

**IV. EARNINGS UNDER CURRENT RATES**

17. WHERE IN EXHIBIT\_\_\_ (DEP-1) HAVE YOU SHOWN YOUR PROPOSED ADJUSTMENTS TO MR. CLANCY'S DETERMINATION OF PRO FORMA OPERATING INCOME UNDER PRESENT RATES?

1. All of my income adjustments, and those of other Ratepayer Advocate witnesses, are summarized on Schedule 3, page 2. This page shows the revenue, expense, tax and income effects of the Ratepayer Advocate's proposed ratemaking adjustments in this proceeding. The remaining pages in Schedule 3 detail the development of the specific adjustments that the Ratepayer Advocate is recommending. Each revenue or expense adjustment will be discussed in the order in which it appears on Schedule 3, pages 2a, 2b and 2c.

1.1 WEATHER NORMALIZATION

17. LOOKING FIRST AT SCHEDULE 3, PAGE 2A, PLEASE DESCRIBE THE BASIS FOR YOUR ADJUSTMENT SHOWN IN COLUMN B.
  1. Natural gas sales are highly dependent on prevailing temperatures, specifically heating degree days. Variability of earnings due to abnormal weather conditions is a well established business risk in the industry that is typically accounted for in cost of capital analyses. To avoid double-counting for this business risk, test year sales are adjusted in the earnings analysis to reflect Abnormal degree days and weather conditions.

In this proceeding, Elizabethtown has proposed a weather normalization adjustment reflecting average heating degree days over the past ten years. Mr. Copeland, on behalf of the Ratepayer Advocate, takes issue with the Company's weather normalization adjustment and instead recommends using the 30-year average heating degree days (1971-2001) that has typically been used in prior New Jersey base rate proceedings. Therefore, I recalculated Elizabethtown's pro

forma sales, revenue, and net margin based on the 30-year average heating degree day data recommended by Mr. Copeland.

17. HOW WERE YOU ABLE TO RECALCULATE PRO FORMA SALES REVENUE TO REFLECT THE 30-YEAR AVERAGE HEATING DEGREE DAYS?

1. In discovery, Elizabethtown provided a copy of its confidential sales and revenue computer model. This model was used to calculate pro forma revenue assuming the ten-year average heating degree days that the Company is recommending in this case. That model also contains a built-in option to calculate pro forma revenue under the 30-year average heating degree day assumption. Therefore, it was a simple matter for me to re-run the Company's model using Mr. Copeland's recommended 30-year heating degree days.

As shown on Schedule 3, page 3, changing the assumption from ten-year average to 30-year average heating degree days increases pro forma revenue by approximately \$9.4 million and increases pro forma net margin by approximately \$2.95 million.

#### 1.1 WAGES AND SALARIES

17. HAVE YOU ANALYZED MR. CLANCY'S PROPOSED PAYROLL ADJUSTMENTS?

1. Yes, I have. In the Company's initial filing, Mr. Clancy proposed a labor expense adjustment that reflected annualized wages and salaries for employees as of May 31, 2002, annualized wages and salaries for positions that were not filled for the entire test period, new positions expected to be filled in the post-test period, new wage rates for bargaining employees to become effective November 2002, and an increase for non-union employees to become effective in January 2003. Together, these adjustments increased the test year labor expense by approximately \$2.3 million.

In the Company's 12&0 update filing, Mr. Clancy reduced the amount of the labor expense increase the Company is requesting by \$121,000 to reflect the Company's current projection that certain positions whose costs were included in Mr. Clancy's original adjustment will not be filled in the post-test period.

17. ARE YOU RECOMMENDING ANY FURTHER ADJUSTMENTS TO THE LABOR EXPENSE REFLECTED IN THE COMPANY'S 12&0 FILING?
  1. Yes, I am. My adjustment summarized on Schedule 3, page 4, reflects the removal of the Company's proposed allowance for vacancies in the test period, elimination of new positions during the post-test year, and elimination of the speculative increase that Elizabethtown has assumed will be granted to nonunion employees in January 2003. Together, these adjustments reduce Mr. Clancy's proposed allowance for labor costs in the 12&0 update filing by \$938,000.

17. WHY DID YOU REMOVE THE ANNUALIZED VACANT POSITIONS DURING THE TEST YEAR?

1. The short answer to that question is that vacant positions do not create a revenue requirement for Elizabethtown. By annualizing currently filled, but previously vacant positions at test year-end, Mr. Clancy, in effect, assumes, without support, there will be no vacancies in the post-test period. With approximately 570 employees, Elizabethtown will nearly always have unfilled positions due to normal turnover, retirements and terminations. There will nearly always be differences between the numbers of authorized and actual personnel on even a monthly basis. To assume, as Mr. Clancy has done, that there will be no vacancies during the entire post-test period is simply unrealistic and unwarranted.

