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August 10, 2012

By Hand Delivery
Honorable Irene Jones, ALJ
Office of Administrative Law
33 Washington Street
Newark New Jersey 07102

Re: In the Matter of the Petition of Atlantic City Electric Company for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1 and for Other Appropriate Relief
OAL Docket No. PUCRL 09929-2011
BPU Docket No. ER11080469

Dear Judge Jones:

Enclosed please find an original and two (2) copies of the Division of the Rate Counsel's Reply Brief in connection with the above referenced matter. Copies of the brief are being provided to the parties by electronic mail and hard copies are being sent by US Regular Mail to all parties on the attached service list.

We are enclosing one additional copy of the materials transmitted. Please stamp and date the copy as "filed," and return to our courier. Thank you for your consideration and assistance.

Respectfully submitted,

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By:*s/ Diane Schulze*
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DS/lg
c: Service List (via electronic mail and US Regular Mail)

I/M/O the Petition of ACE for Approval of Amendments to its Tariff to Provide For an Increase in Rates and Charges for Electric Service Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.2 and for Other Appropriate Relief
BPU Docket No. ER11080469

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STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW
BEFORE THE HONORABLE IRENE JONES

IN THE MATTER OF THE PETITION	)	
OF ATLANTIC CITY ELECTRIC	)	
COMPANY FOR APPROVAL OF	)	
AMENDMENTS TO ITS TARIFF TO	)	
PROVIDE FOR AN INCREASE IN	)	**BPU DOCKET No. ER11080469**
RATES AND CHARGES FOR	)	**OAL DOCKET No. PUCRL 09929-2011**
ELECTRIC SERVICE PURSUANT TO	)	
N.J.S.A. 48:2-21 AND N.J.S.A. 48:2-21.1	)	
AND FOR OTHER APPROPRIATE	)	
RELIEF	)	

REPLY BRIEF ON BEHALF OF THE DIVISION OF RATE COUNSEL

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PRELIMINARY STATEMENT

There is no doubt that in adjudicating an administrative matter, an agency is afforded "great leeway" in terms of the procedures utilized and deference in terms of the positions taken. I/M/O the Provisions of Basic Generation Service, 205 N.J. 339, 347 (2009). The agency must, however, comply with the Administrative Procedure Act, N.J.S.A. 52:14B-1 et seq., and the constitutional guarantee of due process. Id. Its decision must be based on the record before it and be neither arbitrary nor capricious. Public Service Electric and Gas Company v. New Jersey Dep't. of Envtl. Protect., 101 N.J. 95, 103 (1985). In this case, the record was established by Rate Counsel, Walmart, and Atlantic City Electric (ACE) at the hearings in this matter. Rate Counsel maintains that the record fully supports its position and relies on its Initial Brief in support of that position. In its Initial Brief, Board Staff has provided the litigants with its positions on the contested issues, offering for the first time its view of the record that was created by Rate Counsel, Walmart and ACE.

Rate Counsel maintains that in certain key respects, Staff's positions cannot form the basis of an initial or final decision that comports with the legal requirement that the Board's ultimate decision be based on the record and be neither arbitrary nor capricious. As Staff presented no witnesses and no sworn testimony, its positions must be supported by evidence put forth by the other parties in order to form the basis of a finding in this case. However, in at least two significant respects, Staff has selected numbers and positions in a completely arbitrary manner without any support in the record or based on a misunderstanding of it.

First, Staff has chosen a Return on Equity (ROE) that it claims is the "average" between the parties' "biased" analyses. Rather than analyzing which analysis is more accurate, Staff simply rejects both and then argues that "the average of the two recommendations would tend to

be unbiased." *SIB, p. 22.*[1] Putting aside the illogic of this reasoning, Staff then proceeds to put its thumb on the scale in favor of the Company's position. Rather than actually averaging the results of the two analyses performed by the parties, Staff averages the recommendations of the two witnesses, thus "averaging" a number at the low to mid end of the Company's range with the high end of Rate Counsel's range. If Staff had actually averaged the results of the parties' analyses, their ROE number would be 9.94%. [2] Staff then notes that, although his recommendation did not change, updates to Mr. Hevert's analysis that he acknowledged at the hearing resulted in a .60% reduction that should have lowered his recommendation from 10.75% to 10.15%. Although Staff cites this as a reason supporting their analysis, in fact it means Staff has selected the Company's number despite its determination a sentence before that this number is "biased."[3]

Further, although Staff did not conduct a DCF analysis that is in the record, Staff then states that it "obtains a DCF estimate of 10.13% for PHI," which Staff thinks is "a very good proxy for ACE." *SIB, p. 22*. In fact, had there been an opportunity to cross examine (or identify) Staff's witness, the record would show that Staff's "DCF analysis" was faulty, and that a single-company DCF analysis using Pepco Holdings, Inc. ("PHI") is not a good proxy. Finally, to top it all off, Staff then inexplicably rounds its number up to 10.15%, providing an extra return to the Company for no stated reason whatsoever.

Staff's analysis is not a reasoned expert opinion that attempts to bridge the gap between the litigants. It is a perplexing contortion of the record. It adds expert analysis not subject to

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[1] In this brief Rate Counsel refers to its Initial Brief as RCIB, Board Staff's Initial Brief as SIB, Walmart's Initial Brief as WIB and the Petitioner's Initial Brief as PIB.

[2] The range that resulted from ACE's analysis was 10.5% to 11.25%, while the range that resulted from Rate Counsel's analysis was between 8.5% and 9.5%. An average of mid-points of these ranges would be 9.94%.

[3] If these reductions were made, the Company's range would then be 9.9% to 10.65%, with a mid-point of 10.275%. the average of the two mid-points would then be 9.64%.

cross-examination. It includes erroneous calculations, and unexplained additional recovery to the Company. It also sets up a system of “averaging” that rewards parties for inflating their positions and skewing their analyses to reach a particular average. It is a textbook example of arbitrary and capricious and it should not and cannot form the basis of a ruling that is consistent with the record in this matter.

The same is true of the analysis of the Consolidated Tax Adjustment. Staff appropriately rejected ACE’s argument that it should receive 100% of the Consolidated Tax benefit, an argument the courts in New Jersey have already rejected, and which should similarly be rejected by Your Honor and the Board. Staff also appropriately acknowledged that Rate Counsel’s expert applied the formula established by the Board to calculate Consolidated Tax Adjustments. However, Staff inexplicably concludes that applying the Board’s formula in this case would be “unfair” and would result in credit downgrades of ACE, PHI, and potentially all other New Jersey utilities. *SIB, p. 36-38.* Yet Staff fails to acknowledge, much less address, the unfairness of charging ratepayers for ACE’s federal income tax liability, when those taxes are not then paid to the Internal Revenue Service (IRS). It is not disputed that ACE collects money from ratepayers as if it paid taxes and then pays that money to its sole shareholder and parent corporation, Pepco Holdings, Inc. (PHI). PHI applies those funds to offset the tax liability of its consolidated tax group and in the end pays substantially reduced taxes and no federal income tax at all from 2008-2010. The Board’s long-standing consolidated tax formula is designed to compensate ratepayers for essentially lending PHI this money, cost-free to offset its tax liability. It does not, as erroneously asserted by Staff, provide the “entire benefit” to ratepayers, but allocates the benefit based on ACE’s contribution to the consolidated group. ACE’s ratepayers thus get 33.35% of the benefit, while ACE’s shareholder, PHI, gets the remainder. In addition,

because the formula provides for a rate base deduction, ratepayers are not receiving an actual credit of that amount, but compensation for the time value of the money they are "lending" to PHI. This formula is fair and reasonable, and Staff's unilateral determination of "fairness" is inaccurate and unsupported by the record.

Staff sets forth a "parade of horribles" that would occur if the Board's Consolidated Tax Adjustment is applied in this case. Not only are their predictions of corporate doom unsupported by the record, they are contradicted by the record. Staff also does not address how its new formula would impact other New Jersey utilities, as it inevitably will do. Its arbitrary selection of a 15 year look-back period may work to the detriment of other utilities that are not parties to this proceeding. If this new formula is applied only in this case it will create uncertainty and potential unfairness in the application of the Board's consolidated tax policy that could be detrimental to the state's utilities. If this new formula is applied across the board, then it should be established not in a brief filed by Staff after the record in an adjudicatory proceeding has closed, but through a rulemaking in which all interested parties have an opportunity to participate. Metromedia, Inc. v. Director, Division of Taxation, 97 N.J. 313 (1984). In short, Staff's proposal is based on inaccurate information, is unsupported by the record, impermissible under the Administrative Procedure Act, and fundamentally unfair. It must be rejected.

Rate Counsel also urges Your Honor and the Board not to dismiss the serious reliability concerns and customer service problems that are amply established in this record. While the Company argues that it will improve some day, that day must be now. Staff acknowledges the customer service issues but also dismisses the reliability concerns. Rate Counsel strongly urges that any order that issues in this case include tangible and significant consequences for continued

failure to comply with established standards for reliability and customer service. Promises of future compliance are no longer enough to ensure safe, adequate and proper service.

POINT I

RATE COUNSEL'S PROPOSED CAPITAL STRUCTURE AND RETURN ON EQUITY ARE BASED ON SOUND ANALYSIS, ARE FULLY SUPPORTED BY THE RECORD AND SHOULD BE ADOPTED.

There are two areas of disagreement among the parties on Capital Structure. Rate Counsel argued in its Initial Brief that $11.8 million of Short Term Debt should be included in the Capital Structure and that the actual balance of long-term debt should be used for the purpose of setting the Company's capital structure. For the reasons set forth in the testimonies of Rate Counsel's witnesses Mr. Kahal and Ms. Crane, and as addressed in Rate Counsel's Initial Brief, Your Honor and the Board should adopt Rate Counsel's positions and reject those of the Company.

With respect to Return on Equity, the evidence in the record consists of the analyses and testimony performed by Rate Counsel's witness, Mr. Kahal, the analyses and testimony of Atlantic's witness, Mr. Hevert, and the testimony of Walmart's witness, Mr. Chriss. Mr. Kahal's analyses resulted in a range of 8.5% to 9.5% (*RC-1, p.6*), with a recommendation at the high end of the range of 9.5%. Mr. Hevert's analyses resulted in a range of 10.5% to 11.25%. *P-9, p.40.* Although Mr. Hevert acknowledged on cross-examination that appropriate updates would reduce his range by 60% (9.9% to 10.65%), he continues to recommend 10.75%, a number outside that range. *T121:L10-20* (June 18, 2012). Walmart supports Rate Counsel's number as a base number, but argues for a further reduction to reflect the reduced risk associated with the Company's Regulatory Asset Recovery Clause ("RARC") and Infrastructure Investment Program ("IIP"). *WIB, p. 5-6.*

Although Staff did not provide any testimony or witnesses at the hearing, they disclose for the first time in their Initial Brief their recommendation for an ROE of 10.15%. *SIB, p. 21.*

Their reasoning, however, is based on unsworn testimony that was not subject to cross-examination, mistakes of fact, and utterly arbitrary declarations of policy that are counter to established BPU rulings. As set forth more fully below, Staff's recommendation should be rejected, and even if Your Honor or the Board were inclined to adopt some of their recommendations, their calculations should be corrected.

A. Capital Structure

To the extent that Staff's positions mirror the Company's they should be rejected for the same reasons set forth in Rate Counsel's Initial Brief. To the extent that Staff's positions are not based on evidence in the record they must be rejected on that basis. For the most part, Staff merely recites the positions and testimonies of the witnesses regarding Capital Structure and then states its conclusions without articulating the factual basis or legal principles supporting those conclusions. Without evidentiary support, those recommendations should not be adopted.

1. Short-Term Debt

With respect to short-term debt, there is no dispute among Rate Counsel, ACE and Staff that:

- The Board recently authorized Atlantic to utilize up to $250 million in short-term debt financing;
- Atlantic can be expected to make extensive use of short-term debt financing during the time the rates in this case are in effect;
- Short-term debt interest rates are extremely low (less than 1 percent) and this is Atlantic's cheapest source of capital; and
- Atlantic has not proposed (indeed opposes) <u>any</u> mechanism whatsoever for recognizing short-term debt in its cost of service, thereby retaining this cheap financing for shareholders and withholding the cost savings from its customers.

In its Initial Brief, Board Staff supported the Company's position that short-term debt be excluded from the Company's Capital Structure. *SIB, p. 15*. Rate Counsel does not oppose this recommendation but argues that if short-term debt is excluded from capital structure then the Board should ensure that ratepayers receive the benefit of this low cost debt through the proper calculation of the Allowance for Funds Used During Construction (AFUDC). The Uniform System of Accounts assigns short-term debt to Construction Work in Progress (CWIP) in the calculation of the AFUDC rate. Board Staff suggests that in making this proposal Rate Counsel is mixing "apple with orange" as there is no Construction Work in Progress in Rate Counsel's proposed rate base. *SIB, p. 15*. However, during construction of utility assets, the Company capitalizes AFUDC to its construction accounts. When completed, the cost of construction, including accumulated AFUDC, is moved into rate base and the accumulated AFUDC is recovered from ratepayers over the service life of the asset through the annual depreciation and return allowances. Ratepayers are entitled to receive the benefit from the recognition of short-term debt in the calculation of the AFUDC rate which manifests itself in a lower rate base and a lower annual depreciation expense.[4]

In sum, allocating short-term debt to CWIP for AFUDC purposes would satisfy the concerns of all parties. It would allow the exclusion of short-term debt from capital structure while ensuring that ratepayers obtain the full benefit of low cost short-term debt. Your Honor and the Board should direct the Company to follow this procedure.

