BEFORE THE STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW
BOARD OF PUBLIC UTILITIES

IN THE MATTER OF THE PETITION	**) BPU DKT. NO. GR09030195**
OF PIVOTAL UTILITY HOLDINGS, INC.	**) OAL DKT. NO. PUC-03655-2009N**
D/B/A ELIZABETHTOWN GAS FOR	**)**
APPROVAL OF INCREASED BASE TARIFF	**)**
RATES AND CHARGES FOR GAS SERVICE	**)**
AND OTHER TARIFF REVISIONS	

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR.
ON BEHALF OF THE
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Direct Testimony
Of
Michael J. Majoros, Jr.

I. INTRODUCTION

Background and Qualifications

Q. State your name.

A. Michael J. Majoros, Jr.

Q. Who is your employer, and what is your position?

A. I am Vice President of Snavely King Majoros O'Connor & Bedell, Inc. ("Snavely King"), located at 1111 14th Street, N.W., Suite 300, Washington, D.C. 20005.

Q. Describe Snavely King.

A. Snavely King is a small, diverse and veteran-owned Economic and Management Consulting firm founded in 1970 in Washington D.C. Snavely King conducts economic, accounting and technical analyses and research into the costs, rates, revenues, and economic performance of companies in the power, transportation, water and wastewater, public utility and telecommunications industries.

For almost four decades, Snavely King has analyzed and translated the effects of alternative regulatory ratemaking policies and free market practices into their practical cost and pricing consequences. The firm's clients include federal and state government agencies, businesses and individuals. Over the course of its 39-year history, members of the firm have participated in more than 1,000 proceedings before almost all of the state commissions and all Federal commissions that regulate prices in the utilities and transportation industries. Snavely King believes in accountability, fair competition and effective regulation.

Snavely King has also assisted a multitude of non-ratemaking organizations including the U.S. Department of Justice, U.S. Department of Defense, the General Services Agency, the U.S. Environmental Protection Agency, the Maryland Senate and House of Delegates, the Sierra Club and the National Parks Conservation Association.

Snavely King's subject matter experts include professional economists, MBAs, CPAs, attorneys, scientists, engineers, IT professionals, cost analysts and experts in utility finance and operations. Snavely King currently has a Washington D.C. complement of thirteen experts.

Q. Have you prepared a summary of your qualifications and experience?

A. Yes, Appendix A is a summary of my qualifications and experience. Appendix B is a tabulation of my appearances as an expert witness before state and Federal regulatory agencies.

Q. At whose request are you appearing in this proceeding?

A. I am appearing on behalf of the New Jersey Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel").

Q. What is the subject of your testimony?

A. My testimony addresses depreciation.

Q. Do you have any specific experience in the field of public utility depreciation?

A. Yes, among other things, Snavely King specializes in the field of public utility depreciation. We have appeared as expert witnesses on this subject before the regulatory commissions of almost every state in the country as well as several Federal commissions. I have testified in over 100 proceedings on the subject of public utility depreciation,

including several appearances before the New Jersey Board of Public Utilities ("BPU" or "Board").

Q. How many times have you addressed public utility depreciation in New Jersey proceedings?

A. I have appeared in more than twenty New Jersey proceedings on the subject of public utility depreciation. These proceedings have addressed electric, gas, water, telephone and waste removal utilities.

Purpose of Testimony

Q. Explain the purpose of your testimony in this proceeding.

A. Rate Counsel asked me to review Elizabethtown Gas Company's ("E'town," or "the Company") depreciation-related testimony and exhibits. Company witness Dr. Kimbugwe Kateregga prepared E'town's depreciation testimony. I am to express an opinion regarding the reasonableness of the Company's depreciation proposal and, if warranted, make alternative recommendations.

E'town's Current Depreciation Rates

Q. When did the Board approve E'town's current depreciation rates?

A. The BPU established E'town's current depreciation rates in a 1987 rate case – Docket No. GR86121374.[1] Exhibit___ (MJM-1) contains a copy of selected pages from the ALJ's ruling establishing rates for all plant accounts in that proceeding. It also includes the rates themselves from the Direct Testimony of Robert Nottingham, the staff witness that calculated the rates.[2] The Board held these depreciation rates constant in E'town

[1] See RC-ET-IN-A-19 from Infrastructure Case, Docket No. EO09010049.
[2] See RC-ET-IN-A-19 and 20 from Infrastructure Case, Docket No. EO09010049.

Docket No. GR02040245.[3] The current depreciation rates are remaining-life depreciation rates based on plant and reserve balances as of December 31, 1985. The rates include a specific component for cost of removal. The cost of removal component is the direct cause of a $57 million regulatory liability I will discuss in more detail below.

E'town's Proposed New Depreciation Rates

Q. Has E'town proposed a change in the depreciation expense component of its revenue requirement?

A. Yes. Dr. Kateregga conducted a depreciation study based on December 31, 2007 balances in which he recommended an increase to the composite depreciation rate from 3.20 percent to 3.54 percent producing a $2,374,136 depreciation increase.[4] The increase resulted primarily from Dr. Kateregga's proposed changes to service life and net salvage parameters. Dr. Kateregga also proposed a redistribution of book depreciation reserves along with amortization of several general plant accounts.[5]

Q. Subsequently, did Dr. Kateregga update his depreciation study?

A. Yes. According to Dr. Kateregga:

> During the course of conducting the 2008 Depreciation study, it was observed that there was a significant reduction in retirement activity and net salvage reported for Accounts 376.00 – Distribution Mains and 380.00 – Distribution Services over the period 2005-2007. Subsequent to the completion of the study, the Company undertook an investigation of these accounts and concluded that activity reporting for the two accounts had been understated by a combination of process and software changes, employee attrition, and contractor turnover after AGL [Atlanta Gas Light] acquired ETG. The Company provided Foster Associates additional retirements and net salvage transactions that should have been reported between 2005 and 2007 to append to the

[3] Docket No. GR02040245, Order Adopting Stipulation and Initial Decision, issued November 20, 2002, p. 2.
[4] Schedule KAK-1, p. 4.
[5] Direct Testimony of Dr. Kimbugwe Kateregga ("Exhibit P-6"), pp. 7 and 9.

depreciation study database. Upon reviewing and incorporating the additional data, Foster Associates concluded that the resulting changes in parameters were significant and should be included as revisions to the filed study.[6]

