**BEFORE THE STATE OF NEW JERSEY**
**OFFICE OF ADMINISTRATIVE LAW**

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| **I/M/O THE PETITION OF PUBLIC SERVICE ELECTRIC & GAS COMPANY FOR APPROVAL OF AN INCREASE IN GAS RATES AND FOR CHARGES IN THE TARIFF FOR GAS SERVICE** | **) BPU DOCKET NO. GR01050328**<br>**) OAL DOCKET NO. PUC-5052-01** |
| **I/M/O THE PETITION OF PUBLIC SERVICE ELECTRIC & GAS COMPANY FOR AUTHORITY TO REVISE ITS GAS PROPERTY DEPRECIATION RATES** | **) BPU DOCKET NO. GR01050297**<br>**) OAL DOCKET NO. PUC-5016-01** |

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**DIRECT TESTIMONY OF ROBERT J. HENKES**
**ON BEHALF OF**
**THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE**

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PUBLIC SERVICE ELECTRIC AND GAS COMPANY
BPU Docket No. GR01050328
OAL Docket No. PUC-05052-01
Direct Testimony of Robert J. Henkes

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## I. STATEMENT OF QUALIFICATIONS

Q. WOULD YOU STATE YOUR NAME AND ADDRESS?

A. My name is Robert J. Henkes and my business address is 7 Sunset Road, Old Greenwich, Connecticut 06870.

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. Since June of 1999, I am Principal and founder of the firm of Henkes Consulting, a financial management consulting firm specializing in utility regulation.

Q. WHAT IS YOUR REGULATORY EXPERIENCE?

A. I have prepared and/or presented numerous testimonies in rate proceedings involving electric, gas, telephone and water companies in a number of jurisdictions including Arkansas, Delaware, District of Columbia, Georgia, Kentucky, Maryland, New Jersey, New Mexico, Ohio, Pennsylvania, Vermont, the U.S. Virgin Islands and before the Federal Energy Regulatory Commission ("FERC"). A complete listing of jurisdictions and rate proceedings in which I have been involved is provided in Appendix I supplementing this direct testimony. All of my regulatory work has been on behalf of the ratepayers.

Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?

A. Prior to my current position, I was a Principal of The Georgetown Consulting Group, Inc. for the last 20 years, during which I performed the same type of consulting services as I am currently rendering through Henkes Consulting. Prior to my association with the Georgetown Consulting Group, Inc., I was employed by the American Can Company as Manager of Financial Controls. Before joining the American Can Company, I was employed by the Management Consulting Division of Touche Ross & Co. for six years. At Touche Ross, my experience, in addition to regulatory work, included numerous projects in a wide variety of financial areas including cash flow projections, bonding feasibility, capital and profit forecasting, and the design and implementation of accounting and budgetary reporting and control systems.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I hold a Bachelor degree in Management Science, received from the University of Utrecht, The Netherlands in 1966; a Bachelor degree in Marketing, received from the University of Puget Sound in 1971; and an MBA degree in Finance, received from Michigan State University in 1973. I have also completed the CPA program of the New York University Graduate School of Business.

## II. SCOPE AND PURPOSE OF TESTIMONY

Q. WHAT IS THE SCOPE AND PURPOSE OF THIS TESTIMONY?

A. I was engaged by the New Jersey Division of the Ratepayer Advocate ("Ratepayer Advocate") to conduct a review and analysis and present testimony in the matter of the petition of Public Service Electric and Gas Company ("PSE&G" or "the Company") for approval of an increase in its base rates for gas service.

The purpose of this testimony is to present to the New Jersey Board of Public Utilities ("BPU" or the "Board") the appropriate pro forma rate base and pro forma operating income, as well as the appropriate revenue requirement for the Company in this proceeding.

In determining the recommended revenue requirement positions contained in this testimony, I have adopted the recommendations of James Rothschild regarding the Company's overall rate of return and Michael Majoros regarding the appropriate gas plant depreciation rates to be used for rate making purposes in this case.

In developing this testimony, I have reviewed and analyzed the Company's petition, testimonies and exhibits, and filing workpapers; responses to interrogatories and other relevant financial documents and data.

Q. WHAT IS THE STARTING POINT YOU HAVE USED IN THE PREPARATION OF THIS TESTIMONY AND THE ACCOMPANYING SCHEDULES RJH-1 THROUGH RJH-25?

A. PSE&G filed this case on May 25, 2001 based on a test year ended June 30, 2001. All of the Company's unadjusted test year filing data and pro forma test year adjustments are based on

6 months actual data (from July 1, 2000 through December 31, 2000) and 6 months projected data (from January 1, 2001 through June 30, 2001). This will be referred to throughout this testimony as the "6+6" filing. On June 27, 2001, the Company updated its originally filed "6+6" unadjusted test year data with unadjusted test year data on a "9+3" basis (9 months actual and 3 months projected data), however, it did not update all of its originally filed pro forma test year adjustments based on "9+3" data. Because the Company's "9+3" filing update was incomplete, I have used the Company's originally filed "6+6" filing as the starting point of my analyses in this proceeding. The following testimony and the accompanying schedules RJH-1 through RJH-25 describe all of the recommended adjustments made by the Ratepayer Advocate to this starting point in order to arrive at the Ratepayer Advocate's overall recommendations regarding PSE&G's rate of return, rate base, operating income and resulting revenue requirement.

Q. SHOULD THE RECOMMENDED RATEPAYER ADVOCATE POSITIONS THAT ARE CURRENTLY REFLECTED IN THIS TESTIMONY ON A "6+6" TEST YEAR BASIS BE UPDATED FOR FULLY ACTUAL "12+0" TEST YEAR DATA?

A. Yes. In response to various data responses, the Company has confirmed that it will update its case for "12+0" test year filing data on or before August 31, 2001 so that "the Board has the most recent information available when it renders a decision in this proceeding."[1] Once this "12+0" test year information has become available -- for both the unadjusted test year data and all of the pro forma test year adjustments --, the Ratepayer Advocate's recommended "6+6"

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[1] Kruger testimony, page 2 and Stellwag testimony, page 5.

test year positions must be updated to reflect recommended “12+0" test year positions.

## III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. MR. HENKES, PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS IN THIS CASE.

A. The findings and conclusions reached by me in this case are summarized on Schedule RJH-1 and are as follows:

1. The appropriate pro forma rate base amounts to $1,753,303,000 which is $78,075,000 higher than the Company's proposed pro forma rate base of $1,675,228,000 (see Schedule RJH-1, line 1).

2. The appropriate pro forma operating income amounts to $148,791,000, which is $99,044,000 higher than the Company's proposed pro forma operating income of $49,747,000 (see Schedule RJH-1, line 4).

3. Ratepayer Advocate rate of return witness James Rothschild has recommended an appropriate overall rate of return for this Company in this case of approximately 8.22%. This recommended overall rate of return number incorporates a recommended return on equity requirement of 9.85%. The recommended overall rate of return of approximately 8.22% compares to an overall rate of return of 9.05%, incorporating a return on equity rate of 12.00%, proposed by the Company in this case (see Schedule RJH-1, line 2 and Schedule RJH-2).

4. The appropriate revenue conversion factor to convert the income deficiency to the need for a rate increase in this case is 1.6940 (see Schedule RJH-1, line 6).

5. The four recommended rate making components described in points 1 through 4 above indicate the need for an annual rate decrease of $8,045,000. This is $180,598,000 lower than the Company's proposed rate increase of $172,553,000 (see Schedule RJH-1, line 7).

6. The Advocate's recommended revenue requirement for PSE&G in this testimony reflects the recommended reversal of the Company's proposal to transfer its gas supply, storage and capacity contracts out of the regulated utility into an unregulated affiliate. This recommended base rate case position is consistent with the Ratepayer Advocate's position in the separate Transfer Case currently being litigated in BPU Docket No. GR00080564. Thus, the recommended revenue requirement for PSE&G that is contained in this testimony is based on the assumption that all of the Company's gas supply, storage and capacity contracts will remain with PSE&G. This assumption has the effect of increasing the Company's proposed revenue requirement[2] by approximately $16.9 million, everything else being equal. Conversely, if the Board, in Docket No. GR00080564, were to allow the transfer, this would have the effect of decreasing by $16.9 million the Ratepayer Advocate's recommended revenue requirement currently

[2] The Company's proposed revenue requirement is based on the assumption that the transfer will take place.

reflected on Schedule RJH-1 of this testimony.

## IV. REVENUE REQUIREMENT ISSUES

### A. <u>GAS SUPPLY AND STORAGE CONTRACTS TRANSFER</u>

Q. WHAT IS THE COMPANY PROPOSING IN THIS CASE WITH REGARD TO ITS GAS SUPPLY, STORAGE AND CAPACITY CONTRACTS?

A. In a separate proceeding that is currently being litigated before the BPU, the so-called Transfer Case in Docket No. GR00080564, the Company has requested the transfer of all of its gas supply, storage and capacity contracts out of the regulated PSE&G gas utility into an unregulated affiliate. Consistent with PSE&G's positions in the Transfer Case, the Company's base rate filing in the instant proceeding excludes all rate base investments, expenses and revenues associated with the gas supply, storage and capacity contracts proposed to be transferred. Specifically, the Company has excluded from its proposed rate base all test year natural gas inventories and propane stock, amounting to a total rate base reduction of approximately $374 million. This is shown on Schedule RJH-3, line 7. In addition, in pro forma operating income adjustment No. 11[3], the Company has made an overall net pro forma operating income adjustment of approximately $17.5 million to remove all gas supply, storage and capacity related test year revenues, depreciation expenses, operation and maintenance expenses, and rate base rate of return requirements. These Transfer-related pro forma rate base and operating income adjustments have the net effect of reducing the Company's claimed revenue requirement in this case by approximately $16.9 million.

[3] See Schedule ANS-14.

Q. WHAT IS THE RATEPAYER ADVOCATE'S POSITION IN THE DOCKET NO. GR00080564 TRANSFER CASE REGARDING THE COMPANY'S PROPOSAL?

A. I have been informed that the Ratepayer Advocate is strongly opposing the proposed Transfer. As outlined in the direct testimonies of Ratepayer Advocate witnesses Richard Lelash and Paul Chernick in Docket No. GR0080564, some of the more important reasons why the Ratepayer Advocate believes that the proposed contract transfer and associated Requirements Contract between the unregulated affiliate and PSE&G should be rejected by the Board at this time are that the proposed transactions are contrary to the policies and mandates of the Electric Discount and Energy Competition Act ("EDECA") and are imprudent with respect to gas supply procurement.[4] Furthermore, it is the position of the Ratepayer Advocate that "....A transfer should be considered only after a robust competitive natural gas marketplace has developed, and the Board is assured that Public Service's control of its gas supply resources is no longer needed to assure reliable and reasonably priced BGSS, otherwise consumers will be served by an 'unregulated monopoly.'"[5] It is the opinion of the Ratepayer Advocate that such conditions do not exist at this time.

Q. WHAT IS THE RATEPAYER ADVOCATE'S RECOMMENDED POSITION REGARDING THE PROPOSED TRANSFER AS REFLECTED IN YOUR REVENUE REQUIREMENT PRESENTATION IN THE INSTANT BASE RATE PROCEEDING?