The same is true with respect to new positions budgeted for the post-test period. It is improper to reflect projected new hires without also reflecting the labor cost savings that will arise by unfilled positions that will arise during the post-test period. Therefore, Mr. Clancy's adjustment to recognize new positions to be filled in the post-test year should also be rejected. The Company simply has not presented any evidence in this proceeding demonstrating that these new positions actually will be filled during the post-test year period and that savings arising from job vacancies during the post-test period will not offset some or all of the cost of the newly filled positions.

17. WHY HAVE YOU REMOVED THE FOUR PERCENT INCREASE FOR NON-UNION WORKERS IN YOUR LABOR COST ADJUSTMENT?

- A. The proposed four percent adjustment to non-union workers effective January 1, 2003 is speculative and, therefore, does not meet the Board's known and measurable requirement to qualify as an appropriate post-test period expense adjustment.

The January 2003 non-union wage adjustment is speculative in that there currently is no firm commitment by Elizabethtown to grant such an increase. Moreover, even if such an increase were authorized, the Company could delay the effective date of the increase, as it has done in the past, beyond the nine months post-test period provided in the Board's policy statement for recognizing post-test year expense changes. For example, the 2002 wage and salary adjustment for director-level employees did not become effective until April 1, 2002. If similar delays are experienced in 2003, the wage adjustment would not become effective until 10 months beyond the end of the test period, and beyond the limit set in the Board's test period policy statement.

Because there is no firm commitment for Elizabethtown to actually grant non-union employees a four percent increase effective January 2003, and because the company ultimately controls the timing and the amount of any increase to non-union employees, I recommend that the post-test year labor increase for non-union employees be rejected as speculative in this case.



3. INCENTIVE COMPENSATION

17. HAVE YOU REVIEWED ELIZABETHTOWN'S TEST YEAR INCENTIVE COMPENSATION PLANS?

1. Yes, I have. Copies of the three incentive payment plans in effect during the test year were provided in discovery in response to requests by the Board Staff and the Ratepayer Advocate.<sup>5</sup> These plans include the NUI Stock Option, Stock Award and Incentive Plan (Executive Plan), the Sales Force Incentive Plan, and the Collective Bargaining Agreement with Local # 424, Utility Workers Union of American. Elizabethtown has indicated that test year operating expenses include \$901,298 awarded under these three incentive plans.<sup>6</sup> These plans were designed to promote a variety of corporate behaviors including achieving corporate earnings targets, increasing sales, and increasing saving, attendance, workmanship and customer service. Nearly 75 percent of the awards, approximately \$670,000, was granted to executives under the Executive Plan.

17. WHAT IS THE STATED PURPOSE OF THE EXECUTIVE PLAN?

1. The purpose of the Plan was stated as follows:

The 1996 Plan was adopted by the Board in order to align the interests of the Company's management with the interests of the shareholders and to attract, retain and motivate key employees through participation in the long-term growth and financial success of the Company.... The Compensation Committee believes that equity awards can be used to help

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<sup>5</sup>See Company's response to S-EREV-56.

<sup>6</sup>See Company's response to S-EREV-54.

the Company achieve its goals for long-term growth and enhanced shareholder value....<sup>7</sup>

17. UPON WHAT CRITERIA ARE THE AWARDS GRANTED?

A. NUI's Compensation Committee has determined that performance goals and awards will be selected from among the following:

- 1.1 Return on invested capital, return on assets, return on investment, or return on equity (on a gross or net basis);
- 1.2 Earnings from operations, earnings before or after taxes, earnings before or after interest, depreciation, amortization, or extraordinary or special items;
- 1.3 Net income or net income per common share (basic or diluted);
- 1.4 Sales or net revenues;
- 1.5 Cash flow, free cash flow, cash flow return on investment (discounted or otherwise), net cash provided by operations, or cash flow in excess of cost of capital;
- 1.6 Working capital turns;
- 1.7 Interest expense after taxes;
- 1.8 Economic value created;
- 1.9 Operating margin or profit margin;
- 1.10 Stock price or total shareholder return;
- 1.11 Dividend payout as a percentage of net income;
- 1.12 Debt rating; and

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<sup>7</sup>See Company's response to S-EREV-56, Attachment 1, page 4.

1.13 Strategic business criteria, consisting of one or more objectives based on meeting specified goals with respect to customer growth, supplier management, productivity, market penetration, geographic business expansion goals, cost targets, customer satisfaction, employee satisfaction, management of employment practices and employee benefits, supervision of litigation and information technology, and goals relating to acquisitions or divestitures of subsidiaries, affiliates or joint ventures.<sup>8</sup>

17. ARE THESE PERTINENT GOALS AND PERFORMANCE MEASUREMENT CRITERIA ?

1. I do not take issue with either the Plan's purpose statement or with Elizabethtown's decision to motivate key employees through an incentive compensation program. However, I have been informed by counsel that the Board has established a policy of disallowing incentive compensation expense in rate cases. In the most recent Middlesex Water Company Base Rate Case, the Board agreed with Staff and the Ratepayer Advocate positions that incentive compensation expenses in the amount of \$324,057 should not be included in expenses. @ I/M/O the Petition of Middlesex Water Company for Approval of an Increase in Its Rates For Water Service and Other Tariff Changes, BPU Docket No. WR00060362 (June 4, 2001). Consistent with the Middlesex Water case, incentive compensation expenses should not be recovered in the present case.