Q. What are Dr. Kateregga's changes?

A. Dr. Kateregga incorporated E'town's additional data into his analyses and as a result, he changed three of his original recommendations as follows:

1. 376 – Mains: Changed future net salvage from -50% to -25%.
2. 380 – Services: Changed future net salvage from -75% to -50%.
3. 380 – Services: Changed projection life-curve from 45-R4 to 55-L3.[7]

Q. What are the results of these changes?

A. Dr. Kateregga's changes reduce his proposed accrual by $5.1 million.[8] As a result, instead of an increase, Dr. Kateregga now proposes to reduce the composite rate from 3.21 percent to 2.84 percent.[9]

Q. Have you reached a conclusion regarding E'town's proposed depreciation change?

A. Yes. I conclude that Dr. Kateregga's depreciation rates are still too high, even with his correction of the data error discussed above. He ignored the results of his own service life studies for E'town's largest account, Account 376-Mains, and failed to explain his proposal for that account. He also ignored the impact of E'town's substantial capital and maintenance plans and programs and its recently approved infrastructure investment

[6] Supplemental Direct Testimony of Dr. Kateregga ("Exhibit P-6A"), p. 1.
[7] Exhibit P-6A, p. 2.
[8] Id.
[9] Id., p. 3.

program on service lives for this account. [10] Dr. Kateregga's net salvage proposal perpetuates the erroneous inclusion of substantial un-incurred future inflation into current customers' rates. Finally, Dr. Kateregga's reserve redistribution is an unnecessary manipulation and corroborates a need to abandon remaining life depreciation and return to whole-life depreciation.

Q. Why is it important to establish the correct depreciation rates?

A. From an accounting and technical standpoint, it is important to establish correct depreciation rates to properly match depreciation expense to the appropriate period and to avoid a build-up of a depreciation reserve imbalance resulting from overcharging or undercharging depreciation to the proper periods. From a ratemaking standpoint, it is important to establish the correct depreciation to avoid overcharging or undercharging ratepayers for depreciation expense.

Relationship of Depreciation, Cash Flow and Plant Additions

Q. Please explain the relationship of depreciation to cash flow and plant additions.

A. Depreciation is an expense included in a utility's revenue requirement without a corresponding cash outlay. The higher the depreciation expense, the higher the revenue requirement and the resulting charges to customers. Unlike payroll expense, for example, for which a utility makes actual cash payments, no cash flows out of the utility for book depreciation expense. In other words, the utility collects depreciation expense in its revenues because it does not make a cash payment for the expense. The utility retains the cash flow for any use it chooses. The higher the depreciation, the more cash it keeps.

[10] In The Matter Of The Petition Of Pivotal Holdings, Inc. d/b/a Elizabethtown Gas For Approval Of A Utility Infrastructure Enhancement Cost Recovery Rider BPU Docket Nos. EO09010049 and GO09010053.

Depreciation provides cash flow to the utility. In this case, AGL's Treasury Department centrally manages E'town's cash. Consequently, E'town transfers its depreciation-related cash to AGL's "money pool." In other words, E'town's ratepayers pay depreciation to E'town, which then transfers the cash to AGL's "money pool."[11]

Q. What is the relationship between this cash flow and plant additions?

A. Utilities typically do not specifically relate their depreciation cash flow to plant additions. Nonetheless, utilities may assert that they need depreciation cash flow to finance capital additions. When rate base is increasing, utilities may suggest that ratepayers should pay higher depreciation to help finance the increase.

Q. Does E'town assert that any there is any relationship between plant additions and depreciation cash flow?

A. No, in fact, AGL specifically denies any relationship between plant additions and depreciation.[12]

Q. Is it true that accumulated depreciation expense is an offset to rate base, and therefore, ratepayers should acquiesce to higher depreciation rates without challenge?

A. No. Although accumulated depreciation expense is an offset to rate base, it does not follow that ratepayers should be indifferent to excessive depreciation rates. The residential ratepayers' marginal cost of borrowing is much higher than E'town's; residential ratepayers use credit cards with interest rates exceeding 30 percent. Given a choice, a residential ratepayer would prefer to keep his or her money to reduce or avoid

[11] August 4, 2009 discovery meeting at E'town (August 4th meeting) – conference with AGL accounting personnel.
[12] Id.

high cost credit card interest rather than reduce E'town's marginal cost of borrowing. If there is a special need to enhance E'town's cash flow to assist with plant construction, the Board should use a mechanism that provides accountability and transparency such as the enhanced Infrastructure Rider it just approved for E'town. [13]

Q. How have you structured the rest of your testimony?

A. I begin by summarizing my adjustments. Next, I discuss my plant life recommendations, including a discussion of the impact of E'town's current plans and programs, including the recently adopted infrastructure program, on plant lives. I then make a recommendation concerning E'town's cost of removal recovery and discuss a major regulatory liability resulting from its past application of such cost of removal recovery; make a proposal relating to the regulatory liability. I discuss Dr. Kateregga's proposed depreciation reserve redistribution and a change from remaining life depreciation to whole-life depreciation. Finally, I present my depreciation rate recommendations.

Summary of Adjustments

Q. What adjustments are you proposing to make to E'town's calculation of depreciation expense?

A. I propose one adjustment to Dr. Kateregga's plant service lives: 376-Mains. This life adjustment stems from the fact that Dr. Kateregga failed to consider his own statistical life study result. He also failed to consider E'town's capital and maintenance plans and programs, and to consider the results of the Infrastructure agreement.

After the life adjustment, I am also proposing two distinct but related cost of

[13] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009.

removal adjustments. Each of these adjustments relates in some way to one fundamental fact: Dr. Kateregga does not use proper accrual accounting to calculate his proposed depreciation rates. Dr. Kateregga's approach leads E'town to over-recover amounts associated with the future cost of removal ("COR") of retired plant.

Specifically, Dr. Kateregga's method of estimating the amounts collected in depreciation rates to fund the future removal of retired plant dramatically front-loads the effects of inflation. Predictably, this error leads to excessive depreciation expense and the accumulation of excessive depreciation reserves. I implement accrual accounting consistent with generally accepted accounting principles, which in turn provides intergenerational equity. I do this by eliminating future inflation from the cost of removal amounts charged to current periods.