A. Consistent with the position of the Ratepayer Advocate in Docket No. GR00080564, I have

[4] Page 10 of the testimony of Richard W. Lelash, Docket No. GR00080564.

[5] Page 11 of the testimony of Richard W. Lelash, Docket No. GR00080564.

reversed all of the gas supply, storage and capacity transfer adjustments proposed by the Company in this case. Thus, the Ratepayer Advocate's recommended revenue requirement as presented in this testimony is based on the assumption that all of the Company's gas supply, storage and capacity contracts will remain with PSE&G. My recommended reversals of the Company's proposed Transfer adjustments in this case are shown on Schedule RJH-3, line 7 (reversing the Company's proposed rate base exclusion of the natural gas inventories and propane stock) and Schedule RJH-4, line 8 (reversing the Company's proposed operating income adjustment related to the Transfer). The previously described recommended reversals of the Company's proposed Transfer-related rate base and operating income adjustments have the effect of increasing the Company's proposed revenue requirement by approximately $16.9 million, everything else being equal.

Q. IF THE COMPANY'S PROPOSED GAS SUPPLY TRANSFER AND ASSOCIATED REQUIREMENTS CONTRACT BETWEEN PSE&G AND THE UNREGULATED AFFILIATE HAVE THE EFFECT OF DECREASING THE REVENUE REQUIREMENT BY $16.9 MILLION IN THIS CASE, DOESN'T THIS MEAN THAT YOUR RECOMMENDED REVERSAL OF THESE TRANSACTIONS WILL INCREASE THE RATES OF PSE&G'S GAS RATEPAYERS BY $16.9 MILLION?

A. No, it does not. The data would appear to indicate that the Company's gas supply, storage and capacity contract operations have been subsidized by PSE&G's other gas operations. This kind of subsidy will no longer be available if the contracts were to be transferred to the unregulated affiliate and this, in turn, means that the costs to be paid by PSE&G's ratepayers to the unregulated affiliate under the full Requirements Contract for gas supply, storage and capacity functions and services will likely become higher -- potentially to an extent equal to or larger than the $16.9 million subsidy -- than it otherwise would be if these functions and services were to stay with the regulated utility. Thus, the overall rates to PSE&G's gas ratepayers are not likely to change if the Transfer to the unregulated affiliate is rejected by the Board.

B. RATE BASE

Q. HAVE YOU SUMMARIZED THE COMPANY'S PROPOSED AND YOUR RECOMMENDED RATE BASE POSITIONS?

A. Yes. The Company's proposed pro forma rate base of $1,675,228,000, based on "6+6" filing data, is summarized by specific rate base component on Schedule RJH-3. As shown on this schedule, I have recommended a pro forma rate base of $1,753,303,000 by making various rate base adjustments with the net effect of increasing the Company's proposed rate base by a total amount of $78,075,000. Each of these recommended rate base adjustments will be discussed in detail below.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE RECOMMENDED RATE BASE COMPONENTS SHOWN ON SCHEDULE RJH-3?

A. Yes. Most of the components in the recommended rate base reflect projections based on "6+6" test year filing data. Once actual data have become available for the full test year, these recommended rate base balances should be updated based on "12+0" test year data.

- Plant In Service

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO THE COMPANY'S PROJECTED PLANT IN SERVICE BALANCE, AS SHOWN ON SCHEDULE RJH-3, LINE 1.

A. As confirmed in the response to RAR-A-88, in March 2001 the Company booked large ($35 million) gas plant retirements at its Harrison, Linden, Central and Camden production plants. These plant retirements are not reflected in the Company's "6+6" projected plant in service balance at June 30, 2001. In order to reflect these plant retirements, I have recalculated the Company's projected plant balance at 6/30/01 by taking the actual March 31, 2001 plant in service balance[6] as the starting point and then adding the Company's projected net plant additions for the months of April, May and June 2001. As shown on Schedule RJH-5, this results in a recommended 6/30/01 projected plant in service balance of $3,274,459,000. Rate base summary Schedule RJH-3, line 1 shows that this recommended plant balance is $52,411,000 lower than the Company's 6/30/01 projected plant balance.

- Accumulated Depreciation Reserve

Q. PLEASE EXPLAIN YOUR ADJUSTMENT TO THE COMPANY'S ACCUMULATED DEPRECIATION RESERVE BALANCE, AS SHOWN ON SCHEDULE RJH-3, LINE 2.

A. The $35 million of plant retirements described in the prior section of this testimony were

[6] Since the retirements were booked in March 2001, the actual March 31, 2001 plant balance includes the impact of the retirements.

similarly booked to the Company's accumulated depreciation reserve balance in March 2001. These depreciation reserve retirements are not reflected in the Company's "6+6" projected plant in service balance at June 30, 2001. In order to reflect these depreciation reserve retirements, I have recalculated the Company's projected reserve balance at 6/30/01 by taking the actual March 31, 2001 reserve balance[7] as the starting point and then adding the Company's projected net depreciation reserve additions for the months of April, May and June 2001. As shown on Schedule RJH-6, this results in a recommended 6/30/01 projected plant in service balance of $1,386,907,000.

Q. ARE THERE ANY OTHER REASONS FOR THE DIFFERENCE BETWEEN YOUR RECOMMENDED AND THE COMPANY'S PROPOSED PRO FORMA DEPRECIATION RESERVE BALANCES?

A. Yes. As shown on Schedule RJH-6, the Company's proposed pro forma test year-end depreciation reserve balance also includes one-half of the difference between the Company's proposed annualized depreciation expenses and the actual test year depreciation expenses. Similar to this rate making approach, the recommended pro forma depreciation reserve balance includes one-half of the difference between the Ratepayer Advocate's proposed annualized depreciation expenses and the actual test year depreciation expenses.

In summary, the two previously described adjustments result in a total recommended pro forma depreciation reserve balance of $1,370,326,000 which is $83,128,000 lower than the

[7] Since the retirements were booked in March 2001, the actual March 31, 2001 depreciation reserve balance includes the impact of the retirements.

Company's proposed pro forma depreciation reserve balance of $1,453,454,000.

- Lead/Lag Cash Working Capital

Q. PLEASE BRIEFLY SUMMARIZE THE COMPANY'S PROPOSED CASH WORKING CAPITAL ("CWC") ALLOWANCE IN THIS CASE.

A. The Company's proposed cash working capital requirement consists of two components. The first component is the cash working capital determined by use of a detailed lead/lag study. The results of this lead/lag study, indicating a total requirement of $85.5 million, are summarized on Mr. Hahne's Schedule RLH-2. The second component is the Net Assets and Liabilities balance for the test year, representing the uses and sources of cash funds by those assets and liabilities that have not already been accounted for in the lead/lag study or as separate rate base items. As summarized on Mr. Hahne's Schedule RLH-6, this Net Assets and Liabilities balance amounts to a negative cash working capital requirement of $33,690,000, thereby offsetting the $85.5 million positive lead/lag study cash working capital. In summary, the Company's proposed net cash working capital request in this case is $51,816,000, as shown on Mr. Hahne's Schedule RLH-1.

Q. WHAT IS YOUR POSITION IN THIS CASE REGARDING MR. HAHNE'S PROPOSED NET ASSETS AND LIABILITIES CASH WORKING CAPITAL BALANCE?

A. Based on my review and analysis of Mr. Hahne's Net Assets and Liabilities study summarized in Schedule RLH-6 and various discovery responses on this subject, I find these study results to be reasonable. I have therefore accepted the Company's proposed cash working capital reduction of $33.7 million, as shown on my summary rate base Schedule RJH-3, line 4b.

Q. MOVING NOW TO MR. HAHNE'S LEAD/LAG STUDY, DO YOU AGREE WITH THE LEAD/LAG DAYS EMPLOYED IN HIS STUDY?

A. Yes. I generally agree with all of the lead/lag days for revenues, expenses and taxes that are included in Mr. Hahne's study and that are summarized on his Schedule RLH-2.

Q. DO YOU AGREE WITH ALL OF THE REVENUE REQUIREMENT COMPONENTS INCLUDED IN MR. HAHNE'S LEAD/LAG STUDY?

A. No, I do not agree with Mr. Hahne's proposal to include depreciation expenses, deferred income taxes and invested capital with assumed payment lags of 0 days in the study.

Q. COULD YOU EXPLAIN YOUR DISAGREEMENTS IN MORE DETAIL?

A. Yes. I believe that a properly conducted lead-lag study (1) should *exclude* non-cash depreciation expenses and deferred income taxes, (2) should *exclude* the return on equity, and (3) should *include* debt interest with appropriate payment lags.

In general, the appropriate cash working capital should be based on the timing differences between the payment of cash expenses and taxes and the receipt of cash operating revenues. Expenses related to depreciation and deferred taxes simply do not represent or require cash outlays during the lead/lag study period. Therefore, these non-cash expenses should be removed from the lead/lag study.

With regard to the return on common equity, this return element should not result in a cash working capital requirement. Even if one were to assume that there is a cash working capital requirement associated with the return on equity, this effect should already be incorporated in the equity return required by the common stock investor. The Company is essentially taking the position that the common shareholder is entitled to the return on his equity investment at the exact instant that service is rendered. I disagree with this fundamental assumption. While it may sound appropriate that the common shareholder is entitled to the return on his equity investment, it is a fact that the shareholder receives his return through the quarterly payments of dividends and any gain in the Company's stock. This is the mechanism by which the common shareholder is compensated in the real world. For the aforementioned reasons, I recommend that the return on equity be removed from the lead/lag study.

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

Q. SHOULD THE AVAILABILITY OF FUNDS DUE TO THIS INTEREST PAYMENT LAG BE CONSIDERED IN THE DETERMINATION OF THE COMPANY'S WORKING CAPITAL REQUIREMENT?

A. Yes. The interest payments to be made to the bondholders are fixed by contract. They cannot be made earlier nor later than the specified date. In this, the bondholders are like the tax collector or any other creditor of the Company. To refuse to consider the source of working capital from the interest payment lag has the impact of penalizing the ratepayers who are providing revenues to pay all expenses, including interest expenses; and it would provide a "windfall return" to the Company's stockholders. The bondholder, who has a fixed interest on his bond, will not receive any benefits from the act of excluding the interest payment lag from working capital considerations. It will be the common stockholder who will be allowed to earn a return on such available funds, collected from the ratepayer through rates, if this interest payment lag is not recognized for rate making purposes. For all of these reasons, debt interest expenses should be included with the appropriate payment lag in the lead/lag study to determine the Company's cash working capital requirement.

Q. HAVE YOU ADJUSTED MR. HAHNE'S PROPOSED LEAD/LAG STUDY TO REFLECT THE AFOREMENTIONED CONCLUSIONS?

A. Yes. My revised lead/lag study calculations are detailed on Schedule RJH-7. As shown on this schedule, I have removed from Mr. Hahne's lead/lag study the non-cash depreciation expenses and deferred income taxes and the entire Cost of Capital line item, while adding the Company's proposed pro forma long term debt interest with a payment lag of 91.25 days.

