BEFORE THE STATE OF NEW JERSEY

BOARD OF PUBLIC UTILITIES

OFFICE OF ADMINISTRATIVE LAW

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|---|---|---|
| I/M/O THE PETITION OF NEW JERSEY | ] | |
| NATURAL GAS COMPANY FOR | ] | |
| APPROVAL OF AN INCREASE IN ITS | ] | BPU DKT. NO. GR07110889 |
| GAS RATES, DEPRECIATION RATES | ] | |
| FOR GAS PROPERTY, AND FOR | ] | OAL DKT. NO. PUCRL 12545- 07 |
| CHANGES IN THE TARIFF FOR GAS | ] | |
| SERVICE, PURSUANT TO N.J.S.A. 48:2-18 | ] | |
| AND 48:2-21 | ] | |

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DIRECT TESTIMONY OF ANDREA C. CRANE
ON BEHALF OF THE
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL

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## TABLE OF CONTENTS

## I. STATEMENT OF QUALIFICATIONS

**Q. Please state your name and business address.**

A. My name is Andrea C. Crane and my business address is 199 Ethan Allen Highway, Ridgefield, Connecticut 06877. (Mailing Address: PO Box 810, Georgetown, Connecticut 06829.)

**Q. By whom are you employed and in what capacity?**

A. I am President of The Columbia Group, Inc., a financial consulting firm that specializes in utility regulation. In this capacity, I analyze rate filings, prepare expert testimony, and undertake various studies relating to utility rates and regulatory policy. I have held several positions of increasing responsibility since I joined The Columbia Group, Inc. in January 1989.

**Q. Please summarize your professional experience in the utility industry.**

A. Prior to my association with The Columbia Group, Inc., I held the position of Economic Policy and Analysis Staff Manager for GTE Service Corporation, from December 1987 to January 1989. From June 1982 to September 1987, I was employed by various Bell Atlantic (now Verizon) subsidiaries. While at Bell Atlantic, I held assignments in the Product Management, Treasury, and Regulatory Departments.

**Q. Have you previously testified in regulatory proceedings?**

A. Yes, since joining The Columbia Group, Inc., I have testified in approximately 275 regulatory proceedings in the states of Arizona, Arkansas, Connecticut, Delaware, Hawaii, Kansas, Kentucky, Maryland, New Jersey, New Mexico, New York, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Vermont, West Virginia and the District of Columbia. These proceedings involved gas, electric, water, wastewater, telephone, solid waste, cable television, and navigation utilities. A list of dockets in which I have filed testimony is included in Appendix A.

**Q. What is your educational background?**

A. I received a Master of Business Administration degree, with a concentration in Finance, from Temple University in Philadelphia, Pennsylvania. My undergraduate degree is a B.A. in Chemistry from Temple University.

## II. PURPOSE OF TESTIMONY

**Q. What is the purpose of your testimony?**

A. On or about November 20, 2007, New Jersey Natural Gas Company ("NJNG" or "Company") filed an Application with the State of New Jersey, Board of Public Utilities ("BPU" or "Board") seeking a rate increase of $58.36 million in its rates for natural gas service. The Company's request would have resulted in an increase of approximately 4.6% of test year revenues or approximately 28.2% on non-gas margins.

The Company's case is based on a test year consisting of the twelve months ending April 30, 2008. As filed, NJNG's revenue requirement reflected actual results for three months and projected results for the last nine of the test year (3+9). NJNG subsequently updated its filing to reflect nine months of actual results and three months of projections (9+3). In that update, the Company increased its rate increase request to $73.07 million. My testimony is based on this 9+3 update. NJNG will provide an additional update incorporating twelve months of test year data (12+0) prior to the hearings in this case.

The Columbia Group, Inc. was engaged by The New Jersey Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel") to review the Company's Petition and to provide recommendations to the BPU regarding the Company's revenue requirement claims and its Basic Gas Supply Service ("BGSS") incentive programs. I am providing testimony on the revenue requirement issues. James D. Cotton, Principal of The Columbia Group, Inc., is providing testimony on the BGSS incentive programs.

In developing my recommendations, I have relied on the cost of capital and capital structure testimony of Matthew I. Kahal, on the depreciation expense testimony of Michael J. Majoros, Jr., on the cash working capital testimony of David Peterson, on the incentive testimony of James D. Cotton, and on the policy testimony of Richard W. LeLash.

**Q. What are the most significant issues in this rate proceeding?**

A. The most significant issues driving the rate increase request are the Company's claim for a cost of equity of 11.375% and NJNG's request for new depreciation rates. Other significant issues include the valuation of gas supply inventory, requested increases in salaries, wages, and benefit costs, the Company's claim for projected post-test year additions, and its requested recovery of future costs of a proposed new automated meter reading program. The Company's current base rates were effective November 1, 1994.

## III. SUMMARY OF CONCLUSIONS

**Q. Have you been able to reach a final recommendation with regard to the Company's need for rate relief?**

A. No, I have not. As discussed above, NJNG has not yet provided actual results for the full twelve months of the test year. In addition, given the delay in receiving data request responses and the procedural schedule in this case, I have not as yet had the opportunity to clarify certain information that has been provided by NJNG or to seek additional information where necessary, in all cases. Therefore, the recommendations contained in this testimony are preliminary. My revenue requirement recommendation will be updated after the Company files its 12+0 update and I have had the opportunity to review that data and to obtain any additional information necessary to complete my analysis.

**Q. What are your preliminary conclusions concerning the Company's revenue requirement and its need for rate relief?**

A. Based on my analysis of the Company's filing, including its 9+3 update, and other documentation in this case, my conclusions are as follows:

1. The twelve months ending April 30, 2008 is a reasonable test year to use in this case to evaluate the reasonableness of the Company's claim.
2. Based on the testimony of Mr. Kahal, the Company has an overall cost of capital of 7.02% (see Schedule ACC-2).[1]
3. NJNG has pro forma test year rate base of $896.415 million (see Schedule ACC-3).
4. The Company has pro forma operating income at present rates of $66.822 million (see Schedule ACC-7).
5. NJNG has a pro forma, revenue surplus of $6.651 million (see Schedule ACC-1). This is in contrast to the Company's claimed revenue deficiency of $73.073 million.

The recommendations contained in my testimony will be updated, as necessary, based on the Company's 12+0 update.

[1] Schedules ACC-1 and ACC-29 are summary schedules. Schedule ACC-2 is a cost of capital schedule. Schedules ACC-3 to ACC-6 are rate base schedules. Schedules ACC-7 to ACC-28 are operating income schedules.

## IV. COST OF CAPITAL AND CAPITAL STRUCTURE

**Q. What is the cost of capital and capital structure that the NJNG is requesting in this case?**

A. The Company utilized the following capital structure and cost of capital in its original filing:

| | Percent of Total | Cost Rate | Weighted Cost |
|---|---|---|---|
| Equity Capital | 52.47% | 11.375% | 5.97% |
| Total Debt | 47.09% | 5.22% | 2.46% |
| Customer Deposits | 0.45% | 4.58% | 0.02% |
| Total | 100.00% | | 8.45% |

In its 9+3 update, NJNG updated its overall cost of capital to 8.50%.

**Q. What is the capital structure and overall cost of capital that Rate Counsel is recommending for NJNG?**

A. As shown on Schedule MIK-1 of Mr. Kahal's testimony, Rate Counsel is recommending an overall cost of capital for NJNG of 7.02 %, based on the following capital structure and cost rates:

| | Percent of Total | Cost Rate | Weighted Cost |
|---|---|---|---|
| Equity Capital | 48.00% | 9.50% | 4.56% |
| Long-Term Debt | 39.09% | 5.26% | 2.06% |
| Short-Term Debt | 12.50% | 3.00% | 0.38% |
| Customer Deposits | 0.41% | 4.58% | 0.02% |
| Total | 100.00% | | 7.02% |

This is the overall cost of capital that I have used to determine the Company's pro forma required income, as shown on Schedule ACC-1, based on my recommended rate base. I then compared this required income to pro forma income at present rates to determine the Company's need for rate relief. As shown on Schedule ACC-1, my recommendations indicate that the Company currently has a revenue surplus and therefore the BPU should reduce the Company's rates by $6.651 million.

## V. RATE BASE ISSUES

### A. Utility Plant-in-Service

**Q. Are you recommending any adjustments to the Company's claim for utility plant-in-service?**

A. Yes, I am recommending several adjustments. First, I am recommending an adjustment relating to the Company's contract with Ocean Peaking Power, LLC ("OPP"). Second, I am recommending two adjustments to the Company's claim for allowance for funds used during construction ("AFUDC").