17. WHY IS THE PURPOSE OF THE PLAN NOT CONSISTENT WITH RATEPAYER INTERESTS?

1. It is clear that the Executive Plan is intended to increase shareholder wealth. This goal is not consistent with the ratepayers' goal of receiving service at the lowest

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<sup>8</sup>See Company's response to S-EREV-56, Attachment.



1. Ratepayer Advocate witness Michael Majoros has undertaken a comprehensive review of the Company's present and proposed book depreciation rates. As a result of his review, Mr. Majoros is recommending different depreciation rates from those proposed by Elizabethtown for several of the Company's plant accounts. My schedule shows the impact of Mr. Majoros' recommended rates as applied to the post-test year plant balances reflected in rate base as compared with Mr. Clancy's proposed depreciation expense allowance. I show on my schedule that Mr. Majoros' proposed depreciation rates reduce Mr. Clancy's proposed annual depreciation accrual by approximately \$8,955,000.

#### 1.1 PENSIONS

17. WHAT IS THE BASIS FOR YOUR PENSION COST ADJUSTMENT?
  1. My \$1.5 million adjustment eliminates the Company's speculative pension cost estimate for the post-test period. The most recent actuarial determination of NUI's pension costs reflects a \$510,000 net pension credit and applies to the fiscal year 2002. For fiscal year 2003, the Company's adjustment reflects a \$2.05 million (total NUI) pension expense. This amount, however, is not the expense that will be recorded by the Company during 2003. It was not developed from a complete actuarial analysis. It is simply one estimate among others provided by the Company's actuary based on certain performance and operating assumptions. The conditions that will determine the pension cost for 2003 cannot be known at this time. Thus, the 2003 estimate reflected in Mr. Clancy's pension cost adjustment is speculative and does not constitute a known change, as required by the Board's policy concerning post-test period adjustments. In fact, the 2003

pension expense will not be known until after the nine-month post-test year window expires to qualify it as an appropriate expense adjustment in this case. My adjustment to exclude the speculative 2003 pension cost increase is shown on Schedule 3, page 8.

1.1 MEDICAL INSURANCE

17. WHAT TYPES OF ADJUSTMENTS IS MR. CLANCY PROPOSING FOR MEDICAL BENEFITS COSTS?

1. Elizabethtown views medical benefits (including medical, dental and vision care) as a function of its payroll. Thus, Mr. Clancy proposes to increase test year medical care costs to reflect his proposed payroll cost increases. Further, for the post-test period, Mr. Clancy projects a 13.7 percent increase in medical care costs, which is also reflected in his medical expense adjustment.

17. WHAT ARE YOUR ISSUES WITH MR. CLANCY'S MEDICAL BENEFITS ADJUSTMENTS?

1. Because I am recommending that the allowance for test year job vacancies be eliminated from labor costs, the overhead adder for medical benefits on those labor dollars likewise should be eliminated. Moreover, Mr. Clancy's post-test year inflation adjustment is pure speculation. It does not represent actual, known premium or health care cost increases. My adjustment to eliminate the speculative post-test year inflation increase and the benefit allowance for job vacancies reduces the Company's proposed operating expenses by \$398,000, and is shown on my Schedule 3, page 9.

1.1 OTHER POST-EMPLOYMENT BENEFITS (AOPEBS®)

17. WHAT IS THE BASIS FOR YOUR ADJUSTMENT RELATING TO POST RETIREMENT MEDICAL BENEFITS?
1. The same estimates and assumptions used to project fiscal year 2003 pension costs were also used to develop an OPEB cost estimate for 2003. Thus, Mr. Clancy's OPEB adjustment suffers from the same deficiencies that I mentioned in connection with the pension cost adjustment. The estimate of 2003 OPEB costs is speculative. It does not represent the expense that will be recorded by Elizabethtown in the post-test period. Instead of Mr. Clancy's speculative adjustment, my OPEB adjustment recognizes the latest known cost as of November 30, 2002. The adjustment I show on Schedule 3, page 10, reduces Mr. Clancy's OPEB cost claim by \$182,000, by eliminating the speculative increase projected for May 31, 2003.