Q. WHAT IS THE APPROPRIATE CASH WORKING CAPITAL AMOUNT THAT RESULTS FROM THE PREVIOUSLY DESCRIBED REVISIONS TO MR. HAHNE'S LEAD/LAG STUDY?

A. As shown on Schedule RJH-7, the appropriate lead/lag study cash working capital requirement to be recognized for rate making purposes in this case amounts to approximately $43 million. As summarized on Schedule RJH-3, line 4a, this is approximately one-half of the lead/lag study cash working capital requirement of $85.5 million claimed by the Company.

- <u>Gas Stored Underground</u>

Q. HAVE YOU ADJUSTED THE COMPANY'S PROPOSED GAS STORED UNDERGROUND AND FUEL STOCK BALANCES IN THIS CASE AND, IF SO, IN WHAT RESPECT?

A. Yes, I have. First, for the reasons explained earlier in this testimony, I have reversed the Company's proposal to remove its entire gas stored underground inventory and propane fuel inventory from rate base as part of its Docket No. GR00080564 proposal to transfer PSE&G's gas supply, storage and capacity contracts out of the regulatory utility into an unregulated affiliate. As shown on Schedule RJH-3, line 7, this recommended reversal increases the

Company's proposed rate base by $373,919,000.[8]

Second, once I restored the gas stored underground balance back into rate base, I adjusted this gas inventory balance to reflect normalized natural gas pricing conditions which I believe are more representative of what can reasonably be expected during the rate effective period of this case.

Q. COULD YOU EXPLAIN THIS IN MORE DETAIL?

A. Yes. As shown on filing workpaper 167, the Company calculated its pro forma gas stored underground balance by pricing the test year's average monthly inventory volume (expressed in MDThs) at the test year's average gas receipt price per DTh. Workpaper 167 shows that the average monthly volume, on a "6+6" test year basis, is 52,686 MDThs and the average test year monthly natural gas receipt price is $7.0117 per DTh. Multiplying these two numbers results in the Company's calculated pro forma gas stored underground balance of $369,414,000.

I have adjusted both the Company's proposed average monthly gas inventory MDTh volume and the average natural gas receipt price. With regard to volume, I have used the actual 13-month average gas inventory for the period ended March 31, 2001.[9] As shown on Schedule RJH-8, this amounts to 51,683 MDThs. With regard to the natural gas price to be applied to this average volume, I have used the average NYMEX futures based on the Henry Hub natural

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[8] The $373,919,000 balance represents the sum of the Gas Stored Underground balance of $369,414,000 and the Propane Fuel Inventory balance of $4,505,000.

[9] This should eventually be updated for the actual 13-month average gas inventory volume for the test year ended 6/30/01.

gas prices for the 31-month period January 2002 through July 2004. This average price is $3.52. Schedule RJH-8 shows that the multiplication of these two numbers results in a recommended pro forma gas stored underground balance of $181,924,000. This recommended inventory balance is $187,490,000 lower than the Company's calculated inventory balance of $369,414,000.

Q. WHY DO YOU BELIEVE THAT THE USE OF YOUR RECOMMENDED PROJECTED NATURAL GAS UNIT PRICE OF $3.52 PER DTH IS MORE APPROPRIATE THAN THE COMPANY'S PROPOSED PRICE OF $7.012 PER DTH?

A. As the Board is fully aware, starting in the second quarter of 2000 and continuing through the second quarter of 2001, the prices of natural gas have escalated to unprecedented and historically high levels. For example, while the Henry Hub average monthly natural gas price was $2.53 per Dth in the first quarter of 2000, throughout the remainder of 2000 and into the first half of 2001, this average monthly natural gas price increased to levels as high as $9 per Dth. While these natural gas prices have experienced a significant downward trend starting at the end of the second quarter of 2001, this has not changed the fact that the average natural gas receipt price for the test year from June 2000 through June 2001 -- which has been used in the Company's proposed gas inventory calculations -- is at a record-high level that is reflective of the unprecedented and highly unusual run-up in gas prices during the test year.

PSE&G's proposed position in this case assumes that the average natural gas receipt price of $7 per Dth experienced by PSE&G during the test year ended 6/30/01 represents a price that is representative of the prices that, on average, can be expected during the rate effective period of this case. I do not agree with that position. I believe that the gas prices experienced during the test year ended June 30, 2001 are to be considered aberrational and are not reflective of the average prices that can reasonably be expected during the rate effective period of this case. For that reason, I have reflected a "normalized" average natural gas price in the form of the average of the NYMEX futures based on the Henry Hub Natural Gas prices for the 31-month period January 2002 through July 2004. The latest NYMEX natural gas futures available to me at this time are the ones dated Friday, July 20, 2001 showing projected monthly gas prices for the 35-month period August 2001 through July 2004. Since I have assumed that the rates from this case will become effective sometime in the first quarter of 2002, I have calculated the average gas price for the 31-month period January 2002 through July 2004. This average gas price is $3.52 per Dth.

Q. WHY DO YOU BELIEVE THAT THE BASIS FOR YOUR PROJECTED "NORMALIZED" AVERAGE GAS PRICE IS REASONABLE?

A. I believe that the basis for my projected "normalized" average gas price is reasonable and appropriate because the NYMEX futures based on the Henry Hub natural gas prices represent a universally accepted and objective source of natural gas projections that is being used by the utility industry and natural gas industry throughout the United States for gas price projection, trading and hedging purposes.

- <u>Customer Advances</u>

Q. WHY HAVE YOU ADJUSTED THE COMPANY'S PROPOSED CUSTOMER ADVANCES BALANCE, AS SHOWN ON SCHEDULE RJH-3, LINE 5?

A. As confirmed in its response to RAR-A-99, in calculating its proposed 13-month average test year customer advances balance of $1,526,000, the Company made a mathematical error which, when corrected, results in an appropriate average balance of $1,916,000. I have reflected this latter balance in the recommended rate base.

- Accumulated Deferred Income Taxes

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED NET RATE BASE DEDUCTION BALANCE FOR ACCUMULATED DEFERRED INCOME TAXES.

A. As shown in the first column of Schedule RJH-9, the Company has proposed a net rate base deduction balance of $260,444,000 for its projected 6/30/01 accumulated deferred income taxes ("ADIT"). It should be recognized that this proposed net ADIT balance of $260.4 million does not reflect *all* of the Company's accumulated deferred income taxes as of 6/30/01, but only certain selected categories of the Company's total accumulated deferred income taxes.

Q. WHAT CRITERION WAS USED BY THE COMPANY IN ITS DETERMINATION OF THE SELECTED ADIT CATEGORIES TO BE GIVEN RATE BASE CONSIDERATION?

A. The Company has only reflected those accumulated deferred tax categories that are directly related to other rate base components. For example, the ADIT balances for Liberalized Depreciation, Cost of Removal, Investment Tax Credit, Computer Software, Capitalized

Interest and NJ Corporate Business Tax are all directly related to the Company's proposed plant in service and depreciation reserve balances in rate base. The Company has therefore also given rate base recognition to the associated accumulated deferred income taxes.

Q. DOES THE COMPANY'S PROPOSED NET ADIT BALANCE CONTAIN AN ERRONEOUS ADIT COMPONENT?

A. Yes. In response to RAR-A-101(a), the Company acknowledged that its proposed ADIT balance for the NJ Corporate Business Tax is incorrect and that the reflection of the correct ADIT balance for NJ Corporate Business Tax would increase the Company's proposed overall ADIT rate base deduction balance by $3,207,000. I have reflected this correction on Schedule RJH-9, line 6.

Q. DO YOU AGREE WITH THE COMPANY'S EMPLOYED CRITERION THAT ONLY THOSE ACCUMULATED DEFERRED TAX CATEGORIES THAT DIRECTLY RELATE TO OTHER RATE BASE COMPONENTS BE CONSIDERED FOR RATE MAKING PURPOSES?

A. No. I disagree for the reason that the Company's employed criterion is incomplete. The proper criterion to use is: those accumulated deferred income taxes that relate directly to *other rate base components or to components of capital structure in the Company's overall rate of return calculation* can appropriately be considered for rate making purposes. As previously discussed, the Company's proposed net ADIT rate base balance consists of deferred taxes that are solely related to other items that are included in rate base. The Company has not considered rate base inclusion of accumulated deferred income taxes related to capital structure components.

Q. ARE THERE ACCUMULATED DEFERRED INCOME TAXES THAT ARE DIRECTLY RELATED TO CAPITAL STRUCTURE COMPONENTS?

A. Yes. These concern the accumulated deferred income taxes associated with the Company's unamortized Loss on Reacquired Debt balance. In calculating the proposed embedded cost of long-term debt rate in the capital structure claimed for rate making purposes in this case, the Company reduced its long term debt proceeds balance with the unamortized Loss on Reacquired Debt balance and added the amortization of its Loss on Reacquired Debt to the debt cost.[10] The effect of this is that it increased the Company's effective cost of long-term debt in the Company's overall rate of return claim.

In summary, the unamortized Loss on Reacquired Debt balance has been used by the Company to increase its effective embedded cost of debt in the claimed overall rate of return number and, thereby, has increased the revenue requirement to be funded by the ratepayers. It would only be fair and appropriate to then also recognize the accumulated deferred income taxes associated with the unamortized Loss on Reacquired Debt balance as a rate base deduction in this case, thereby partially offsetting the revenue requirement increase impact of the use of the unamortized Loss on Reacquired Debt balance in the Company's overall rate of return determination.

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[10] This is confirmed by the Company in its response to RAR-A-100(a).

Q. WHAT IS THE 6/30/01 ACCUMULATED DEFERRED INCOME TAX BALANCE ASSOCIATED WITH THE COMPANY'S UNAMORTIZED LOSS ON REACQUIRED DEBT BALANCE?

A. As shown in filing workpaper 187 and summarized on Schedule RJH-9, line 7, the accumulated deferred income tax balance directly related to the Company's unamortized loss on reacquired debt balance as of 6/30/01 amounts to $3,549,000. The recommended reflection of this additional ADIT category would further increase the Company's proposed net ADIT rate base deduction balance by $3,549,000.

Q. WHAT IS YOUR RECOMMENDED ADIT BALANCE TO BE USED FOR RATE MAKING PURPOSES IN THIS CASE BASED ON THE PREVIOUSLY DISCUSSED TWO RECOMMENDED ADJUSTMENTS TO THE COMPANY'S PROPOSED ADIT RATE BASE BALANCE?

A. As shown on Schedule RJH-9, I recommend that a total net ADIT balance of $267,200,000 be used as a rate base deduction in this case. This recommended net ADIT balance is $6,756,000 larger than the Company's proposed net ADIT balance and has the effect of reducing the Company's proposed rate base by that same amount of $6,756,000.

- Consolidated Income Tax Benefits

Q. DOES THE BOARD HAVE A RATE MAKING POLICY WITH REGARD TO THE RATE

MAKING TREATMENT OF TAX BENEFITS TO BE ASSIGNED TO REGULATED UTILITIES UNDER ITS JURISDICTION AS A RESULT OF THESE UTILITIES' FILING OF CONSOLIDATED INCOME TAX RETURNS?