**Q. Please describe your adjustment relating to the OPP contract.**

A. On December 20, 2002, NJNG filed a petition with the BPU seeking approval of a Service Agreement with OPP. Specifically, the Company proposed to provide firm transportation service to OPP, which owned and operated a gas-fired electric generation facility in Lakewood, New Jersey. In order to serve OPP, NJNG had to make certain capital investments, while OPP was obligated to pay certain demand and variable charges over the initial ten-year term of the Service Agreement.

Pursuant to a Settlement Agreement ("OPP Settlement Agreement") among the parties, NJNG agreed to share 50% of the gross margins associated with monthly demand and variable charges with NJNG ratepayers. This provision was agreed upon for a period of four years. The OPP Settlement Agreement provided that after four years, the sharing formula would be "equal to the sharing formulae approved by the Board in its review of NJNG's incentives, which is expected to commence prior to the October 31, 2003 termination date of NJNG's incentives."[2] In the event that the Board had not rendered a decision in the NJNG incentive proceeding prior to May 31, 2007, the OPP Settlement Agreement provided that the parties should commence settlement discussions in an effort to resolve the sharing issues for the remaining six years of the Service Agreement. Moreover,

2 Response to RCR-A-73, page 10.

the OPP Settlement Agreement provided that the sharing would terminate in the event that a base rate case was concluded during the initial term of the Service Agreement.

At May 31, 2007, NJNG unilaterally commenced an 80/20 sharing between ratepayers and shareholders, respectively. The sharing issue was subsequently addressed in the Settlement Agreement in BPU Docket No. GR06120871 ("Incentive Settlement Agreement"), which addressed NJNG's proposals to extend its incentive programs. In the Incentive Settlement Agreement in that case, the parties agreed that NJNG would share the OPP margins on an 85/15 basis as of September 1, 2007. Moreover, all incentives were subject to review in the Company's next base rate case. In this case, NJNG has proposed to continue the sharing formula of 85/15. Given this sharing, the Company has also proposed to remove the net book value of the OPP investment from rate base.

**Q. What is Rate Counsel's recommendation with regard to the OPP sharing mechanism in this case?**

A. Rate Counsel witness James D. Cotton is proposing that the sharing of the OPP margins terminate and that 100% of such margins be credited to the BGSS. Accordingly, I have made an adjustment to add back to rate base the net book value of the OPP investment. This adjustment has two components, an addition to utility plant-in-service and an addition to the Company's depreciation reserve, as shown in Schedule ACC-4.

**Q. Didn't the OPP Settlement Agreement state that any revenue deficiency would be borne**

**solely by NJNG, and not passed on to NJNG's other customers?**

A. Yes, it did. However, the OPP Settlement Agreement recognized the possibility that the Company would not file a base rate case and therefore that sharing could continue for a period of up to ten years. It is unclear whether the OPP Settlement Agreement required the Company to absorb any investment-related costs in the event that sharing was terminated prior to the end of the ten-year term, or only required the Company to absorb these costs after the initial ten-year term to the extent that such costs were not fully recovered. Given this ambiguity, and the fact that Rate Counsel is proposing that customers now receive 100% of any margin resulting from the Service Agreement, I am recommending that the unrecovered net book value of the OPP investment be included in rate base.

**Q. What is AFUDC?**

A. AFUDC represents the financing costs incurred by a utility while plant is under construction, i.e., while the plant is booked to Construction Work In Progress ("CWIP"). Once the plant is completed and placed into service, it should be transferred from CWIP to utility plant-in-service. At that time, the Company should cease accruing AFUDC.

**Q. Please explain your recommended adjustments relating to AFUDC.**

A. As shown on Schedule ACC-5, I am recommending two adjustments to the Company's utility plant-in-service claim relating to AFUDC that the Company has booked to its plant accounts. First, as discussed on pages 22-24 of Mr. LeLash's testimony, Rate Counsel is recommending an adjustment to eliminate AFUDC on projects that were not promptly transferred to utility plant-in-service. This delay caused additional AFUDC to be accrued on these projects prior to their transfer to the plant accounts. Mr. LeLash is recommending that $188,000 of AFUDC be disallowed as a result of these delays. Accordingly, at Schedule ACC-5, I have reduced the Company's utility plant-in-service balance to reflect Mr. LeLash's adjustment.

**Q. What is your second adjustment to the Company's AFUDC claim?**

A. As also discussed in Mr. LeLash's testimony, on pages 24-25, the Company unilaterally revised its AFUDC calculation in October 2007 to include an equity component. This change had the effect of increasing the Company's AFUDC rate from 4.7% to 8.3%.[3] Mr. LeLash and I are recommending that the BPU reduce the Company's utility plant-in-service balance to reflect the additional AFUDC that was accrued at the higher rate of 8.3%.

**Q. What is the basis for this adjustment?**

A. There are several reasons for this adjustment. First, the Company claims that it was permitted to include an equity component in its AFUDC formula pursuant to the Stipulation in its last base rate case, BPU Docket No. GR91081393J. The Stipulation in that case states that the Company "shall be permitted to accrue AFUDC in accordance with the methodology described in the Uniform System of Accounts adopted by the Board," which is the Federal

3 Per the response to S-RREV-77.

Energy Regulatory Commission ("FERC") Uniform System of Accounts ("USOA"). While the FERC methodology does include an equity component, it appears that the FERC AFUDC formula first assumes that plant will be financed by short-term debt. It is only after the short-term debt is fully utilized that the formula begins to include a common equity component. Thus, NJNG has not demonstrated that its revised AFUDC formula maximized the use of short-term debt in the financing of the Company's CWIP.

In addition, as further discussed in the testimony of Mr. LeLash at page 24, Rate Counsel believes that the Company should have sought BPU approval for this accounting change. For both of these reasons, I am recommending that the BPU reduce the Company's utility plant-in-service claim to eliminate that portion of the AFUDC that was generated by the inclusion of equity in the AFUDC formula. My adjustment is shown in Schedule ACC-5.

**B. <u>Gas Supply and LNG Inventory</u>**

**Q. How did the Company develop its claim for gas supply and LNG in inventory?**

A. In its original filing, NJNG developed its claim for gas supply and LNG inventory by using a 13-month average of volumes from July 31, 2006 to July 31, 2007. It priced these volumes at the December 2008 NYMEX rate. In its 9+3 update, the Company calculated a 13-month average of volumes from January 31, 2007 to January 31, 2008. In the update, NJNG again priced these inventory volumes at the December 2008 NYMEX rate.

**Q. Are you recommending any adjustment to the Company's claim?**

A. Yes, I am recommending that the actual inventory balance for the test year be used in the Company's pro forma rate base.

**Q. What is the basis for your adjustment?**

A. The Company's adjustment reaches eight months beyond the end of the test year in this case. Therefore, the use of the December 2008 NYMEX inventory valuation violates the test year matching principle that investment, revenues, and expenses should be matched to a point in time. Moreover, this adjustment is speculative. The current December 2008 NYMEX value does not necessarily represent what prices will actually be in December 2008. In addition, there is no justification for the Company's assumption that its inventory value will equal the market price in December 2008. Accordingly, this December 2008 NYMEX price does not represent a known and measurable change to the test year and the Company's adjustment should be rejected by the BPU.

**Q. How did you quantify the Company's gas supply and LNG inventory?**

A. I utilized the most recent actual 13-month average inventory balance that I had available. In response to RCR-A-89, NJNG provided average balances through December 2007. Therefore, my adjustment reflects the 13-month average balance from December 2006 to December 2007. I recommend that the Board utilize the actual 13-month average for the test year, from April 2007 to April 2008, when the Company provides its 12+0 updates.

### C. Cash Working Capital

**Q. What is cash working capital?**

**A.** Cash working capital is the amount of cash that is required by a utility in order to cover cash outflows between the time that revenues are received from customers and the time that expenses must be paid. NJNG filed a lead/lag study in support of its cash working capital claims in this case.

**Q. Is Rate Counsel recommending any adjustment to the Company's cash working capital claim?**

A. Yes, Rate Counsel is recommending several adjustments to the Company's lead/lag study as discussed in the testimony of David Peterson. I have incorporated Mr. Peterson's cash working capital adjustments in developing the pro forma rate base shown in Schedule ACC-2. As noted by Mr. Peterson, the Company's cash working capital claim should be further updated to reflect the level of cash operating expenses approved by the Board in this proceeding.

### D. Consolidated Income Taxes

Q. **Did NJNG include a consolidated income tax adjustment in its filing?**

A. No, it did not. NJNG calculated its pro forma income tax expense on a "stand-alone" basis. The Company's filing ignores the fact that the NJNG does not file its federal income taxes on a stand-alone basis, but rather files as part of a consolidated income tax group. By filing a consolidated return, NJNG can take advantage of tax losses experienced by other member companies. NJNG has been a member of the consolidated income tax group since New Jersey Resources Corporation ("NJR") began filing consolidated tax returns in 1982.[4] The tax loss benefits generated by one group member can be shared by the other consolidated group members, resulting in a reduction in the effective federal income tax rate. These tax savings should be flowed through to the benefit of New Jersey ratepayers.