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[4] In addition, as set forth more fully in Point III below, if short-term debt is not included in Capital Structure, ratepayers should not have to pay for the cost of the Company's Credit Facility. If ratepayers do not benefit from the Credit Facility, they should not have to pay for it.

2. The Appropriate Long-Term Debt Balance

The Company removed $18 million of unamortized debt-related expenses from the actual balance of long term debt. As discussed in Rate Counsel's Initial Brief, this is a non-standard adjustment and is contrary to typical practice in New Jersey for setting capital structure. *RCIB 13-14*. Staff, in its brief, (*SIB, p. 14*) argues that if Your Honor and the Board were to adopt Rate Counsel's recommendation this would somehow violate the "matching principle" – an argument that is not explained and has not previously been made in this proceeding.

Since this argument was not made prior to Staff's brief, witness Kahal has had no opportunity to respond to Staff's "matching" concept. *SIB, p. 14*. Rate Counsel therefore can only respond in a limited manner at this time. Initially, it should be noted Staff's Brief provides no real analysis of this principle and how it should be applied. Presumably, if capital structure is to somehow "match" rate base (as Staff implies), then they should be the same dollar amount. This is clearly not the case. Staff appears to be introducing a new and unworkable standard for determining the ratemaking capital structure—implying that somehow it must "match up" with the approved rate base and that ad hoc and non-standard adjustments to foster this asserted matching are proper. In this case, the adjustment sought by both Atlantic and Staff is improper and contrary to the interests of customers.

Staff in its Initial Brief also disagreed with Mr. Kahal's observation that Mr. McGowan's method of deriving his capital structure is "contrary to typical practice in New Jersey for setting capital structure." *SIB, p. 13-14.* Staff did not cite to any New Jersey case or decision or offer any witness to rebut Mr. Kahal's testimony, but simply states that it "disagrees with such criticism." *Id*. Staff did not present testimony on this issue, nor did Staff ask Mr. Kahal any questions on this issue. Mr. Kahal, on the other hand, has testified in New Jersey on capital

structure issues for over 20 years. *RC-1 Appendix A.* Staff then offers its rejection of Mr. Kahal's expert testimony with unsworn testimony regarding "standard corporate practices in issuing a bond" and an undefined "matching principle" that Staff considers "key to the construction of an appropriate capital structure." *SIB, p. 14.* As these "expert opinions" offered by Staff are not in the record and were not subject to cross examination, they should be given no weight.

Finally, it must be noted that neither Atlantic nor Staff in their Initial Briefs are willing to argue that Rate Counsel's recommended capital structure is unreasonable. On cross-examination, Mr. McGowan conceded that Mr. Kahal's recommendation of 48 percent equity/52 percent debt is fully consistent with the Company's capital structure objectives. *T95:L5-24* (June 18, 2012). In sum, Your Honor and the Board should employ the actual balance outstanding of Long-Term Debt and reflect it in the Capital Structure as recommended by Rate Counsel. The actual balance should not be artificially lowered by subtracting out the unamortized balance of debt expense. Rate Counsel's recommendation on capital structure provides for the full recovery of those expenses as Mr. McGowan acknowledged in his Rebuttal Testimony. *P-7*, p.2.

B. Return on Equity

The record on Return on Equity consists of the pre-filed testimonies and cross examination of Mr. Kahal for Rate Counsel and Mr. Hevert for the Company as well as the testimony filed by Mr. Chriss on behalf of Walmart. Based on their analyses, Mr. Kahal recommended a Return on Equity in the range of 8.5% to 9.5% and Mr. Hevert recommended a Return on Equity range of 10.5% to 11.25%. Mr. Kahal's specific recommendation was at the high end of his range, at 9.5%. Mr. Hevert chose a point in the middle of his range at 10.75%.

Walmart's testimony supports Rate Counsel's recommendation and advocated a further reduction due to the reduced risk associated with ACE's RARC and IIP. Staff did not provide any Rate of Return testimony. Although their Initial Brief includes what can only be considered "testimony," Staff's Initial Brief is **not** sworn, and was **not** subject to cross examination. To the extent their Brief includes factual assertions not supported by the record, they must be excluded from consideration.

Staff in its Initial Brief makes three arguments supporting its proposed return on equity of 10.15 percent. First, Staff claims that since both the Company and Rate Counsel must be presumed to be "biased" in setting forth their ROE recommendations, the best resolution is simply to average together their two "biased" recommendations – regardless of the merits of the evidence – in the hopes of obtaining a result that is magically unbiased. Second, Staff notes that Mr. Hevert's original recommendation of 10.75 percent, when updated in rebuttal must be reduced by 0.60 percent. Staff cites this updated recommendation from Mr. Hevert of 10.15 percent as evidence that their "averaging" produced a reasonable result. Third, Staff asserts that Atlantic's parent, PHI, is the best available risk proxy for Atlantic, and Staff apparently conducted a PHI stand-alone DCF analysis that results in a recommended ROE of 10.13 percent. (*SIB, p. 22*) Staff then rounds this number up to 10.15% to further argue the reasonableness of their averaged number.

All three arguments are fatally flawed and inherently inconsistent. First, there is nothing in the record to support the assertion, which was not even raised by Atlantic, that Rate Counsel's rate of return recommendation is biased in any way. Mr. Kahal conducted several analyses that are fully set forth in his testimony, and were the subject of cross-examination. Rate Counsel and the Company explored through cross-examination their arguments as to why their

recommendation was based on sound analysis and their adversary's was not. Staff does not cite anything to support its statement that either of the recommendations was "biased" and Staff did not elicit any evidence whatsoever that supports a finding of "bias."

Moreover, Rate Counsel's recommendation is not lower than the Atlantic's actual market cost of equity. Contrary to Staff's assertions, the evidence shows the 9.5 percent recommendation fully addresses the Company's financial needs and is fair to shareholders. In fact, Mr. Kahal's recommended ROE award is **higher** than his DCF midpoint and higher than his CAPM study results would support. Moreover, the record reflects that Mr. Kahal's filed testimony regarding return on equity in New Jersey for the last five years has been far from biased. Rate Counsel produced this information in response to a Transcript Request from Staff. *T192:L15-25 – T193:L1-12* (June 18, 2012) (The Transcript Request and Response are attached to this Brief in Attachment A.). As is demonstrated in Attachment A, excluding the JCP&L Demand Response Program, Docket No. EO08050326, the average rate of return recommended by Mr. Kahal over the last five years has been over 10.0%. This is less than 0.3 percent different than the returns on equity granted by the Board over the same period, hardly a demonstration of "bias."

Staff's position that the average of the two experts' recommendations leads to an "unbiased" result is nonsensical and capricious. *SIB, p. 22.* Carried out to its logical conclusion, this formula would *encourage* the parties to produce biased results, skewing their analysis so that the average would be more beneficial to them. This cannot be how the process works. Both parties here produced experts who conducted analyses that are fully set forth in their testimony. Both parties subjected these experts to cross-examination and made an effort to show what they believed were flaws in the other side's analyses. While a middle ground may be appropriate

based on the credibility of the experts' analyses and the flaws revealed on cross-examination, simply "splitting the baby" virtually defines a result that is arbitrary and capricious.

Not only that, but Staff's middle ground was not calculated correctly. Staff argues: "The average of the returns on equity of 10.75% and 9.50% respectively recommended by Messrs. Hevert and Kahal turns out to be 10.13%, very close to 10.15%." *SIB, p. 21***.** This statement ignores the fact that Mr. Kahal's number is at the high end of his range of 8.5% to 9.5%, and that Mr. Hevert's number is at the middle of his range. It also ignores the fact that Mr. Hevert's recalculation of his models for his Rebuttal Testimony resulted in a substantially lower range that Mr. Hevert did not include when maintaining his 10.75% recommendation. This adjustment, a reduction of 60 basis points, would have to be made before any fair "averaging" could occur.

Had Staff employed an appropriate calculation, its proposed ROE would be below 10%. The range that resulted from ACE's analysis was 10.5% to 11.25%, while the range that resulted from Rate Counsel's analysis was between 8.5% and 9.5%. An average of the mid-points of these ranges would be 9.94%. If Staff had lowered ACE's range by 60 basis points to 9.9% to 10.65%, as both the Company and Staff conceded was appropriate, the average of the mid-points would be 9.64%. Even if you continued to use the midpoint of ACE's range and the high end of Rate Counsel's, once the .60% adjustment is applied, the resulting average is 9.825%. Thus, the only way to achieve a calculation that exceeds 10% is to utilize different points in each expert's range and Mr. Hevert's unadjusted numbers. Yet, as to those numbers, Staff states:

> An examination of all of the results of Mr. Hevert's analyses, together with the above observations, reveals no clear-cut clue as to how Mr. Hevert concludes that 'an ROE in the range of 10.50% to 11.25% reasonably represents the range of the Cost of Equity for ACE in today's capital markets. I further believe that within that range, an ROE of 10.75% is reasonable, if not conservative." *SIB, p. 19* (citation omitted).

Having found this range unreasonable, it is arbitrary and capricious for Staff to then use it to "average" with Rate Counsel's range.

Staff acknowledges this, noting that a proper update of Mr. Hevert's cost of equity yields 10.15 percent. *SIB, p. 22*. Staff appears to believe that this supports using that number, even though this approach ignores Staff's own misgivings about Mr. Hevert's range, and even though it means that Staff is in effect choosing the Company's number rather than "averaging." It also completely ignores Mr. Hevert's inappropriate reliance on riskier vertically-integrated electric utilities as the risk proxy to set Atlantic's distribution service (or "wires") cost of equity.

Staff also relies on a PHI stand-alone DCF study that it apparently conducted after the record closed based on data taken from Mr. Kahal's testimony. It should be noted first that both cost of capital experts in this case testified that a single company DCF study should not be relied upon to support an ROE recommendation. *SIB, p. 22.* Staff's stand-alone PHI DCF study should be given little weight since it was not subject to cross-examination and is not a valid methodology according to the expert testimony that is in the record.

Nonetheless, if one were to accept this methodology, it would not support a finding greater than Mr. Kahal's 9.5 percent recommendation. Staff's error is in taking the actual PHI dividend yield (5.51 percent) and combining with a 4.5 percent midpoint growth rate. The 4.5 percent is **not** the PHI growth rate but rather is the midpoint of Mr. Kahal's electric proxy group growth rate range. Staff arrives at its 10.15 percent end result only by committing the error of selecting the wrong data – combining a specific company dividend yield with a proxy group average growth rate. As Mr. Kahal's Schedule MIK-4 clearly shows, the PHI-specific growth rate ranges from 2.6 percent (see page 5 of that schedule) to 4.0 percent (see page 3 of that schedule). Thus, had Staff employed the correct PHI specific data provided in the record, the

PHI stand-alone DCF study result would be:

5.51% x (1.013) + 2.6% = 8.2 percent; and

5.51% x (1.02) + 4.0% = 9.6 percent

This is a DCF range of 8.2 to 9.6 percent, with a midpoint of 8.9 percent. Even the upper end of this range approximates Mr. Kahal's recommendation and is far below the Staff's 10.15 percent.

In sum, it is clear that Staff's 10.15% return on equity is not based on a reasoned, logical analysis of the testimonies and cross examination of Mr. Kahal and Mr. Hevert. It is based on factual errors, faulty methodologies, and arbitrary statements unsupported in the record. For the reasons set forth herein and in Rate Counsel's Initial Brief, Rate Counsel's Return on Equity of 9.5% should be adopted.

POINT II

RATE COUNSEL PROPOSED CONSOLIDATED TAX ADJUSTMENT CONFORMS WITH BOARD PRECEDENT AND FAIRLY APPORTIONS THE CONSOLIDATED TAX BENEFIT BETWEEN RATEPAYERS AND THE COMPANY.

Neither the Company nor Board Staff disputes that Rate Counsel's witness, Ms. Crane, applied the Board's long-standing policy regarding Consolidated Tax Adjustments ("CTA"). Both, however, argue that the policy should be changed. The Company seeks to eliminate the adjustment altogether, despite well-established law to the contrary. Board Staff, citing "fairness" and unsubstantiated allegations of corporate disaster, offers arbitrary adjustments to ostensibly lead to a number they believe is "fair" in this case. However, amid their concerns for "fairness," neither the Company nor Board Staff even acknowledge the unfairness of the fact that each year Atlantic collects from ratepayers money for income taxes they never pay to the Internal Revenue Service (IRS). Atlantic collects federal income taxes from ratepayers and gives that money to its corporate parent and sole shareholder, who pays reduced taxes based on the consolidated filing and in some years *pays no taxes at all.* If "fairness" is the governing criterion, it is hard to believe that the Company's or Staff's position would be adopted by the Board.

In fact, PHI uses the funds it collects from Atlantic's ratepayers to offset tax losses by other PHI entities, essentially borrowing that money from ACE ratepayers to reduce its tax liability. The Board's existing policy, and Rate Counsel's adjustment, simply credits ratepayers for their investment. While Staff acknowledges that these savings must be shared with ratepayers, they apply an arbitrary 50/50 split, arguing that otherwise ratepayers would receive "all of the benefit of consolidated tax savings" *SIB, p. 40*. This is simply not correct. It ignores the fact that this is a rate base deduction that compensates ratepayers only for the time value of the benefit provided to the consolidated group. It ignores that an allocation is made that provides

ACE ratepayers with an allocated share of the consolidated tax benefits of 31.35%. By cutting this benefit in half, Staff is reducing the ratepayers' share even further while ACE's shareholder, PHI, retains the vast majority of the tax benefit. Again, it is hard to believe that the Board would adopt such an unfair and one-sided policy, and Rate Counsel urges, for the reasons set forth in greater detail below, that Your Honor apply what is undisputedly the current Board policy on consolidated taxes.