A. Yes. The Board has an established policy requiring that any tax savings allocable to a utility as a result of the filing of consolidated income tax returns be reflected as a rate base deduction in the utility's base rate filings. The BPU first established this policy in its Decision and Order ("D&O") in the Atlantic City Electric Company rate proceeding, BPU Docket No. ER90091090J, dated September 30, 1992. In this D&O, 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 D&O in the most recent Jersey Central Power and Light Company ("JCP&L") base rate proceeding, BPU Docket No.

ER91121820J, dated February 25, 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.

Q. DOES PSE&G FILE A CONSOLIDATED INCOME TAX RETURN?

A. Yes. The Company files a consolidated federal income tax return with the parent company, Public Service Enterprise Group ("PSEG"), and its other subsidiaries.

Q. HAVE YOU CALCULATED THE APPROPRIATE CONSOLIDATED INCOME TAX ADJUSTMENT TO BE APPLIED TO PSE&G FOR RATE MAKING PURPOSES IN THIS CASE IN ACCORDANCE WITH THE METHODOLOGY PREVIOUSLY ESTABLISHED BY THE BPU?

A. Yes. My calculations are detailed on Schedule RJH-10. As shown on this schedule, I recommend that the Company's rate base in this case be reduced by $89,363,000 to reflect the impact of the consolidated income tax benefits accumulated from 1991 through 2000 that are allocable to PSE&G's gas operations. It should be noted that in calculating this recommended rate base deduction amount, I have considered PSE&G's assumed allocable share of PSEG's Alternative Minimum Tax ("AMT") payments. This AMT consideration has reduced the recommended consolidated income tax rate base deduction in this case.

Q. PLEASE DISCUSS THE INFORMATION SHOWN ON SCHEDULE RJH-10 IN MORE DETAIL.

A. While the BPU has ruled that a utility's consolidated income tax benefits accumulated since mid-1990 can be considered for rate making purposes in a base rate proceeding, I have started my analysis regarding PSE&G's cumulative consolidated income tax benefits with the year 1991 and ended it with the year 2000. All of the tax data for the years 1991 through 1999 on Schedule RJH-10 are based on PSEG's actual consolidated income tax returns. The data for the year 2000 are based on PSEG's projected year 2000 consolidated income tax results provided in response to RAR-A-35. Columns I through III of the schedule show the total PSEG taxable income numbers for each year and the breakout of this total taxable income between the regulated PSE&G utility and the non-regulated operations of PSEG. As shown in column III, the non-regulated operations of PSEG have generated a total net taxable loss amount of almost $1.6 billion in the 10-year period 1991 - 2000. Next, I applied the Company's statutory federal income tax rate of 35% to each of the annual taxable income losses from the non-regulated PSEG operations to arrive at the annual consolidated income tax benefits assignable to PSE&G in accordance with the BPU's approved methodology. As shown in column V, this results in a total cumulative PSE&G-assigned consolidated income tax benefit of $557,169,000. Next, I offset PSEG's actual AMT payments against the PSE&G-assigned consolidated income tax benefit. Again, this is in accordance with the BPU's approved methodology. Columns VI and VII show that these AMT offsets reduce the consolidated income tax benefits by $103,471,000, leaving a net-of-AMT consolidated income tax benefit of $453,698,000. Finally, I then applied PSE&G's actual gas operations income tax ratios[11] to the net annual consolidated income tax benefits in column VI in order to arrive at the appropriate cumulative net income tax benefits for the 10-year period 1991 - 2000 assignable to PSE&G's gas operations. As shown in column IX, this cumulative net consolidated income tax benefit amount is $89,363,000.

[11] As distinguished from the electric operations income tax ratios.

C. OPERATING INCOME ISSUES

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED AND YOUR RECOMMENDED PRO FORMA OPERATING INCOME POSITIONS.

A. The Company has proposed a total pro forma test year operating income amount of $49,747,000 based on its "6+6" filing data. As shown on Schedule RJH-4, I have recommended a large number of operating income adjustments with the effect of increasing the Company's proposed pro forma operating income to a recommended pro forma test year operating income level of $148,791,000. Each of these recommended operating income adjustments will be discussed in detail below.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THE RECOMMENDED PRO FORMA OPERATING INCOME SHOWN ON SCHEDULE RJH-4?

A. Yes. All of the components making up the recommended pro forma test year operating income are still based on "6+6" test year data. Once actual data have become available for the full test year, the recommended pro forma test year operating income, including all of the recommended pro forma income adjustments, must be updated based on "12+0" test year data.

- Test Year-End Customer Revenue Annualization Adjustment

Q. WHAT REVENUE ADJUSTMENTS HAVE BEEN PROPOSED BY THE COMPANY IN THIS CASE?

A. The Company has proposed one revenue adjustment in this case, that is its proposed weather normalization adjustment which reduced the Company's per books test year revenues by almost $20 million, as shown on Schedule ANS-3, page 1. Through this adjustment, the Company has normalized the test year customer consumption levels based on 30-year average normalized weather determinants. The reason for the Company's proposed large revenue reduction adjustment is that the actual portion of the "6+6" test year filing data contains abnormally cold weather. Based on my review of the Company's proposed weather normalization methodology, I have accepted the Company's proposed revenue weather normalization adjustment.

Q. HAS THE COMPANY RESTATED ITS PROPOSED WEATHER-NORMALIZED TEST YEAR REVENUES TO REFLECT THE CUSTOMER LEVELS AS OF THE END OF THE TEST YEAR, JUNE 30, 2001?

A. No. As confirmed in its response to RAR-A-86, the Company's proposed weather-normalized test year revenues are based upon the average customer levels in the test year.

Q. DOES THIS REPRESENT AN ISSUE IN THIS CASE?

A. Yes. The issue is that the Company has not annualized its proposed test year revenues for the growth in the number of customers. Because of this, the Company's proposed test year revenues are not properly "matched" with the Company's proposal to use a test year-end rate base in this proceeding.

Q. COULD YOU EXPLAIN THIS IN MORE DETAIL?

A. Yes. As discussed before, the Company's proposed test year revenues are based on the test year's average number of customers. In this regard, it is important to recognize that the plant investment that has supported the Company's average test year number of customers is the Company's average test year plant, not the (higher) June 30, 2001 test year-end plant investment level. Since the Company has proposed the use of the higher test year-end plant in service balance, it would be appropriate and consistent to then annualize the revenues for the growth in customers up to the end of the test year.

Q. WHAT SPECIFIC REVENUE ANNUALIZATION APPROACH AND METHODOLOGY DO YOU RECOMMEND BE USED IN THIS PROCEEDING IN ORDER TO ACCOMPLISH THIS YEAR-END RATE BASE VERSUS YEAR-END CUSTOMER GROWTH MATCHING?

A. It is reasonable to assume that the Company's actual average test year plant in service is approximately equivalent to the actual plant in service level during the mid-point of the test year. Therefore, the difference between the proposed test year-end plant level and the average test year plant level essentially represents one-half year's worth of growth in the Company's plant investment level. Since the Company's proposed test year residential revenues are based on the average number of customers, the appropriate revenue annualization adjustment should similarly be based on one-half year's worth of growth in the number of customers. Since I do not have the Company's detailed revenue model available, I requested the Company to perform this test year-end customer growth analysis and provide the resulting increase in margins (revenues net of the associated impact on gas costs and taxes) when compared to the Company's proposed test year "6+6" margins. My detailed request to the Company and the results of the Company's calculated revenue annualization for test year-end customer growth are contained in the response to RAR-IDR-2.

Q. WHAT WAS THE RESULT OF THIS REVENUE ANNUALIZATION ANALYSIS FOR TEST YEAR-END CUSTOMER GROWTH AND HOW DOES THE REFLECTION OF SUCH ANNUALIZED REVENUES IMPACT THE COMPANY'S PROPOSED PRO FORMA TEST YEAR OPERATING INCOME IN THIS CASE?

A. The response to RAR-IDR-2 shows that my recommended revenue annualization adjustment for customer growth up to the end of the test year increases the Company's proposed "6+6" test year revenue margins by $819,000. As shown on Schedule RJH-11, this increases the Company's proposed pro forma test year operating income by $484,000.

- <u>Unadjusted Test Year Labor O&M Ratio Adjustment</u>

Q. WHAT IS THE COMPANY'S PROPOSED POSITION WITH REGARD TO THE PRO FORMA OPERATION AND MAINTENANCE EXPENSE ("O&M") RATIO FOR ITS LABOR COSTS TO BE USED FOR RATE MAKING PURPOSES IN THIS CASE?

A. The Company proposes to use an O&M expense ratio of 83% to allocate its pro forma labor costs to operation and maintenance expenses in this case. In its response to RAR-A-133, the Company states in this regard:

> The 83% [O&M expense ratio] is based upon the 2001 budget and is representative of the allocation percentage anticipated when rates set in this proceeding are in effect.

Q. HAS THE COMPANY USED THIS 83% O&M EXPENSE RATIO ON A CONSISTENT BASIS FOR ALL LABOR COSTS CLAIMED IN THIS CASE?

A. No. While the Company assumed this pro forma labor O&M expense ratio of 83% in the determination of its proposed pro forma wage and salary *increase* adjustment on Schedule ANS-5, it did not restate its unadjusted "6+6" test year labor expenses based on this same pro forma O&M expense ratio of 83%. As confirmed in its response to RAR-A-134, the O&M expense ratio for the unadjusted "6+6" test year labor expenses is 81.4%.

Q. DO YOU AGREE WITH THE COMPANY'S PROPOSAL TO USE A PRO FORMA O&M EXPENSE RATIO OF 83% FOR ITS LABOR EXPENSES?

A. No. The fact that the Company's proposed O&M expense ratio of 83% is based on its 2001 budget does not mean that this ratio is therefore the most representative of what can reasonably be expected during the rate effective period of this case. Not only is the accuracy of this budgeted 83% O&M ratio for the year 2001 not verifiable at this time due to the lack of actual data for the full year 2001, it is also not known at this time whether this ratio will be representative of the conditions that will exist, say, during the next 5 to 10 years. Thus, the proposed 83% ratio is simply not a known and measurable number that the Board should rely on in this case.

Q. WHAT LABOR O&M EXPENSE RATIO DO YOU RECOMMEND BE USED FOR RATE MAKING PURPOSES IN THIS CASE?

A. It is not easy to predict this O&M expense ratio with reasonable accuracy. As confirmed in the response to RAR-A-41 (A-B), the Company's actual labor O&M expense ratios experienced during the last 5 years are as follows:

| | |
|---|---|
| 1996: | 77.4% |
| 1997: | 75.7% |
| 1998: | 76.5% |
| 1999: | 79.2% |
| 2000: | 83.3% |

Since the Company's actual labor O&M expense ratios have historically fluctuated from year to year, I believe it would be reasonable to consider an average of these historic ratios to be the appropriate normalized labor O&M expense ratio for rate making use in this case. The average ratio for the 5-year period 1996 - 2000 in the above table is 78.4% and I recommend that the Board use this O&M expense ratio in the determination of *all* labor expenses to be included in this case, i.e., not only in the determination of the pro forma labor *increases*, but also in the determination of the appropriate level of unadjusted test year labor expenses.