**Q. Why should these tax benefits be flowed through to the Company's ratepayers?**

A. These tax benefits should be flowed through to ratepayers because these benefits reflect the actual taxes paid. Establishing a revenue requirement based on a stand-alone federal income tax methodology would overstate the Company's tax expense, result in a windfall to shareholders, and result in rates that are higher than necessary.

**Q. Has this issue been addressed previously by the BPU?**

A. Yes, this issue has been addressed previously by the BPU, which found that a consolidated income tax adjustment was appropriate. At pages 7-8 of its Decision in the 1991 Jersey Central Power and Light Company ("JCP&L") base rate case (BPU Docket No. ER91121820J), dated February 25, 1993, the BPU found that:

> 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 filing a consolidated

4 Per the response to S-RREV-85.

> tax return. Income from utility operations provides 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.

In the Board's Final Order, dated July 25, 2003, in the 2002 JCP&L base rate case, Docket No. ER02080506, page 45, it stated:

> As a result of making a consolidated tax filing during the years 1991-1999, GPU, JCP&L's parent company during that time period, as a whole paid less federal income taxes than it would have if each subsidiary filed separately, thus producing a tax savings. The law and Board policy are well-settled that consolidated tax savings are to be shared with customers.

Unregulated subsidiaries are free to manage their activities as they see fit. The reality is that NJR has elected to file a consolidated income tax return for its subsidiaries, including NJNG. Moreover, NJNG has been a member of a consolidated income tax group since the Board first adopted consolidated income tax adjustments. Apparently the filing of a consolidated tax return still offers advantages to NJR and members of the consolidated income tax group. Because NJR has elected to file a consolidated tax return for its member companies, including NJNG, I believe it is a settled matter that the tax savings should be shared with utility ratepayers.

**Q. Did NJNG comply with BPU policy regarding consolidated income taxes in its filing in this case?**

A. No, the Company has not complied with accepted BPU policy and has instead requested rate recognition for federal income tax expense on a stand-alone basis.

**Q. Do you believe that NJNG has provided any new or compelling reason to justify a change in Board policy on the issue of consolidated tax savings?**

A. No, I do not. I understand that the Company would prefer not to share tax benefits with its customers but they have not introduced any compelling new argument to support a departure from Board policy. In fact, the Company has not provided any testimony explaining why it did not include a consolidated income tax adjustment in its filing.

**Q. How does NJR determine the actual amount of taxes paid by NJNG to its parent each year?**

A. The payment of taxes is discussed in the Affiliate Allocation and Billing Procedures that was provided in response to RCR-A-10. According to these procedures, NJNG pays the amount of its stand-alone tax liability to NJR. However, it appears from these procedures that NJR then pays these excess funds to the members of the consolidated income tax group with tax losses, resulting in a contractual means to have the regulated and profitable subsidiaries subsidize unregulated and unprofitable ventures. These procedures transfer the excess amounts collected from ratepayers for income tax expense from the utility to the affiliate that generated the income tax loss, effectively resulting in a subsidization of the unregulated affiliate by New Jersey ratepayers. In contrast, the consolidated income tax adjustment adopted by the BPU partially compensates ratepayers for this subsidization, by crediting ratepayers with carrying costs on these funds.

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**Q Are consolidated income taxes a violation of the normalization requirements of the Internal Revenue Service ("IRS")?**

A. No, they are not. Prior to 1990, there was some question as to whether or not consolidated income tax adjustments violated the normalization provisions of the IRS. However, around that time, the IRS determined that such adjustments do not violate the normalization rules. The BPU subsequently adopted consolidated income tax adjustments for New Jersey utilities. The BPU should continue its practice of requiring a consolidated income tax adjustment for NJNG in this case. My consolidated income tax adjustment for NJNG is shown in my rate base summary, Schedule ACC-3.

**Q. How did you quantify your adjustment?**

A. There are two methods of calculating consolidated income tax adjustments, the operating income method and the rate base method. With the rate base method, a utility's rate base is reduced by the accumulated tax benefits allocated to each entity that has positive taxable income. This method does not directly reduce the income tax expense included in a utility's revenue requirement, but rather provides for the treatment of these accumulated benefits as cost-free capital. This is the method adopted by the BPU.

The second method, the operating income method, provides for a direct reduction to pro forma income taxes to reflect the utility's allocable share of tax benefits resulting from tax losses of affiliates.

In data request S-RREV-89, Staff asked the Company to quantify the consolidated income tax benefit, based on the methodology approved by the Board in its Order in the recent base rate case proceeding involving Rockland Electric Company, BPU Docket No. ER02100724. While the supporting details of that response are claimed by NJNG to be confidential, the Company's calculation resulted in a total allocable loss of $7.643 million. Allocating this loss to NJNG on the basis of NJNG's share of the total positive taxable income over the period results in a rate base adjustment of $5.375 million. This is the adjustment that I have included in my rate base summary schedule, Schedule ACC-2.

### E. Summary of Rate Base Issues

**Q. What is the impact of all of your rate base adjustments?**

A. My recommended adjustments reduce the Company's rate base from $953.088 million as reflected in its filing, to $896.415 million, as summarized on Schedule ACC-3.

## VI. OPERATING INCOME ISSUES

### A. Pro Forma Revenues

**Q. Are you recommending any adjustments to the Company's pro forma revenue claim?**

A. Yes, I am recommending two adjustments to the Company's pro forma revenue claim. Specifically, I am recommending an adjustment to reflect billed revenues rather than amounts referred to by NJNG as "calendarized" revenues. I am also recommending that the Company's revenues be annualized to reflect the number of residential customers at April 30, 2008, the end of the test year in this case.

**Q. How did the Company determine the revenue from gas sales reported on its financial statements?**

A. As described in the response to RCR-REV-13, the Company uses what it terms a "calendarized approach" to determine its revenue for financial reporting purposes. The Company's calculation begins by first determining the total gas delivered each month to NJNG. This volume of gas, which the Company identifies as "therms-to-account-for", consists of gas delivered through the gas supply interconnection meters serving NJNG, as well as any true-up from the prior month. The Company then assigns the therms-to-account-for to the various customer classes. Customers with automatic meter read ("AMR") devices are assigned sales volumes based on the actual AMR readings. The remaining gas is assigned to other customers based on a pro-rata allocation of actual or estimated meter reads. Revenues are then determined for each customer class based on the therms assigned to that class as well as the applicable customer charges. Thus, the overall revenues recorded for financial reporting purposes are not directly based on the revenues that are actually billed to customers each month.

**Q. Does the Company ever true-up its calendarized sales and its billed sales?**

A. In response to RCR-REV-14, the Company indicated that a true-up occurs "in the contra account receivable balance which adjusts the accounts receivable recorded from cycle bill information to the calendarized revenue amount." It appears from this response that any such true-up is a balance sheet transaction, not an income statement transaction. Therefore, I do not believe that the revenues reported for financial reporting purposes are ever trued-up to reflect the revenues actually billed to customers.

**Q. What is the impact of the methodology used by the Company to record revenues?**

A. As shown in the response to RCR-A-157, in some months the Company's calendarized revenues exceed billed revenues, and in some months the Company's billed revenues exceed calendarized revenues. However, at any given point in time, the differential can be significant. For example, as shown in that response, in November 2007, the Company's calendarized revenues exceeded its billed revenues by approximately 73.5%, i.e., calendarized revenues were 73.5% higher than billed revenues. Conversely, in March of 2008, the Company's billed revenues exceeded its calendarized revenues by about 16.3%. On a rolling twelve-month average, the difference between calendarized and billed revenues ranged from 1.40% to (5.03%) over the past three years. For the twelve months ending March 2008, the rolling twelve-month average was (0.65%), meaning that the Company billed 0.65% more revenue than it recorded for financial reporting purposes.

**Q. Do the other New Jersey gas utilities use the same methodology as NJNG for recording revenues?**

A. No. It is my understanding that NJNG is the only New Jersey gas utility using this methodology.

**Q. What concerns do you have about the methodology used by NJNG?**

A. I have several concerns. First, the Company's methodology results in a basic disconnect between the revenues recorded for financial reporting purposes and the amounts actually billed to customers. Moreover, at any given point in time this discrepancy can be significant. In addition, while there is some attempt to reconcile calendarized and billed revenues through the Company's accounts receivable balance, it does not appear that there is a reconciliation performed in the Company's income statement. The calendarized method used by NJNG also creates difficulties in ensuring that costs are accurately reconciled to revenues in various adjustment mechanisms such as the Conservation Incentive Program ("CIP") clause, the Basic Gas Supply Service ("BGSS") clause, and the Societal Benefits Charge ("SBC") clause. Finally, the calendarized method used by NJNG is subject to manipulation while the use of billed sales provides an objective and verifiable measure of the

Company's revenues.