A. The Company's Adjustments

First, the Company argues in its Initial Brief that the "Board should discontinue its policy of imposing consolidated tax adjustments on New Jersey utilities." *PIB, p. 3.* Rate Counsel recognizes that many states do not impose a consolidated tax adjustment. However, it is settled law in New Jersey that utility consumers are entitled to have reflected in the calculation of utility rates the savings that result from the utility's participation in a consolidated tax group. <u>In re Lambertville</u>, 153 <u>N.J. Super</u>. 24 (App. Div. 1977) <u>rev'd in part on other grounds</u>, 79 <u>N.J</u>. 449 (1979). The Board is not free to simply change this established law. As noted by the Company, observation of the law "is not merely a convenience or convention." *PIB, p. 13.*

Moreover, one of the Board's statutory duties is to determine just and reasonable rates which are sufficient to allow the Company to recover its costs of service and a reasonable return on its investment. Rates fixed - as suggested by the Company - with no consolidated tax adjustment, would give Atlantic, and its sole shareholder PHI, not only the fair return to which they are entitled but also the full amount of an expense collected from ratepayers but never in fact incurred. As noted by the Supreme Court, it is the position of the Federal Power Commission, that it is unacceptable;

> [T]o determine the cost of service on a hypothetical figure – to fix jurisdictional rates 'on the basis of converting a hypothetical tax payment into a prudent

> operating expense.' . . . The Commission's function . . . [is] to fix just and reasonable rates, not to insure that other affiliates would be made whole for their tax losses out of income from regulated enterprises.

Federal Power Commission v. United Gas Pipe Line, 386 U.S. 237, 87 S. Ct. 1003 (1967) (internal citations omitted).

Finally, the Company complains that by applying the Board's formula, Rate Counsel's adjustment is "staggering," and argues "if a policy and practice ever needed to be changed, it is this policy given the circumstances presented in this case." *PIB, p. 4-5.* The Company cites Mr. Fetter's speculation of a credit rating downgrade and argues that Ms. Crane is "dismissive" of the Company's concerns, "her articulated standard seems to be based only on whether the utility will be able to keep the lights on. That is a standard that this Board has never embraced . . . " Id.

Ms. Crane's testimony does not reflect "dismissiveness" of the Company's financial situation but rather reflects the unfairness of ignoring the ratepayers' perspective, which the Company consistently ignores. She stated:

> The point is that a lot of things impact credit ratings. And I don't think the Board should be afraid to take the action that it thinks [is] appropriate because there may be a downgrade. And in fact, companies are downgraded from time to time, in fact they're even downgraded to junk bonds from time to time. And even utilities are downgraded from time to time to junk bond status, and actually they seem to still be able to provide utility service. Yes, generally it costs more if you are downgraded. However, it also costs more for ratepayers if they are paying an income tax expense that is not being passed through to the IRS.

T74:L3-16 (June 25, 2012).

Here, as discussed at length in Rate Counsel's Initial Brief, the evidence does not support the Company's claims of impending financial ruin. At most, Company witness Fetter speculated, the imposition of Rate Counsel's consolidated tax adjustment could result in a one notch downgrade in ACE's credit rating to Baa3, still investment grade and certainly not the financial ruin predicted by the Company. While such a downgrade is possible, it is by no means

certain that such a downgrade would occur if the Board's formula for the consolidated tax adjustment is applied as proposed by Rate Counsel.

What is staggering is the amount of taxes that PHI avoids by structuring itself "for legal and business purposes without having to incur adverse federal tax implications." *P-29, p.7.* If "without having to incur adverse federal tax implications" means "to avoid paying taxes" the Company has certainly succeeded. For example, for a back of the envelope calculation, by looking at Staff's schedule S-7 A. page 5 of 8, we see that the PHI utilities (Pepco, Delmarva and ACE) combined had $2.4 billion in taxable income over the 15 years used in Staff's adjustment. Assuming a tax rate of 35%, it would be reasonable to estimate that those utilities collected $834,092,384 in rates to pay federal income taxes. On page 6 of 8, we see that when the income of the utility subsidiaries is combined with the other PHI subsidiaries, the total for <u>all</u> affiliates is only $553,634,235 in taxable income. Again assuming a tax rate of 35%, this would yield an estimate of $193, 771, 982 owed in federal income taxes. Thus, under these calculations, PHI would have collected from the ratepayers of its regulated utilities $640 million more than the tax liability of the consolidated group.

Of course, PHI does not necessarily pay even that $193,771,982 in taxes. An analysis of 280 Fortune 500 companies by Citizens for Tax Justice found that while PHI's profits totaled $882 million from 2008-2010 the Company had a *negative* tax rate of 57.6% during that period. *RC-77*. Indeed, PHI had the lowest effective tax of all the companies included in the analysis. The Company does not dispute this.

While Rate Counsel is not suggesting that PHI's negative tax rate is contrary to law, Rate Counsel maintains it is the Board's obligation to address the fact that New Jersey utility consumers are paying "phantom" taxes to benefit PHI's shareholders. The Board has done so

through the establishment of its formula to calculate the consolidated tax adjustment, which Rate Counsel indisputably applied. Dispensing with such an adjustment is not only contrary to law, it is unfair and unsupportable. Your Honor and the Board should therefore reject the Company's speculative claims of harm and impose a consolidated income tax adjustment that fairly compensates New Jersey ratepayers for tax expense collected through utility rates and not paid to the IRS.

B. Staff's Adjustments

Staff agrees with Rate Counsel that the "consolidated tax savings should be shared with customers" and that to make such an adjustment is "consistent with Board policy." *SIB, p. 32*. Staff argues that ratepayers should not be charged "a 'phantom' tax which never goes to the IRS" and recognizes that State courts require "that consolidated tax savings be passed along to customers. " *SIB, p. 34* (citing In re Lambertville, 153 N.J. Super. 24 (App. Div. 1977) rev'd in part on other grounds, 79 N.J. 449 (1979). Staff further recognizes that the consolidated tax adjustment calculated by Rate Counsel witness Andrea Crane was "in fact, calculated using the methodology approved by the Board in the 2004 RECO decision and is consistent with current Board policy." *SIB, p. 35.*

"However" begins the next paragraph and from there on, Staff ignores the record in this proceeding, disregards long standing Board policy, and arbitrarily establishes a methodology for calculating a consolidated tax adjustment that Staff has decided is "fair." Without a single citation to the record, Staff alleges that the Board's long-standing formula could be considered a "taking" by investors. Staff speculates that the "end result" of Rate Counsel's application of that formula "could be lower stock prices, lower credit ratings, higher capital costs and damage to

investors' view of the Board." *SIB, p. 36* Staff states that the investment community "would be shocked" at the consolidated tax adjustment calculated for the Company in this proceeding. *SIB, p. 37.* Staff's brief continues with statements unsupported in the record of the dire consequences of applying the Board's existing formula, stating that "in addition to the deleterious impact on shareholder value, bond investors and ratepayers would be impacted as a result of the likely credit rating downgrade" and that the investment community could downgrade the entire New Jersey utility industry if the Board's consolidated tax formula is not changed. *SIB, p. 37-38.*

Staff's fear of falling skies is neither accurate nor supported by the record. Ms. Julie M. Cannell was hired by the Company to testify to the investor's perspective. Ms. Cannell did not testify that the consolidated tax adjustment would panic investors, although she certainly had the opportunity to do so. Rather Ms. Cannell focused on the appropriate return on equity and the "very high value" that investors place on "consistent and constructive regulation." *P-1, p. 16.* Ms. Cannell noted "[w]here there is a predictable track record of regulatory decisions and actions, investors are able to anticipate reliably the future actions of a commission." *P-1, p.21.* Certainly, PHI's investors would expect the BPU to maintain its consistency and apply a consolidated tax adjustment in this rate case. In fact, any deviation from BPU policy could result in greater investor uncertainly, not only for PHI's investors, but for the investors of the other New Jersey utilities as well.

Moreover, the evidence in the record does not support the assertion that the credit agencies will turn their backs on New Jersey utilities due to impending CTA adjustments. The perspective of the three major credit rating agencies was provided in testimony filed by Ms. Cannell. Ms. Cannell notes that Moody's views New Jersey as "a reasonably supportive jurisdiction due to its history of timely and adequate recovery of increased costs." *P-1, p.26*

(citing Moody's Investors Service, Pepco Holdings Inc. Jan. 4, 2011). Ms. Cannell also notes that while Moody's considers "an increasing trajectory of capital expenditures" a cause for concern, the rating agency has expressed sufficient confidence in "the constructive nature of New Jersey regulation to maintain a stable outlook on ACE's ratings." *Id.* Fitch notes that its ratings for ACE "reflect a manageable capital expenditure plan, moderate external financing needs and absence of debt maturities over Fitch's forecast period." *Id.* S&P, who upgraded PHI in 2010, "expressed its expectation that the excellent business profile will be sustained due to PHI's 'focusing on the three regulated T&D utilities and not increase[ing] unregulated operations beyond a nominal contribution to consolidated operating income.'" *P-1, p.28.* According to Ms. Cannell, S&P further expanded on that statement:

> The lack of competition, low operation risk as a [T&D] electric utility, and credit-supportive regulatory environment contribute to cash flow stability. ACE benefits from regulatory mechanisms that provide for the pass through of power costs to ratepayers outside a base rate case.

P-1, p.28.

These positive statements were made with full knowledge of the Board's long-standing CTA policy. Thus, the record does not support a finding that a potential CTA adjustment made to ACE's rate base in this proceeding will raise concerns with the credit rating agencies.

The Company also hired Mr. Steven M. Fetter to testify to the appropriateness of a consolidated tax adjustment and to the negative impact of the use of the Board's consolidated tax methodology on the Company's credit profile. *P-28, p.4*. Even Mr. Fetter - who has predicted credit downgrades resulting from Commission decisions across the country – did not predict the catastrophic repercussions set forth in Staff's brief. *T34:L5-T35L15* (June 25, 2012). When asked at the hearing whether Rate Counsel's recommended consolidated income tax adjustment would have a detrimental impact on credit ratings, Mr. Fetter replied "Potentially." *T35:L16-20*

(June 25, 2012). Mr. Fetter later testified that in his opinion the proposed CTA "would likely result in a one notch downgrade in ACE's credit rating to Baa3." *P-28, p.16.* This "potential" downgrade would still result in an investment grade credit rating and is closely tied to the management and financial polices of PHI.

According to Mr. Fetter, the qualitative factors used by rating agencies to set credit ratings "include regulation, management and business strategy, and access to energy, gas and fuel supply with recovery of associated costs." *P-28, p.10.* Regulatory policies are only one aspect of a much bigger picture. Ultimately, it is PHI's management and business strategies and PHI financial policies that will determine ACE's access to capital and funding amounts. *RC-1, p. 56.* Staff's dramatic predictions therefore are ill-considered and not supported by the record.

Staff's proposed modifications to the Board's policy are similarly unwise and unsupported. Based on nothing but the fact that the Company's concerns "resonated," Staff determined that "it would make sense to 'bracket' the time frame in which the calculation is made." *SIB 39.* Staff also decided that the Board's "sharing" mechanism "may need to be revisited" given both the time frame and the discount rate used. Staff then apparently made a "discounted present value" analysis and determined that the Board's policy results in ratepayers receiving "all the benefit" of consolidated tax savings. *SIB, p. 40.*

Initially, it should be noted that Staff's "discounted present value" analysis - the avowed basis for Staff's "belief" that ratepayers are getting all the benefit of the consolidated tax savings - has not been provided to the parties. The author of this analysis has not filed testimony nor has this person been made available for cross examination. No schedules or workpapers supporting this "belief" have been provided, and, at this point in the proceedings, the record is closed. What

we are left with is one unsubstantiated sentence in Staff's brief. It is therefore not possible for Rate Counsel to reasonably address this "belief" or refute this analysis.

What is clear is that Staff's selection of a 15-year look back period was arbitrary. There is nothing in the record to support Staff's decision to use a 15-year time frame for the calculation of a consolidated tax adjustment. There is no logic, no reasoned analysis regarding the use of a 15-year look back period. There was no connection made to tax law or regulatory policy. Staff expressly rejected Mr. Warren's recommendations regarding the appropriate look back period. *SIB, p. 38*. Why Staff chose 15 years and not 10, 14, 18 or 20, is a mystery.

Similarly, there is nothing in this record or in Staff's brief to suggest why Staff chose a 50/50 sharing of the proposed adjustment. There is nothing to suggest that Rate Counsel's consolidated tax adjustment, indisputably calculated according to current BPU policy, should be cut in half. To the contrary, Staff's statement that ACE's ratepayers get "all of the benefit of consolidated tax savings" *(SIB, p. 40)* is simply incorrect. There is ample evidence in the record in this proceeding to show that shareholders get all of the loss benefit allocated to the unregulated affiliates and all of the benefit that should go to the regulated affiliates in jurisdictions without a CTA. Specifically, ACE's allocation is 31.35%[5]. *RC-4, p.36*. It is that percentage that is allocated to provide a benefit to ACE's ratepayers. ACE's sole shareholder, PHI, gets the remaining 68.65% benefit.