Q. WHAT IS THE IMPACT OF THIS RECOMMENDATION ON THE COMPANY'S PROPOSED PRO FORMA OPERATING INCOME IN THIS CASE?

A. On Schedule RJH-12, I have restated the Company's proposed unadjusted test year labor expenses based on the recommended O&M expense ratio of 78.4%. As shown on line 5 of this schedule, this increases the Company's proposed pro forma operating income by $3,459,000. The impact of the use of this recommended O&M expense ratio in the determination of the appropriate pro forma labor *increase* adjustment to be recognized in this case will be discussed in the next section of this testimony.

- Pro Forma Labor Expense Increase Adjustments

Q. DOES THE BOARD HAVE A RATE MAKING POLICY REGARDING "POST-TEST YEAR" ADJUSTMENTS?

A. Yes. In its Decision on Motion For Determination of Test Year and Appropriate Time Period For Adjustments, Docket No. WR8504330, 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, but that such historical test year data may be adjusted for "known and measurable" changes. 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.

In that same Decision, the Board also established the following appropriate time period to apply to post-test year income and expense items:

> Known and measurable changes to income and expense items for a period of nine months beyond the end of the test year;

Q. WHY IS THIS BPU RATE MAKING POLICY RELEVANT IN THIS CASE?

A. As shown on Schedule ANS-5, the Company in this case is proposing to reflect the annualized impact of 4 wage and salary increases: (1) the May 1, 2001 bargaining unit employee ("BU") wage increase; (2) the May 1, 2002 BU wage increase; (3) the April 1, 2001 MAST employee salary increase; and the April 1, 2002 MAST employee salary increase. Thus, two of these wage/salary increases concern the annualization of "in-test period" wage/salary increases and two of these wage/salary increases concern the annualization of post-test year increases. The relevancy of the aforementioned BPU post test year rate making policy goes to these latter two post-test year wage/salary increases. This is because both these proposed wage/salary increases fall beyond the 9-month post test year period allowed by the Board. Furthermore, the proposed estimated April 1, 2002 MAST salary increase of 4% is not a contractual increase that can be considered known and measurable at this time.

Q. WHAT IS YOU RECOMMENDATION BASED ON THE FOREGOING INFORMATION?

A. For the reasons that I just discussed I recommend that the Board not give rate recognition to the two proposed wage/salary increases in the year 2002. I am also making this recommendation because of the uncertainty associated with the post-test year labor costs to be incurred by PSE&G's gas operations with regard to the services rendered by the proposed Service Company.

Q. COULD YOU ELABORATE ON THIS LATTER POINT?

A. Yes. Even though the Company has proposed to transfer out of the regulated PSE&G company all employees associated with the proposed centralized corporate support group in PSEG Service Corporation ("Service Company"), all of the labor expenses associated with these to-be-transferred employees are still included in the unadjusted "6+6" test year expenses.[12] As explained in the response to RAR-A-78 B, the Company has left all labor expenses of the employees proposed to be transferred to the Service Company in the unadjusted test year " ... since a representative amount of expense is expected to be charged to PSE&G gas operations for the use of these assets by the PSEG Services Corporation." This assumption may or may not come true and, in my opinion, adds significant uncertainty to the post-test year labor expenses to be incurred by PSE&G, either through direct PSE&G labor charges or by way of cost allocations from the Service Company to PSE&G. Given these potential uncertainties regarding PSE&G's post-test year *overall* labor charges, I believe it would not be appropriate to then recognize an estimated *increase* in these post-test year labor charges.

[12] See response to RAR-A-124 (a)

Q. IS THERE ANOTHER RECOMMMENDED CHANGE TO THE COMPANY'S PROPOSED PRO FORMA LABOR INCREASE ADJUSTMENT BESIDES THE ELIMINATION OF THE 2002 LABOR INCREASES PROPOSED BY THE COMPANY?

A. Yes. In determining the impact of its proposed labor increase adjustment, the Company has used a labor O&M expense ratio of 83%. As discussed in detail in the prior section of this testimony, I recommend the use of a labor O&M expense ratio of 78.4% in this case.

Q. HAVE YOU CALCULATED THE IMPACT OF YOUR RECOMMENDATIONS ON THE COMPANY'S PROPOSED PRO FORMA OPERATING INCOME?

A. Yes. My calculations are shown on Schedule RJH-13. My recommended elimination of the Company's proposed 2002 labor increases together with the recommended labor O&M expense ratio of 78.4% results in an increase of $3,575,000 in the Company's proposed pro forma operating income.

- <u>Service Company Labor Expense Adjustment</u>

Q. PLEASE EXPLAIN THE SERVICE COMPANY LABOR EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-4, LINE -5.

A. As confirmed in the responses to RAR-A-43 and RAR-A-132, the Company inadvertently reflected the pro forma wage and salary increase impact of the employees that were transferred to the Service Company. The response to RAR-A-132 shows that the correction for this error would decrease the Company's proposed wage/salary increases for 2001 and 2002 by a total amount of approximately $270,000 (the sum of $113,000 for the 2001 wage increase and $157,000 for the 2002 wage increase). However, consistent with my recommended removal of all of the Company's proposed wage/salary increases for the year 2002 in a separate expense adjustment in this case, I am only reflecting the error correction of $113,000 for the year 2001 shown in the response to RAR-A-132.

As detailed in footnote (2) of Schedule RJH-4, the correction for this calculation error increases the Company's proposed pro forma test year operating income by $67,000.

- Incentive Compensation Expense Adjustment

Q. WHAT IS THE COMPANY'S PROPOSED POSITION IN THIS CASE WITH REGARD TO INCENTIVE COMPENSATION EXPENSES?

A. In this case, the Company is proposing to charge its ratepayers with approximately $9.5 million for incentive compensation expenses.

Q. WHAT HAS BEEN THE HISTORY CONCERNING THESE INCENTIVE COMPENSATION EXPENSES?

A. As shown in the response to RAR-A-47(B), the incentive compensation expenses incurred by the Company in the last three years and as proposed for the test year ended 6/30/01 amount to the following annual levels:

| | |
|---|---|
| 1998 | $2,546,000 |
| 1999 | $5,388,000 |
| 2000 | $9,110,000 |

| | |
|---|---|
| Test Year | $9,453,000 |

As is evident from the above table, these incentive compensation expenses have grown at almost exponential levels. The proposed test year expense level is almost four times as high as the incentive compensation expenses incurred in 1998, slightly more than 2 ½ years ago.

Q. COULD YOU BRIEFLY DESCRIBE THE COMPANY'S THREE INCENTIVE COMPENSATION PROGRAMS THAT MAKE UP THE PROPOSED TEST YEAR INCENTIVE COMPENSATION EXPENSES OF $9.5 MILLION?

A. Yes. The response to RAR-A-47 (A) has the following descriptions of these three incentive compensation plans:

> <u>Long-Term Incentive Plan (LTIP)</u>
> Participation in the LTIP is limited to officers and senior level associates. The LTIP is designed to provide a direct linkage between the executive's interests and increases in shareholder value by encouraging certain executives of PSE&G to increase their ownership of PSEG common stock. Stock options granted at fair market value and are the primary vehicle used in the LTIP. Stock options motivate and reward executives for meeting corporate objectives that are intended to more closely align the executives interests with the long-term interest of PSEG shareholders as well as to better related total compensation to competitive practice.
>
> <u>Management Incentive Compensation Plan (MICP)</u>
> MICP is considered a short-term annual incentive compensation plan for PSE&G officers as well as other officers throughout the enterprise. MICP is designed to motivate and reward officers for achievement of individual goals, business unit goals and overall company results. Individual officer incentive goals are based on each participant's area of responsibility and relate to business plans, financial targets, customer service and other key objectives. A portion of an individual's award is influenced by overall corporate financial performance.

Performance Incentive Plan (PIP)

All PSE&G MAST associates participate in PIP. Similar to MICP, the PIP is considered a short-term annual compensation plan. The overall objective of the program is to provide market based total compensation opportunity (salary plus incentive) that is competitive with similar positions found in other energy services organizations. Similar to MICP, awards are driven, in part, by overall corporate performance as well as business unit results such as customer service, employees safety, etc.

Q. IS INCENTIVE COMPENSATION AWARDED TO THE ELIGIBLE RECIPIENTS IN ADDITION TO THEIR "REGULAR" COMPENSATION?

A. Yes. The incentive compensation is being paid to the Company's officers, senior management and MAST employees in addition to their current "regular" compensation. It should be noted that this "regular" wage/salary compensation has also experienced steady increases from year to year. The response to RAR-A-49 (revised) shows that the following wage/salary increases were received by PSE&G's Executive and MAST employees during the last 3 years:

| | Executive | MAST |
|---|---|---|
| 1998 | 4.0 % | 4.0 % |
| 1999 | 5.3 % | 4.0 % |
| 2000 | 4.4 % | 4.1 % |

Thus, at the same time that the incentive compensation for executives and MAST associates increased almost four-fold, from $2.5 million in 1998 to $9.1 million in 2000 and $9.5 million in the test year, the "regular" wage/salary compensation for the executives increased by an average rate of 4.6% per year and for the MAST associates increased by an average of approximately 4.0% per year.

Q. DO THE PROPOSED TEST YEAR PRO FORMA WAGES AND SALARIES INCLUDE INCREASES FOR THE COMPANY'S EXECUTIVE AND MAST ASSOCIATES' "REGULAR" COMPENSATION?

A. Yes. The Company has proposed salary increases of 4% for 2001 and another 4% for 2002.

Q. BASED ON THE PREVIOUSLY DISCUSSED INFORMATION, WHAT IS YOUR RECOMMENDATION WITH REGARD TO THE RATE TREATMENT FOR THE INCENTIVE COMPENSATION EXPENSES PROPOSED BY THE COMPANY IN THIS CASE?

A. I recommend that the Company's proposed test year incentive compensation expenses of $9.5 million be disallowed for rate making purposes in this case. As shown on Schedule RJH-14, my recommendation increases the Company's proposed pro forma test year operating income by $5,591,000.

Q. WHAT ARE THE REASONS FOR THIS RECOMMENDATION?

First, for the LTIP, the criteria for determining the awards to be paid out under the plan are solely a function of corporate financial performance and "are intended to more closely align the executives interests with the long-term interest of PSEG shareholders." Similarly, for the MICP and PIP plans a portion of an individual's awards payable under these plans are determined by the achievement of pre-determined overall corporate financial performance goals such as improvements in return on investment, earnings per share, *etc*. The shareholders of the parent corporation, PSEG, are the primary beneficiaries of such corporate financial performance improvements. For those reasons, PSEG's stockholders should be made responsible for these discretionary costs.

Second, the Company's recent (1998 - 2000) overall average wage and salary increases for executives and MAST associates have ranged from 4.6% to 4.0% per year and the Company has proposed pro forma wage and salary increases of a similar magnitude in this case. Given the recently experienced and currently continuing low inflation rates, the Company's recent actual and proposed pro forma wage and salary increases would appear to be quite generous and more than adequate. In my opinion, it would be excessive to have the ratepayers additionally fund the incentive compensation expense claimed in this case.