**Q. Is the Company's revenue claim in this case based on calendarized or billed sales?**

A. The Company's claim in this case is based on a combination of calendarized sales and forecasted sales. However, as discussed in the response to RCR-REV-19, the Company's 12+0 update will reflect twelve months of calendarized sales, adjusted for normal weather.

**Q. What do you recommend?**

A. I recommend that the Company's pro forma revenue in this case be based on actual billed sales during the test year. Billed sales represent the amount that the Company should actually expect to receive from ratepayers, less an appropriate allowance for uncollectibles. Moreover, billed sales can be objectively measured and verified. Moreover, they do not depend upon usage and allocation assumptions that could turn out to be incorrect, resulting in a potential mismatch between calendarized revenues and actual bills. For all these reasons, I recommend that the BPU determine the Company's revenue requirement by using billed revenues instead of calendarized revenues.

**Q. How did you quantify your adjustment?**

A. To quantify my adjustment, I have increased the Company's calendarized therms by 0.65%, as noted above, this is the actual difference between the calendarized and billed therms for the twelve months ending March 2008, which is the most recent data provided by the

Company. I have priced these incremental therms at an average margin of $0.2392 per therm, based on the Company's responses to RCR-RD-27 and RCR-RD-28. My adjustment is shown in Schedule ACC-8.

**Q. Why didn't you quantify your adjustment separately for each customer class?**

A. My adjustment is not quantified on a customer class basis because the Company did not provide calendarized vs. billed therm data on a customer class basis. The only calendarized vs. billed sales data provided by NJNG was developed on a total company basis. Class-specific data was requested in RCR-REV-5. However, the Company responded that since its revenues were forecasted, it could not provide underlying calendarized vs. billed data. Actually, the Company did have three months of actual data when it originally filed its petition and it had nine months of actual data when it filed its 9+3 updates.

**Q. What data should the Company provide with its 12+0 update?**

A. With its update, NJNG should provide twelve months of calendarized vs. billed data, broken out by the customer classes used in RCR-RD-27 for its proof of revenue. In addition, it should update RCR-RD-27 to reflect billed sales, normalized for normal weather conditions. Any other revenue adjustments proposed by NJNG should also be developed on the basis of billed revenues. Finally, NJNG should provide all underlying assumptions and calculations used in the development of its pro forma revenue claim at present rates based on billed sales.

**Q. Do you have any additional comments regarding the use of calendarized vs. billed sales?**

A. Yes. Since I am recommending that billed sales be used to set base rates in this proceeding, it is necessary for the Company to use billed sales to determine its recoveries under any adjustment mechanisms that are in place, such as the Conservation Incentive Program ("CIP"), the Basic Gas Supply Service ("BGSS") clause, the Societal Benefits Charge ("SBC") clause, or others. For example, a benchmark level of usage will be established in this case against which future usage will be measured to determine if a CIP adjustment is warranted. If base rates are established based on billed sales and the CIP is determined based on calendarized sales, there will be an inherent mismatch that will understate or overstate the required CIP adjustment. In order to avoid any such inconsistency, the BPU should require NJNG to use billed sales for base rates as well as for the Company's various adjustment clauses.

Finally, I understand that in the Company's most recent BGSS proceeding, BPU Docket No. GR06060415, the Company agreed to conduct an internal review of the "therm and revenue recognition process" and to provide a detailed report in its upcoming BGSS proceeding, which is due to be filed on June 1, 2008.[5] I will update my recommendations, as necessary, once I have had the opportunity to review the Company's submission.

**Q. What is the second revenue adjustment that you are recommending in this case?**

5 Stipulation I/M/O the Petition of New Jersey Natural Gas Company for the Annual Review and Revision of its Basic Gas Supply Service (BGSS) for F/Y 2007, BPU Docket No. GR06060415, paragraph 10.f.

A. The Company's pro forma revenue claim is based on nine months of actual customer counts and three months of projected customers. NJNG did not make any adjustment to annualize its pro forma revenue to reflect actual customers at April 30, 2008, the end of the test year.

**Q. Do you believe that such an adjustment is necessary?**

A. Yes, I do. Annualization adjustments are frequently made to reflect the number of customers at the end of the test year. This is especially true of residential customer counts, which often increase consistently from month-to-month in utility systems that are growing. Assuming that customers are added proportionately over a twelve-month period, the actual test year revenue would include customer counts at the midpoint of the test year, in this case October 31, 2007. However, by the end of the test year, NJNG would have added additional customers, and revenue from these customers should be reflected in the Company's pro forma revenue claim. Therefore, I am recommending an adjustment to annualize residential customers to reflect customer counts at April 30, 2008.

**Q. Is your adjustment consistent with the Company's rate base claim in this case?**

A. Yes, it is. NJNG's rate base reflects a valuation at April 30, 2008. Moreover, the vast majority of the Company's rate base is composed of net plant, which reflects a valuation at the end of the test year. The few rate base components that were determined based on 13-month averages, such as materials and supplies and gas inventory, are components that typically fluctuate from month-to-month and therefore an end of test year valuation would be inappropriate. However, for rate base components that generally increase each month, such as utility plant-in-service, the Company has included the balance at the end of the test year. To properly match this investment with the customers being served, it is reasonable to also make an adjustment to reflect residential customer counts at the end of test year.

**Q. How did you quantify your adjustment?**

A. I annualized residential customers based on customer counts at April 30, 2008. I then compared these customer counts to the number of billing determinants used by NJNG in its proof of revenues. This resulted in an adjustment of 5,356 residential customers. I assumed a total average margin per customer of $334.47, based on the Company's proof of revenues. This resulted in incremental revenue of $1.79 million, as shown in Schedule ACC-9.

**Q. Why are you limiting your adjustment to residential customers?**

A. I am limiting my adjustment to residential customers because other customer classes demonstrate fluctuations from month-to-month. While other customer classes are generally growing, the growth is not consistent throughout the year. Therefore, the use of customer counts at the end of the test year would overstate pro forma revenue from these classes. In addition, non-residential customers generally exhibit more divergent usage patterns than residential customers. Therefore, an adjustment that is based on an average usage for the class may not be representative of usage for customers that were actually added during the test year. For these reasons, I have limited my recommended adjustment to residential customers.

## B. Lost Revenues

**Q. Please describe the Company's claim relating to lost revenues, as shown in Schedule JSB-32 to Mr. Buth's testimony.**

A. As described on pages 14-15 of Mr. Buth's testimony, NJNG requested recovery of lost revenues resulting from energy conservation projects in Docket No. GR05100846, I/M/O the Petition of New Jersey Natural Gas Company for the Annual Review and Revision of its Societal Benefits Clause ("SBC") Factors and the Weather Normalization Clause ("WNC") Factor for the 2004-2005 Winter Period. Pursuant to a Stipulation in that case, the parties agreed to examine this issue in the Company's next base rate case. The Company is seeking recovery of $1.419 million relating to this issue.

**Q. What do you recommend?**

A. I recommend that the Company's claim for recovery of these lost revenues be denied. I have several reasons for my recommendation. First, the lost revenues referenced in the Stipulation are $1.129 million, $290,000 less than the amount being claimed in this case. Second, the Company is proposing to recover these lost revenues over one year. Therefore, if NJNG's proposal were accepted by the BPU, the Company would recover $1.419 million each and every year until new base rates are established. Assuming that rates resulting from this case are in place for more than one year, the Company would be guaranteed to over-recover these lost revenues.

Third, the Company has not provided any compelling reason why these lost revenues should be recovered. It has not demonstrated that its financial integrity would be jeopardized if recovery were denied. These lost revenues constitute less than one-tenth of one percent of the Company's pro forma test year revenues. Over the three year period for which lost revenues are being claimed, NJNG's shareholders retained over $19 million of BGSS incentives, incentives that were established, in part, to maintain the integrity of the Company's financial condition between base rate cases. In addition, since the Company filed its 2004-2005 SBC/WNC case, the BPU has approved the CIP program, which provides a potential new source of revenue to offset conservation losses. Finally, it is my understanding that the BPU generally has a policy against recovery of lost revenues. For all these reasons, I recommend that the Company's claim be denied. My adjustment is shown in Schedule ACC-10.

### C. <u>Salaries and Wages</u>

**Q. How did the Company develop its salary and wage claim in this case?**

A. The Company's salary and wage claim is based on three adjustments. First, NJNG annualized its salary and wage costs based on the average monthly straight time expense for the period May 2007 to December 2007 and the actual number of employees at December 2007. The Company then made an adjustment to annualize salaries for the period May 2008 to December 2008 by increasing the prior year's average monthly straight time expense by

4.4%. The 4.4% increase is the weighted increase, assuming that non-union employees receive a 5.0% increase and that union employees receive a 4.0% increase. Union employees receive annual increases on December 8 of each year, while non-union employees receive increases effective with the first payroll period in January.[6] Finally, the Company made a further adjustment to annualize salaries at January 1, 2009, based on another 4.4% increase. NJNG made similar adjustments for increases in the Service Company salaries and wages. The Service Company adjustments were based on annual increases of 5.0% for all Service Company personnel.