Then I propose the reclassification and amortization of a $57 million regulatory liability that E'town has reported pursuant to Financial Accounting Standard No. 143 ("SFAS 143") resulting from past excess collections caused by over-estimates of the future cost of removing retired plant.[14]

Finally, I recommend whole-life depreciation. Whole-life depreciation is the superior approach and its use will eliminate the need to debate the propriety of redistributing book depreciation rates.

II. ADJUSTMENT TO SERVICE LIFE FOR MAINS

Service Lives

Q. What is a service life?

[14] See response to RCR-DEP-86.

A. A service life is the period between the date a utility places an asset in service and the date it retires the same asset from service. For mass property group accounts such as mains and services, service lives are determined for depreciation purposes based on statistical analyses of the average length of time investments recorded in a given account are likely to remain in the account before the corresponding property is retired.

Q. How did Dr. Kateregga estimate plant lives?

A. Dr. Kateregga conducted statistical life studies of E'town's plant accounts using the retirement-rate or actuarial method of plant life analysis. This approach relates dollars of retirements by age groups to dollars of plant exposed to retirements in the same age groups to calculate an "observed life table" ("OLT") The next step is to smooth and extend the observed life by matching it to a family of mathematical ("Iowa") curves by the process of least squared differences.

Q. Do you normally rely on statistical results?

A. Yes, I rely on statistical analyses when appropriate. I begin by conducting a complete life analysis with as much accurate data as I have and which covers the longest possible time. I make a decision about whether I have sufficient data for fitting. If yes, I fit Iowa curves to the complete OLT. I then consider the result of this process to represent the complete historical indication. Next, I attempt to determine whether that pattern will continue in the future, or whether I should consider other factors of asset mortality. If there were no other apparent factors, I would most likely recommend the historical result. If I identify other factors, I reflect those factors in a recommendation that can be compared the original OLT with the difference being explained by the existence of the other factors.

Q. What kind of other relevant factors do you consider?

A. In general, I consider wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities such as a Company's plans, programs and/or changes in its operating environment.

Disagreement with Dr. Kateregga

Q. Please explain your disagreement with Dr. Kateregga's service life proposal for account 376-Mains.

A. Exhibit___ (MJM-2) is a copy of Dr. Kateregga's statistical analysis of account 376-Mains, after he corrected it for missing retirement data that the Company provided to him after the completion of his 2008 depreciation study. His best-fit life is 120 years combined with an SC curve. Dr. Kateregga, however, proposes a 60-year life combined with an R3 Iowa curve to calculate the remaining life of E'town's account 376-Mains. This is about one-half the correct life, as shown in his analysis.

Q. Did Dr. Kateregga provide any reasons for proposing a life about one-half of what his data supports?

A. No. Data Request RCR-DEP-50 asked Dr. Kateregga to provide, for any accounts where he "did not base his service life/curve selection on the results of his retirement rate analysis," to explain why he did not do so, and to explain the basis for the life/curve combinations he selected. The response stated in its entirety: "Service life statistics were estimated as described in Schedule KAK-1." Schedule KAK-1 contains no discussion of the basis for his service life/curve selection for Account 376 or any other specific account.

Q. Please explain your proposed adjustment to Dr. Kateregga's service life proposal for Account 376-Mains.

A. I recommend an 80-year life for account 376-Mains. Although I am unaware of any specific reason unique to E'town for not using the 120-year best-fit life, I am recommending an 80-year life for two reasons. First, as shown in the exhibit, the indication from Dr. Kateregga's first-degree fit is 80 years. Second, it is at the upper end of lives used in the industry for this account, which is a conditional limit I would have considered had I done my own analysis.

Q. Please explain the Company's current plans and operating environment that you believe Board should recognize in its consideration of estimated future average service lives for Account 376-Mains.

A. Company witness Jodi Gidley indicates that among the primary drivers of E'town's proposed increase are increased investment in infrastructure over past several years, continued investment in improving service, and increased depreciation expense.[15] Ms. Gidley explains, "Since the [2004 E'town] acquisition in 2004, [E'town] has invested over $124 million in new capital to extend service, improve operations and system reliability and upgrade equipment used by our workforce."[16] In my opinion, investment programs such as these suggest longer service lives of E'town's infrastructure because its primary assets are pipes in the ground.

Company witness Donald F. Carter describes E'town's service area and construction program.[17] He describes significant capital expenditures that I expect will

[15] Direct Testimony of Jodi Gidley ("Exhibit P-1"), p. 4.
[16] Id., p. 6.
[17] Direct Testimony of Donald F. Carter ("Exhibit P-2"), p. 4.

increase the expected service lives of the Company's investments in mains. The Union Division is a relatively mature service area where E'town makes a majority of capital expenditures to replace and upgrade aging infrastructure. E'town is currently into the 4th year of a 5-year Pipeline Replacement Program ("PRP") developed to accelerate the replacement of 8-inch elevated pressure ("EP") cast iron pipeline.[18] A majority of E'town's 2009 capital expenditures related to pipeline replacements are associated with completing the 8-inch PRP.[19] E'town's Northwest Division is a newer distribution system that is experiencing more growth than the Union Division. Most of the Northwest Division capital expenditures are associated with new business and DOT/Municipal relocation work.[20]

In past few years, an important part of E'town's capital spending program has been ongoing replacement of small and large diameter EP cast iron mains. In 2007, the Company completed a program whereby it fully replaced all of its 4- and 6-inch EP cast iron mains.[21] Beginning in 2006, E'town increased its annual spending on the replacement of large diameter EP mains in order to replace all of its 8-inch EP cast iron at a total cost of $35 million (scheduled completion in 2009.)[22]

Q. Has the Company embarked on any additional programs that will extend plant lives?

[18] Id.
[19] Id.
[20] Id.
[21] Id., p. 5.
[22] Id.