1.1 UNCOLLECTIBLES

17. PLEASE EXPLAIN YOUR ADJUSTMENT TO UNCOLLECTIBLE ACCOUNTS THAT YOU DETAIL ON SCHEDULE 3, PAGE 11, OF YOUR REVENUE REQUIREMENT EXHIBIT.
1. The uncollectible accounts expense is partially a function of revenue. I have included more revenue in my study than Mr. Clancy includes in his study due to the weather normalization issue. Therefore, it is necessary for me to also increase the allowance for uncollectible accounts. My recommended allowance for uncollectible accounts is the product of pro forma revenue (\$317,903,000) and the

uncollectible percentage (1.341 percent<sup>9</sup>), or \$4,263,000. This is approximately \$126,000 more than Mr. Clancy has included in his study for uncollectible accounts. The same 1.341 percent allowance for uncollectible accounts is included in my revenue expansion factor calculated on Schedule 1, page 2, as is applied to the income deficiency calculated on my Schedule 1, page 1.

10. COMPREHENSIVE RESOURCE ANALYSIS (ACRA@)

17. PLEASE DESCRIBE THE BASIS FOR YOUR ADJUSTMENT RELATING TO CRA EXPENSES.

1. The Board requires Elizabethtown and other New Jersey gas distribution utilities to identify gas supply requirements and DSM opportunities under the CRA program. Mr. Clancy's direct testimony in this proceeding explains that CRA costs have been deferred and are being recovered through the Company's Societal Benefits Charge (ASBC@). Thus, Mr. Clancy has proposed an adjustment to synchronize CRA revenue collections with the amortization expense so that the CRA has no net impact on base rates, however, Mr. Copeland's weather normalization adjustment increases sales in the post-test year. Therefore, CRA recoveries will increase as well. Thus, it is necessary for me to make a corresponding adjustment to Mr. Clancy's CRA amortization determination. Mr. Copeland's weather normalization adjustment will increase CRA recoveries by approximately \$32,000 annually. I have made a corresponding \$32,000 adjustment to Mr. Clancy's proposed CRA amortization level.

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<sup>9</sup>Clancy Schedule RJC 4-9A.



2. REMEDIATION ADJUSTMENT CLAUSE (ARAC®)

17. WHAT IS THE BASIS FOR YOUR ADJUSTMENT TO PRO FORMA RAC CHARGES?

1. Elizabethtown is responsible for cleaning up certain manufactured gas plant sites. Recovery for the related cleanup costs is provided for under the RAC program. Similar to the CRA expense, the Electric Discount and Energy Competition Act, (ÆEDECA®) requires that RAC charges be recovered through the Company=s SBC. Mr. Clancy=s direct testimony indicates that this is how Elizabethtown has been accounting for and recovering authorized RAC charges. Here again, since Mr. Copeland is proposing to increase post-test year sales relative to what is reflected in the Company=s filing, a RAC expense adjustment is necessary to synchronize RAC revenue with the amortization to remove RAC from base rates. My adjustment, which increases the RAC amortization level by \$14,000, is detailed on Schedule 3, page 13.

12. INSURANCE

17. PLEASE EXPLAIN YOUR ISSUE WITH MR. CLANCY=S INSURANCE COST ADJUSTMENT.

1. Elizabethtown has been notified by carriers of premium increases for several of its insurance policies. Such increases are properly reflected in this rate proceeding because they constitute a known change in the cost of service. For general liability insurance, however, the Company merely speculates that its costs will increase by 25 percent in the post-test period. Because this claimed increase is not supported by actual notification by an insurance carrier, it does not meet the Board=s known and measurable standard. That portion of Mr. Clancy=s insurance

adjustment relating to the speculative 25 percent increase for general liability insurance should be rejected by the Board in this proceeding. This reduces Mr. Clancy's claim for insurance costs by \$183,000 as shown on my Schedule 3, page 14.

13. RATE CASE EXPENSE

17. IN ADDITION TO DIRECT COSTS INCURRED BY ELIZABETHTOWN PERSONNEL, HOW MUCH DOES THE COMPANY ANTICIPATE THAT IT WILL COST TO PROCESS THIS RATE CASE?

1. Mr. Clancy's revenue requirement study includes a rate case expense amortization allowance based on his estimate that this case will cost the Company \$910,000 to process. The total cost estimate is broken down as follows:

Legal	\$ 450,000
Lead-lag study	150,000
Capital Improvements Clause Design	60,000
Depreciation	50,000
Cost of capital	45,000
Climatologist	10,000
Cost of service study	35,000
Temp help	5,000
Court reporters	<u>35,000</u>
Total cost estimate	\$ <u>910,000</u>