**Q. Are you recommending any adjustments to the Company's claim?**

A. Yes, I am recommending two adjustments. First, the Company's claim includes 2009 pro forma payroll increases that will not take place until well after the test year in this case. The inclusion of these payroll increases reaches too far beyond the end of the test year selected by NJNG in this case and should be rejected. Rates are set based on a regulatory triad that synchronizes rate base, revenues and expenses at a point in time. The Company's proposal to include these pro forma labor costs violates the principle that all elements of the Company's revenue requirement should be matched at a point in time.

**Q. What do you recommend?**

A. In order to preserve the regulatory triad, I have limited the Company's salary and wage

6 Per the response to S-RREV-59.

adjustment to increases that took place in 2008. This has the effect of including in rates annualized salaries through 2008. My adjustment is shown in Schedule ACC-11.

**Q. What is your second payroll adjustment?**

A The Company's claim is based on a December 2007 count of 562 employees at NJNG and 109 employees at the Service Company, 89 of which are allocated to NJNG. In its claim, the Company has included adjustments to reflect 26 additional NJNG employees and 7 new allocated Service Company employees. As a result of these adjustments, the Company's claim includes 588 NJNG employees and 96 allocated Service Company employees. The Company's attempt to include these employees in its revenue requirement is another example of NJNG attempting to unreasonably extend the test year well beyond the April 30, 2008 that it selected in this case.

**Q. How does the Company's claim compare to the actual level of employees?**

A. According to the response to RCR-A-105, at April 10, 2008, NJNG had 574 employees and the Service Company had a total of 111 employees, a percentage of which would be allocated to NJNG. The April 10, 2008 employee count represents the most recent information provided in response to discovery.

**Q. What do you recommend?**

A. I recommend that the Company's pro forma salary and wage expense be based on the actual number of employees at the end of the test year. At Schedule ACC-11, I have made an adjustment to reflect salaries and wages for the actual employees as of April 10, 2008. I recommend that NJNG update its workpapers to Schedule JSB-21 when it files its 12+0 updates to reflect the actual number of employees at the end of the test year, and that its salary and wage adjustment be revised accordingly.

### D. Incentive Compensation Costs

**Q. Please describe the Company's incentive compensation program.**

A. The Company has incentive compensation plans for both its union and non-union employees. The incentive compensation plan for union employees has two plan triggers, tied to growth in NJR and NJNG earnings. Both of these triggers must be met in order for payments to be made. If these triggers are met, there are then three individual measures that are evaluated, including NJNG earnings growth, business unit rating and department/unit productivity. The business unit rating is based on the Chairman's evaluation of how well the business unit did in meeting certain guidelines. Department/ unit productivity is based on measures developed by the Company and the union. The non-union incentive compensation plan is similarly based on measures that include corporate earnings, business unit performance, and individual performance.

**Q. How much is included in the Company's pro forma expense claim relating to incentive**

**compensation plans?**

A. As shown in the Company's workpapers to Schedule JSB-21, the Company claim includes $3.482 million of employee compensation costs for NJNG employees and slightly over $1 million in costs allocated from the Service Company.

**Q. Do you believe that the incentive compensation program is an appropriate cost to pass through to ratepayers?**

A. No, I do not. I have several concerns about these types of programs, most of which are based, at least in part, on a utility's ability to achieve certain earnings goals. Providing employees with a direct financial interest in the profitability of the Company is an objective that would benefit shareholders, but it does not benefit ratepayers. Incentive compensation awards that are based on earnings criteria may violate the principle that a utility should provide safe and reliable utility service at the lowest possible cost. This is because these plans require ratepayers to pay higher compensation costs as a consequence of high corporate earrings, a spiral that does not directly benefit ratepayers, but does benefit shareholders, as well as the management responsible for establishing such programs and to whom much of the incentive compensation is granted.

Incentive compensation plans tied to corporate performance result in greater enrichment of company personnel as a company's earnings reach or exceed targets that are predetermined by management. It should be noted that it is the job of regulators, not the shareholders or company management, to determine what constitutes a just and reasonable rate of return award to shareholders in a regulated environment. Regulators make such a determination by establishing a reasonable rate of return award on rate base in a base rate case proceeding.

Allowing a utility to charge for additional return that is then distributed to employees as part of a devised plan to divide extraordinary profits violates all sense of fairness to the ratepayers of the regulated entity. It is certain to result in burdensome and unwarranted rates to its ratepayers, and also violates the principles of sound utility regulation, particularly with regard to the requirement for "just and reasonable" utility rates.

**Q. What would be the appropriate response by the BPU if the earnings of NJNG were in excess of its authorized rate of return?**

A. If the BPU determined that these excess earnings were expected to continue, the appropriate response would be to initiate a rate investigation, and, if appropriate, to reduce the utility's rates.

**Q. Are NJNG employees being well compensated separate and apart from these employee incentive plans?**

A. Yes, they are. As derived from the Company's workpapers, the average NJNG pro forma straight time salary is $50,587 while the average straight time salary at the Service Company is $83,537.[7] In addition, employees at NJNG earn on average another 20% annually in overtime payments. Salary and wage increases have also kept pace with industry standards. Union increases have ranged from 3.5% to 4.0% annually over the past three years while non-union increases have averaged 4.16% over this period.[8] NJNG's salary and wage levels appear reasonable even if the incentive compensation plans are not considered.

**Q. What do you recommend?**

A. Since the employee compensation plan is based on financial performance triggers, and since at least some of the measures are tied to the financial performance of NJNG and NJR, I recommend that the costs of incentive compensation awards granted under these plans be eliminated from the Company's revenue requirement. This recommendation will require the Board of Directors to establish incentive compensation plans that shareholders are willing to finance. As long as ratepayers are required to pay the costs of these incentive plans, then there is no incentive for management to control these costs. This is especially true since the management of the Company are primary beneficiaries of such plans. Therefore, I recommend that the Company's claim for incentive compensation costs be denied. My adjustment is shown in Schedule ACC-12.

**Q. Has the BPU previously addressed this issue?**

A. Yes. Rate Counsel has informed me that the Board has a policy of disallowing incentive

7 These amounts do not include the 2009 increase being requested by NJNG in its filing.
8 Per the response to RCR-A-22.

compensation costs when the performance triggers and benchmarks are tied to financial performance objectives. In the 2000 Middlesex Water Company base rate case, Board Staff argued in its Initial Brief that,

> Staff is persuaded by the arguments of the RPA that, at this time, the incentive compensation expenses should be 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.[9]

While the Administrative Law Judge ("ALJ") in that case recommended that Middlesex be permitted to recover 50% of its incentive compensation costs in rates, the BPU rejected the ALJ's recommendation and instead ordered that 100% of these costs be disallowed.[10]

In an earlier decision, the BPU found that including employee incentives in utility rates is especially troublesome during difficult economic times, finding that,

> 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 and 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

9 I/M/O the Petition of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Charges, BPU Docket No. WR00060362, Staff Initial Brief, page 37.

10 I/M/O the Petition of Middlesex Water Company for Approval of an Increase in Its Rates for Water Service and Other Tariff Charges, BPU Docket No. WR00060362, Order Adopting in Part/Modifying in Part/Rejecting in Part Initial Decision at 25-26 (June 6, 2001).

> 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.[11]

It is indisputable that ratepayers are once again facing very difficult economic conditions, with unprecedented prices for gasoline, rising food and utility costs, widespread housing foreclosures, and a general economic turndown. Thus, the BPU's reasoning for disallowing these costs is just as relevant today as it was in 1993. The BPU's findings on this issue therefore support my recommendation that all such costs be excluded from the Company's revenue requirement.

**Q. Have you also made an adjustment to the Company's payroll tax expense claim?**

A. Yes, I have made an adjustment to eliminate the payroll taxes associated with my recommended adjustments relating to salary and wage costs and employee incentive compensation. To quantify my payroll tax adjustment, I utilized the statutory social security and medicare tax rate of 7.65%. I then reduced my adjustment to incorporate the Company's assumption that 12.5% of salary and wage costs would be exempt from social security and medicare taxes. My adjustment is shown in Schedule ACC-13.

## E. <u>Pension and Benefits Expense</u>

11 I/M/O the Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions, BRC Docket No. ER91121820J, Final Decision and Order Accepting in Part and Modifying in Part the Initial Decision at 4 (June 15, 1993).