In addition, ratepayers do not get any of the direct benefit of lower income tax expense. Given the methodology used by the BPU for determining consolidated tax adjustments, rates include the full income tax expense based on ACE's level of revenues and expenses found by the BPU to be reasonable. Ratepayers are paying 100% of this pro forma income tax expense. Therefore, because the consolidated tax adjustment is a rate base adjustment and not a direct

[5] When using Staff's 15 year look back period, Atlantic's allocation is reduced to 22.98%. *SIB sch. S-7*.

expense reduction, the benefit to ratepayers is only the time value of the benefit provided to the consolidated group. As noted by the Board in the 1993 JCP&L base rate case adopting the base rate adjustment methodology:

> 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).

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, Decision and Order (June 15, 1993).

Thus, ratepayers actually get only a small percentage of the benefit of the consolidated tax adjustment. By reducing that small amount by half, Staff exacerbates this imbalance. It is far from "fair" and is not what the Board has established as a reasonable policy. For this reason it is unlikely to be adopted by the Board and should be rejected.

In sum, after twenty years of consistency, Staff now believes, based on nothing more than feelings and undisclosed calculations, that the 15 year time frame and the 50/50 sharing of the rate base adjustment achieves a "fair sharing" of consolidated tax savings. Staff doesn't say why their chosen resolution of this issue is fair, nor does Staff explain why this proposed adjustment "is consistent with sound financial management policy." Moreover, Staff does not say how – if at all – this new policy will be applied to the other New Jersey utilities, only that the "recommendations made herein should be considered reasonable within the context of the case." *SIB 40*. PSE&G has expressed its concern regarding the state-wide impact these changes could have on the entire New Jersey utility group. "The Board's decision in this proceeding could have precedential effect and impact not only the petitioner, but also New Jersey's other utilities, including PSE&G and its customers."[6] Presumably the other utilities in the State have similar

[6] PSE&G Motion to Participate, August 19, 2011.

concerns. While Staff acknowledges the need to address this issue in a more generic manner, Staff argues that Your Honor and the Board should unilaterally impose changes to this long standing Board policy without an understanding of how it will impact other utilities or what the long-term effect will be on ratepayers.

The fact is, there is nothing "fair" about Staff's proposal. It was selected in a manner that virtually defines "arbitrary and capricious." It was not tested through cross-examination or discovery. It was not substantiated in the record in this case. What is in the record is that New Jersey's ratepayers pay ACE each year for federal income taxes that are not then paid to the IRS, that the BPU views this as the equivalent of ratepayers lending ACE's parent cost-free capital, and that the BPU has a long-standing policy of calculating ratepayers' share that is far from "all of the benefit." Staff cannot simply pick a number after the record has closed and have that form the basis for overturning long-standing BPU policy. Any changes to the Board's consolidated tax policy should be done on a full record, or, given the wide-ranging consequences of such a change, in the context of a rule making with input from all interested parties. Staff's proposal should therefore be rejected.

POINT III

YOUR HONOR AND THE BOARD SHOULD REJECT THE COMPANY'S INFLATED REVENUE REQUIREMENT AND ADOPT RATE COUNSEL'S RECOMMENDED RATE BASE OF $509,616,000 WITH OPERATING INCOME OF $36,930,000.

The Company, in its Initial Brief, mostly reiterated arguments made in testimony and addressed by Rate Counsel in its Initial Brief. Rate Counsel will not repeat those arguments in this brief but instead will focus on specific issues not addressed in our Initial Brief. Staff's position was presented for the first time with the filing of initial briefs. Therefore, Rate Counsel will concentrate this Reply Brief on new issues raised by the Company and issues raised for the first time in Staff's brief.

A. Rate Counsel's Recommended Rate Base of $509.6 Million Should Be Adopted.

The Company's 12+0 update, upon which Rate Counsel's testimony was based, included a pro forma rate base of $987.1 million. *RC-4, sch. ACC-3*. Rate Counsel recommended adjustments to the Company's rate base claim of $477,497,000 resulting in a total rate base for the Company's electric operations of $509,616,000. *RC-4, Sch. ACC-3*. Each of these adjustments is discussed below.

1. Utility Plant in Service – Post-Test Year Plant Additions

Rate Counsel adjusted the Company's rate base to exclude proposed post-test year electric plant additions through June 30, 2012 of $54,352,000. *RC-4, Sch. ACC4.* Rate Counsel addressed at length in our Initial Brief why these proposed additions should not be included in rate base and that discussion will not be repeated here. Board Staff properly agreed with Rate

Counsel that the proposed post-test year plant additions should not be included in the Company's rate base.

The Company, on the other hand, argues that any plant additions paid for within nine months of the end of the test year should get rate base treatment. The Company's argument, however, renders the Elizabethtown Water[7] criteria that post-test year additions must be "major in nature and consequence" meaningless. The Company asserts that the Board has never "rendered a decision to Petitioner's knowledge denying a request for post-year (sic) additions based upon that criteria". *PIB, p. 25* While the Company may not be aware of such cases, the Board has certainly excluded post-test year additions that were not major in consequence. As discussed in Rate Counsel's Initial Brief, the Board has excluded "routine, ongoing plant additions" finding that they "do not meet the 'major in nature and consequence' test set by the Board." *RCIB, p. 33-34*, citing I/M/O Middlesex Water Co. For Approval of An Increase in Its Rates For Water Service and Other Tariff Changes, BPU Docket No. WR00060362, Order Adopting in Part/ Modifying in Part/ Rejecting in Part/ Initial Decision, (June 6, 2001).

As the Company's proposed post-test year additions are routine and not "major in nature and consequence," they do not meet the Board's criteria and, as advocated by Rate Counsel and Staff, should not be included in rate base.

2. Plant Held for Future Use

Rate Counsel recommends that the Board reject the Company's inclusion in rate base of $6.275 million in plant held for future use. Rate Counsel relies on the discussion of this issue in the Initial Brief. *RCIB, p. 36.*

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[7] In Re Elizabethtown Water Company Rate Case, BPU Dkt. No. WR8504330, Decision on Motion for Determination of Test Year and Appropriate Time Period for Adjustments (May 23, 1985).

3. Cash Working Capital ("CWC")

Cash working capital is an element of rate base and can be defined as monies advanced by the utility's investors to cover expenses associated with the provision of service to the public during the lags between the payment of those expenses and the collection of revenues from its customers. The Company's proposed CWC addition of $104.068 million to rate base was based on the Company's lead/lag study performed using 2010 data and applied to test year operations. *RC-4, p. 18.* The Company, in its Reply Brief, merely restates its belief that its CWC proposal complies with BPU precedent.

a. Deferred Taxes

Staff agreed with Rate Counsel that the Company's proposal to include deferred income taxes in the lead/lag study for purposes of determining the appropriate cash working capital requirement is contrary to BPU rate making policy and agreed it should be eliminated deferred income taxes from the Company's calculation. *SIB, p. 43 (*citing I/M/O PSE&G for an Increase in Rates, BPU Docket No. ER85121163 (April 6, 1987)). Staff agreed the deferred taxes did not require an outlay of investor capital and therefore recommended the exclusion of deferred taxes from the calculation of cash working capital. *SIB, p. 45-46*. Thus, pursuant to the Board's long-standing policy on this issue, deferred taxes should be excluded from lead/lag studies when determining Atlantic's cash working capital requirement. *RCIB, p. 37-38*.

b. Non-Cash Depreciation and Amortization Expenses

Board Staff determined that depreciation expense should be included in the lead/lag study and assigned a zero lag as proposed by the Company. *SIB, p. 46.* Staff relied on the reasoning of the ALJ in the PSE&G case cited above that "investors should be compensated for the revenue

lag in the recovery of depreciation expense and the amortization of owned nuclear fuel." *SIB, p. 44* (quoting I/M/O PSE&G, Initial Decision, supra at 33.)

It is Rate Counsel's position that the properly conducted lead/lag study should exclude non-cash expenses. *RC4, p.15*. The expenses that relate to depreciation and amortization simply do not represent or require cash outlays by the Company during the study period used in the lead/lag analysis. The non-cash expenses of depreciation and amortization do not produce a need for additional cash to be supplied by the investors during the lead/lag study period.

Rate Counsel's reasoning on this issue is supported by the NARUC Staff Subcommittee on Accounting and Finance.[8] In its 2003 Rate Case and Audit Manual, the subcommittee noted that under the lead/lag methodology, "one is attempting to measure the actual time between a utility's out-of-pocket payment of expense to provide service and the collection of revenues for service." The committee goes on to say that any debate as to which expenses should be included in a cash working capital should be answered "by looking at the theory of what is attempting to be measured (e.g., the measurement of *paid* expenses may argue against the inclusion of depreciation) and what treatment these items have been given in previous cases." Thus, as the purpose of the lead/lag study is to measure paid expenses, non-cash items which do not require an outlay of cash do not belong in a lead/lag study meant to measure the payment of expenses. Rate Counsel recommends that the Board's current policy be reconsidered and that the non-cash depreciation expense and amortization expense be excluded from the lead/lag study for purposes of determining the Company's appropriate cash working capital in this case. *RCIB, p. 38*.

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[8] Rate Case and Audit Manual, NARUC Staff Subcommittee on Accounting and Finance, Summer 2003, www.naruc.org/publications/ratecase_manual.pdf. Pursuant to N.J.A.C. 1:1-15.2 Your Honor may take judicial notice of this NARUC treatise. Rate Counsel notes that a NARUC treatise was relied upon by the Company's expert witness at hearing. *T26:L5-16* (June 27, 2012)

c. The Return on Investment Capital

Staff believes that the return on invested capital should be included in the lead/lag study and assigned a zero lag as proposed by the Company. Staff bases this belief on the conviction that "investors are entitled to earn a return as service is rendered, that is daily." *SIB, p. 47.* As discussed in Rate Counsel's initial brief, the fundamental assumption that the PHI shareholder is entitled to the return on his or her equity investment at the exact instant that service is rendered is incorrect. *RCIB, p. 39*. Shareholders receive their return through the quarterly payment of dividends and any gain in the Company's stock price. Dividend payments are discretionary. The Company is under no contractual obligation to pay dividends or to increase its stock price. Moreover, as acknowledged at the hearing, when dividend payments are made, they are made on a quarterly basis, not on a daily basis which is the assumption inherent in the use of a zero lag. *T61:L13-15* (June 21, 2012). Therefore, even if shareholder return is included in cash working capital, it should be assigned a lag of 90 days, consistent with the payment of quarterly dividends.

d. Debt Interest Expenses

Staff has adopted the Company's position on this issue without comment. *SIB Sch. S-6* As discussed in Rate Counsel's Initial Brief, the Company's CWC calculation failed to reflect the fact that the revenue requirement includes a component for interest expense, which is a contractual obligation of the utility. *RCIB, p. 40.* The rates paid by the Company's customers are set to produce, in addition to other amounts, the sums necessary to pay for the Company's interest expense to bondholders. Id. Since the Atlantic pays its bondholders twice a year but collects revenues for such bondholder payments on a daily basis, the Company has the use of funds provided by ratepayers for interest expense as working capital during the interim period

between interest payments. Id. The Company's ratepayers provide these funds continuously, in a steady stream, and not in a pattern that matches or coincides with the Company's liability for the expense. Ratepayers, not the Company, are correctly entitled to the benefit of funds collected from them earlier than would be warranted to pay the Company's interest expense. Ratepayers clearly should not be required to pay a return to shareholders on capital which ratepayers provide. It is settled regulatory policy that shareholders are not entitled to a return on capital which the shareholders have not provided. Federal Power Commission v. Hope Natural Gas, 320 U.S. 591 (1944), Bluefield WaterWorks v. Public Service, 262 U.S. 679 (1923). Accordingly, the actual interest lag should be reflected in the calculation of cash working capital. *RC-4, ACC-7.*

e. Interest on Customer Deposits and Investment Tax Credits

Board Staff agreed with Rate Counsel witness Andrea Crane that the lag on payment of interest on customer deposits should be increased from 0 days to 365 days. *SIB, p. 49* Staff agreed that Rate Counsel's adjustment to the CWC calculation was "reasonable" and recommended that interest on customer deposits should be included in the case working capital calculation with an expense lag of 365 days. Board Staff also agreed with Rate Counsel's recommendation that the expense lag associated with Investment Tax Credits (ITCs) be adjusted from 0 days to (10.01) days. Staff stated that Rate Counsel's adjustment to the CWC calculation was "reasonable" and recommended that investment tax credit should be included in the cash working capital calculation with an expense lag of 10.01 days. Rate Counsel relies on our Initial Brief on this issue. *RCIB, p. 42*.

f. Unidentified Adjustment

On Schedule S-6, Staff noted a Rate Counsel adjustment of $1,688,000 was "unidentified. Rate Counsel apologizes for the confusion. The $1,688,000 "adjustment" results from the fact that due to a formula error, Ms. Crane's total CWC adjustment did not include the interest expense adjustment of ($1,688,000) shown in Schedule ACC-7 at line 12, making it appear that $1,688,000 was unidentified. This correction will reduce Rate Counsel's recommended cash working capital adjustment to $81.579 million.

4. Unamortized Balances – Credit Facility Costs and Hurricane Irene

ACE is requesting that the average balance of unamortized costs associated with the Company's Credit Facility be included in rate base and that shareholders be permitted to earn a return on this balance at the Company's overall cost of capital. The Company has also proposed to amortize the costs associated with Hurricane Irene over three years and seeks to have that unamortized balance also included in rate base.

