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

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

TESTIMONY OF DAVID E. PETERSON
ON BEHALF OF THE
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL

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I. INTRODUCTION

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

A. My name is David E. Peterson. I am a Senior Consultant employed by Chesapeake Regulatory Consultants, Inc. ("CRC"). Our business address is 1698 Saefern Way, Annapolis, Maryland 21401-6529. I maintain an office in Dunkirk, Maryland.

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

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

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

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

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

A. Yes. I have presented testimony in 118 other proceedings before the state regulatory commissions in Alabama, Arkansas, Colorado, Connecticut, Delaware, Indiana, Kansas, Maine, Maryland, Montana, Nevada, New Jersey, New Mexico, New York, Pennsylvania, South Dakota, West Virginia, and Wyoming, and before the Federal Energy Regulatory Commission. In addition, I have twice testified before the Energy Subcommittee of the Delaware House of Representatives on the issues of consolidated tax savings and tax normalization.

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

II. SUMMARY

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

A. My appearance in this proceeding is on behalf of the New Jersey Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel").

Q. HAVE YOU TESTIFIED IN OTHER PROCEEDINGS BEFORE THE NEW JERSEY BOARD OF PUBLIC UTILITIES ("BOARD")

A. Yes, I have. I have submitted testimony in the following proceedings before the Board:

Utility	Docket No.
South Jersey Gas Company	GR8704329
	GR03050413
	GR03080683
New Jersey-American Water Company	WR88070639
	WR91081399J
	WR92090906J
	WR94030059
	WR95040165
	WR98010015
	WR03070511
	WR06030257
ACE/Delmarva Merger	EM97020103
Atlantic City Electric Company	ER03020110
FirstEnergy/GPU Merger (JCP&L)	EM00110870
Jersey Central Power & Light	ER02080506
	ER05121018
Rockland Electric Company	ER02100724
	ER06060483
Public Service Electric and Gas	EM00040253
Exelon/PSE&G Merger	EM05020106
Conectiv/Pepco Merger (ACE)	EM01050308
Elizabethtown Gas Company	GR02040245
	GR09030195
United Water New Jersey, Inc.	WR07020135
New Jersey Natural Gas Company	GR07110889

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

A. I was asked to assist Rate Counsel in analyzing Public Service Electric and Gas Company's ("PSE&G" or "the Company") request for a rate base allowance for cash working capital. PSE&G's request for a cash working capital allowance is based on a lead-lag study conducted by Daniel M. Furlong. The purpose of my testimony is to present the results of my analysis of Mr. Furlong's lead-lag study to Your Honor and the Board and to recommend alternative ratemaking treatments for several items included in Mr. Furlong's study. Based on my calculation of PSE&G's cash working capital requirement I recommend the inclusion of a $210,535,000 rate base allowance for electric distribution operations and a $123,699,000 rate base allowance PSE&G's gas distribution operations. These amounts are $69,274,000 and $33,967,000 less than the amounts that were included in PSE&G's proposed rate base (6+6 filing) for the electric and gas divisions, respectively.[1]

III. CASH WORKING CAPITAL

Q. FOR WHAT PURPOSE SHOULD A CASH WORKING CAPITAL ALLOWANCE BE INCLUDED IN RATE BASE?

A. A cash working capital allowance should be included in rate base to compensate investors for investor-supplied funds, if any, used to provide the day-to-day cash needs of the utility. These cash needs can be measured in a lead-lag study. A lead-lag study measures the time between (1) the provision of service to utility customers and the receipt of revenue for that service by the utility, and (2) the provision of service by the utility and its disbursements to employees and suppliers in payment for the associated costs. The difference between the revenue

[1]PSE&G's 6+6 filing includes a $279,809,000 cash working capital allowance for the Electric Department and a $157,666,000 cash working capital allowance for the Gas Department. See

"lag" and the expense "lead" is expressed in days. The difference, which can be either a net lag or a net lead, multiplied by the average daily cash operating expenses, quantifies the cash working capital required for, or available from utility operations.