**Q. How did NJNG determine its pension and benefits expense claim in this case?**

A. The Company's claim includes projected pension costs, other post employment benefit ("OPEB") costs, and medical and dental expenses. According to the testimony of Mr. Buth at page 12, the Company's claim "reflects the forecasted pension, OPEB, medical and dental expenses through fiscal year 2009 and includes actuarial assumptions and changes in employee demographics as prepared by Buck Consultants."

It appears from a review of the Company's workpapers that the Company started with its 2009 fiscal year projections, and then made further adjustments to increase its projected pension costs by $700,000 and to increase its projected OPEB costs by $1.5 million. Thus, it is unclear if the Company's claim for pensions and OPEB costs reflects fiscal year 2009 estimates, as stated in Mr. Buth's testimony, or fiscal year 2010 projections. The Company's adjustment reflects an increase of over 33% in its test year pension and benefit costs.

**Q. Are you recommending any adjustment to the Company's claim in this case for pension and benefits expenses?**

A. Yes, I am recommending that NJNG's post-test year adjustments be disallowed. Regardless of whether the Company's claim includes fiscal year 2009 projections or fiscal year 2010 projections, the Company's projections reach too far beyond the end of the test year and should be rejected by the Board. As discussed above with regard to the Company's salary and wage claim, NJNG has violated the test year matching principle by including costs that extend well beyond April 30, 2008, the end of the test year in this case. Fiscal year 2009 ends on September 30, 2009, seventeen months past the end of the test year. Thus, even if the Company's claim is based on revised fiscal year 2009 projections, this claim is too far outside of the test year to be included in new rates. My adjustment to eliminate the Company's increase in pension and benefit costs is shown in Schedule ACC-14.

**F. <u>Sales Incentive Expenses</u>**

**Q. Please describe the Company's adjustment relating to sales incentive expenses.**

A. NJNG has included an adjustment to reflect increased costs associated with conversions for systems from propane to natural gas. The Company's test year costs include $1,207,669 for incentive payments made to commercial and residential customers to entice customers to convert from electric, oil, or propane to natural gas. The Company is proposing to amortize these costs over a three-year period. Therefore, it has reduced its test year costs by $805,000, as shown in Schedule JSB-23.

**Q. Are you recommending any adjustment to the Company's claim?**

A. Yes, I am recommending that all such incentive payments be disallowed. Just as utilities are generally prohibited from recovering promotional advertising costs from ratepayers, they should also be prohibited from recovering these promotional costs. These incentive payments provide a competitive advantage to the Company over its competitors providing other fuel sources. Moreover, it seems inconsistent to permit the recovery of these promotional costs in rates while at the same time promoting conservation efforts through the

CIP. Accordingly, I am recommending that the Company's claim for sales incentive payments be disallowed. My adjustment is shown in Schedule ACC-15.

**Q. Have you also eliminated the residential efficiency upgrade costs incurred in the test year?**

A. Yes, I have. The Company and its shareholders made certain commitments with regard to conservation programs as part of the Settlement Agreement in the CIP proceeding. The Company has not demonstrated that its claim for residential efficiency upgrade costs is consistent with the funding obligations of its shareholders pursuant to that Settlement Agreement. Therefore, at Schedule ACC-15, I have also made an adjustment to eliminate the residential efficiency upgrade costs from the Company's claim in this case.

## G. <u>Plant-in-Service Additions</u>

**Q. Please describe the Company's operating income adjustment relating to plant-in-service additions.**

A. Most utilities that seek to recover post-test year plant additions include CWIP in their rate base claims or make some other rate base adjustment. In this case, NJNG has not included any post-test year additions to rate base. Moreover, the Company claimed in response to S-RREV-77 that "CWIP is not included in rate base."

However, while CWIP may not have been explicitly included in rate base, the Company did include an adjustment to reflect post-test year plant in its revenue requirement claim. At Schedule JSB-35, NJNG made an operating income adjustment to reflect a) the return requirement associated with $16.355 million in capital expenditures, b) annual depreciation on these capital expenditures, and c) incremental net operating costs.

**Q. What projects are included in the Company's claim?**

A. NJNG has included the Stafford LNG vaporizer, the Whiting approach main as well as distribution mains and services, the Franklin line, and a plant accounting software package.

**Q. What is the Company's rationale for including these costs in its revenue requirement in this case?**

A. Other than the fact that these projects will provide benefits to customers, the Company has not provided any justification for the unusual ratemaking treatment that it is requesting in this case. Moreover, the existence of benefits to ratepayers is not sufficient justification for including post-test year additions in the Company's revenue requirement. One would expect that all construction projects benefit customers. However, the test year concept requires that plant reflected in rates be used and useful in the provision of utility service in the test year.

**Q. What is your objection to including CWIP or other post-test year plant in rate base?**

**A.** CWIP or other post-test year plant additions are not appropriate rate base elements. CWIP and other post-test year plant additions do not represent facilities that are used or useful in the provision of utility service during the test year. In addition, including this plant in rate base violates the regulatory principle of intergenerational equity by requiring current ratepayers to pay a return on plant that is not providing them with utility service and which may never provide current ratepayers with utility service.

One of the basic principles of utility ratemaking is that shareholders are entitled to a return on, and to a return of, plant that is used and useful in the provision of safe and adequate utility service. By its definition, CWIP and other post-test year additions do not meet these criteria. Moreover, allowing this plant to be recovered in rates before it is placed into service transfers the risk during project construction from shareholders, where it properly belongs, to ratepayers.

**Q. What do you recommend?**

A. I recommend that the Company's claim to include a return on post-test year plant additions, depreciation expense, and associated operating expenses in its revenue requirement be denied. My adjustment is shown in Schedule ACC-16.

## H. Deferred Asset Recovery

**Q. Please describe the Company's claim for recovery of a deferred asset, shown in Schedule JSB-29.**

A. In its filing, NJNG is requesting recovery of a deferred asset associated with a change in the corporate business tax ("CBT") rate. As discussed on page 13 of Mr. Buth's testimony, in 2006 the State of New Jersey implemented a surcharge to the CBT. This surcharge had the effect of increasing the CBT tax rate from 9.00% to 9.36%. NJNG has been deferring this surcharge on its books and records of account for financial reporting purposes. It is now seeking to recover this deferral from ratepayers.

**Q. Is it appropriate to include these deferred costs in the Company's prospective rates?**

A. No, it is not. The Company's claim constitutes retroactive ratemaking and should be denied by the BPU. If a utility wants to defer a cost for ratemaking purposes, it has an obligation to seek a deferred accounting order from the regulatory authority. Most accounting orders issued by regulatory agencies permit a utility to seek future rate recovery of a previously-incurred cost, although accounting orders generally do not guarantee such recovery. In any case, NJNG did not receive BPU authorization to defer these costs. Therefore, allowing these past costs to be recovered would violate the prohibition against retroactive ratemaking.

The prohibition against retroactive ratemaking is a well-established regulatory principle. A company cannot unilaterally decide to defer costs and expect recovery in a future rate case. If the Company believed that the CBT surcharge would have a material impact on its financial integrity, then it had an obligation to seek authorization for deferral from the Board. No such authorization was sought and recovery of these past costs should be denied. My adjustment is shown in Schedule ACC-17.

**Q. Do you have any further comments about the Company's claim for recovery of these deferred costs?**

A. Yes. The Company has included a one-year amortization period for these costs, similar to the methodology used for its claim for lost revenues. Therefore, if the BPU were to grant the Company's request, NJNG would recover 100% of these deferred costs each and every year until new base rates are established, resulting in an over-recovery of these costs and a windfall for shareholders. This fact lends further support to my recommendation that the Company's claim be denied.

### I. <u>Pipeline Integrity Management ("PIM") Costs</u>

**Q. Is Rate Counsel recommending any adjustment to the PIM costs claimed by NJNG in this filing?**

A. Yes. As discussed on pages 38-41 of Mr. LeLash's testimony, Rate Counsel is recommending that distribution-related PIM costs be excluded from the Company's claim. Mr. LeLash quantified his recommended disallowance on Schedule 5 of his testimony. He is recommending the disallowance of $125,800 in return on investment, of $54,208 in depreciation expense, and of $18,676 in incremental expenses. At Schedule ACC-18, I have made an adjustment to eliminate these costs from the Company's revenue requirement consistent with Mr. LeLash's recommendation.

### J. <u>Rate Case Costs</u>

**Q. How did the Company develop its rate case cost claim?**

A. NJNG is requesting recovery of rate case costs of $475,000, as shown in Schedule JSB-28 to

Mr. Buth's testimony. The Company's claim includes legal costs of $200,000, outside consultant costs of $225,000, and administrative costs of $50,000. The Company is proposing to recover these costs over a three-year period. Therefore, NJNG is requesting an annual recovery of $158,000.