A. Yes. On October 16, 2008 New Jersey Governor Jon Corzine announced an Economic Stimulus Plan.[23] As part of that plan, he called on New Jersey gas and electric utilities to assist in promoting economic recovery in the State by increasing planned investments in necessary and beneficial utility infrastructure. In response, the BPU encouraged utilities to formulate plans for enhanced investments in infrastructure.[24] E'town's proposal was finalized and agreed to in the Board's April 28, 2009 Decision and Order Approving Stipulation in Docket Nos. EO09010049 and GO09010053. As stated in the Order:

> Looking generally at all of the infrastructure settlements before the Board, and at ETG's in particular, the Board FINDS that the infrastructure programs reviewed today, if successfully executed, will both increase employment in the State and enhance the reliability of the utilities' distribution systems. Only capital projects which enhance the reliability, safety and security of each utility's distribution system are eligible under these programs as Qualifying Projects. These are projects originally scheduled for future years which can be brought forward into the 2009-2010 time period because they have already been researched and planned by the companies. In the absence of this program, most of the projects would be completed, but only in future years.[25]

There are four projects included in E'town's Utility Infrastructure Enhancement Program:

- Replace 29 miles (20 in year 1 and 9 in year 2) of Elevated Pressure ("EP") ten-inch and twelve-inch cast iron main at an estimated cost of $25.2 million. According to the Company this will improve the reliability of E'town's system, as this type of main is prone to graphitic corrosion.

[23] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, p. 1.
[24] BPU Docket Nos. EO09010049, et al., Order Designating Commissioner, issued January 29, 2009, p. 1.
[25] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, p. 7.

- Replace 41.9 miles (11.4 in year 1 and 30.5 in year 2) of low-pressure four-inch cast iron main at an estimated cost of $15.6 million. The benefits are the same as those for the 10-inch and 12-inch EP replacement described above.
- Construct 6 miles of high pressure ("HP") eight-inch main between Sparta Township in Sussex County and Franklin Township in Hunterdon County, allowing elimination an existing 24-mile one way feed, at an estimated cost of $4.8 million. This project creates redundancy between the Vernon and Sussex gate stations.
- Construct 20 miles of HP twelve-inch main between Washington Township and Newton Township in Sussex County at an estimated cost of $14.8 million. This will permit interchangeability of supply between Tennessee, Transcontinental Gas Pipe Line LLC and Columbia Gas Transmission System.[26]

Q. What is the impact of the Infrastructure Program?

A. The Infrastructure Program in combination with E'town's other enhanced capital and maintenance programs will lengthen certain plant lives, thus reducing depreciation expense. They will lengthen plant lives because after completion, the need for immediate replacements, leaks for example, should lessen and the result of that should be longer statistical life indications. In other words, the fewer the retirements, the longer the service lives. At a minimum, it is clearly unreasonable to assume that service lives will become shorter as Dr. Kateregga has done.

[26] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, Appendix A.

E'town is replacing old, worn out inferior technologies with new modern technologies that do not have the design flaws of the assets they are replacing.[27] A majority of E'town's mains replacements are with current generation plastic pipe. Although some earlier generations may have experienced certain flaws, I am unaware of any problems relating to the current generation.[28] It is unreasonable to assume that the current plastic replacements will have a shorter life than the metallic pipes they are replacing.

Q. Is it true that these programs relate to larger diameter mains, which constitute a relatively small percentage of E'town's total miles of mains?

A. Yes, most of these relate to larger mains; but even though they constitute a small percentage of the miles, they represent a large percentage of investment dollars.

Q. Does E'town agree that Dr. Kateregga should have considered these programs in his life estimates?

A. Exhibit___ (MJM-3) is a Company response from the Infrastructure case. At a minimum, the Company recognizes that such capital, maintenance and infrastructure plans are normally considered in conjunction with a depreciation study.[29]

Q. Are you certain that Dr. Kateregga <u>did not</u> take any of this into consideration?

A. Yes. Data Request RCR-DEP-51 asked the Company to "Identify and explain all Company programs which might affect plant lives." Dr. Kateregga responded that,

[27] Confirmed in August 4th on-site meeting.
[28] Id.
[29] Infrastructure Case RC-ET-IN-A-11

"There are currently no Company programs that materially affect plant lives."[30] I disagree.

III. PROPER REFLECTION OF COST OF REMOVAL IN DEPRECIATION RATES

Excessive Cost of Removal in E'town's Depreciation Rates

Q. Please provide some background regarding your adjustment to remove inflation from Dr. Kateregga's future cost of removal estimates.

A. One of the components of Dr. Kateregga's depreciation rates is a current estimate of future cost of removal. He expressed this estimate as a ratio applied to the current plant balance. A cost of removal ratio increases the overall depreciable cost because it allocates a portion of the estimated future removal cost to each year of the asset's service life. This process is, by definition, accrual accounting.

Q. Do you object to this process?

A. No, I do not object to this process if properly applied.

Q. Has Dr. Kateregga properly implemented accrual accounting principles in developing his cost of removal estimates?

A. No. Dr. Kateregga uses a front-loaded approach that increases the current estimate of future costs of removal for a substantial amount of future inflation. In other words, Dr. Kateregga's approach charges current ratepayers on an undiscounted basis for future inflation – an un-incurred expense. Dr. Kateregga justifies this approach by erroneously claiming that charging current ratepayers for un-incurred future inflation is "accrual accounting." I disagree with Dr. Kateregga. Accrual accounting consists of matching revenues costs to the periods incurred, as opposed to cash basis accounting, which

[30] See response to RCR-DEP-51.

recognizes revenues and expenses when received or disbursed. Dr. Kateregga's approach fails that fundamental test because it front-loads future inflation to current periods, thus failing to match it to the periods incurred. That is why GAAP specifically precludes Dr. Kateregga's approach, as I explain below.

Q. How does Dr. Kateregga's approach result in inflated future cost of removal estimates?

A. Dr. Kateregga bases his future cost of removal estimates on the relationship of current cost of removal expenditures in today's dollars versus the original cost of the plant being retired expressed in old historical dollars. He calculates a ratio of current cost of removal (in today's dollars) to original cost of plant (in historical dollars). This ratio includes a substantial amount of prior cost/price increases, primarily labor, driven by inflationary pressure. He then applies that ratio to today's plant balances to project the future cost of removal. His calculation extrapolates all of the past inflation into the future and then assigns a portion of that future inflation to current costs.

Q. What is the effect of Dr. Kateregga's approach?

A. Dr. Kateregga's inflated future cost of removal rates result in a $2.6 million annual charge for future costs of removal versus the $0.6 million E'town incurs on average. This type of difference has resulted in a $57 million cost of removal regulatory liability that will increase by at least $2 million each year.[31]

Q. What adjustment is necessary to correct this flaw?

A. In order to develop the *current* dollars needed to cover the future cost of removal, Dr. Kateregga should have used the present value of the projected higher future costs that

[31] See response to RCR-DEP-86.

reflect inflation. He should have discounted those inflated amounts back to their present value. Alternatively, rather than inflating current costs to projected future costs and then discounting them back to present value, the same end can be reached by removing inflation from the projected future removal costs in the first instance.