In this proceeding, Mr. Furlong sponsors a lead-lag study based on accounting and payment information for the twelve months ended June 30, 2009. Mr. Furlong's analysis, however, goes far beyond the measurement of PSE&G's cash working capital requirement.

Q. HOW DOES MR. FURLONG'S CASH WORKING CAPITAL CALCULATIONS OVERSTATE PSE&G'S WORKING CASH REQUIREMENT?

A. The overstatement results primarily from Mr. Furlong's improper inclusion of non-cash transactions in the working capital calculation. Non-cash transactions do not create a requirement for cash working capital. The non-cash transactions that Mr. Furlong included in his working capital calculation are: uncollectible accounts, deferred taxes, depreciation and amortization expenses, other post-retirement benefits ("OPEB") expenses and return on investment. Combined, inclusion of these non-cash transactions in the lead-lag calculation significantly overstates the Company's actual working cash requirement. Also, I take issue with the way that Mr. Furlong addressed the expense lead days for affiliate service company charges in his lead-lag study which, further overstated PSE&G's working cash requirement.

Schedule DMF-3-R1 attached to the Revised Direct Testimony of Daniel M. Furlong.

Q. WHY IS IT IMPROPER TO INCLUDE NON-CASH EXPENSES IN CASH WORKING CAPITAL?

A. As I stated earlier in my testimony, a rate base allowance for cash working capital allowance compensates the utility for investor funds used to finance the day-to-day cash operating needs of the utility. Cash flows arising from non-cash expenses do not serve this purpose and, therefore, should not be included in the working cash allowance.

Q. WHAT IS YOUR SPECIFIC OBJECTION TO INCLUDING THE UNCOLLECTIBLE ACCOUNTS EXPENSE IN THE LEAD-LAG STUDY?

A. Despite the fact that including uncollectible expenses in the lead-lag study decreases the Company's cash working capital and revenue requirements in this case, it is simply illogical and improper to do so. In fact, doing so is contrary to the definition of cash working capital that I provided earlier.

PSEG writes off an account after service has been rendered if the account has been determined to be uncollectible. Thus, Mr. Furlong measured the time interval between the provision of service and the date at which an uncollectible account is written off – 178.28 days on average.[2] Mr. Furlong's inclusion of uncollectible accounts in his lead-lag analyses thus implies that since revenues from paying customers are received, on average, 49.31 days after service is rendered, the Company enjoys a 128.97 day net cash working capital benefit arising from the uncollectible accounts.

I do not dispute that uncollectible accounts represent a legitimate expense in an accounting sense given that the expense reduces net income and that uncollectible accounts represent a legitimate ratemaking expense as well. But, the

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[2] See Revised Direct Testimony of Daniel M. Furlong, page 5.

administrative decision to declare an account uncollectible does not create a source of working cash for the Company. To see the obvious fallacy of including the uncollectible accounts expense in the lead-lag study one need only answer the question: How does a customer who does not pay his utility bill become a source of cash working capital for the utility? If that were the case, utilities would be encouraging all customers to not pay their utility bills. Obviously, this is an absurd result. The average lag in customer payments, including late paying customers, is measured in the revenue lag portion of the study. All that is necessary and appropriate to complete the lead-lag study is to measure the timing of PSE&G's payment of ***cash*** expenses. PSE&G's uncollectible accounts, however, are not ***cash*** expenses. Therefore, uncollectible accounts expenses should not be included in the lead-lag study. On my Schedule___(DEP-1), I recalculated PSE&G's cash working capital requirement after excluding uncollectible accounts expenses.

Q. WHY SHOULD DEFERRED TAXES NOT BE INCLUDED IN THE LEAD/LAG ANALYSIS?

A. It is appropriate to exclude deferred taxes from the working capital calculation because there is no continuing cash payment required from either the Company or investors for tax deferrals. Because no periodic cash outlay is required, no investment in working capital is required either. Deferred taxes have been collected from ratepayers, without being paid to the US Treasury by the utility. It is ludicrous to conclude that deferred tax expenses create a cash working capital requirement, since no investor funds were expended for them.