While the Company explains at length the importance of the credit facility, there is no support for granting shareholders a return of the unamortized costs associated with the credit facility. *PIB, p. 31-32.* Similarly, ACE describes at length the severity of Hurricane Irene but gives no support for inclusion into rate base of the unamortized costs associated with the storm. Board Staff did not discuss either issue but included both on the list of issues "on which Staff shares the same view as Rate Counsel." *SIB, p. 2.* The Company is asking ratepayers to pay not only for these costs that were incurred but to pay shareholders a return on any costs that are not immediately recovered in rates. This is inappropriate and therefore, as discussed in Rate Counsel's Initial Brief, the Company's request for rate base treatment for these unamortized costs should be denied. *RCIB, p. 43-45.*

5. Prepaid Pension Asset / OPEB Liability

ACE's sole argument in support of the rate base treatment for the prepaid pension asset and the OPEB liability is that "PHI's other jurisdictions (Delaware, Maryland, and the District of Colombia) have all approved the ratemaking treatment supported by ACE in this proceeding for both the inclusion of the prepaid pension asset as well as OPEB liability." Rate Counsel has discussed at length the inconsistency associated with the Company's position and will not repeat that argument here. *RCIB, p. 45-48.* Board Staff has not adopted the Company's position but rather has included this issue on the list of issues "on which Staff shares the same view as Rate Counsel." *SIB, p. 2*.

6. Conclusion

(1) Rate Counsel's recommended rate base of $509.6 million should be adopted. *RC-4, Sch. ACC-3.*

(2) The $54.352 million in post-test year plant additions proposed by the Company in this proceeding should be disallowed. *RC-4, Sch. ACC-3.*

(3) The Company's inclusion in rate base of $6.275 million in plant held for future use should be disallowed. *RC-4, Sch. ACC-3.*

(4) A positive lead/lag study cash working capital requirement of approximately $81.579 million should be adopted.

(5) The Company's inclusion in rate base of $1.329 million in unamortized credit facility costs should be rejected. *RC-4, Sch. ACC-3.*

(6) The Company's proposal to include in rate base a prepaid pension asset of more than $35.9 million should be rejected. *RC-4, Sch. ACC-3.*

(7) The Company's proposal to include in rate base $5.127 million in unamortized storm damage costs associated with Hurricane Irene should be rejected. *RC-4, Sch. ACC-3.*

(8) The Company's proposal to decrease rate base by $15.317 million to reflect the amount by which OPEB costs exceed the associated contributions and market returns should be rejected. *RC-4, Sch. ACC-3.*

B. Pro Forma Revenue Adjustments

In calculating its pro forma revenues, the Company began with actual test year revenues of $286,205,092 as reflected in the 12+0 update. *P-20, JCZ R-2*. It then normalized these revenues for normal weather, annualized these revenues for changes in the number of customers through June 30, 2012, and made an additional revenue adjustment to these revenues for declining consumption. *P-20, JCZ R-4, JCZ R-5.* Rate Counsel witness Andrea Crane made two adjustments to the Company's pro forma revenues as shown in the 12+0 filing, an adjustment relating to weather normalization and to declining consumption for a total adjustment of $1,986,000.

1. A Thirty Year Period Should Be Used to Determine Normal Weather

In support of its request for a 20-year weather normalization period, the Company argues that its 2003 rate filing (15 year weather norm proposal) and its 2009 rate filing (20 year weather norm proposal) were both resolved "via a stipulation with no adjustment to the weather normalization period." *PIB, p. 29.* Simply because a specific issue is not separately addressed in a rate case stipulation does not mean that the parties have agreed in that stipulation to accept the Company's position. Nor does it indicate that the Company's position has been adopted by the Board. It only means the issue was not explicitly addressed in the agreement.

The Company then goes on to argue that the Board has "throughout its history" established "weather normalization adjustments on a case by case basis" and cites to a PSE&G base rate proceeding in which the parties agreed that 20 years of weather data would be used for the purpose of the gas weather normalization clause. *Id*. The Company's discussion of

“weather normalization adjustments” in the PSE&G base rate case is in apposite. As noted by Ms. Crane at the hearing: “PSE&G has a weather normalization adjustment mechanism which basically will true up revenues for normal weather, and that’s a very, very different situation than the situation that we are dealing with here where there is no weather normalization adjustment.” *T112:L24 – T113:L4*. (June 21, 2012)

In summary, Rate Counsel relies on its extensive discussion of this issue in its Initial Brief (*RCIB, p. 61-63*) and recommends that the Board adjust the sales projections of Petitioner’s pro forma revenue claim based on a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its original test year revenue forecast. Board Staff agrees with this adjustment. *SIB, Sch. S-4*.

2. Atlantic’s Revenue Adjustment Based On Declining Consumption Is Speculative And Has No Support In The Record

The Company adjusted its pro forma test year revenue based on the assumption that customer usage will decline in the future from its actual test year weather-normalized consumption. In our Initial brief, Rate Counsel recommended that the Board reject this adjustment as speculative and contrary to past experience with regard to electric usage. *RCIB, p. 63-64*. Board Staff agrees with this adjustment. *SIB, Sch. S-4*.

In its Initial Brief, the Company – still relying on first quarter usage - claims that the decline in usage has continued into 2012. As discussed at the hearings, these numbers do not include any of the 2012 summer months and Atlantic is a summer peaking utility. *T27:L7-28:13* (June 21, 2012). Certainly, the sweltering heat waves that have continued to torment New Jersey residents have had a positive impact on customer usage numbers. The Company’s adjustment to reduce actual test year consumption for speculative declines in future usage should be rejected.

C. Expense Adjustments

1. Salary and Wage Expense (Post-Test Year)

Based on two different determinations of what is "major in nature and consequence," Board Staff and the Company seek to charge ratepayers for routine wage and salary increases that take place outside of the Company's chosen test year. The Company claims that because the 2012 wage and salary adjustment totals $1.4 million, it is "major and consequential to the Company" (*PIB, p. 31*) and Board Staff argues that "because these wage increases occur on a regular basis, they are indeed major in nature and consequences." *SIB, p. 53*. Neither the Company nor Staff cites to any Board Order supporting these positions.

In fact, as noted in Rate Counsel's Initial Brief, the Board has provided some insight into the "major in nature and consequence" standard that is based on neither cost nor routine. *RCIB, p. 31-35*. That routine on-going projects are not considered "major in nature and consequence" was confirmed by the Board in a water utility base rate case. In that case, Middlesex Water Company had proposed rate recognition for projected post-test year plant additions totaling $3,816,558. I/M/O Middlesex Water Co. For Approval of An Increase in Its Rates For Water Service and Other Tariff Changes, BPU Docket No. WR00060362, Order Adopting in Part/ Modifying in Part/ Rejecting in Part/ Initial Decision, (June 6, 2001) (hereinafter Middlesex Water). In Middlesex Water BPU Staff determined that $1,949,398 out of the total projected post-test year additions of $3,816,558 represented non-major *routine* construction projects. The Board's Order stated in this respect:

> With respect to the proposed routine capital budget items, amounting to $1,949,398, Staff was not persuaded that such expenditures, which the Company classified as routine, met the "major in nature and consequence" standard as set by the Board. *Id.* at 7.

The Board's Order adopting Staff's recommendations goes on to state with regard to this issue:

> The ALJ also agreed with Staff's recommendation to reject the inclusion of $1,949,398 of proposed capital budget items, contending that these items are in fact routine, ongoing plant additions, and do not meet the "major in nature and consequence" test set by the Board. *Id.*

The Board subsequently re-affirmed that routine post-test year plant additions do not qualify as major in nature and consequence in denying Elizabethtown Gas over $9.0 million in post-test year plant additions. "The Board is in agreement with Staff's recommendation on this issue. Staff noted that by far the largest portion of the requested plant additions are routine in nature that occur in the normal course of events". In the Matter of the Petition of Elizabethtown Gas Company for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions, BPU Docket No. GR88121321 (February 2, 1990) (hereinafter "Elizabethtown Gas."). Thus, routine post-test year expenditures are not considered by the Board as "major in nature and consequence" even at amounts greater than the wage increases Atlantic seeks to include here. Rate Counsel therefore urges that only test year salary and wage increases be included in the Company's revenue requirement and that all post-test year increases be excluded from the Company's revenue requirement. *RCIB, p. 65*

2. Incentive Compensation

Staff agrees with Rate Counsel that $2.462 million of non-officer incentive compensation costs should be eliminated from the Company's cost of service. *SIB, p. 58.* As discussed at length in Rate Counsel's Initial Brief, incentive plans that are based largely on earnings criteria are not sufficiently related to the provision of safe and reliable utility service to justify passing

this cost onto ratepayers. *RCIB, p. 66-70.* As recognized by Staff, Rate Counsel's position on this issue is fully consistent with Board policy. *SIB, p. 58-59.*

3. Payroll Tax Expense

Rate Counsel relies on the discussion in its Initial Brief, setting forth why the recommended adjustments for salaries and wage expense and for incentive compensation require that an adjustment be made to eliminate the associated payroll tax expense. *RCIB, p. 70.*

4. Supplemental Executive Retirement Program (SERP) Expense

The Company claims that the SERP allows the Company to "make up for IRS limits which cap the amount of salary that the Company may use in calculating benefits." *P-20, p. 40.* According to the Company, because of the IRS limit, "executives do not receive equitable pension contributions, relatively speaking, when compared with the typical company employee." *P-20, p. 40-41.* In other words, as discussed in Rate Counsel's Initial Brief, because PHI executive compensation is so generous, their pension contribution would be above that amount that the IRS allows, if, on a percentage basis, the contributions equated with a "typical" PHI employee. The Company is therefore asking, based on a questionable definition of "equity," that ratepayers make up the difference. Rate Counsel does not object to ACE offering SERP benefits to these named executives officers whose retirement benefits are "limited" by the IRS. Rate Counsel does object, however, to including these excessive benefits in rates. *RCIB, p. 71-72.*

Board Staff agrees with Rate Counsel that it is improper to include in rates $1,293,614 in expenses associated with the PHI Supplemental Executive Retirement Program. Staff argues that ratepayers should not be charged costs that relate to "non-qualified" supplemental retirement

benefits for key executives that are over and above the normal retirement programs provided by PHI for its employees. *SIB, p. 64*

5. Medical Benefit Expense

The Company claims that Rate Counsel has not shown that medical expenses will not increase and therefore, according to ACE, the Company's post-test year medical expense adjustment should be accepted. *PIB, p. 43* Staff argues that the Company is entitled to 2012 increases in medical benefit costs "because they are for the most part, actually incurred."

Whether or not these costs were "actually incurred," does not justify allowing recovery for these post-test year expenses under the Elizabethtown Water standard. *SIB, p. 66*. Moreover, the record does not support a finding that they have been "actually incurred," as the evidence regarding medical benefit increases relies solely on "forecasted net increases" (*P-20, p.10*) and an "anticipated annual growth rate." *PIB, p. 42.* Rebuttal testimony filed by ACE provides for the year ending 2012, "estimated benefits increase – rate effective period." *P-20, JCZ R-7.* The Company acknowledges in its Initial Brief, "[f]or purposes of its post-test year adjustment, the Company has selected an anticipated annual growth rate for benefit costs below the average growth rate included in the Lake study, which matches the specific rate ACE uses for its financial planning." *PIB, p. 42.* Thus, Staff's assertion that the 2012 medical benefits increase sought to be included by the Company have been "actually incurred" is not accurate.

Despite the evidence cited above, Staff relies on testimony of the Company's witness at the hearing that these costs were incurred in "the rate effective period," or "that nine month window that the E-town Order specified." *T101:L1-20* (June 21, 2012). The witness further testified that a data response "looked at the first four months of benefits expenses of this year

versus last year, and there has been an overall nineteen percent increase" *T101:L21-24* (June 21, 2012).

Notably, Staff adjusts for 2012 medical benefit expenses by increasing operating income by $123,000. *SIB, p. 66*. This is the amount of the Company's claimed estimated benefit increase for the six months ending June 2013 as shown on Company schedule JCZ R-7a. Thus, Staff has accepted as actuals the Company's "Estimated Benefits Increase – Rate Effective Period" for year ending 2012 shown on Company schedule JCZ R-7. Staff's acceptance of the projected increases is contrary to the "convincingly reliable data" mandated by the Board in the Elizabethtown Water Order for the inclusion of post-test year adjustments. Your Honor and the Board should reject the inclusion of post-test year estimates in the Company's cost of service. (*RCIB, p. 72-74*).

6. Corporate Restructuring Expense

In its brief, Atlantic claims that after the sale of the non T&D business, "PHI was left with approximately $20 million of expenses associated with the divested business." *PIB, p. 46*. A subsequent reorganization "resulted in a total savings of $28 million, $8 million more that the remaining costs from the divested business." Yet the Company seeks to charge New Jersey ratepayers $5.668 million in additional costs for corporate restructuring. *P-19, p.26, JCZ-22*. As discussed in our Initial Brief Rate Counsel objects to the inclusion of these additional costs in ACE's distribution rates. *RCIB, p. 74.* Staff agrees with Rate Counsel. *SIB, p. 68.*

7. Rate Case Expense

Atlantic suggests that the Board should re-visit its long-standing policy that rate case expenses should be shared 50/50 between shareholders and ratepayers, an approach that is both

equitable and consistent with long-standing Board policy. As discussed in Rate Counsel's Initial Brief, the theory behind the 50/50 sharing approach is that a utility's primary motivation in filing a rate case lies in adding shareholder value. *RCIB, p. 75.* Given this motivation, it is entirely appropriate that rate case expenses be borne in part by the Company's shareholders. Staff agrees with Rate Counsel that "consistent with longstanding policy, the rate case expenses for the Company should be shared on a 50/50 basis." *SIB, p. 73.*

8. Non-Recurring Expense

Board Staff agrees with Rate Counsel that the non-recurring expense related to sick leave accrual should not be included in rates. *SIB, p. 69*. As discussed in Rate Counsel's Initial Brief, non-recurring costs are generally excluded from a regulated utility's revenue requirement. *RCIB, p. 76*. Utility rates are designed to be prospective and to reflect a normalized level of future costs, not recovery of previously-incurred costs. Accordingly, Atlantic's revenue requirement should be adjusted to remove non-recurring sick leave accrual policy costs.