Q. Have variants of this approach been approved in this jurisdiction?

A. Yes, several recent New Jersey rate cases reflect variants of this net salvage method. In Rockland Electric Company's 2002 rate case, I recommended the use of a net salvage allowance based on the average costs of removal actually incurred by the company over a 5-year period. The BPU endorsed my testimony regarding the use of a net salvage allowance rather than reflecting inflated future costs of removal in rates, although the Board used the average net salvage over a 10-year period, as recommended by Staff, instead of the five-year average I recommended.[32]

In Jersey Central Power & Light Company's 2002 rate case, the BPU agreed with me that the inclusion of inflated net salvage in depreciation rates was inappropriate. The Board adopted my recommendation of a $4.8 million net salvage allowance, based on the cost of removal included in JCP&L's test year budget for transmission, distribution and general plant.[33]

Atlantic City Electric Company also uses the net salvage allowance method to accrue net salvage pursuant to the settlement in the last rate case.[34] However, their previous rates did not have a provision for net salvage at all.

[32] I/M/O Rockland Electric Company, BPU Docket Nos. ER02080614 and ER02100724, Initial Decision, June 10, 2003 and Summary Order, July 31, 2003.
[33] I/M/O Jersey Central Power & Light Company, BPU Docket Nos. ER0208056, ER0208057, EO02070417 and ER02030173, Summary Order, August 1, 2003.
[34] I/M/O Atlantic City Electric Company, BPU Docket Nos. ER03020110, ER04060423, EO03020091 and EM02090633, Decision and Order Adopting Initial Decision and Stipulation of Settlement, May 26, 2005.

Q. Have any other Commissions accepted a similar net salvage allowance approach?

A. Yes. The Pennsylvania Public Utility Commission uses the normalized net salvage allowance as a matter of course. Most recently, the Delaware Public Service Commission adopted the normalized net salvage allowance approach based on the five-year average for Delmarva Power & Light, the largest electric utility in that state.[35]

Q. Can you demonstrate that using the present value approach constitutes accrual accounting and that Dr. Kateregga's approach does not constitute accrual accounting?

A. Yes. Exhibit___ (MJM-4) is a chart I designed to demonstrate those facts. It compares the collection of inflation using Dr. Kateregga's approach versus the present value accrual approach. As you can see, both Dr. Kateregga's approach and the present value approach accumulate the same amount of inflation expense at the end of the asset's life, but only the present value approach matches inflation to the periods incurred. Dr. Kateregga's approach front-loads future inflation costs into current periods, and by doing so extracts excess payments from ratepayers. Dr. Kateregga's approach overcharges ratepayers in the early years and undercharges ratepayers in the later years. This flies in the face of the "intergenerational equity" concept and accrual accounting; it stands them on their heads.

Q. Is Dr. Kateregga's approach required under the Uniform System of Accounts ("USoA")?

A. No, nothing in the USoA requires depreciation rates based on inflated future costs.

[35] I/M/O Delmarva Power & Light Company, Docket No. 05-304, Findings, Opinion and Order No. 6930, Issued June 6, 2006, page 87.

Q. Have ratepayers been harmed by Dr. Kateregga's approach?

A. Yes. As will be explained below, New Jersey ratepayers have paid E'town $57 million more than the Company's actual cost of removal and cost of removal requirements.

Q. Does Dr. Kateregga acknowledge this excess?

A. No. Dr. Kateregga does not acknowledge the excess.

Q. What do you recommend?

A. The Board should reject all of Dr. Kateregga's inflated future cost of removal estimates because he should have measured them on a present value basis.

Q. Did you ask Dr. Kateregga to calculate these present value ratios?

A. Yes. I asked him to do this in Data Request RCR-DEP-44. Dr. Kateregga admitted that his net salvage estimates incorporate future inflation, but he stated, "Absent a per-unit net salvage analysis, it is not possible to calculate the present value of future inflation from [his] historical ratios. Dr. Kateregga did not conduct a per-unit net salvage analysis."[36]

Q. Have you calculated Dr. Kateregga's future net salvage ratios on a present value basis?

A. Yes, pages 7 and 8 of Exhibit___ (MJM-8) contain those calculations. I removed the inflation from each of Dr. Kateregga's estimates. Using the Handy-Whitman Index, I measured the inflation incurred from 1999 to 2007, i.e., the 9 years Dr. Kateregga included in his net salvage studies. I used that to discount his proposals.

Q. Are your estimates perfect?

A. No estimate is perfect, but at least my estimates are theoretically superior to Dr. Kateregga's for the very simple reason that I did not include future inflation in the

[36] Response to RCR-DEP-44.

estimate. My estimates represent the present value of my future cost of removal estimates.

Q. Have you compared your future cost of removal estimates to those of Dr. Kateregga?

A. Yes. Pages 7 and 8 of Exhibit___ (MJM-8) compare my present value estimates to Dr. Kateregga's inflated estimates.

IV. REGULATORY LIABILITY RESULTING FROM EXCESSIVE COST OF REMOVAL CHARGES

Accounting Changes Requiring Reporting of Regulatory Liability

Q. Have any significant accounting changes taken place since the 1987 Order in BPU Docket No. GR86121374?

A. Yes. In 2002, the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standard No. 143, which addresses asset retirement obligations ("AROs") associated with long-lived plant.[37] SFAS No. 143 focuses primarily on legal obligations to incur a cost when an asset is retired. In this testimony I will refer to such obligations as legal asset retirement obligations ("legal AROs"). As an example, nuclear decommissioning trust funds result from a legal ARO. SFAS No. 143 considers such obligations to be a component of the original cost of the asset. It requires capitalization and depreciation of the discounted fair value of the estimated asset retirement cost over the asset's life. As the legal ARO liability increases due to inflation, it is "accreted" to income. In other words, SFAS No. 143 matches inflation to the period incurred. This matching, in turn, constitutes accrual accounting.

[37] FERC Order No. 631 is that agency's implementation of SFAS No. 143 for regulatory purposes for utility operations subject to that agency's jurisdiction.