Q. MR. FURLONG ARGUES THAT BECAUSE INVESTOR CAPITAL WAS EXPENDED WHEN PLANT ASSETS WERE ACQUIRED THIS JUSTIFIES INCLUDING DEFERRED TAXES IN THE LEAD-LAG STUDY. DO YOU AGREE?

A. No. This is *non sequitur* reasoning. No one can dispute that investors expended funds at the time the Company acquired plant assets. This undisputed fact, however, actually supports my position that deferred taxes should not be recognized in the cash working capital calculation. The cash transaction with investors associated with plant in service giving rise to deferred taxes already occurred in the past. There is no further cash outlay from either investors or the Company that is in any way connected with the deferred taxes from that point on. No working capital is needed by the utility for this item. Thus, there is no justification for a cash working capital allowance for deferred income taxes.

Q. WHAT IS YOUR OBJECTION TO INCLUDING THE DEPRECIATION EXPENSE IN THE LEAD-LAG STUDY?

A. Like deferred income taxes, depreciation is a non-cash expense. Once again, the cash transaction associated with a plant asset occurred when the asset was first acquired. No additional investor-supplied funds for working capital purposes are required following the initial investment.

Rather, the depreciation expense is an accounting accrual established to provide a systematic means for the utility to recover the cost of a plant asset over its useful service life. The utility, however, does not write out a check at the end of each month for “depreciation expense” to investors. For that reason, depreciation expense represents a significant source of cash flow for the utility even though it is a non-cash expense as far as PSE&G’s cash working capital requirement is concerned. Therefore, it is not appropriate to include depreciation and amortization expenses in the lead-lag study.

Q. WHY IS IT APPROPRIATE TO EXCLUDE OTHER POST RETIREMENT BENEFITS ("OPEB") EXPENSES FROM THE WORKING CASH CALCULATION?

A. Mr. Furlong included the OPEB asset and liability as separate elements of the net assets and liabilities rate base allowance reflected on his Schedule DMF-8. In addition, he also included OPEB expenses in his calculation of the expense payment lead for employee benefits using a zero-day expense lead, thereby creating an additional 49.31-day cash requirement for OPEB expense.[3] Mr. Furlong's approach double-counts the working capital requirement for OPEB expenses. To avoid the double-count, it is necessary to either remove OPEB expenses from the cash working capital calculation, as I have done in my analysis. Alternatively, the payment lead days for OPEB expenses can be changed to match the revenue lag (49.31 days). This too would eliminate the double-count.

Q. IS MR. FURLONG'S TREATMENT OF RETURN ON INVESTMENT IN THE CASH WORKING CAPITAL CALCULATION APPROPRIATE?

A. No, it is not. Mr. Furlong's proposed cash working capital allowance includes an amount for PSE&G's returns on the common equity, preferred stock and long-term debt used to finance rate base. Looking first at common equity, Mr. Furlong includes the common equity return in his lag study using a zero-day expense lead. Mr. Furlong's treatment is as if stockholders are being compensated on a daily basis. The fact is that stockholders receive compensation in two forms: 1) through quarterly dividend payments, if any, and 2) through capital appreciation, if any, upon the sale of the stock. If one were to measure the actual delay in the

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[3] See Mr. Furlong's Schedule DMF-5-R1.

utility's cash outlay to stockholders, one would refer to the quarterly dividends that are being paid, rather than assume a zero lag as Mr. Furlong has done. But, because there is no contractual requirement for PSEG to pay stockholders a quarterly dividend, the common equity return should not be included in the cash working capital measurement in the first place.

Q. HOW DID MR. FURLONG TREAT LONG-TERM DEBT INTEREST AND PREFERRED STOCK DIVIDENDS IN HIS WORKING CAPITAL CALCULATION?

A. Mr. Furlong treated these two items the same way that he treated the common equity return, i.e., he simply lumped these two return elements in with the common equity return and applied a zero-day lag to PSE&G's total net income.