Third, the Company has not presented any evidence in this case showing the specific benefits that are accruing to the ratepayers as opposed to PSEG's shareholders as a result of these incentive compensation plans for which these same ratepayers are asked to pay 100% of the costs. Neither has the Company presented a shred of evidence in this case showing that there is any appreciable difference in the productivity level of PSE&G's executives and MAST employees as a direct result of the incentive compensation paid out by the Company.

Fourth, I believe that the recent large increases in this expense category should concern the Board. As previously discussed, the Company has increased its incentive compensation almost four-fold within the span of 2 ½ years, from $2.5 million in 1998 to $9.5 million in the test year ended 6/30/01. If the Board were to give rate recognition to the expense level requested by the Company in this case, this would provide very little, if any, incentive for PSE&G to minimize or contain these incentive compensation expenses.

Q. DOES THE BOARD HAVE A STATED RATE MAKING POLICY WITH REGARD TO THE RATE TREATMENT OF INCENTIVE COMPENSATION?

A. Yes. In its Final Decision and Order in the Jersey Central Power & Light Company rate case, Docket No. 91121820J, dated February 25, 1993, the Board stated on page 4 of this Decision and Order:

> 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.

The conditions in the instant PSE&G gas base rate proceeding are strikingly similar to the conditions surrounding the incentive compensation issue in the above-referenced JCP&L case. As discussed before, PSE&G's three incentive compensation programs are either fully or partially driven by the Company achieving financial performance goals for the benefit of shareholders of the parent corporation. Furthermore, to date, the ratepayers of PSE&G have experienced an unprecedented 34% increase in their average gas bills since mid 2000, no doubt resulting in severe economic hardships for many of these ratepayers, particularly the residential and small commercial rate groups. Furthermore, the large gas cost deferral balance currently on the Company's books that PSE&G will be able to pass on to its captive ratepayers in the near future will cause the Company's current historically high gas commodity rates to stay at those levels for some time to come.

Q. DID THE BOARD REITERATE THIS INCENTIVE COMPENSATION RATE MAKING POLICY IN A MORE RECENT LITIGATED BASE RATE CASE?

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

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

While the ALJ in that case ruled that 50% of Middlesex's incentive compensation expenses could be recovered in rates, the Board overruled the ALJ and ordered that 100% of these incentive compensation expenses be removed from Middlesex's rates.[13]

- <u>Pension and FAS 106 Expenses</u>

Q. PLEASE DESCRIBE THE COMPANY'S TEST YEAR PENSION AND FAS 106 EXPENSES AS COMPARED TO THE BUDGETED PENSION AND FAS 106 EXPENSES FOR THE YEAR 2001.

A. As shown on Schedule RCK-14R these expense levels are as follows:

[13] See transcript pages 10 through 13 of the April 25, 2001 Board Meeting.

| | ($Millions) | |
|---|---|---|
| | Test Year | Year 2001 |
| Pension expenses | $ 8.4 | $11.8 |
| FAS 106 expenses | $19.2 | $17.4 |

Q. WHAT ARE THE COMPANY'S PROPOSED POSITIONS REGARDING THE PRO FORMA PENSION AND FAS 106 EXPENSES TO BE RECOGNIZED FOR RATE MAKING PURPOSES IN THIS CASE?

A. With regard to pension expenses, the Company has reflected the higher expense amount budgeted for the year 2001. As stated on page 11 of Mr. Stellwag's testimony, "This adjustment in the amount of $3.4 million operating expense increase reflects the increase in pension expenses for 2001 over our test period amount."

By contrast, for the FAS 106 expenses, the Company has not proposed the budgeted lower FAS 106 expenses for the year 2001. Instead, the Company reflected the test year FAS 106 expenses which are $1.8 million higher than the budgeted 2001 FAS 106 expenses.

Q. DO YOU AGREE WITH THESE PROPOSED POSITIONS?

A. No. I believe it is unreasonable and inappropriate to reflect the budgeted 2001 expense for the pension expenses (resulting in a $3.4 million expense increase) while not giving similar recognition to the budgeted 2001 FAS 106 expenses (which would have resulted in $1.8 million expense reduction).

Q. WHAT IS YOUR RECOMMENDATION WITH REGARD TO THESE TWO EXPENSE ITEMS?

A. While I have accepted the Company's proposed 2001 budgeted pension expense level of $11.8 million, I recommend for consistency purposes that the Company's 2001 budgeted FAS 106 expense level similarly be reflected for rate making purposes in this case. As shown on Schedule RJH-15, this recommendation decreases the Company's pro forma operating expenses by $1,762,000, with a resulting operating income increase impact of $1,042,000.

Q. HAS THE COMPANY PROVIDED ANY REASONS FOR THE PROJECTED DECREASE IN ITS FAS 106 EXPENSES IN THE YEAR 2001 AS COMPARED TO THE TEST YEAR?

A. Yes. In its response to RAR-A-67e, the Company states that, "....Decreases in the estimated 2001 expense is due to the lower than expected increases in medical and prescription drug costs to Enterprise for 2001. Also, effective 2001, PSEG Company employee co-payment premiums have increased for medical and prescription drug plans...."

- <u>Gas Supply and Storage Transfer Income Adjustment</u>

Q. PLEASE EXPLAIN THE PRO FORMA INCOME ADJUSTMENT OF $17,519,000 SHOWN ON SCHEDULE RJH-4, LINE 8.

A. For the reasons explained earlier in this testimony, I have reversed all of the pro forma adjustments proposed by the Company in this case to reflect its proposed transfer of its gas supply, storage and capacity contracts from the regulated PSE&G gas utility to an unregulated affiliate. As part of this proposal, the Company in the current filing proposed a pro forma adjustment reducing its test year operating income by $17,519,000. My reversal of this pro forma adjustment results in an adjustment that increases the Company's proposed pro forma operating income by that same amount, $17,519,000.

- Regulatory Commission Expense Adjustment

Q. PLEASE EXPLAIN THE RECOMMENDED REGULATORY EXPENSES TO BE RECOGNIZED FOR RATE MAKING PURPOSES IN THIS CASE.

A. As shown on Schedule RJH-16, the recommended regulatory expenses consist of three expense components: (1) normalized annual rate case expenses; (2) the annual amortization of the separate depreciation study that has been consolidated with this rate case; and (3) a normalized annual expense level for other miscellaneous regulatory activities and dockets.

With regard to the rate case expenses for this case, the Company initially projected a total expense of $300,000, but then updated this initial projection to $800,000 by adding $500,000 for outside legal expenses to its original cost estimate of $300,000.[14] In this case, the Company is proposing that its updated rate case expense estimate of $800,000 should not be shared on a 50/50 basis and should not be amortized over a period longer than one year. This is inappropriate and should be summarily rejected by the Board. The actual rate case expense for the Company's most recent gas base rate case in 1991 was $384,000.[15]

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[14] See responses to RAR-A-63 and RAR-A-107.

[15] Response to SRA-36.

As shown on Schedule RJH-16, line 1, I recommend a total projected rate case expense level of $550,000 for this case. This recommended expense projection is the same as PSE&G's projection except that I have halved the Company's $500,000 outside legal expense claim. In my opinion, the Company's proposal to charge its ratepayers with outside legal fees of $500,000 for this single base rate case should be considered excessive by the Board. I believe that an outside legal fee amount of $250,000 for this case would be more than adequate. The total recommended rate case expense level of $550,000 is approximately 43% higher than the actual rate case expense incurred by the Company in its last gas base rate case. In accordance with long-standing BPU rate making policy, I also recommend that the total rate case expense amount of $550,000 be shared on a 50/50 basis between the Company's ratepayers and stockholders. Finally, I recommend a 5-year amortization period for these shared rate case expenses. Based on the facts that the Company's last gas base rate proceeding was 10 years ago and that it is quite possible that this Company may either never file another gas base rate case or may wait another 10 years for its next case, I believe the use of a 5-year amortization period for the rate case expenses in this case is to be considered very conservative.

In summary, the recommended normalized annual rate case expense level to be recognized for rate making purposes in this case should be $55,000 as shown on line 4 of Schedule RJH-16.

Q. COULD YOU NOW DESCRIBE THE SECOND COMPONENT OF THE RECOMMENDED TOTAL REGULATORY EXPENSES?

A. Yes. This concerns the expenses projected for the separate depreciation proceeding. As shown on lines 5 - 7, I have accepted the Company's estimated expense of $145,000 for this proceeding and have applied the same 5-year amortization period as used for the rate case expenses. This results in a recommended annual amortization expense of $29,000.

Q. PLEASE DESCRIBE THE THIRD COMPONENT OF THE RECOMMENDED TOTAL REGULATORY EXPENSES.

A. The third component concerns other regulatory expenses associated with a representative level of miscellaneous regulatory activities and dockets that may be experienced by PSE&G on an ongoing basis. In order to determine what would be a reasonable representative annual expense number, I have considered the equivalent "other" regulatory expenses that were actually incurred by PSE&G in the last five years, from 1996 through 2000. As shown in footnote (4) of Schedule RJH-16, the 5-year average of these actual "other" regulatory expenses is $303,000 and this is what I recommend to be the appropriate normalized annual expense level to be recognized for rate making purposes in this case.

Q. HOW DOES YOUR RECOMMENDED REGULATORY EXPENSE LEVEL DIFFER FROM THE COMPANY'S PROPOSED REGULATORY EXPENSES AND WHAT IMPACT DOES THE RECOMMENDED EXPENSE ADJUSTMENT HAVE ON THE COMPANY'S PROPOSED PRO FORMA TEST YEAR OPERATING INCOME?

A. As shown on line 9 of Schedule RJH-16, the total recommended annual regulatory expense level amounts to $387,000, which is $945,000 lower than PSE&G's reflected annual regulatory expense level of $1,332,000. This recommended expense adjustment of $945,000 has the effect of increasing the Company's proposed pro forma operating income by $559,000.

Q. WHAT KIND OF SUPPORT HAS THE COMPANY PROVIDED REGARDING ITS PROPOSED "6+6" TEST YEAR OTHER REGULATORY EXPENSE LEVEL OF $1,332,000?

A. In RAR-A-108 (b) I requested the following information from the Company:

> Please provide a detailed breakout of the $1,332,437 expense total by specific regulatory activity and associated docket number (if applicable). In addition, please provide the basis for each of these expense estimates by regulatory activity.

In its response, the Company simply stated that out of the total $1.3 million, $650,000 was for consultant fees, $500,000 for legal fees and the remaining $182,000 for advertising, court reporting and bill inserts. The Company did not provide the expense detail by regulatory activity and/or docket number and did not provide the basis for each of the estimated expense components.

- <u>Gas Research & Development Expense Adjustment</u>

Q. WHAT IS THE ISSUE WITH REGARD TO THE GAS TECHNOLOGY INSTITUTE ("GTI") RESEARCH AND DEVELOPMENT COSTS THAT ARE CURRENTLY BEING

RECOVERED IN THE LGAC?

A. As explained on page 21 of the testimony of Mr. Stellwag, PSE&G provides approximately $2.5 million per year to GTI for research and development programs through a FERC funding surcharge on pipeline suppliers that is bundled into PSE&G's customers' commodity costs as part of the Company's LGAC. FERC is eliminating this funding mechanism for GTI over a 7-year phase-out schedule, starting in 1998 and ending in 2004, so that this surcharge will no longer be in effect by year-end 2004.