Q. Is the legal ARO liability you just discussed a regulatory liability?

A. No. The SFAS No. 143 liability for legal AROs is the estimated current amount of the cost of the legal obligations associated with the retirement of an asset. It is not a regulatory liability.

Q. Does E'town owe the SFAS No. 143 legal ARO liability to ratepayers?

A. No. The legal SFAS No. 143 ARO liability is the estimated amount that E'town would legally be required to spend if it retired an asset today.

Q. Explain the regulatory liability that E'town does owe to ratepayers as reported in its Annual Report to Shareholders and Form 10 Ks.

Although SFAS No. 143 focused primarily on legal AROs, it also identified a significant regulatory liability resulting from public utilities' past inclusion of inflated future cost of removal and dismantlement factors in depreciation rates. FERC identified these amounts as "non-legal" AROs, meaning that the utilities do not have actual legal obligations and liabilities to incur these costs in the future. Consequently, they are not a capital cost of the asset. SFAS No. 143 requires reporting of non-legal AROs as liabilities to ratepayers-if the requirements of SFAS 71 are met.[38]

SFAS No. 143 applies to all entities subject to GAAP. That includes both competitive non-regulated entities as well as regulated public utilities such as E'town. In general, GAAP does not allow entities in general to include estimated future removal costs, inflated or not, in their depreciation rates. Regulation, on the other hand, has allowed public utilities to include allowances for removal costs in depreciation rates.

Upon implementation of SFAS No. 143, GAAP required these utilities to

[38] SFAS No. 143, paragraph B.73.

determine their SFAS 143 liability for legal AROs and compare that amount to what they had actually collected for future removal costs through depreciation rates. SFAS No. 143 requires reclassification of any excess from accumulated depreciation to a Regulatory Liability account.

Q. What was the logic for this reclassification?

A. If a non-regulated entity had mistakenly included cost of removal in its depreciation rates in the past, its depreciation rates would have been overstated and it would have understated its net income by virtue of the overstated depreciation expense. Consequently, SFAS No. 143 required the non-regulated entity to record a cumulative adjustment as an increase to income or shareholders' equity.

At the same time, GAAP recognizes the relationship between regulated utilities' costs and prices and, instead of requiring them to take these prior excess collections into income, they were required to report them as regulatory liabilities owed to ratepayers.[39] SFAS No. 143 specifically requires reporting of non-legal AROs as regulatory liabilities to ratepayers, if the requirements of SFAS No. 71 are met.[40]

Q. What conditions create a regulatory liability using GAAP?

A. SFAS 71, ¶11, provides that a regulator's rate actions impose a liability on the utility to its customers (regulatory liability) if the regulator provides "current rates intended to recover costs expected to be incurred in the future with the understanding that if those costs are not incurred, future rates will be reduced by corresponding amounts."[41] For Commission-regulated utilities, this "understanding" has been implicit. Nevertheless, the

[39] FERC identified these amounts as "non-legal" asset retirement obligations, meaning that the utilities do not have actual legal obligations and liabilities to incur these costs in the future. (FERC Order No. 631, Para. 36.)
[40] SFAS No. 143, paragraph B.73.
[41] SFAS No. 71, ¶11 and 11(b).

understanding is sufficiently clear that, in response, E'town has created a regulatory liability for GAAP financial reporting purposes. Now that SFAS No. 143 has identified the amounts, we should recognize them as the regulatory liabilities they are.

Q. Does E'town have any regulatory liabilities relating to non-legal AROs?

A. Yes. The responses to S-RDEP-10 and RCR-DEP-86 provided the E'town portions of AGL's December 31, 2006, 2007 and 2008 regulatory liabilities for cost of removal:

E'town Regulatory Liabilities Resulting from Non-Legal AROs
($millions)[42]

Year Ended 12/31	Amount
2006	$ 50.5
2007	54.6
2008	57.0

This table shows that E'town's regulatory liability grew from 2006 to 2007 and again from 2007 to 2008. While E'town did not provide the information for prior years, there is no doubt in my mind that it has grown each year since its inception.[43] In other words, since the regulatory liability has grown for AGL overall, I believe it has also grown for E'town because nothing has changed. It continues to collect the excess as plant continues to grow.

Q. What causes E'town's regulatory liability to be such a large number?

A. It is a large number due to the inflated cost of removal ratios that underlie all those prior collections. It is an excess caused primarily by something that should never have been charged to ratepayers in the first place — inflation that has not been incurred.

Q. What causes E'town's regulatory liability to increase each period?

[42] Responses to S-RDEP-10 and RCR-DEP-86.
[43] See responses to S-RDEP-10 and RCR-DEP-88.

A. E'town's cost of removal collections exceeds its actual cost of removal expenditures each period. Hence, the balance grows and grows. In other words, E'town's cost of removal regulatory liability has increased each period because E'town continually collects substantially more cost of removal cash from its customers than it actually spends, just as Dr. Kateregga proposes to continue in this proceeding.

Need for Board Recognition of the Regulatory Liability

Q. Should the Board officially recognize this regulatory liability in rates?

A. Yes. The Board should recognize E'town's non-legal ARO reserve as a regulatory liability for regulatory and ratemaking purposes. Although E'town has recognized these amounts as regulatory liabilities in its annual GAAP reports, it has not done so for regulatory and ratemaking purposes.

Q. Should the Board require separate identification and reporting of these amounts?

A. Yes. It is critical that the Board require E'town to explicitly identify and report this regulatory liability and all related activity in all future reports, rate cases and depreciation studies that it files. The Board should require prominent disclosure of its explicit recognition of this amount as an intrastate regulatory liability in E'town's future regulatory reports to the BPU to ensure sufficient recognition of and transparency concerning these amounts.

They are hidden from the ratemaking process and regulatory scrutiny in New Jersey unless they are separately identified and reported. Were it not for my testimony, the issue would not have come before the Board in this proceeding even though E'town has built a $57 million regulatory liability for gas plant with no explicit plan either to return the money or to spend the money for cost of removal.