**Q. Are you recommending any adjustments to the Company's claim?**

A. Yes, I am recommending two adjustments. First, I am recommending that the BPU adopt a five-year amortization period for rate case costs. NJNG's last base rate case was filed over fifteen years ago, with new rates effective November 1, 1994. Since that case, the BPU has approved various BGSS incentive programs and the CIP, most of which Rate Counsel is recommending be continued. These incentive programs should mitigate the need for NJNG to file frequent base rate cases. The fact that NJNG was able to avoid filing a rate case for fifteen years suggests that a combination of customer growth and other revenue sources were successful in mitigating the impact of cost increases on the Company's bottom line. While I do not expect that there will be another fifteen year lapse before the Company files its next base rate case, history suggests that a three-year amortization period is too short. Therefore, I am recommending that the Company's rate case costs be amortized over five years. My adjustment is shown in Schedule ACC-19.

**Q. What is your second recommended adjustment to rate case costs?**

A. The BPU has a well-established policy of requiring a 50/50 sharing of rate case costs between ratepayers and shareholders. This policy recognizes that shareholders benefit from rate case filings and therefore shareholders should fund a portion of these costs. NJNG did not reflect any such sharing in its claim for rate case costs. Instead, the Company has included 100% of these costs in its revenue requirement. Accordingly, at Schedule ACC-19, I have also recommended an adjustment to reflect 50/50 sharing of rate case costs between ratepayers and shareholders, consistent with BPU policy.

### K. Proposed Automated Meter Reading Program

**Q. Please describe the Company's claim for costs associated with a proposed automated meter reading program.**

A. In its 9+3 update, the Company included a new adjustment relating to a proposed Automated Meter Reading ("AMR") program. This claim is shown on Schedule JSB-39 and was described on pages 17-19 of Mr. Buth's testimony (9+3). The Company is proposing to install AMR technology throughout its Monmouth County service area over a 12-15 month transition period. In its revenue requirement, NJNG has included return on investment of $1.080 million, depreciation expense of $721,000, and incremental operating costs of $241,000.

**Q. Are you recommending any adjustment to the Company's claim?**

A. Yes, I am. First, I should clarify that my recommendations are focused on the appropriate ratemaking treatment for these costs. Howard Woods is filing testimony on behalf of Rate

Counsel, addressing the operational aspects of the Company's proposal. With regard to the ratemaking issue, I am recommending that the Company's claim be denied.

**Q. What is the basis for your recommendation?**

A. My recommendation is based on the fact that this investment represents post-test year plant additions. Therefore, this investment was not used and useful in the provision of utility service during the test year. The Company's proposal violates the test year concept, results in single-issue ratemaking, and should be rejected by the BPU. While I am not opposed to the Company investing in AMR technology, there is no compelling reason why such investment should be given the extraordinary rate treatment being requested by NJNG. The Company's proposal is another attempt to shift risk from shareholders to ratepayers without any commensurate benefit to ratepayers.

The Company acknowledged that the AMR program, even if implemented as proposed, will be phased-in over a period of 12-15 months, well outside of the test year in this case. In addition, one would expect the program to result in cost reductions, due to the elimination of meter readers, increased accuracy of meter readings, and improved safety. These associated cost reductions have not been included in the Company's filing. Moreover, while an AMR program may have benefits over current metering methodologies, the adoption of a new metering/billing technology as such technologies evolve is part of the normal business cycle for any business, including utilities. Incorporating new technologies is an ongoing part of managing the gas business. There is nothing inherent in the AMR program that suggests the need for a different ratemaking methodology or the need to violate the test year matching concept.

**Q. What do you recommend?**

A. I recommend that the proposed AMR adjustment be rejected. AMR represents a natural evolution in metering / billing technology and should be treated as such by the BPU. While there are undoubtedly benefits to be realized from AMR, these benefits do not justify the extraordinary ratemaking treatment being requested in this case, i.e., recovery of costs that will not be incurred for 12-15 months after the end of the test year and without any consideration of off-setting cost savings. For all these reasons, I recommend that the BPU reject NJNG's proposed AMR adjustment. My adjustment is shown in Schedule ACC-20.

## L. Management Audit Expenses

**Q. Please describe the Company's claim for recovery of Management Audit costs.**

A. In its claim for outside services costs, NJNG included a claim of $790,000 relating to a BPU-mandated management audit. The Company is proposing to amortize these costs over six years. According to the response to S-RREV-135, the Management Audit costs are being amortized over six years based on the provisions of N.J.S.A. 48:2-16.4, which states that "An audit shall be conducted at least every 3 years, except where the Board finds that an audit is unnecessary. In no event, however, shall an audit be conducted less than once every 6 years." The amount of the Company's claim is based on the Management Audit proposal submitted to the BPU by The Liberty Consulting Group, as shown in the response to S-RREV-134.

In addition to the Company's claim relating to Management Audit costs, NJNG has also included a claim of $168,000 in outside services expense for costs associated with an Affiliate Standards review. The Company is proposing to amortize these costs over two years. According to the response to S-RREV-131, "[t]he Affiliate Standards estimated cost is being amortized over a two year period since EDECA and the related BPU regulations require a Competitive Services Audit of energy utilities to be performed every two years."

**Q. Are you recommending any adjustment to the Company's claim for Management Audit costs?**

A. Yes, I am. The Management Audit contains a section on Affiliate Standards, and the extent to which the Affiliate Standards comply with EDECA. Therefore, by including both Management Audit costs and Affiliate Standard review costs in rates, the Company is over-stating the costs that it will incur related to Affiliate Standard reviews. Since the Company has used a six year amortization period for Management Audit costs and a two-year amortization period for Affiliate Standard reviews, there is essentially one two-year period of overlap in the Company's claims. This has the effect of double-counting Affiliate Standard review costs for two out of the six years included in the Management Audit amortization. Therefore, I am recommending that the Management Audit costs be reduced to eliminate a portion of the costs attributable to review of Affiliate Standards, since the Company recovers these costs through the allowance for Affiliate Standard review costs included in outside services expense. My adjustment is shown in Schedule ACC-21.

**M. Institutional and Educational Expenses**

**Q. What are institutional and educational expenses?**

A. Institutional and educational expenses are civic and charitable contributions made by the Company.

**Q. How did NJNG treat institutional and educational expenses in its filing?**

A. As described on page 14 of Mr. Buth's testimony. NJNG has included what it terms "a reasonable level of financial assistance for educational institutions, scholarship and hospital funds, youth programs, local branches of national organizations and other institutional entities..." in its claim for utility rates. Mr. Buth's testimony references Schedule JSB-31, which shows an expense increase of $51,000.

**Q. To what does this $51,000 claim relate?**

A. This claim relates to Company donations of $51,000 to the New Jersey Shares program that were originally booked below-the-line by NJNG. These are the only donations identified by NJNG in its filing.

**Q. Does the Company's filing include other civic and charitable donations, in addition to the $51,000 referenced above?**

A. Yes, it does. In addition to the civic and charitable donations identified by NJNG, there are also other donations included in the Company's claim that were originally booked to above-the-line accounts. As shown in the response to S-RREV-38, the Company included in its test year claim donations made by NJR, a portion of which were allocated to NJNG. These donations were booked by NJNG to Account 921, an above-the-line account. Accordingly, they are embedded in the Company's revenue requirement claim.

**Q. Do you believe that it is appropriate to recover charitable contributions made by utilities from captive ratepayers?**

A. No, I do not. Utility rates should include a reasonable level of costs that are necessary for the provision of safe and reliable utility service. Charitable contributions are not necessary for the provision of safe and adequate utility service and these costs should not be borne by ratepayers. Furthermore, by including such contributions in utility rates, utilities force ratepayers to indirectly contribute to those organizations selected by utility management, effectively forcing ratepayers to support organizations whose goals and objectives may conflict with those of any specific ratepayer. For these reasons, most regulatory commissions prohibit utilities from recovering charitable contributions in their utility rates. While it is admirable that NJNG and NJR make civic and charitable contributions, shareholders should be responsible for funding the civic and charitable donations made by the Company.

**Q. Has this issue been addressed previously by the BPU?**

A. Yes, it is my understanding that the BPU has a policy prohibiting the recovery of civic and charitable contributions from ratepayers. In addition, I have been advised by Rate Counsel that this issue has been adjudicated by the New Jersey courts and that the BPU's ban on recovery of civic and charitable contributions from ratepayers was upheld.

**Q. What do you recommend?**

A. I recommend that the BPU reject the Company's claim for recovery of civic and charitable contributions in rates. This recommendation is consistent with good ratemaking policy, with the BPU's prior rulings on this issue, and with the decision of the New Jersey courts. Moreover, the BPU should eliminate not only the contributions made directly by NJNG and originally booked below-the-line, but also those contributions allocated to NJNG from NJR that are embedded in the Company's claim. My adjustment is shown in Schedule ACC-22.