9. Credit Facilities Expense

In this proceeding, ACE has requested a rate base adjustment of $1.329 million and an operating expense claim of $760,000 relating to the short-term credit facility operated by PHI. Rate Counsel witness Andrea Crane recommended two adjustments to the Company's operating expense claim but conditioned this recommendation on the inclusion of short term debt in the Company's capital structure.

Staff has included Credit Facility Expense on the list of items "on which Staff shares the same view as Rate Counsel" and included Rate Counsel's adjustments in the Staff's operating income summary. *SIB, p. 2, SIB sch. S-4.* Staff and Rate Counsel's views diverged however when Staff recommended that short term debt be excluded from capital structure.

It is important to note that the Rate Counsel has included the adjusted credit facility costs in our proposed revenue requirement based on our recommendation that short-term debt be included in the capital structure. Rate Counsel does not object to the exclusion of short term debt from the capital structure. However, if the Company and Staff's position is adopted and short-term debt is excluded from capital structure, then all credit facility costs should be eliminated from the revenue requirement. There is no basis upon which to include these costs if ratepayers are not receiving any of the benefits associated with the credit facility. The Company cannot have it both ways; it cannot deny ratepayers the benefit of low cost short-term debt while at the same time charging ratepayers the cost associated with this debt. *RCIB, p. 78.*

10. Storm Damage Expense

Rate Counsel recommended, in its Initial Brief, that Hurricane Irene costs should be included in the Company's storm damage normalization adjustment. *RCIB, p. 79.* In addition, if amortization was determined to be the proper treatment for these costs, Rate Counsel urged Your Honor and the Board to reject the Company's proposed inclusion of any Hurricane Irene unamortized balance in rate base. Board Staff has not commented on the normalization/amortization issue but has rejected rate base treatment for storm damage costs. *SIB sch. S-3.*

11. Meals and Entertainment Expense

The Company has included in this filing approximately $70,500 of meals and entertainment expenses that are not deductible on the Company's income tax return. This reflects a disallowance of 50% of Atlantic's total meals and entertainment expense, which is the percentage that is disallowed by the IRS. Rate Counsel recommended that Your Honor and the Board deny the Company's request for recovery of these costs reasoning that costs not deemed to

be reasonable business expenses by the IRS should not be considered reasonable business expenses included in a regulated utility's cost of service. *RCIB, p. 80* Board Staff only rejected that portion of the Company's claimed expense relating to entertainment, arguing that the entertainment expenses "are not a necessity directly associated with the Company's responsibility to provide safe and reliable service." *SIB, p. 71.* Board Staff did not make an adjustment to the meals portion of the claimed expense only noting that "it is not relevant for ratemaking purposes whether the IRS rule disallows meals and entertainment expense for tax purposes." *Id.* For the reasons set forth in Rate Counsel's Initial Brief, Your Honor and the Board should adopt Rate Counsel's recommendation to exclude 50% of meals and entertainment expenses and reject the Company's attempt to include "normal business meals" (*PIB, p. 48,)* and entertainment expenses, not properly considered business expenses for tax purposes, in the Company's cost of service. *RCIB, p. 80*

12. Membership Dues Expense

Rate Counsel recommended in its Initial Brief that the membership dues expense associated with lobbying activities be disallowed. *RCIB, p. 80-81* Rate Counsel adjusted the Company's claimed membership dues expense 20% to reflect that portion of dues to certain organizations used for lobbying activities. Board Staff did not agree that only lobbying expenses should be removed from rates arguing that even the non-lobbying activities of these organizations bear no relation to the provision of electric distribution service. *SIB, p. 74*. Rate Counsel relies on the discussion of this issue in its Initial Brief. *RCIB, p. 80-81*

13. Advertising Expense

Rate Counsel is recommending that one expenditure be included in the Company's advertising cost claim be disallowed. Specifically, ACE has included $25,000 in advertising

costs relating to the Company's sponsorship of the Atlantic City Convention Center (ACCC). *P-20, p.39.* The Company argues that it has the flexibility to adjust the ACCC advertising to reflect current energy related themes of interest to its customers. *PIB, p. 51*. Notably, ACE does not claim that the advertising at issue is used to inform customers about current energy issues, only that it has the flexibility to do so.

Rate Counsel recommended that these costs be disallowed as these costs relate to institutional advertising and are not necessary for the provision of safe and reliable regulated utility service. *RCIB, p. 81*. Board Staff agreed with Rate Counsel. *SIB sch. S-4*.

14. Interest On Customer Deposits

The Company and Board Staff agree with Rate Counsel's proposal to use the 2012 annual interest rate on customer deposits of 0.13%. *RCIB 83, SIB sch. S-4*. The Company has reflected this change in rebuttal testimony. *P-20, Sch. JCZ R-19.*

15. Depreciation Expense

Ms. Crane made two adjustments to the Company's claim for pro forma depreciation expense. First, Ms. Crane eliminated the depreciation expense reflected in the Company's filing associated with post-test year plant additions. *RC-4, Sch. ACC-29*.
In addition, Ms. Crane made an adjustment to the Company's filing to reflect the parties' agreement that Atlantic would retain the annual cost of removal expense of $2.935 million, which was previously approved by the BPU and which is currently being collected in utility rates. *RCIB, p. 83,* Staff agreed with Rate Counsel's adjustments. *SIB sch S-4.* Rate Counsel relies on the discussion of this issue in its Initial Brief.

16. Interest Synchronization

The interest synchronization adjustment should be recalculated based upon the rate base and weighted cost of debt approved by the Board. *RCIB, p. 83*.

17. BPU/Rate Counsel Assessment

Rate Counsel's revenue multiplier reflects the current BPU assessment of 0.1875% and the current Rate Counsel assessment of 0.0353%. Both the Company and Board Staff have agreed that Rate Counsel' revenue multiplier is the rate to be applied to the level of pro forma revenue found by the Board to be appropriate. *RCIB, p. 84, SIB, p. 2.*

18. Conclusion

As discussed above and as demonstrated in the testimony, Rate Counsel respectfully requests that Your Honor deny Atlantic's request as shown in its 12+0 update for an increase of $90,268,000 in its distribution rates.[9] Rate Counsel recommends Your Honor adopt Rate Counsel's recommended revenue requirement deficiency of $5,475,000. Specifically Rate Counsel recommends operating income adjustments as follows:

(1) The sales projections of Petitioner's pro forma revenue claim should be adjusted to reflect a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its pro forma revenue forecast. Rate Counsel's recommendation will increase the Company's pro forma revenues by $262,000

(2) The Company's adjustment to reduce actual test year consumption for future declines in usage should be rejected. This adjustment results in an increase in net revenues of $1,724,000 and reduces the proposed rate increase by $1,728,000.

(3) Salary and wage increases should be limited to the increases that occurred during the test year, annualized to reflect a full year of costs. This adjustment results in a reduction in the Company's proposed rate increase of $1,886,000.

[9] In the Company's rebuttal filing, the Company's request was quantified at $82.731 million excluding SUT. *P-20, p.2*.

(4) The Company's proposed incentive compensation expenses of $2.462 million should be disallowed for rate making purposes in this case. Given the Company's capitalization ratio, this adjustment results in a reduction in the Company's proposed rate increase of $1,310,000.

(5) In conjunction with the recommended adjustments for salaries and wage expense and for incentive compensation expense, an adjustment must also be made to eliminate the associated payroll tax expense. This adjustment results in a reduction in both the operating expense and the revenue requirement of $244,000.

(6) The SERP benefit should be excluded from Atlantic's distribution rates, thereby reducing the Company's revenue requirement by $1,296,000.

(7) The Company's pro forma adjustment relating to medical expenses should be rejected thereby reducing the Company's revenue requirement by $625,000. *RC-4, Sch. ACC-34.*

(8) Employee severance expenses related to the sale of PHI competitive business units should not be recovered from New Jersey ratepayers. This adjustment reduces the Company's revenue requirement by $1.681 million.

(9) Atlantic's shareholders should be required to pay 50% of the Company's rate case expenses. This adjustment reduces the Company's revenue requirement by $85,000.

(10) Atlantic's revenue requirement should be adjusted to remove non-recurring sick leave accrual policy costs. This adjustment reduces the Company's revenue requirement by $1,200,000.

(11) If short-term debt is excluded from Atlantic's capital structure, all costs associates with the Company's Credit Facility costs should be eliminated from the Company's revenue requirement. These costs include adjustments to eliminate costs for the expired credit facility and adjustment made to correct the annualization error made by the Company.

(12) Rate Counsel does not object to the Company's proposal to normalize storm damage costs based on a three-year average of actual costs incurred. Rate Counsel believes, however, that the costs incurred for Hurricane Irene should be included in this normalization. This recommendation has no impact on the revenue requirement.

(13) The Company's request for recovery of certain meal and entertainment costs that are not deemed to be reasonable business expenses by the IRS should be denied. This recommendation will reduce the Company's revenue requirement by $64,000. *RC-4, Sch.34.*

(14) In accordance with long-standing Board policy that lobbying expense is not "an appropriate expense to impose on ratepayers," a portion of membership costs associated with lobbying activities should be disallowed. This recommendation will reduce the Company's revenue requirement by $40,000.

(15) The Company's proposal to charge ratepayers $25,000 in advertising costs relating to the Company's sponsorship of the Atlantic City Convention Center should be rejected. This recommendation will reduce the Company's revenue requirement by $23,000.

(16) The depreciation expense reflected in the Company's filing associated with post-test year plant additions should be eliminated. This adjustment will reduce the Company revenue requirement by $1,682,000.

(17) The parties have agreed that ACE would retain the annual cost of removal expense of $2.935 million reflected in current rates, which results in a revenue requirement adjustment of $8,093,000. The Company has agreed to file a depreciation study in its next base rate case.

E. Regulatory Asset Recovery Charge ("RARC")

In its Initial Brief, Rate Counsel recommended that Your Honor and the Board reject Atlantic's attempt to expand the RARC to include any expense that the Company finds "reasonable" and instead terminate the RARC and move the Board-approved amortizations into base rates. *RCIB 88-92*. Rate Counsel relies on the discussion in its Initial Brief in support of its recommendation. Here, Rate Counsel will address two arguments made by the Company in its Initial Brief. *PIB p. 52-54*.

The Company first argues that the fact that no other utility has this recovery mechanism is not a sufficient basis for the Board to adopt Rate Counsel's recommendation to eliminate the RARC. *PIB 53.* The Company states that the Board does not treat all utilities the same and cites to the infrastructure tracking mechanisms as an example of the Board's non uniform regulatory treatment among the State's utilities. *Id.*

In making the point that of all the State's utilities only ACE has the RARC, Rate Counsel is not arguing that all utilities should be treated exactly the same. Rather Rate Counsel is

pointing out that the costs that the Company now seeks to recover through a special recovery mechanism are costs incurred by all utilities and are typically recovered through base rates over some appropriate amortization or normalization period. *RC-4, p. 74*. Atlantic's continually growing RARC is contrary to the way in which utility rates are established for the majority of non-fuel operating and maintenance expenses. *Id.* Regulation is supposed to be a substitute for competition, utilities are provided with an opportunity, but not a guarantee, to earn a return and to recover prudently-incurred costs. By transferring these costs from base rates to a clause, the Company has a virtual guarantee of recovery that is not appropriate and is not granted to other utilities.

Secondly, Rate Counsel recommended that costs incurred out of the test year for which Atlantic had not requested deferred accounting should be excluded from recovery through the RARC. Rate Counsel also recommended disallowance of DOT audit costs of less than $50,000 arguing that these costs did not rise to a level that warrants extraordinary ratemaking treatment.

Atlantic replies that the proposed additions to the RARC have not been questioned as to their legitimacy, only as to timing and materiality, neither of which is criteria for inclusion in RARC recovery. But this criteria has been set by ACE. There is no Board Order saying timing and materiality are not relevant for determining recovery through the RARC, only the Company's brief and Mr. Janocha's testimony. *PIB p. 54*, *T15:L6-12.* In fact timing and materiality are certainly factors that the Board should consider when a utility is seeking guaranteed cost recovery.