17. HOW DOES MR. CLANCY PROPOSE TO TREAT RATE CASE EXPENSE IN THIS CASE?

1. Following Board precedent, Mr. Clancy proposes to recover one-half of the estimated cost of the rate case. To accomplish this, he has reflected a two-year amortization of these costs in his revenue requirement study.
17. ARE THE COMPANY'S RATE CASE EXPENSES KNOWN AT THIS TIME?
  1. No, they are not. While it is certain that Elizabethtown has incurred and will continue to incur expenses associated with this proceeding, the precise amount of those expenses cannot be determined at this time. Nor is there any reasonable way for the Ratepayer Advocate to evaluate the reliability of the Company's \$910,000 cost estimate at this time. Therefore, a better way to approach this issue is to have the Company provide proof of actual costs incurred towards the end of the case, along with estimates of any remaining costs outstanding, if any. This procedure is fair to the ratepayers, without harming the Company, while simply recognizing a cost estimate now that may be far different from Elizabethtown's actual costs is patently unfair. Because I believe that Elizabethtown's initial cost estimates may be excessive, I have reduced the \$910,000 cost estimate by 25 percent as a place holder until actual costs become known.
17. OTHER THAN REDUCING THE COST ESTIMATE BY 25 PERCENT AT THIS TIME, IS THERE ANOTHER ADJUSTMENT TO RATE CASE EXPENSES THAT YOU RECOMMEND?
  1. Yes. There is no support for Mr. Clancy's proposed two-year amortization of rate case expenses. Ideally, the ratemaking allowance for rate case expense would

levelize the total cost over the number of years between rate cases. Elizabethtown's experience in filing rate cases does not support its proposed two-year amortization. It has been 12 years since Elizabethtown has filed a base rate proceeding.

Moreover, there are significant costs and activities built into Mr. Clancy's cost estimate that would not recur in the Company's next base rate filing even if another base rate case were to be filed within the next two or three years. For example, I would not expect Elizabethtown pay for another comprehensive lead-lag study, capital improvements clause design study, or depreciation study if the company were to file another base rate proceeding in the relatively near future. Nor would I expect the same level of expenses for outside legal counsel to be repeated in the next rate filing. Together, these activities make up \$710,000 of the total \$910,000 cost estimate. Thus, even if Elizabethtown filed another base rate proceeding in two or three years, the levelized cost going forward from that case may not be any greater than the levelized cost in this case if we establish a longer amortization now for current rate case expenses.

To recognize that Elizabethtown does not have an established history of filing rate cases on a bi-annual basis and that many of the costs incurred in this proceeding will not be necessary in the next base rate proceeding I recommend that actual, known rate case expenses arising in this proceeding be amortized over a five-year period. My adjustment to accomplish this is shown on Schedule 3, page 15.

14. MISCELLANEOUS EXPENSES

17. PLEASE EXPLAIN THE MISCELLANEOUS EXPENSE ADJUSTMENT SHOWN ON SCHEDULE 3, PAGE 16, OF YOUR REVENUE REQUIREMENT EXHIBIT.

1. Together, the expenses shown on this schedule represent costs incurred by Elizabethtown that were not necessary for the provision of safe, adequate and reliable service to New Jersey ratepayers. They include charitable contributions, promotional dinners and entertainment events, lobbying expenses, local chamber dues, and employee golf memberships. I do not take issue with the utility's right to undertake these activities. I do object to having ratepayers fund these activities, however. In fact, the July 25, 2002 decision by the New Jersey Supreme Court held that charitable contributions paid for by a utility could not be subsidized by consumers and, therefore, should not be included in a utility's revenue requirement. Matters of politics and charity are personal. Each individual has a right to contribute as he or she sees fit. It is not proper, however, to require New Jersey ratepayers to contribute to these organizations and activities on behalf of the Company. Similarly, the Board maintains a long standing policy to exclude public relations, lobbying and political activities expenses out of rate cases. Re Jersey Central Power and Light Company BRC Docket No. ER91121820J (June 15, 1993). I consider promotional dinners and entertainment events and local chambers dues to fall into this category. Therefore, my adjustment, which reduces test year expenses by \$148,000, eliminates the cost of these activities from Elizabethtown's revenue requirement.

15. INTEREST SYNCHRONIZATION

17. PLEASE DESCRIBE YOUR INTEREST SYNCHRONIZATION ADJUSTMENT THAT YOU SHOW ON SCHEDULE 3, PAGE 17.

1. This schedule shows the required adjustment to state and federal income taxes to synchronize the interest expense tax deduction with the debt portion of the overall return requirement recommended by Mr. Copeland. The pro forma tax deduction for interest expense is the product of the weighted average embedded cost of debt and my rate base determination.

17. SINCE YOU ARE RECOMMENDING THAT CUSTOMER DEPOSITS BE ELIMINATED FROM RATE BASE RATHER THAN INCLUDED IN THE CAPITAL STRUCTURE, HOW HAVE YOU TREATED THE INTEREST EXPENSE ON CUSTOMER DEPOSITS?

1. Because I have deducted customer deposits from rate base, I also removed them from the capital structure as well. Thus, my interest synchronization adjustment does not calculate the tax deduction for interest on customer deposits. Therefore, I have developed a separate adjustment on the income statement to include customer deposit interest as an above-the-line expense and to reflect the tax deductibility of the interest on customer deposits. This adjustment is shown on my Schedule 3, page 2c, Column C.