Q. SHOULD LONG-TERM DEBT INTEREST AND PREFERRED STOCK DIVIDENDS BE ACCOUNTED FOR IN THIS MANNER?

A. No. Unlike common stock dividends, there are contractual requirements associated with debt interest and preferred stock dividends that obligate PSE&G and PSEG to make specified payments on certain dates. In this respect, the debt interest and preferred dividend elements of PSE&G's return more closely resemble its other cash operating expenses. Therefore, payment leads for long-term debt interest and preferred stock dividends should be separately recognized in the lead-lag calculation. Long-term debt interest is paid semi-annually, creating 91.25-day expense lead. Preferred stock dividends are paid quarterly, resulting in a 45.63-day expense lead. Both expense lead days should be incorporated into the lead-lag calculation.

Q. ARE YOU RECOMMENDING ANY OTHER CHANGES IN THE EXPENSE LEAD DAYS CALCULATED IN MR. FURLONG'S LEAD-LAG STUDY?

A. Yes. I am recommending a change relating to the expense lead days that Mr. Furlong uses for "other O&M" expenses.

Q. HOW DID MR. FURLONG CALCULATE EXPENSE LEAD DAYS FOR OTHER O&M EXPENSES?

A. Mr. Furlong explained in his Revised Direct Testimony that he examined accounts payable invoices not charged to other expense categories of $25,000 and higher for the representative months of February and May 2009 and August and November 2008. From this sample, he calculated weighted average lead days of 28.09 for other O&M expenses.[4]

Q. IS MR. FURLONG'S APPROACH REASONABLE?

A. No, it is not. The payment lag associated with what is likely the most significant "other O&M" expense is completely ignored in Mr. Furlong's analysis. PSE&G's payments to the affiliate service company, PSEG Services Corporation ("Service Company"), represents approximately $185 million or 35 percent of total expenses within the other O&M expense category, yet the associated payment lags are not measured in Mr. Furlong's analysis. By excluding recognition of expense lead days associated with PSE&G's payments to the affiliate service company, Mr. Furlong overstated the Company's working cash requirement.

Q. HOW SHOULD PSE&G'S PAYMENTS TO THE SERVICE COMPANY BE FACTORED INTO THE LEAD-LAG STUDY?

[4] Revised Direct Testimony of Daniel M. Furlong, page 6.

A. Since PSE&G's payments to the Service Company are significant in dollar terms and the timing of PSE&G's payments is controlled by the signed "Service Agreement", it is appropriate to create a separate expense category for Service Company expenses within the lead-lag study, as I have done on Schedule___(DEP-1).

Q. HOW DID YOU CALCULATE EXPENSE LEAD DAYS FOR PSE&G'S PAYMENTS TO THE SERVICE COMPANY?

A. As I previously stated, the timing of PSE&G's payments to the Service Company is controlled by the Service Agreement.[5] Paragraph 6 of the Service Agreement specifies the following concerning billing and payment requirements:

> "An accounting of the services performed by the Service Company will be rendered on or before the 9th business day of each month for all services rendered during the previous moth pursuant to this Agreement. The Operating Company shall within ten (10) days after the receipt of such accounting render to the Service Company payment of the amount due."

Thus, the expense lead associated with Service Company billings can calculated by summing the average monthly service period (15.21 days), the Service Company's billing lag (13.29 days)[6] and the 10 day grace period provided for in the Service Agreement. From this, I incorporated a 38.5 day expense lead into my lead-lag analysis for Service Company charges, as shown in Schedule___(DEP-1).

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[5] A copy of the Service Agreement, dated September 30, 2003, was provided as an attachment to PSE&G's response to RCR-A-61.

[6] The 9th business day billing lag specified in the Service Agreement equates to a 13.29 calendar day billing lag, on average.