Q. HAVE YOU PREPARED A SCHEDULE SHOWING THE PROJECTED IMPACT OF THIS FERC SURCHARGE PHASE-OUT ON THE COMPANY'S LGAC RECOVERY FOR THESE GTI R&D ACTIVITIES?

A. Yes. As shown on Schedule RJH-17, line 6, the GTI R&D expenses recovered by PSE&G through the LGAC declined from approximately $2.5 million in 1998 (the start of the phase-out) to $2.1 million in the unadjusted test year. The phase-out will then be completed in the years 2002 through 2004 with estimated declining annual LGAC recovery levels of $1.4 million (2002), $1.2 million (2003) and $0 (2004), respectively.[16]

Q. WHAT IS PSE&G'S PROPOSAL IN THIS CASE REGARDING THIS PHASE-OUT OF THE FERC SURCHARGE?

A. As explained on page 22 of the testimony of Mr. Stellwag, PSE&G is requesting that it be allowed to continue funding GTI research and other research organizations on a direct basis

[16] This information can be found in the response to RAR-A-77 A.

through base rates. Of the total that PSE&G customers contributed under the old plan, GTI directed 52.6% to gas distribution research, 13.1% to transmission pipeline research, and 34.3% to gas production research. PSE&G is requesting research funds equal to the portion of the 1998 FERC surcharge that funded gas distribution research and transmission pipeline research. Under PSE&G's proposal, this amounts to an annual funding amount of approximately $1.6 million, determined by applying the gas distribution research percentage of 52.6% and the transmission pipeline research percentage of 13.1% to the actual 1998 FERC surcharge LGAC recovery for GTI R&D of $2,527,000.

Q. HAVE YOU PREPARED A SUMMARY OF THE TOTAL "BASE RATE" RESEARCH AND DEVELOPMENT EXPENSES[17] INCURRED BY PSE&G FOR THE LAST THREE YEARS, THE UNADJUSTED TEST YEAR, AND THE PRO FORMA ADJUSTED TEST YEAR AS PROPOSED BY THE COMPANY?

A. Yes. As shown on Schedule RJH-17, lines 1 - 5, the Company's base rate R&D expenses have increased from $378,000 in 1998 to annual amounts in excess of $1 million in 2000 and the test year. In my opinion, it probably is no coincidence that the Company's base rate R&D expenses experienced a significant increase after 1998, the year that the FERC surcharge for the GTI R&D expense recovery in the Company's LGAC started its 7-year phase-out. In other words, it is likely that the Company stepped up its own internal R&D efforts to make up for the reduced GTI R&D efforts as a result of the declining funding levels in accordance with the

[17] "Base rate" R&D expenses are all R&D expenses that are not separately recovered by PSE&G in automatic adjustment mechanisms such as the LGAC but for which reimbursement will have to come from the Company's base rates.

FERC-mandated phase-out schedule.

For the pro forma adjusted test year, PSE&G is proposing to increase the unadjusted test year base rate R&D expenses of $1 million by an additional $1.6 million for the replacement of the GTI R&D expense recovery in the LGAC that is being phased out by the end of 2004. Thus, the total pro forma adjusted test year base rate R&D expense amount requested by PSE&G in this case amounts to $2.6 million.

Q. HAVE YOU ADJUSTED THE COMPANY'S PROPOSED PRO FORMA BASE RATE R&D EXPENSE LEVEL OF $2.6 MILLION?

A. Yes. First, while PSE&G currently provides natural gas commodity service, EDECA contemplates that commodity service will be provided by the competitive market. For that reason, PSE&G's proposal to continue to fund GTI R&D directed to transmission pipeline matters is inappropriate. Accordingly, I have adjusted the Company's proposed pro forma GTI R&D base rate expense adjustment of $1.6 million to remove the portion of this $1.6 million directly related to pipeline transmission R&D by GTI. The resulting recommended level of GTI R&D base rate expense of $1,329,000 is therefore only related to GTI's gas distribution R&D. The calculation of this recommended GTI R&D expense level of $1,329,000 is shown in footnote (3) of Schedule RJH-17.

Second, I do not believe it appropriate to then add this recommended pro forma GTI R&D expense level of $1,329,000 to the unadjusted test year R&D expenses of $1 million. As I concluded before, it is likely that this internal PSE&G R&D expense category increased from $378,000 in 1998 to $1 million in the test year to make up for the reduced GTI R&D efforts as a result of the declining funding levels in accordance with the FERC-mandated phase-out schedule that started in 1998. Since the recommended pro forma GTI R&D expense level of $1,329,000 essentially represents a continuation of GTI's gas distribution R&D efforts in 1998, I believe it would be appropriate, for consistency purposes, to then also restate the test year's PSE&G internal R&D expense level of $1 million to the level experienced in 1998. This would result in a recommended pro forma test year PSE&G internal R&D expense of $378,000.

In summary, as shown on line 5 and footnote (3) of Schedule RJH-17, the total recommended pro forma R&D expenses to be recognized for rate making purposes in this case amounts to $1,707,000.

Q. WHAT IS THE IMPACT OF YOUR R&D EXPENSE RECOMMENDATIONS ON THE COMPANY'S PROPOSED PRO FORMA OPERATING INCOME IN THIS CASE?

A. Schedule RJH-17, lines 7 - 9 show that my recommendations increase the Company's proposed pro forma operating income by $529,000.

Q. DO YOU HAVE ANY ADDITIONAL COMMENTS REGARDING THIS ISSUE?

A. Yes. It should also be noted that, on top of the recommended base rate R&D expense level of $1,707,000, the Company will continue to receive LGAC recoveries through the end of 2004 to fund GTI R&D efforts. As shown on line 6 of Schedule RJH-17, these annual LGAC recovery levels are estimated to be at levels of approximately $1.5 million in 2002 and $1.2 million in 2003 and it will not be until the end of 2004 that this LGAC recovery will be fully phased out.

- <u>Deferred Marketing Amortization Expense Adjustment</u>

Q. PLEASE DESCRIBE THE COMPANY'S PROPOSAL WITH REGARD TO ITS DEFERRED MARKETING AMORTIZATION EXPENSES.

A. In the year 1999, the Company's Appliance Service Business engaged in certain marketing activities to support various lines of its business. Rather than treating the costs associated with these activities as a current expense in the year (1999) that these costs were incurred, the Company decided to defer these costs on its books and amortize the deferred costs over a 5-year period. However, in the year 2000, the Company made the decision to write off the entire unamortized deferred cost balance that was still on its books at that time. This write-off was booked in October 2000. As a result, the test year used in this case includes $3,511,421 of these deferred cost write-off charges. The Company is proposing in this case to continue to reflect the original 5-year amortization expense amount. Since this amounts to an annual amortization of approximately $884,000, the Company has proposed a pro forma adjustment to reduce the test year write-off charges by $2,627,000. This proposed pro forma adjustment is shown on the Company's filing workpaper 284, as well as in the first column of Schedule RJH-18.

Q. DO YOU AGREE WITH THE COMPANY'S PROPOSAL?

A. No. I disagree with the Company's proposal for several reasons. First of all, this concerns an "out-of-period" cost incurrence for an event that took place prior to the start of the test period. Specifically, the ASB marketing activities took place during the months of February 1999 through November 1999[18] which is 17 to 7 months prior to the 7/1/2000 start of the test period in this case. I believe it is inappropriate to now charge the ratepayers for this retroactive cost on a prospective basis through the Company's proposed expense amortization. The Company *initially* decided to defer the costs when incurred in 1999 and *then* (in October 2000) decided to treat the cost as a current expense. Had the Company initially made the correct decision by treating the cost as a current expense in 1999 when the cost was incurred, there would be no issue in this case because these costs would no longer be on the Company's books in the test year. Instead, the test year now includes a current write-off expense for a retroactive out-of-period event which the Company is proposing to charge to the ratepayers based on a 5-year amortization schedule. This is unreasonable and should be rejected by the Board.

Secondly, since the entire deferred cost balance was fully written off in October 2000, this cost balance is no longer on the Company's books as of October 2000. It is inappropriate for the Company to charge the ratepayers with an annual amortization charge of almost $900,000 for a deferred cost balance that no longer exists.

Q. DO YOU HAVE ANY OTHER COMMENTS REGARDING THIS ISSUE?

A. Yes. As confirmed in the response to SRA-22, the Company incurred a large gas related gain in the sale of a gas easement at its Bayonne generating station. This involved the sale of a gas asset that has always been included in the Company's gas rate base and for which the gas ratepayers -- up to the rate effective date of the instant case -- have always paid for the asset's return on investment, depreciation expenses, property taxes and O&M expenses. The sale

[18] See the response to RAR-A-114 and RAR-A-116.

resulted in a pre-tax gain of $3.3 million. Similar to the ASB marketing activities, this sale involves an out-of-period event (the gain took place in 1996). However, in contrast to what it has proposed for the ASB marketing costs, the Company has not proposed to defer and amortize on a prospective basis this out-of-period gain on sale of $3.3 million. This is inconsistent. Of course, the appropriate rate treatment should be that neither one of these items be recognized in this case as they both involve retroactive, out-of-period events.

Q. IN CONCLUSION, WHAT IS YOUR RECOMMENDATION REGARDING THE COMPANY'S PROPOSED ASB MARKETING COST ISSUE IN THIS CASE?

A. Based on the aforementioned reasons, I recommend that the Company's proposed deferred marketing expense amortization amount of $883,000 be removed from the pro forma test year expenses. As shown on Schedule RJH-18, this recommendation increases the Company's proposed pro forma test year operating income by $522,000.

- <u>Expired Amortization Expense Adjustments</u>

Q. WHAT IS THE ISSUE WITH REGARD TO EXPIRED AMORTIZATION EXPENSES IN THIS CASE?

A. In this case, the Company has proposed to remove from its test year expenses the amortization expenses associated with the Gas Service Information Management System (GSIMS). The Company made this proposal because the amortization of this deferred cost item expires in November 2001 which is before the start of the rate effective period in this case. In other words, the Company has correctly removed this amortization from the test year expenses because this expense will no longer be incurred by the time that the rates from the instant proceeding will become effective.

Q. WHEN DO YOU EXPECT THE RATES FROM THIS CASE TO BECOME EFFECTIVE?

A. Based on the procedural schedule in this case, I expect that the rates from this case will become effective at some point in time during the first quarter of 2002.

Q. ARE THERE OTHER AMORTIZATION EXPENSES INCLUDED IN THE TEST YEAR THAT WILL SIMILARLY EXPIRE PRIOR TO OR AROUND THE TIME THAT THE RATES FROM THIS CASE WILL BECOME EFFECTIVE?

A. Yes. As shown on Schedule RCK-15, the test year includes $113,000 for amortization expenses associated with the Integrated Infrastructure System and $182,000 for amortization expenses associated with the Corporate Distributed System. The response to RAR-A-19 confirms that the Integrated Infrastructure System amortization expired during the test year, in February 2001[19], while the Corporate Distributed System amortization is scheduled to expire in the first quarter of 2002. The Company did not propose to remove the test year amortization expenses for these two items.