16. SUMMARY OF REVENUE REQUIREMENT

17. WHAT IS THE COMBINED EFFECT OF ALL OF THE ABOVE ADJUSTMENTS ON ELIZABETHTOWN-S CLAIMED EARNINGS UNDER PRESENT RATES?

1. As shown on my Schedule 3, page 1, Mr. Clancy has calculated pro forma earnings under present rates of \$17,023,000. My adjustments add \$8,944,000 to Mr. Clancy's claimed earnings. Thus, I calculate that Elizabethtown's present base rates generate \$25,967,000 of earnings under pro forma conditions and a 6.58 percent overall return on rate base.

Ratepayer Advocate witness Mr. Copeland determined that Elizabethtown requires a 9.5 percent return on common equity capital and a 7.68 percent overall return on rate base. Thus, rate levels should be adjusted to achieve a \$7,469,000 annual revenue increase to allow Elizabethtown an opportunity to earn Mr. Copeland's recommended rate of return.

5. SYSTEMS IMPROVEMENT ADJUSTMENT CLAUSE (SIAC)
17. HAVE YOU REVIEWED THE COMPANY'S PROPOSED SIAC?
  1. Yes, I have. The Company's witness, Mr. Chilton is proposing a post-rate case rate mechanism designed to increase base rates on an annual basis, subject to an earnings test, to recover incremental revenue requirements associated with certain system improvement projects and accelerated completion of Elizabethtown's cast iron main replacement program. The incremental rate adjustments would be timed to coincide with the annual BGSS filings.
17. WHAT ARE YOUR RESPONSIBILITIES WITH RESPECT TO ANALYZING THE PROPOSED SIAC?
  1. Ratepayer Advocate witness Frank Hollowa has reviewed Elizabethtown's capital projects from an engineering standpoint. The Ratepayer Advocate asked me to analyze

the proposed SIAC from a ratemaking policy perspective. Specifically, I was asked to offer my opinion concerning whether there was anything in Elizabethtown's financial profile that suggests a need for an SIAC and to discuss the ratemaking policy issues that arise concerning the SIAC and the earnings test.

17. HAS ELIZABETHTOWN SUFFICIENTLY DEMONSTRATED THE NEED FOR AN SIAC?

1. No, it has not. Other than expressing its desire to avoid base rate scrutiny over the next several years, Elizabethtown has not shown a need for special regulatory treatment for plant expansion costs. Nor has it identified any need that currently is being unmet under the Board's traditional rate setting policies with respect to plant additions.

In my opinion, special regulatory treatment may be appropriate when a utility is financially incapable of meeting its service obligation absent special treatment. For example, in a situation where a utility is unable to secure financing for a needed project due to bond covenant restrictions, special ratemaking provisions may be necessary. Such is not the case with Elizabethtown, however. Elizabethtown does not claim that it is unable to finance the projects that the SIAC is designed to cover. Even if this were the case, the proposed SIAC would not solve the problem. The SIAC would not change base rates until after each project had been completed and was in service. This is long after when Elizabethtown would obtain financing for these projects. Thus, the only support for the proposed SIAC seems to be Elizabethtown's desire to avoid a base rate case over the next several years.



17. IS AVOIDING BASE RATE CASES A SUFFICIENT AND LEGITIMATE REASON FOR ADOPTING AN SIAC?

1. No, it is not. While most utilities would love to increase base rates annually while, at the same time, avoiding comprehensive base rate reviews, rate mechanisms that provide this result generally are not in the public interest. Ratepayers depend on regulators to conduct periodic reviews to determine just and reasonable rates. Moreover, I have been advised by counsel that in New Jersey, allowing for incremental rate increases for one element of a utility's cost structure without also examining all other elements of the utility's costs has been prohibited as single issue ratemaking. It has been a long recognized principle that such a one-sided treatment of expenses in favor of the utility does not result in just and reasonable rates. See, *In re Revision of Rates by Redi-Flow Corp.*, 76 N.J. 21, 41 (1978); see also, *In re Intrastate Industrial Sand Rates*, 66 N.J. 12 (1974). Just and reasonable rates can only be determined after examining the utility's unit cost of service with respect to a consistent test period. That is, all revenue, expense, investment and sales volumes should be examined within a given test period. Only after all of these elements that go into the utility's unit cost of service have been examined can a truly just and reasonable rate be established. Recognizing single cost increases without also recognizing all other changes in costs, investments, expenses, and sales volumes will distort the unit cost of service calculation. For this reason, I oppose rate increases based on single line-item cost increases. My opposition holds regardless of whether or not the single item under consideration is expected to produce net income. Beyond the test period, all revenue, expense, investment, and sales volume levels can be expected to change to some degree. Ignoring all changes except for one single cost increase outside of a test period is simply inappropriate rate setting policy.