Q. Would it be sufficient to report the item as a "deferred credit"?

A. No. A deferred credit is an accounting mechanism that defers income on the balance sheet, which is then ultimately flowed into income over time. Treatment as a deferred credit would fail to address the core issue. As I indicated, E'town will take a deferred credit into income. A deferred credit does not have the ratemaking status of a regulatory liability. A regulatory liability is an amount owed to ratepayers. E'town collected the money at issue here for a particular purpose and if not used for that purpose it should reduce future rates, as described in SFAS No. 71, ¶11. However, E'town could easily assert in the future that ratepayers have no claim to a deferred credit. The Board must specifically recognize and require reporting by E'town of the $57 million as a regulatory liability for regulatory and ratemaking purposes.

Q. What is wrong with continuing to record the regulatory liability as accumulated depreciation?

A. E'town and all utilities consider accumulated depreciation to represent the measure of their capital that they have recovered from their ratepayers. As simplistic as it sounds, utilities consider any amount in accumulated depreciation to be "their money" even if they collected it for an estimated un-incurred future cost.

Q. Is it true that ratepayers are better off because accumulated depreciation is a rate base deduction?

A. No, that is not true. Accumulated depreciation is indeed a rate base deduction, but a regulatory liability can (and should) also be a rate base deduction. This is a false distinction between the two approaches.

Q. Does E'town agree that its collections for non-legal AROS result in a regulatory liability?

A. E'town agrees that it has a regulatory liability for GAAP purposes since it reported it in its GAAP financial statements. However, it does not agree that it has a regulatory liability for regulatory accounting and ratemaking purposes. In Exhibit___ (MJM-5) E'town denies that it has any regulatory liability for its excess collections.[44] Furthermore, on August 4, 2009 I had a discussion with both E'town and AGL personnel. AGL denied having a liability to ratepayers and E'town said the $57 million represented capital recovery.[45]

E'town's response explains why it is necessary for the Board to recognize the regulatory liability. It denies the obvious in this rate proceeding.

E'town's GAAP financial statements report a $57 million regulatory liability for cost of removal as of December 31, 2008. Given that E'town can only create a regulatory liability consistent with the letter and spirit of SFAS No. 71, the Company must have determined (at least for financial reporting purposes) that, in its management's judgment, the amounts it has collected but not yet spent for costs of removal are "probable" of being credited to ratepayers through the ratemaking process. SFAS No. 71 clarifies that the phrase "credited to ratepayers" means "if those costs are not incurred, future rates will be reduced by corresponding amounts."[46] E'town does agree that both GAAP and the SEC recognize this fact, and in order to get a "clean" audit opinion, it must report the amount as a regulatory liability as long as it remains regulated, and subject to cost-based rate

[44] Response to RCR-DEP-92.
[45] August 4th meeting.
[46] SFAS No. 71, ¶11b.

base/rate of return regulation.

Q. Why did you emphasize the proviso "as long as it remains regulated and subject to cost-based, rate base/rate of return regulation"?

A. The Edison Electric Institute and several individual utilities fought hard before FASB and FERC to avoid the identification and reporting of the regulatory liability that I have just described. They won at the FERC level and lost at the FASB level. I am concerned because, if E'town were to be deregulated or if regulation were to change from "cost-based" to some form of alternative "price-based" regulation, history tells us the Company would have every interest in immediately transferring its $57 million regulatory liability into its GAAP income. This amount could well disappear from the scene unless the Board protects it on behalf of ratepayers.

Q. Why do you believe that E'town would transfer its $57 million non-legal regulatory liability into GAAP income?

A. E'town will transfer the regulatory liability into GAAP income because that is what GAAP requires. If utilities are deregulated, or if regulation changes significantly, the provisions of SFAS No. 71 will no longer apply. The regulatory liability amount will flow immediately and explicitly to GAAP income, because SFAS No. 143 requires it to flow to income if it is not payable to ratepayers. This is what electric utilities did when their production plants were deregulated.

After that, E'town could assert that any attempt by the Board to get the money back constitutes an unlawful taking. The urgency for the Board to declare this as a regulatory liability for regulatory and ratemaking purposes has never been so great. Therefore, E'town must specifically designate this amount as a regulatory liability for

ratemaking purposes.

Q. Do you have any evidence to corroborate the money is at risk?

A. Yes. Two recent events have underscored the need to protect this money: the impending move from GAAP to International Financial Reporting Standards ("IFRS") and a filing by Georgia Power asking to amortize its cost of removal regulatory liability back to itself.

Q. Please explain your concerns regarding IFRS.

A. Any time a company moves away from rate base regulation its regulatory liabilities are at risk. For instance, upon adoption of alternative regulation, the telephone industry took $11.5 billion of its excess collections into equity. The U.S. is moving towards adopting IFRS in place of GAAP. Currently IFRS does not provide for regulatory liabilities, such as the cost of removal liability. However, on July 23, 2009 the International Accounting Standards Board ("IASB") published for public comment an Exposure Draft on Rate-Regulated Activities. Based on this Exposure Draft, regulatory assets and liabilities will be allowed but they must be reported "at the expected present value of the cash flows to be recovered or refunded as a result of regulation, both on initial recognition and at the end of each subsequent reporting period."[47] This major accounting change will put the $57 million into further jeopardy, as it means that utilities will take into income all amounts over the present value of the liability.

Exhibit___ (MJM-6) contains two recent articles from the Public Utilities Fortnightly.[48] The first article is by Mr. Ferguson who is a depreciation witness that regularly testifies on behalf of utilities and regularly advocates that they continue to

[47] IASB July 2009 Exposure Draft – Rate-regulated Activities, p. 9.
[48] John Ferguson, "Fixing Depreciation Accounting", Public Utility Fortnightly, October 2008, pp. 16-20 and Scott Hartman, "Ready for IFRS?", Public Utility Fortnightly, January 2009, pp. 10-16.

collect the excess cost of removal I have discussed. In November 2008, Mr. Ferguson proposed that when these companies move to the new set of accounting standards, IFRS, the utilities should transfer the regulatory liabilities to their equity accounts. In the second article, Mr. Hartman from the accounting firm of Ernst & Young says the same thing.

Q. Is IFRS something new?

A. The accounting profession and the SEC have been considering a switch from GAAP to IFRS for some time.

Q. What will be the effect?

A. In my opinion, what GAAP has brought – i.e., identification of the SFAS No. 143 Regulatory Liability - IFRS will take away by transferring it to equity – at least to the extent the actual regulatory liability exceeds the present value of the refundable cash flow.