Q. WHAT IS YOUR RECOMMENDATION WITH REGARD TO THESE TWO

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[19] This is 9 months earlier than the November 2001 expiration of the GSIMS system amortization which the Company has proposed to remove from the test year expense.

AMORTIZATION EXPENSE EXPIRATIONS?

A. Since one of the amortizations has already expired (in 2/01) and the other one is scheduled to expire in the first quarter of 2002, or around the same time that the rates from this case are expected to go into effect, I recommend that the test year amortization expenses for these two items be removed. As shown on Schedule RJH-19, this recommendation increases the Company's proposed pro forma operating income by $174,000.

- Charitable Contribution Expense Adjustment

Q. PLEASE EXPLAIN YOU RECOMMENDED CHARITABLE CONTRIBUTION EXPENSE ADJUSTMENT YOU SHOWN ON SCHEDULE RJH-4, LINE 13.

A. In this case, the Company has proposed to include in its "above-the-line" test year operating expenses total charitable contribution expenses of $1,523,000 that, for book purposes, are recorded in the "below-the-line" expense Account 426. I have removed the entire $1.5 million of these proposed charitable contribution expenses in accordance with the July 25 decision by the New Jersey Supreme Court which ruled that charitable contribution expenses incurred by a utility cannot be subsidized by consumers and, therefore, cannot be included as legitimate business expenses for rate making purposes. As shown on Schedule RJH-4, line 13, this recommended adjustment increases the Company's proposed pro forma test year operating income by $901,000.

- Rent Expense Error Correction

Q. PLEASE EXPLAIN THE RENT EXPENSE ERROR CORRECTION SHOWN ON SCHEDULE RJH-4, LINE 14 AND DETAILED ON SCHEDULE RJH-20.

A. As explained in its response to RAR-A-78, the Company made an error in the calculation of the rent expense adjustment associated with the proposed transfer of assets to the Service Company. As shown on Schedule RJH-20, the correction for this error would increase the Company's rent expenses by $969,000, and decrease the Company's after-tax operating income by $573,000. I have reflected the income impact of this error correction on Schedule RJH-4, line 14.

- Property Insurance Expense Adjustment

Q. WHAT IS THE ISSUE WITH REGARD TO PROPERTY INSURANCE EXPENSES, AS SHOWN ON SCHEDULE RJH-4, LINE 15 ?

A. The Company's recent actual historic and proposed test year property insurance expenses are as follows:

| | |
|---|---|
| 1999 - Actual | $ 304,993 |
| 2000 - Actual | $ 299,294 |
| 12-months ended 3/31/01 - Actual | $ 215,537 |
| Projected Test Year Ended 6/30/01 | $1,120,927 |

In the response to RAR-A-118, the Company states that it made an error in the determination of the budgeted property insurance amount for the first six months of 2001 that is included in the projected "6+6" test year expense amount of $1.1 million. This same response also seems to suggest that the corrected "6+6" test year expense amount should be $732,450, but that even this amount should be allocated to other expense accounts. Since the response to RAR-A-118 is not clear as to what the correct Account 924 - Property Insurance amount for the test year should be after all proper allocations are performed, I have reflected the actual Account 924 - Property Insurance expenses of $215,537 for the most recent 12-month period for which actual data are available at this time, the 12 months ended March 31, 2001. This recommended expense number should be updated with actual Account 924 - Property Insurance expenses for the full actual test year once such information has become available. As shown on Schedule RJH-21, my recommendation increases the Company's proposed pro forma test year income by $535,000.

- Miscellaneous Expense Adjustments

Q. PLEASE EXPLAIN THE INCOME ADJUSTMENT FOR MISCELLANEOUS EXPENSE ADJUSTMENTS YOU SHOW ON SCHEDULE RJH-4, LINE 16.

A. As shown in more detail on Schedule RJH-22, the overall miscellaneous expense adjustment amount is $508,000, consisting of 9 different test year expense removal adjustments each of which I will now discuss.

The first adjustment concerns the removal of certain public relations expenses included in the test year which are classified by the Company as "community affair activity" expenses. The total test year amount for these expenses is $219,000, as shown in the response to RAR-A-55. From this response one can also see that these activities primarily consist of such items as philantropic activities, employee volunteer activities, summer concerts for the Newark community, promotional materials, community assistance in raising money for projects, and seminars on school violence. I recommend that these expenses be removed for rate making purposes as they are related to activities that have nothing to do with the provision of safe and adequated gas service. I also believe that these type of expenses represent contributions by PSE&G for which the New Jeresey Supreme Court ruled, in its recent Charitable Contributions decision dated July 25, 2001, that they may not be subsidized by the utility's captive ratepayers.

The second and third adjustments concern the removal of all "institutional" advertising expenses included in the test year. Specifically, the advertising expenses included in Account 930.1 - General Advertising are for image creation and goodwill building activities that have as their main purpose to promote PSE&G as a good corporate citizen. In addition, the Company has confirmed in response to SRA-43(c) that a portion of its American Gas Association ("AGA") dues is being used for national advertising and is not specifically focused to New Jersey or PSE&G's service territory. The Board has a rate making policy to disallow such so-called "institutional" advertising.

The fourth, fifth and sixth adjustments concern the removal of all lobbying expenses included in the test year expenses. The inclusion of these lobbying expenses in the test year above-the-line expenses is confirmed by the Company in its responses to SRA-43 and RAR-A-51.

The seventh adjustment concerns the removal from the test year of expenses associated with the provision of certain financial services to PSE&G's top officers. As described in the response to RAR-A-48, these financial services include personal financial counseling and estate planning for PSE&G officers and other selected senior management personnel. I do not believe that the Company's ratepayers should be required to fund these type of top officers' compensation "perks". This should be the responsibility of the Company's shareholders.

The eighth adjustment concerns the removal of all Electric Power Research Institute ("EPRI") expenses that are included in the test year by PSE&G. As confirmed in the response to RAR-A-121, the Company's proposed test year expenses include a total of $61,600 for EPRI related expenses. Out of this total expense, an amount of $37,000 represents the portion of PSE&G's total annual EPRI membership dues that has been allocated to the the Company's gas operations. The remaining expense portion of $24,600 are for charges paid by the Company's gas business to EPRI Solutions, a research division of EPRI. The Company believes it is appropriate to reflect these EPRI charges "... because of the fuel and micro turbine cell research being funded at EPRI Solutions."[20] I do not agree with the Company's position on this issue. EPRI is a national research organization established by, and with the purpose of servicing, the electric utility industry. It may well be that some of EPRI's research may be of some use to PSE&G's gas business. Conversely, it may similarly be the case that the research conducted by national gas research organizations such as GTI is of some use to PSE&G's electric operations. However, as confirmed in the response to RAR-A-123 (a), non of the costs of the GTI R&D is being allocated to PSE&G's electric operations. Based on these reasons, it is my recommendations that the membership dues and invoices paid by PSE&G to EPRI during the test year should be assigned 100% to PSE&G's electric operations.

Finally, the ninth adjustment concerns the removal of certain expenses that were allocated by PSEG to PSE&G's gas operations. As shown in footnote (2) to Schedule RJH-22,

[20] See the responses to RAR-A-75 and RAR-A-121.

these expenses include charitable contribution expenses and contributions to the Liberty Science Center and New Jersey Aquarium.

- Pro Forma Depreciation Expense Adjustment

Q. IS THE COMPANY PROPOSING BASE RATE RECOGNITION OF NEW DEPRECIATION RATES IN THIS CASE?

A. Yes. In the parallel depreciaton case, Docket No. GR01050297, that was filed by the Company on May 4, 2001, the Company is requesting Board approval for new depreciation rates. In the instant base rate proceeding, the Company is proposing base rates to recover the depreciation expenses resulting from BPU approval of the Company's proposed new depreciation rates.

The Company's proposed pro forma annualized depreciation expenses that are based on these proposed new depreciation rates amount to $154.5 million.[21] This proposed annual depreciation expense level is approximately $56 million higher than the "6+6" test year per books depreciation expense level of $98.7 million.

Q. DOES THE RATEPAYER ADVOCATE'S DEPRECIATION EXPERT, MICHAEL MAJOROS, AGREE WITH THE COMPANY'S PROPOSED NEW DEPRECIATION RATES?

A. No. Mr. Majoros does not agree with the Company's proposed new depreciation rates and has

[21] The detailed derivation of this PSE&G-proposed pro forma annualized depreciation expense amount, showing the Company's proposed 6/30/01 depreciable plant balances and the proposed new depreciation rates applicable to these plant balances, is contained in the reponse to RAR-A-16 C, page 8 of 8.

recommended appropriate alternative depreciation rates that should be approved by the BPU for rate making purposes in this case. Mr. Majoros has supplied me with his recommended depreciation rates and I have used these depreciation rates in the calculation of the recommended pro forma annualized depreciation expenses in this case.

Q. WHERE DO YOU SHOW THESE RECOMMENDED PRO FORMA ANNUALIZED DEPRECIATION EXPENSE CALCULATIONS?

A. These calculations are shown on Schedule RJH-23. As shown on line 20 of this schedule, Mr. Majoros' recommended depreciation rates produce a recommended level of pro forma annualized depreciation expenses of $65,526,000 based on the same level of test-year end depreciable plant as was used by the Company in its proposed pro forma depreciation expense adjustment calculations.

Q. WHAT IS THE IMPACT OF THE DIFFERENCE BETWEEN THE RATEPAYER ADVOCATE'S RECOMMENDED AND THE COMPANY'S PROPOSED PRO FORMA ANNUALIZED DEPRECIATION EXPENSE LEVELS?

A. As shown on Schedule RJH-23, lines20 - 24, the Ratepayer Advocate's recommended pro forma annualized depreciation expense level of $65,526,000 is $89,014,000 lower than the Company's proposed pro forma annualized depreciation expense level of $154,540,000. This recommended expense reduction has the effect of increasing the Company's proposed pro forma test year after-tax operating income by $63,404,000.

- Income Tax Error Correction

Q. PLEASE EXPLAIN THE INCOME TAX ERROR CORRECTION SHOWN ON SCHEDULE RJH-4, LINE 18.

A. As explained in its response to RAR-A-69, the Company overstated the income tax benefits associated with its proposed pro forma depreciation expense increase adjustment on Schedule ANS-4. As shown in more detail on Schedule RJH-24, the correction for this error would increase the Company's income tax liability, and decrease the Company's operating income, by $376,000.

- Interest Synchronization Adjustment

Q. WHAT IS THE ISSUE WITH REGARD TO THE INTEREST SYNCHRONIZATION ADJUSTMENT SHOWN ON SCHEDULE RJH-4, LINE19?

A. There is no issue per se. As shown in more detail on Schedule RJH-25, the only reason why the recommended interest synchronization income tax impact is different from the Company's proposed interest synchronization income tax impact is because of the differences in the Company's proposed and Ratepayer Advocate's recommended rate base and weighted cost of debt positions. Because of these differences, the Ratepayer Advocate's pro forma interest deduction for income tax purposes is larger than the Company's. As can be seen from Schedule RJH -25, line 7, this results in an increase of $1,328,000 in the Company's proposed pro forma test year operating income.

Q. MR. HENKES, DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

A. Yes, it does.