Q. PLEASE SUMMARIZE THE EFFECT OF YOUR RECOMMENDED ADJUSTMENTS TO PSE&G'S CASH WORKING CAPITAL CALCULATION.

A. My summary cash working capital calculations are shown on Schedule___(DEP-1) using PSE&G's filed 6+6 expenses. On this schedule, I eliminated all non-cash expenses and the common equity return and I adjusted the expense lead days for preferred stock dividends, interest on long-term debt, and Service Company expenses, as previously described in my testimony. After making these changes I calculated a cash working capital requirement for PSE&G's electric and gas operations of $210,535,000 and $123,699,000, respectively. My recommended cash working capital allowances at this time do not incorporate Ms. Crain's recommended expense adjustments. My schedule should be updated later in the proceeding to properly synchronize the cash operating expenses included in the lead-lag study with those that are approved for ratemaking purposes in the Board's final order.

Q. DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

A. Yes, it does.

SCHEDULE DEP-1

Schedule___(DEP-1)

PUBLIC SERVICE ELECTRIC AND GAS COMPANY

Cash Working Capital Requirement
Test Year Ending December 31, 2009 (6+6 Filing)
$(000)

	ELECTRIC					GAS				
	Expense	Rate Counsel		Payment Lag		Expense	Rate Counsel		Payment Lag	
	As Filed	Adjustments	As Adjusted	(Days)	Dollar Days	As Filed	Adjustments	As Adjusted	(Days)	Dollar Days
(A)	(B)	(C)	(D)	(E)	(F)	(G)	(H)	(I)	(J)	(K)
1. Electric supply costs	$3,683,550		$3,683,550	36.12	$133,049,826	$0		$0	0.00	$0
2. Gas supply costs	0		0	0.00	0	1,920,321		1,920,321	34.61	66,462,310
3. Salary and wages	198,479		198,479	14.97	2,971,231	220,254		220,254	14.97	3,297,202
4. Pension and benefits	123,275		123,275	(2.48)	(305,722)	84,463		84,463	(2.88)	(243,253)
5. Uncollectibles	55,661	(55,661)	0	178.28	0	33,005	(33,005)	0	299.55	0
6. Service Company	0	104,524	104,524	38.50	4,024,174		80,655	80,655	38.50	3,105,218
7. Other O&M	375,031	(104,524)	270,507	28.09	7,598,542	158,558	(80,655)	77,903	28.09	2,188,295
8. Depreciation & amortization	306,622	(306,622)	0	0.00	0	94,538	(94,538)	0	0.00	0
9. Income taxes:										0
10. Current federal	106,110		106,110	37.00	3,926,070	(10,699)		(10,699)	37.00	(395,863)
11. Current state (CBT)	28,139		28,139	(77.11)	(2,169,798)	7,962		7,962	(84.79)	(675,098)
12. Deferred	(30,648)	30,648	0	0.00	0	79,070	(79,070)	0	0.00	0
13. Taxes other than income	114,502		114,502	(19.93)	(2,282,025)	61,055		61,055	(20.78)	(1,268,723)
14. Return on investment	276,731	(276,731)	0	0.00	0	172,458	(172,458)	0	0.00	0
15. Preferred stock dividends	0	1,922	1,922	45.63	87,686	0	1,169	1,169	45.63	53,344
16. Interest on long-term debt	0	109,535	109,535	91.25	9,995,096	0	66,636	66,636	91.25	6,080,508
17. Total	$5,237,452	($496,909)	$4,740,543	33.10	$156,895,080	$2,820,985	($311,266)	$2,509,719	31.32	$78,603,940
18. Revenue lag days				49.31					49.31	
19. Expense lead days				33.10					31.32	
20. Net lag days				16.21					17.99	
21. Expense per day				$12,988					$6,876	
22. Working cash required				$210,535					$123,699	
23. Cash working capital as filed (6+6 update)				279,809					$157,666	
24. Rate base adjustment				($69,274)					($33,967)	

Source:
PSE&G Schedule DMF-3-R1 and Peterson Testimony