In sum, as discussed in detail in its Initial Brief, Rate Counsel recommends that Your Honor and the Board reject Atlantic's attempt to expand the RARC to include any expense that it

finds "reasonable" and instead terminate the RARC and move the Board approved amortizations into base rates. *RCIB p. 72-81.*

F. Miscellaneous

1. Infrastructure Investment Program Surcharge

Rate Counsel relies on the arguments made in its Initial Brief on this issue. *RCIB, p. 93-96.*

2. Request for Storm Damage Deferral

Rate Counsel relies on the discussion made in its Initial Brief on this issue. *RCIB, p. 96-97.*

3. Basic Generation Service Administrative Costs

Rate Counsel relies on the arguments made in its Initial Brief on this issue. *RCIB, p. 93-96.*

4. Excess Depreciation Reserve Amortization

The Company agreed with Rate Counsel's recommendation that the Company would make a status filing on the depreciation reserve amount refunded to date on August 31, 2013. *PIB, p. 50.*

5. Allowance for Funds Used During Construction

As discussed in Rate Counsel's Initial Brief, the Company suggests that it is proper to exclude short-term debt from the ratemaking capital structure because it is fully accounted for in the financing of CWIP through the rate used to calculate the Allowance for Funds Used During Construction ("AFUDC"). The Company's claim that short - term debt is accounted for in the AFUDC is contradicted however by the AFUDC rate of 8.25% used by the Company and based on a 1993 BPU Order. It is Rate Counsel's position that the use of this out-dated AFUDC rate is

improper and the Company should use an AFUDC rate that more properly reflects the actual costs.

Rate Counsel does not object to the Company and Staff's exclusion of short term debt from the capital structure, however, if short-term debt is not included in the capital structure it should go to the AFUDC rate as discussed in Point I of this Reply Brief. *RC-1, p. 16*. Your Honor and the Board should direct the Company to use the FERC formula to calculate its AFUDC rate going forward and to update its AFUDC rate on a monthly basis to more accurately reflect current costs. In this way, the Company will no longer be overcharging ratepayers by using an inflated AFUDC rate and ratepayers will begin to receive some of the benefit of very low short-term debt rates.

POINT IV

THE COMPANY'S CONSISTENTLY POOR RELIABILITY PERFORMANCE REQUIRES ACTION.

The record in this case demonstrates that since at least 2004, Atlantic has been consistently failing to meet the minimum reliability standards established by the Board. Rate Counsel has raised this issue repeatedly, with ACE finally agreeing to a specific plan for improvement in the second phase of its last rate case. Unfortunately, the Company continues to fail. The Company and Board Staff excuse ACE's poor performance by arguing that it would have passed in earlier years had later regulations been applied, and that it's too early to tell if their reliability improvement plan will work. Ratepayers are not as willing to wait for the Company to achieve the minimum level of reliability that the regulations require. Rate Counsel continues to urge, and believes the record supports, an order that requires compliance with the reliability metrics within a specified period of time, and establishes consequences if those metrics are not achieved.

In its Initial Brief, the Company claims that by making reliability an issue in this case, Rate Counsel is trying to "undermine" the Phase 2 Stipulation from ACE's previous base rate case in which the Company agreed to institute the Reliability Improvement Program ("RIP") program over five years. *PIB, p. 80*. As discussed in Rate Counsel's Initial Brief, this argument fails to recognize that while Atlantic implements its RIP, it continues to be bound by the Minimum Reliability Level established by the Board. Minimum Reliability Levels are standards

set by the Board and as the term "minimum" indicates, it is a minimum performance level that the electric utilities should be meeting every year.[10] It is defined in the Board's regulation as:

> [T]he minimum acceptable reliability as measured by CAIDI and SAIFI data as specified in N.J.A.C. 14:5-8.9. Performance equal to or better than the minimum reliability level is acceptable. Performance that is worse than the minimum reliability level is unacceptable and may be subject to penalty.
> N.J.A.C. 14:5-1.2 (emphasis added);

The regulation applicable to all NJ electric utilities states:

> (a) Each EDC shall take reasonable measures to perform better than the minimum reliability levels in N.J.A.C. 14:5-8.5.
> (b) Performance that falls below the minimum reliability levels in this subchapter is a violation of this chapter and may be subject to penalty.
> N.J.A.C. 14:5-8.2.

Rate Counsel witness, Mr. Salamone correctly interprets the above by stating that the "Board is fairly explicit in their statutes that those standards are in fact minimum standards, not standards that a company should seek to maintain, but in fact a set of standards that the company should seek to exceed." *T71 -72* (June 19, 2012). The Minimum Reliability Level should not be confused with a utility's CAIDI and SAIFI "benchmark" [11] which is a performance level that is harder to attain and, unlike the Minimum Reliability Levels, can be missed by the Company without regulatory consequence. The Company attempts to improperly treat the Minimum Reliability Level as an aspirational goal instead of the minimum acceptable performance required by the Board's regulations.

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[10] Each electric utility's 5 year average of its CAIDI and SAIFI performance for years 2002-2006 plus 1.5 standard deviation are used by the Board to set that utility's minimum reliability level. N.J.A.C. 14:5-8.9(a)(3).

[11] Each electric utility's 5 year average of its CAIDI and SAIFI performance for years 2002-2006 are used by the Board to set that utility's Benchmark. N.J.A.C. 14:5-8.9(a)(1) and (2).

Even after the parties entered into a Phase 2 Stipulation in the Company's last rate case that set forth specific actions to be taken to improve reliablity, Atlantic again failed the 2011 SAIFI Minimum Reliability Standard. *RC-20*, B1.B2. The Phase 2 Stipulation was meant to encourage improvement, not provide an excuse for continued poor performance. Under ACE's reasoning, Rate Counsel would not be permitted to raise Atlantic's declining performance until the 5-year RIP expired. This is not in the Phase 2 Stipulation and would not have been consistent with ACE's continuing responsibility to provide safe, adequate and proper service. Having instituted the RIP to address persistent failures in the past, ACE cannot now use the RIP as a free pass that would allow the Company's performance to further deteriorate. Atlantic is not exempt from meeting the Board's Minimum Reliability Levels for another 5 years, and its continued failure to do so must be addressed.

Despite the Company's assertions that "ACE has made progress towards improving its system reliability and increasing investment in its infrastructure," the evidence in the record does not support this. *PIB, p. 80.* The Company takes Mr. Salamone's statements out of context in an effort to argue that Atlantic has improved reliability levels. *PIB, p. 81*. When asked about Atlantic's performance in the first few months of 2012, Mr. Salamone's testified:

> –[G]iven the performance we saw in 2011 I would reserve judgment before jumping to a conclusion that reliability will in fact be improved for 2012. I will agree that this is a good indication that reliability is moving in the right direction but we still have the entire year of 2012 to get to before we can make any conclusions, and even with the introduction of a completed year for 2012 I would want to see a more sustained performance level because if you look back over the past eight years there were some years that performance was within acceptable limits, and some of that is driven by weather conditions, if you have a mild winter or a mild summer, cool summer, you can easily have a very well performing system. *T86:L14-25* (June 19, 2012)

As discussed fully in Rate Counsel's Initial Brief, considering that the winter of 2012 was the mildest in recent years, the slight increase in reliability for this past winter may be due more to warmer weather conditions than to Atlantic's efforts to improve reliability. *RC-21.*

Board Staff's assertion in its brief that Atlantic has been meeting the Board's Minimum Reliability Level is not accurate. In its initial brief Staff claims that "ACE has performed within the Board's approved reliability goals during the 2004 through 2010 period"(*PIB, p. 92*); and "an examination of the Company's distribution performance since 2001 shows it regularly performed better than or met the Board's required minimum reliability performance levels." *Id.* This statement is directly contradicted by the testimony of Mr. William M. Gausman, Senior Vice President of Pepco Holding, Inc. when he was cross- examined during evidentiary hearings in this proceeding. When questioned by Rate Counsel about Atlantic's 2007 Annual Systems Performance Report filed with the Board (*RC-22*) Mr. Gausman admitted Atlantic did not pass the SAIFI Minimum Reliability Levels from 2004 through 2007:

> Q. So on page 3 of your rebuttal you talk about ACE's performance in the 2004 to the 2010 time-frame. Let's look at the SAIFI chart on top for 2004, first. The minimum reliability level line is 1.13. Did the Company pass it in 2004?
>
> A. The level was 1.14, that was just a hundredth above the minimum reliability level of 1.13.
>
> Q. So you didn't pass it?
>
> A. No.
>
> Q. How about 2005?
>
> A. For the system number we did not pass.
>
> Q. 2006?
>
> A. No.

Q. How about [200] 7?

A. No.

T19:L6-21 (June 19, 2012)

Although Atlantic did meet CAIDI levels for the most part during the same time period, 2004-2007, Mr. Gausman also admitted that the Company did not meet the minimum reliability level in 2006:

> Q. Now let's look at the CAIDI numbers that appear on the chart below the SAIFI. And we will look at the same time period, 2004 through 2007. Now, the minimum reliability level is 132 on [sic] the benchmark is 85. How did you do in 2006?
>
> A. 2006, the system level did not meet the minimum reliability level.
>
> Q. You failed?
>
> A. Yes.

T20:L6-15 (June 19, 2012)

As the chart below demonstrates, Atlantic failed multiple times in the last ten years.

Atlantic's SAIFI and CAIDI Performance 2003-2007 (excluding major events)*

	SAIFI	**CAIDI**
Atlantic Minimum Reliability Level	1.13	132
2003	1.34 (Failed)	104 (Passed)
2004	1.14 (Failed)	95 (Passed)
2005	1.39 (Failed)	113 (Passed)
2006	1.71(Failed)	148 (Failed)
2007	1.49 (Failed)	111 (Passed)

*Data from RC-22, 2007 Atlantic System Performance Report. Please note that the SAIFI numbers decimal points were omitted in Rate Counsel's Initial Brief.

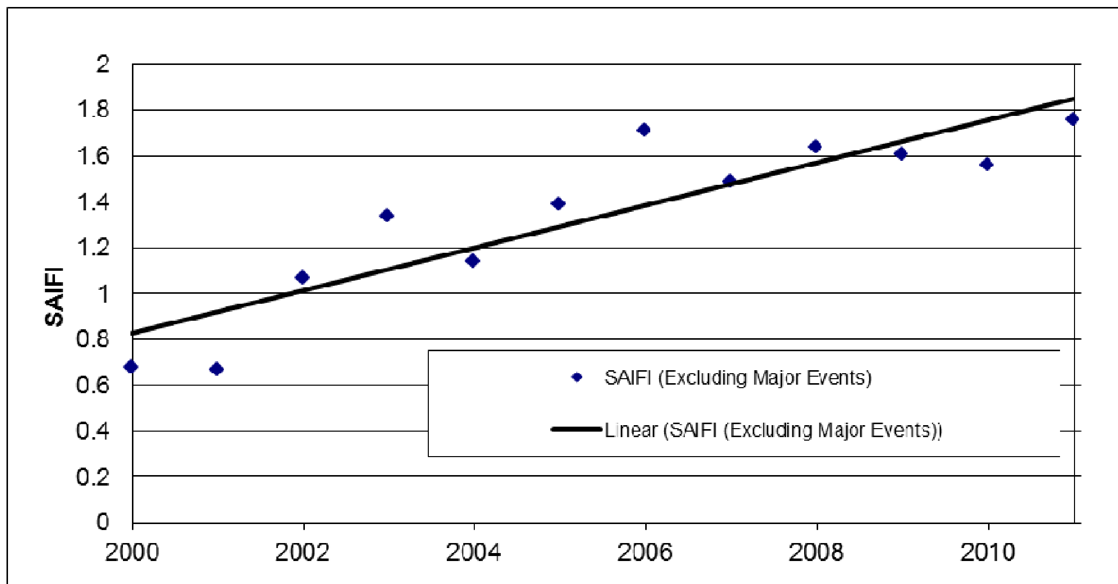
As can be seen in the chart below, despite the significant easing of the Board reliability standard in 2008, Atlantic still failed to meet the SAIFI Minimum Reliability Level in 2011.

Atlantic's SAIFI and CAIDI Performance 2008-2011
(excluding major events)*

	SAIFI	CAIDI
Atlantic Minimum Reliability Level post 2008	1.71	144
2008	1.64 (Passed)	131 (Passed)
2009	1.61 (Passed)	131 (Passed)
2010	1.56 (Passed)	118 (Passed)
2011	1.76 (Failed)	110 (Passed)

As shown on Rate Counsel Exhibit CPS 1 (Updated to include 2011) ACE's SAIFI (Excluding major events) from 2000-2011 was as follows:

Exhibit CPS 1 Updated ACE SAIFI (Excluding major events) from 2000-2011[12]



12 Exhibit *RC-30.*

If there had been no relaxation of the Minimum Reliability Level applicable to Atlantic, the Company would have failed SAIFI every year from 2004 to the present. That level of performance cannot be considered acceptable.

Staff's dismissal of Atlantic's failures and refusal to recommend meaningful changes to ensure safe, adequate and proper service to Atlantic's customers is contrary to its mission, and should be given no weight. In support of its contention that this base rate case is not the appropriate venue to establish reliability requirements for Atlantic, Staff argues that the Company's RIP will address many of the deficiencies of Atlantic's reliability performance (*SIB, p. 93*) and if the Company fails, the Board can then exercise its authority to "impose monetary fines and other penalties against any utility that fails to meet the State's standards and requirements." *SIB, p. 94.* Though it is true that there are provisions in the Board's regulation that subject Atlantic to penalties, the Company has yet to be fined for its failures over last 10 years.

The State of New Jersey granted Atlantic an exclusive franchise to operate a monopoly in Southern New Jersey and with that privilege the Company accepted the responsibility to provide safe, adequate and proper service to its captive customers. N.J.S.A. 48:2-21 and N.J.S.A. 48:2-23. Although the State has held up its part of the bargain by allowing Atlantic to operate without competition, Atlantic has failed to fulfill its part by providing an adequate level of service. Atlantic's customers have no choice but to be served by the monopoly utility or move out of Atlantic's service territory. As such, if a regulated utility is unable or unwilling to provide the level of service required, it is incumbent on the regulators to insure that Atlantic performs properly and invests in its infrastructure so that safe adequate and proper service is provided.