**N. <u>Dues / Lobbying Expenses</u>**

**Q. Has the Company included any lobbying-related costs in its claim?**

A. Yes, the Company has included dues in its revenue requirement for certain organizations that engage in lobbying activities. In response to S-RREV-43, NJNG indicated that 3.0% of its dues to the American Gas Association ("AGA") and 10.5% of its dues to the New Jersey Utility Association were identified by these organizations as being used for lobbying activities.

**Q. Do you agree with the AGA's claim that only 3.0% of its dues are directed toward lobbying activities?**

A. No, I do not. In response to RCR-A-116, the Company provided the 2007 and 2008 AGA budgets. While only 2% of the 2007 budget and 4% of the 2008 budget are identified as lobbying-related, the AGA is taking a very limited view of lobbying. The Vision Statement of the AGA is to be "the most effective and influential energy trade association in the United States while providing clear value to its membership."[12] In addition, the first bullet point under its Mission Statement is to focus "on the advocacy of natural gas issues...." Based on my knowledge of the AGA and on its public statements, I believe that more than 3.0% of its budget should be classified as lobbying-related for ratemaking purposes.

**Q. Are lobbying costs an appropriate expense to include in a regulated utility's cost of service?**

A. No, they are not. Lobbying expenses are not necessary for the provision of safe and adequate utility service. Ratepayers have the ability to lobby on their own through the legislative process. Moreover, lobbying activities have no functional relationship to the provision of safe and adequate regulated utility service. If the Company were to immediately cease contributing to these types of efforts, utility service would in no way be disrupted. For all these reasons, I recommend that costs associated with lobbying activities be disallowed.

12 Per the AGA website.

**Q. How did you quantify your adjustment?**

A. According to the budgets provided in the response to RCR-A-116, approximately 25% of the AGA budget is directed toward Public Affairs activities. Based upon the AGA budget, as well as my review of the AGA website, I am recommending that 25% of the Company's AGA dues be disallowed on the basis that such costs constitute lobbying activities. My adjustment is shown in Schedule ACC-23. On that schedule, I have also included a disallowance of 10.5% of the Company's dues to the New Jersey Utility Association.

**O. <u>Advertising Costs</u>**

**Q. Are you recommending any adjustments to the Company's claim for advertising costs?**

A. Yes, I am recommending several adjustments. In the response to S-RREV-39, the Company provided details on the advertising costs incurred during the test year. The Company's claim includes $162,822 in informational and instructional advertising, $1,628 of inserter room expenses, and $193,943 of general advertising. I am recommending that many of the costs associated with general advertising be disallowed. I am not recommending any adjustments to the Company's claims for informational and instructional advertising or inserter room expenses.

**Q. What costs are you recommending that the BPU disallow?**

A. I am recommending that the BPU disallow costs relating to general publicity, promotional advertising, civic/community advertising, and Project Venture costs. None of these costs relate to activities or services that are necessary for the provision of safe and adequate regulated utility service. With the exception of Project Venture costs, these advertising costs all appear to be corporate image or public relations costs that are directed toward promoting the corporate image of the utility, rather than toward the provision of regulated utility service to its customers.

Moreover, as described in the response to RCR-A-146, Project Venture is a mentoring program for school children. Therefore, the Project Venture costs are more appropriately identified as civic and charitable donations than as advertising costs. As discussed above, ratepayers should not be responsible for funding civic and charitable expenditures made by regulated utilities. Therefore, I have also included these costs in my recommended disallowance.

Finally, I am also including in my recommended disallowance $4,615 of government affairs expenses, identified in the response to S-RREV-42. These costs relate primarily to civic events sponsored by the Company. Such sponsorships are another vehicle for the Company to promote the corporate image, providing benefits to its shareholders.

Unless the Company can show a direct relationship between the advertising costs included in its claim and the provision of safe and adequate utility service, these costs should be disallowed. The Company has not made such a showing at this time. Therefore, I recommend that the general publicity, promotional advertising, civic community, Project Venture, and government affairs costs discussed above be disallowed. My adjustment is shown in Schedule ACC-24.

**P. Depreciation Expense**

**Q. Have you made any adjustment to the Company's claim for pro forma depreciation expense?**

A. Yes, I have. Rate Counsel witness Michael J. Majoros, Jr. is recommending depreciation rates that differ from the rates proposed by the Company in its filing. I have used the rates recommended by Mr. Majoros in developing my revenue requirement recommendation. Mr. Majoros's recommended rates were shown in Schedule MJM_12, page 1 of his testimony.

I have applied Mr. Majoros's proposed depreciation rates to the Company's utility plant-in-service balance for each account as of April 30, 2008, as provided in its 9+3 update. My adjustment is shown in Schedule ACC-25. Rate Counsel's recommended pro forma depreciation expense will be updated with actual plant balances once the 12+0 update is filed by NJNG.

**Q. Is it possible that there will be other updates to your recommended depreciation expense?**

A. Yes. In its workpapers for the depreciation expense adjustment shown in Mr. Buth's testimony at Schedule JSB-20, the Company has included an annual expense associated with Personal and Professional Services, Account 391.04. This account was not included in Mr. Majoros's study nor does it appear that Mr. White included this account in the depreciation study that he performed on behalf of NJNG. Therefore, I have also made an adjustment to eliminate the Company's claim for depreciation expense associated with this account. I have asked the Company for additional information on this account. If the Company provides supporting documentation for these costs, I will update my depreciation expense adjustment, if necessary.

In addition, the Company's supporting workpapers for Schedule JSB-20 have two entries missing - the proposed depreciation expense for Stores Equipment and for Tools, Shop, and Garage Equipment. Since the Company did provide a total for General Plant, as well as amounts for other general plant accounts, I was able to estimate the expenses being claimed for these two accounts. If the Company updates its workpapers to reflect the actual claim for these accounts, I will update my adjustment accordingly.

**Q. <u>Interest Synchronization and Taxes</u>**

**Q. Have you adjusted the pro forma interest expense for income tax purposes?**

A. Yes, I have made this adjustment at Schedule ACC-26. It is consistent (synchronized) with my recommended rate base and with the capital structure and cost of capital recommendations of Mr. Kahal. I am recommending a lower rate base than the rate base included in the Company's filing while Mr. Kahal's recommendations result in a lower overall cost of capital for NJNG. Rate Counsel's recommendations, therefore, result in a lower pro forma interest expense for the Company. This lower interest expense, which is an income tax deduction for state and federal tax purposes, will result in an increase to the Company's income tax liability under Rate Counsel's recommendations. Therefore, I have included an interest synchronization adjustment that reflects a higher pro forma income tax expense for the Company and a decrease to pro forma income at present rates.

**Q. What income tax factors have you used to quantify your adjustments?**

A. As shown on Schedule ACC-27, I have used a composite income tax factor of 41.08%, which includes a corporate business tax rate of 9.36% and a federal income tax rate of 35%. These are the state and federal income tax rates contained in the Company's filing. My revenue multiplier, which is shown in Schedule ACC-28, reflects these same income tax factors. In addition, the revenue multiplier also includes the BPU and Rate Counsel assessments as well as an allowance for uncollectibles.

## VII. REVENUE REQUIREMENT SUMMARY

**Q. What is the result of the recommendations contained in your testimony?**

A. My adjustments indicate a revenue surplus at present rates of $6.651 million, as summarized on Schedule ACC-1. This recommendation reflects revenue requirement adjustments of $79.724 million to the Company's requested revenue requirement increase of $73.073 million.

**Q. Have you quantified the revenue requirement impact of each of your recommendations?**

A. Yes, at Schedule ACC-29, I have quantified the revenue requirement impact of the rate of return, rate base, revenue and expense recommendations contained in this testimony.

**Q. Will your revenue requirement recommendations change as a result of the Company's 12+0 updates?**

A. While the ratemaking methodologies discussed in this testimony are not likely to change as a result of the Company's updates, it is possible that my overall revenue requirement recommendation will change based on the Company's actual results for the full twelve months of the test year. Therefore, this testimony will be revised, as necessary, based on the information provided in the Company's 12+0 updates.

**Q. In addition to the operating income provided by your revenue requirement recommendation, does NJNG have other sources of income as a result of its natural gas operations?**

A. Yes. NJNG has several incentive programs in place, as discussed in Mr. Cotton's testimony. Moreover, Mr. Cotton is recommending that most of these programs be continued. Although margins from these programs fluctuate from year-to-year, it is anticipated that the Company will retain approximately $6-8 million per year in margins from these programs. This additional income is not reflected in my revenue requirement. In addition, the BPU has also approved a pilot CIP program for NJNG that provides the Company with an opportunity to recover certain margins that are lost as a result of its conservation programs. Although the CIP will be reset to $0 with the effective date of new rates in this case, NJNG will be able to request recovery of additional amounts pursuant to the CIP if it can demonstrate that usage has declined relative to the benchmarks established in this case.

**Q. Does this conclude your testimony?**

A. Yes, it does.