and is detrimental to ratepayers who depend on regulators to require comprehensive reviews prior to resetting base rates. Imagine the outcry from Elizabethtown that would result if the Ratepayer Advocate proposed a rate clause to reduce rates over the next four years each time the Company's embedded cost of debt declined while ignoring all other cost changes. Perhaps Mr. Chilton tacitly acknowledges the unfairness to ratepayers and the disadvantage that the SIAC places on ratepayers when he proposes to implement the SIAC and increase rates without noting the increase as a separate item on the customers' bills.<sup>10</sup> Rate cases, as unpleasant and expensive as they are, are the most equitable way to establish base rates for all concerned parties. Under conditions of increasing unit costs rate cases are unavoidable. Yet, they provide the best means for ratepayers to feel confident that regulators are holding rates to reasonable and necessary levels.

17. IS IT CERTAIN THAT ADOPTING THE SIAC WILL OBVIATE THE NEED FOR ELIZABETHTOWN TO SEEK BASE RATE INCREASES OVER THE NEXT SEVERAL YEARS?
  1. No. It is not certain that Elizabethtown will not also ask the Board for additional base rate increases during the years over which the SIAC is to be effective. Elizabethtown has not proposed a base rate filing moratorium in exchange for authority to implement an SIAC. Thus, New Jersey ratepayers are exposed to annual rate increases under the SIAC and also face the prospect of additional base rate increases over the next four years in spite of the SIAC. The Company obviously is not proposing a symmetrical adjustment clause to decrease base rates if the unit cost of service actually declines over the next four years. Thus, the

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<sup>10</sup>Direct Testimony of Robert Chilton, Exhibit P-5, page 11, lines 18-20.

SIAC, in addition to possible additional base rate relief, places Elizabethtown in a win-win situation. In West Virginia, where post-test year capital expansion costs have been included in special rate riders, the utilities are not allowed to file additional base rate increases during the rate moratorium period.

17. DOESN'T COUPLING THE RECOVERY OF AN SIAC CHARGE WITH AN EARNINGS TEST GUARANTEE THAT RATES WILL REMAIN JUST AND REASONABLE?

1. No, it does not. Mr. Chilton proposes to use the earnings test designed for the WNC as an initial basis for implementing an annual SIAC charge. I was not involved in establishing the WNC earnings test; therefore, I cannot comment on the reasoning for that specific earnings test. It is my opinion, however, that the WNC earnings test is not a sufficient basis for determining whether an SIAC charge is appropriate and that the resulting base rates are just and reasonable.

An appropriate examination of Elizabethtown's earnings to determine that rates are just and reasonable involves the same investigation and the same level of detail that is undertaken in a base rate proceeding. Just and reasonable rates are those that reflect the utility's underlying cost of service. To make this determination, one would have to thoroughly examine the utility's cost of service, as is done in a base rate proceeding such as this one.

Abbreviated earnings analyses, such as that proposed by Mr. Chilton, may not reflect Elizabethtown's actual unit cost of service or the justness and reasonableness of rates. Rates set in this proceeding are based on the sales, costs, and conditions that were present during the test period or in the approved post-test

period. No claim is made, however, that the same conditions will exist into the future, or that the recommendations made, and Board policies that have been set with current conditions in mind, will be appropriate into the future. Thus, earnings tests that are based on past Board regulatory treatments and cost allowances are not necessarily appropriate into the future as conditions, costs and circumstances change.

If the Board felt that utility cost structures were reasonably stable and predictable there would never be a need for base rate filings. The Board could establish its ratemaking policies and set an initial rate. Thereafter, the utility would need only to file abbreviated earnings tests based on established Board precedent and change base rates accordingly. We all know that this is not the case, however. The Board correctly requires comprehensive rate reviews before re-setting base rates. Changes in circumstances and treating new regulatory issues cannot be reasonably accommodated in abbreviated earnings reviews. My position on the SIAC is consistent with the views expressed by the Ratepayer Advocate in its review of the Distribution System Improvement Charge (DSIC). The DSIC was a recovery mechanism proposed by the water utilities to pass through to the ratepayers certain fixed costs of plant projects completed and placed in service between rate cases that are allegedly non-revenue producing. A working group, comprising of several of the state's water utilities, Staff and the Ratepayer Advocate was organized to discuss the the need for such a recovery mechanism. Docket No. WO 99120926. In disbanding the Working Group, Staff noted in a April 5, 2000 letter to the parties: "Staff is suspending all future meetings of the DSIC Working Group and Subworking Groups, until Staff receives the necessary information demonstrating the threshold need for, and the compelling public

interest to be served by, DSIC.@ I have been informed by counsel that the Working Group has not met since the issuance of the letter.