The “wait and see” if reliability improves attitude expressed by both the Company and Staff in their respective briefs is troubling and fails to address the concerns of large number of Atlantic customers that continue to be saddled with poor electric service. By adopting Rate Counsel’s recommendations in its Initial Brief, Your Honor and the Board will send a clear signal to the Company that business as usual will no longer be tolerated.

If, however, Staff’s position is adopted, Rate Counsel respectfully requests that Atlantic be ordered to file quarterly reports on the Company’s reliability performance and that a Phase II of this current base rate case be kept open so that if such improvements are not forthcoming, the Company will be appropriately penalized for its continued poor performance.

POINT V

ATLANTIC'S CUSTOMER SERVICE CONTINUES TO DETERIORATE AND MUST BE ADDRESSED.

ACE argues, in its Initial Brief, that the Board and ratepayers must continue to wait until it implements its Customer Service Improvement Plan ("CSI Plan") for its performance to improve. ACE claims that its agreement to the CSI Plan, in the 2011 Stipulation, absolves it of all other customer service obligations arising from any applicable statute, regulation or Board Order and waives the rights of all parties to object to its performance:

> [J]ust over a year after the [parties] reached a mutually agreeable resolution to outstanding issues and concerns, Witness Colton seeks to use this proceeding to impose additional requirements on the Company. *AIB, p. 87.*

The Company repeatedly tries to dodge its obligations, for example, it argues that the CSI Plan "addressed" customer service appointments thereby seeking to avoid its obligation under N.J.A.C. 14:3-3.8 and the 2002 Merger Order, to honor all service appointments. See *RC-3*, p. 5; *RC-3*, p. 18-19; *RC-3*, Sched. RDC-2.

However, as set forth in Mr. Colton' testimony, as expanded upon at the hearing before Your Honor, and as specified in Rate Counsel's Initial Brief, the Company's attempt to dodge or delay its obligations must be rejected. The CSI Plan and the August 2012 report on its results cannot substitute for the basic obligations that Atlantic has as a monopoly utility company subject to the Board's jurisdiction. The CSI Plan did not even begin to address all of ACE's customer service shortcomings, in fact, Mr Dickerson conceded that the CSI Plan was not intended to be a comprehensive settlement of customer service needs. *T65:L2-9* (June 20, 2012). As detailed at length in testimony, the Company already has failed to deliver on earlier promises to improve its customer service, in violation of Board regulations and Orders. E.g., *T109:L6 -*

T109:L15 (June 20, 2012) (CSI Plan did not address DPAs); *T106:L9 - T107:L3* (June 20, 2012) (CSI Plan did not address disconnection over-noticing).[13]

The Company's argument also dismisses its legal obligations and its abysmal customer service. The 2011 Stipulation did include several measures that the Company agreed to undertake promptly. But that agreement did not excuse or exempt the Company from performing all of its obligations as a regulated public utility. The 2011 Stipulation expressly applies only to Phase 2 of the Company's last base rate case, Docket Nos. ER09080664 & EA07100794. It states, for example:

> It is the intent of the Parties that the terms and conditions set forth in this Phase 2 Stipulation, and any Board Order to be issued as a result hereof, shall not be deemed to change, alter or modify the provisions and requirements of the 2002 Merger Order.

P14, 2011 Stipulation, p. 21, ¶¶ 7, 8.

Nowhere does the 2011 Stipulation or Board Order relieve the Company of any obligation arising from any other Board Order or regulation or from the Company's obligation to provide safe, adequate and proper service to its customers.

The Company dismisses as a "rehash," the evidence of its failing customer service over the past several years. *PIB, p. 84*. But ACE fails to rebut any of the evidence. The Company's customer service metrics have continued to deteriorate. ACE agreed in the 2002 Merger Order, Docket No. EM01050308, that its complaints would not exceed 1,500 per year, but it now exceeds that limit by nearly 50%. *RC-3*, p. 5, lines 5-7. ACE also has not honored its obligation to keep all scheduled customer service appointments. *RC-3*, p. 5; *RC-3*, p. 18- 19; *RC-3*, Sched. RDC-2. ACE does not rebut these facts, instead the Company says that it will submit a performance report on the CSI Plan later this month. *RCIB, p. 84-85*.

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[13] The CSIP also did not address the shortcomings in the Company's voice response unit and its outsourced call center staff that Mr. Colton described. *RC-3*, p. 38- 47.

Another area of concern not rebutted in the Company's Initial Brief is the 90% failure rate of ACE's deferred payment arrangements ("DPAs") characterized by Mr. Colton as "extraordinary", *RC-3*, p.6, and "disturbing," *T84:L1-12* (June 20, 2012). The Company has refused to change those practices, and has not even acknowledged that this high failure rate is a problem, stating that the Overland audit, the CSI Plan and the stipulation already addressed the "alleged" deficient performance. *PIB, p. 86*.

The Company still refuses to admit that sending an average of 60 notices for every disconnection is excessive and counterproductive, and is not a prudent management technique. Although the Company claimed that Board rules compel it to issue 60 or more shutoff notices for every shutoff it actually performs, *P-16*, p. 6, lines 12-19, on cross- examination Mr. Dickerson admitted that there is no such Board regulation. *T44:L24 - T45:L4-7* (June 20, 2012). In fact, ACE now claims there is no legal standard governing its sending of disconnect notices. *PIB, p. 86-87.* The Company admits that it has no information showing any advantage from issuing more shutoff notices, *RC-53*; *RC-54*; *RC-55*; *RC-52*; in contrast, Mr. Colton explained how ACE's practice is counter-productive. *T87:L15 - T89:L3* (6/20/12); *RC-3*, p. 58; id. at p. 64-69.

Mr. Colton testified that he finds it "hard to imagine that [ACE] can abide by the elements of the CSI Plan." *T101:L14-18* (June 20, 2012). Mr. Colton explained that ACE has not designed an evaluation of its CSI Plan that applies basic management research methods. *T101:L14 – p. 104:5* (June 20, 2012). Mr. Colton testified that the CSI Plan required ACE to conduct "Moment of Truth" surveys, but ACE has failed to demonstrate what it has done to implement this obligation. *RC-3*, p. 21–22 (referring to ACE responses to RCR-CI-18 and RCR-CI-19).

Instead of addressing Mr. Colton's testimony regarding the CSI Plan, the Company attempts to attack his data as outdated. Mr. Colton's testimony relied on the survey information provided by ACE in its discovery responses, *RC-3*, p. 21, *RC-34; RC-35*, which covered the years 2008 through 2011, *RC-3*, p. 22, n. 16, with limited data back to 2005, <u>see</u> *RC-34*, "Pepco Holdings (PHI) Residential Customer Satisfaction Research Program: Key Findings for 2010," p. 10. Nevertheless, ACE complains that Mr. Colton relied on "three- to five-year-old surveys." *PIB, p. 85*. The fact remains that ACE has failed to demonstrate that it is even now analyzing the root causes of its customer service problems to identify and implement effective responses. It is difficult to imagine how ordering ACE to improve its customer service immediately will "disturb" its Plans, as it suggests in its Initial Brief. *PIB, p. 88.*

While Board Staff recognizes in its Initial Brief that there has been an increase in customer complaints filed with the Board against ACE, over the last three years, it cites the number of complaints in the first two quarters of 2012 as justification for not taking any action, even though that data did not cover the peak summer months and thus is not a fair comparison. *SIB, p. 94-95*. Staff also recognizes that the Company needs to increase its compliance with the Administrative Code, enhance its provision of safe, adequate and proper service, and employ greater flexibility in setting deferred payment arrangements. *SIB, p. 95*. However, Staff does not indicate any willingness to require such improvements. They simply call for certain modifications to the wording of the Company's tariff, "[t]o enable ACE's customers to better comprehend the terms and conditions of the Company's tariff." *SIB, p. 96*.

Rate Counsel maintains that the ratepayers of New Jersey have waited long enough. The Company has no exemption from its obligation to provide adequate customer service and it has failed to rebut the facts establishing its failure. The time has come for the Board to exercise its

enforcement authority and penalize the Company for its consistently poor performance with a reduction in its authorized Return on Equity and direct the Company to meet the standards and metrics required by Board regulations and Orders, as set forth specifically in Rate Counsel's Initial Brief.

POINT VI

RATE COUNSEL'S RECOMMENDED ELECTRIC RATE INCREASE SHOULD BE IMPLEMENTED BASED ON THE BOARD-APPROVED COST ALLOCATION AND RATE DESIGN PRINCIPLES.

In our Initial Brief, Rate Counsel recommended that Your Honor and the Board increase the Company's revenue by $5.474 million, and that this increase should be allocated entirely among the Company's Residential and Street and Private Lighting customer classes, $4.956 million to the Residential class and $518,126 to the Street and Private Lighting class. *RCIB, p. 132.* Rate Counsel also said that the Company's proposed allocation of the rate increase, based on the Company's proposed cost of service, was a reasonable allocation. Rate Counsel witness Mr. Peterson testified that, under either allocation method, the peak demand method proposed by the Company or the peak and average method proposed by Board Staff, the revenue spread proposed by Company witness Mr. Janocha produces reasonable results. *RC-5*, p. 15, lines 14-16; id., p. 13, lines 9-10.

The Company seeks to increase the current residential customer charge from $2.73 per month to $5.75 including Sales and Use Tax. *PIB, p. 77-78*. Rate Counsel also recommended that the Your Honor and the Board reject the Company's proposal to increase the Company's service charge and recommended that customer service charges be kept at the current level. Board Staff agreed with Rate Counsel on this issue. *SIB, p. 91.*

Long standing Board policy limits customer costs to those costs which are demonstrated to vary directly and linearly with the number of customers on the system, unaffected by either demand or energy consumption.[14] There is no evidence in this proceeding as to ACE's costs that vary directly and proportionately with the number of customers it serves; in fact, Mr. Janocha

[14] I/M/O Jersey Central Power and Light Company, BPU Docket No. ER91121820J, Final Decision and Order, (June 15, 1993), p.17.

admitted that ACE never performed that analysis. *T70:L4-10* (June 27, 2012). Without this fundamental analysis, there is no basis in the record of this proceeding for any change in the Company's present Residential customer monthly service charge.

As discussed fully in Rate Counsel's Initial Brief, ACE's proposal to increase its Residential customers' monthly service charge by 110 percent violates the principle of gradualism and would result in ACE having the highest monthly service charge among the State's four regulated electric utilities. *RC-5*, p. 20. In addition, ACE's proposed Residential monthly service charge increase would fall disproportionately on small volume users, who, Mr. Janocha estimates, are approximately 21 percent of its Residential customers. *RC-5*, p. 9, *RC-5*, p. 20. Accordingly, Your Honor and the Board should not increase the Company's Residential monthly service charge.

For the reasons set forth above, Your Honor and the Board should allocate Rate Counsel's proposed rate increase based on Mr. Peterson's recommended Rate Design:

a. The entire $5.474 million revenue increase recommended by Rate Counsel should be allocated among the Company's Residential and Street and Private Lighting customer classes, $4.956 million to the Residential class and $518,126 to the Street and Private Lighting class.
b. Rate Counsel does not object to the use of either the class diversified demand allocation method or the peak and average allocation method in this case, because they produce similar results here.
c. The Company's monthly service charge for Residential Service customers should not be increased.
d. The Company's monthly service charge for Monthly General Service customers should not be increased.
e. As discussed in our Initial Brief, Rate Counsel has no objection to Mr. Janocha's recommendation to begin eliminating the declining block rate for Residential customers during the winter heating season.

CONCLUSION

For the reasons stated in our Initial Brief and this Reply Brief, in the testimonies of our witnesses, and in the balance of the record, Rate Counsel respectfully requests that Your Honor and the Board deny Atlantic's request for an increase in its electric rates. Rate Counsel recommends that Your Honor and the Board adopt Rate Counsel's revenue requirement of $8.128 million including RARC, as well as adopt Rate Counsel's adjustments that were itemized in our Initial Brief.

Respectfully submitted,

Stefanie A. Brand
Director, Division of Rate Counsel

Dated: August 10, 2012

ATLANTIC CITY ELECTRIC COMPANY
BPU Docket No. ER11080469

Data Request of Trial Staff to
Rate Counsel Witness Kahal
Transcript Request of June 18, 2012

Please provide Mr. Kahal's return on equity recommendations in all previous cases before the New Jersey Board of Public Utilities within the past five years. This applies to all cases in which his testimony was actually prefiled.

Response

The chart below provides the listing of returns on Mr. Kahal's equity recommendations in testimony that was actually filed. It is keyed to his Appendix A listing of cases, and it provides the updated return on equity recommendations when available.

Appendix A #	Utility	Docket Number	Date	ROE Recommendation
313	PSE&G	E007040278	6/2007	9.75% / 10.05%1)
324	NJNG	GR070110889	4/2008	9.75 (updated)
325	NJAWC	WR08010020	7/2008	10.25
338	JCP&L	E008050326	8/2009	7.8[2]
339	Etown	GR09030195	8/2009	10.1
347	PSE&G	GR09050422	11/2009	10.0 (updated)
352	Rockland	ER09080668	3/20/10	10.1
353	South Jersey	GR10010035	5/2010	10.0 (updated)
356	United Water	WR09120987	6/2010	10.0

(1) 9.75 percent for electric and 10.0 percent for gas. This pertains just to energy efficiency/renewable investments and assumes that Rate Counsel's other ratemaking treatments are accepted.

(2) This applies just to demand response program investments.