17. DO YOU HAVE ANY OTHER CONCERNS WITH THE EARNINGS TEST PROPOSED BY MR. CHILTON?

1. Yes, I do. I object to the plus100 basis point earnings band that Mr. Chilton places on the return on equity to determine in an earnings review if Elizabethtown would qualify for an SIAC charge. In other words, Mr. Chilton proposes that Elizabethtown's common equity return could float 100 basis points in the earnings test above the Board awarded level and still qualify new investment for an SIAC surcharge. Using the Company's proposed rate base and capital structure as an example, a 100 basis point increase in the equity return would allow Elizabethtown to earn in revenues approximately \$3.5 million more than the rate award granted in this proceeding and still qualify for additional recoveries under the SIAC.

I have two objections to Mr. Chilton's proposal in this respect. First, if established Board precedent is to be followed, then there is no support for treating the common equity return any differently from any other Board-ordered adjustments by including an additional common equity return allowance in the earnings test as Mr. Chilton recommends. Second, if any earnings band were appropriate to consider, Mr. Chilton's reasoning is counter-intuitive. Common equity returns are set by regulators in part based on risk factors facing the utility. To the extent that the risk of not achieving timely recovery of new plant investment is recognized in establishing an equity return allowance, that risk is reduced by the SIAC. Therefore, if an equity band is to be considered at all, it

should be set lower than the authorized rate of return, not greater as Mr. Chilton proposes. In this way, ratepayers will not be asked to compensate the Company twice for the same element of risk.

17. MR. CHILTON STATES THAT ELEMENTS OF THE PROPOSED SIAC WERE BORROWED FROM A RATE TREATMENT THAT THE BOARD APPLIED TO SOUTH JERSEY GAS COMPANY IN A 1997 RATE PROCEEDING. WHAT ARE YOUR COMMENTS ON THIS?
  1. What the Board authorized for South Jersey in the 1997 rate proceeding and what Mr. Chilton is proposing as an SIAC in this proceeding are two entirely different things. Mr. Chilton's proposed SIAC would increase base rates to recover the incremental revenue requirements of the qualifying construction projects. The Board did not authorize periodic base rate increases for South Jersey for its qualifying projects, however. Rather, South Jersey was permitted to retain a larger portion of the margin on off-system sales and transportation until the incremental revenue requirement was met. That is, South Jersey would not have recovered anything under the special program if it did not achieve an adequate level of off-system sales and transportation. South Jersey's base rates were not affected by the special adjustment. Mr. Chilton's SIAC, on the other hand, would increase base rates regardless of the Company's marketing ability to achieve additional sales and transportation loads to offset the cost of the new facilities. Thus, there are striking differences between the two programs. Clearly, the proposed SIAC is more onerous on Elizabethtown's ratepayers than the treatment that was afforded to South Jersey as part of a comprehensive settlement among the parties in South Jersey's 1997 rate proceeding.

In summary, the Company has not demonstrated a financial need for an SIAC nor has it shown that an SIAC is in the public interest. Moreover, the Company also proposes to include in the SIAC provision for the collection of expenditures that may be required by a state task force investigating new security measures for the utility industry in response to the September 11, 2001 disaster.<sup>11</sup> This proposal likewise should be rejected. First, such expenditures are purely speculative at this time. Second, it is likely that if the task force were to impose new security measures affecting the utility industry, the task force would also establish a procedure for the utilities to recover the related costs.

I find no basis for recommending special rate treatment for any of Elizabethtown's future construction requirements. The Board's ratemaking policy already extends up to six months beyond the end of the test year to consider post-test year plant additions. The Board also permits utilities to set rates based on year-end operating conditions. These two factors go a long way to help utilities reduce problems with attrition. But, the Board can only go so far. It need not adopt rate principles that assure utilities that they will not need to file base rate cases for an extended period of time. Ratepayers deserve to have confidence in their regulators that the rates being paid reflect the utility's underlying cost of service. This can only be accomplished through periodic comprehensive rate reviews in base rate proceedings. Mr. Chilton's SIAC proposal is antithetical to this process. For these reasons, I recommend that Your Honor and the Board reject the Company's proposal to implement an SIAC.

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<sup>11</sup>Direct Testimony of Robert Chilton, Exhibit P-5, page 8.

**VI. AUTOMATED METER READING**

**Q. DO YOU HAVE ANY COMMENTS IN ADDITION TO THOSE OF MS. ALEXANDER CONCERNING THE COMPANY'S PROPOSED CUSTOMER TECHNOLOGY CLAUSE (ACTC®)?**

2. Yes, I have a brief comment. In her testimony, Ratepayer Advocate witness Ms. Alexander concludes that Elizabethtown does not need a special program to recover the costs associated with installing automated meter reading (AMR®) devices. The Company's proposal was to amortize in rates the installation costs over a five-year period through a CTC rider. Because Ms. Alexander testifies against the need for special rate treatment for these costs, a five-year amortization would not be appropriate. Rather, the Company should follow the Board's capitalization policies and the Uniform System of Accounts and account for the AMR costs accordingly.

**Q. DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?**

A. Yes it does.