Q. But won't that be merely for financial purposes?

A. Once E'town takes that money into income, there is no longer any remedy for ratepayers. E'town may consider any regulatory attempt in the future to recover the money, whether through depreciation or otherwise, as a "taking" of property or "confiscation of capital."

Q. Please discuss the recent filing by Georgia Power.

A. On June 29, 2009 Georgia Power filed a request with the Georgia Public Service Commission asking the Commission to approve and enter an Accounting Order allowing the Company to amortize over 18 months approximately $324 million of the Company's

retail regulatory liability for costs of removal to partially offset operating expenses for 2009 and 2010.[49] I have attached the Company's request as Exhibit___ (MJM-7).

In Georgia Power's 2001 base rate case, the Commission changed the method the Company uses to collect for cost of removal. It bases the allowance on the 10-year historical average of its actual removal costs. The Commission did not make any changes or requirements relating to the existing cost of removal reserve.[50] Georgia Power's June 29, 2009 Application requested that approval to transfer the bulk of its cost of removal regulatory liability from account 108 – Accumulated Depreciation to account 254 – Other regulatory liabilities and then begin amortizing that regulatory liability over 18 months.[51]

Q. Did Georgia Power propose to amortize that regulatory liability back to ratepayers, as one would expect regarding the amortization of a regulatory liability (an amount owed to ratepayers)?

A. No. Georgia Power was not proposing to amortize the amount back to ratepayers. Georgia Power was asking to amortize the amount into its own income between rate cases.[52]

> By amortizing the other COR over the 18-month period in addition to the many cost controls already initiated, the Company's expenses would be reduced without impairing the Company's ability to fulfill its asset removal obligations on a timely basis. This adjustment would move the Company's retail return on equity closer to the 10.25 percent lower end of the ROE range allowed by

[49] Georgia Power Company's Request for an Accounting Order to Amortize a Portion of Its Regulatory Liability for Accrued Removal Costs, GA PSC Docket No. ____-U, issued June 29, 2009, p. 1. Attached as Exhibit___ (MJM-7). It is my understanding this was resolved without being docketed.
[50] Id., p. 7.
[51] Id.
[52] Id., pp. 7-8.

> the Commission, which the Company believes will help support the capital market access it currently enjoys.[53]

Q. What does this mean?

A. Georgia Power demonstrated its intent on taking the over-collections for cost of removal into its own income without recognizing this in its service rates to customers. Despite prior claims that the collections were necessary to ensure they would have sufficient funds available to remove retired plant when needed, it wants to keep the money. It also showed a willingness to admit that collecting cost of removal based on average experience is not going to lead the Company to certain financial ruin, as some have claimed. Finally, it underscores the need for the Commission to be proactive in protecting the money for ratepayers.

Q. Would Georgia Power's proposed amortization have any other negative impacts on ratepayers?

A. Yes. Georgia Power's proposal to remove these amounts from accumulated depreciation outside of a rate case would increase both depreciation expense and rate base, without any benefit flowing to ratepayers. Ratepayers would lose all the excess money they provided to Georgia Power for inflated future removal costs and rate base will increase.

Q. What would happen to rate base under Georgia Power's proposal?

A. Rate base would immediately increase between rate cases. Ratepayers would lose the excessive money they paid for cost of removal and Georgia Power would penalize them with a correspondingly higher rate base.

Q. Is E'town aware of the Georgia Power application?

[53] Id., pp. 7-8.

A. I am not sure about E'town employees, but on August 4, 2009, AGL accounting personnel explained that they were aware.[54]

Q. What is the appropriate treatment of E'town's non-legal ARO regulatory liability?

A. The Board must separate E'town's non-legal ARO regulatory liability from accumulated depreciation. The appropriate accounting entry is a debit to account 108 - Accumulated Depreciation and an equivalent credit to account 254–Other regulatory liabilities.

Q. Do you have any recent examples?

A. Yes. New Jersey Natural Gas recently agreed in Settlement to reduce its overall depreciation rate from the previously approved 3.0 percent to 2.34 percent, and to amortize to income the costs associated with the non-legal asset retirement obligation ("ARO") of approximately $79 million over 48.26 years, resulting in an annual amortization of $1.649 million.[55] The settlement properly reflected the amortization in customer rates.

In New Jersey American Water's recent case, the parties stipulated in Settlement that the Company's water composite depreciation rate would remain at 2.33%. This reflected a $48,000,000 return to customers at $1,200,000 per year over forty (40) years, of "Non-Legal Asset Retirement Obligation." It also included, an Average Net Negative Salvage Allowance method calculated over 5 years.[56]

[54] August 4th on-site meeting.
[55] I/M/O New Jersey Natural Gas Company, BPU Docket No. GR07110889, Stipulation of Settlement on Revenue Requirement, Policy Issues and Depreciation Rates, July 30, 2008, p. 5, item B.
[56] I/M/O New Jersey American Water Company, Inc., BPU Docket No. WR08010020, Stipulation, issued November 12, 2008, p. 5.

Return of the Existing Regulatory Liability to Ratepayers

Q. What should the Board do with E'town's regulatory liability on a going-forward basis?

A. The Board should amortize it back to ratepayers over the average remaining life of E'town's plant, but it is critical that service rates reflect the amortization. Otherwise, the amount should remain as a rate base reduction in perpetuity.

Q. Is the amortization a form of retroactive ratemaking?

A. No. It is merely an amortization netted against depreciation expense.

Q. What amortization period do you recommend?

A. I propose a remaining life amortization period, which would set the annual amortization amount to approximately $1.6 million per year.

V. RESERVE REDISTRIBUTION AND WHOLE LIFE VERSUS REMAINING LIFE DEPRECIATION

Q. Dr. Kateregga proposes a redistribution of book reserves. Do you agree with this adjustment?

A. No.

Q. Please explain the controversy and confusion surrounding Dr. Kateregga's reserve redistributions.

A. E'town maintains its book reserve by plant account. Because Dr. Kateregga proposes remaining life depreciation, the level of the reserve for each individual account becomes critical.

Q. What is the difference between the recorded book reserves and Dr. Kateregga's redistributed reserves?

A. The recorded book reserves are what are on E'town's books. Dr. Kateregga's redistributed reserves result from shifting recorded book reserves according to his individual computed theoretical reserves. This shifting is not necessary, it is subjective, and it gives rise to potential disputes about the propriety and magnitude of his redistributions.

Q. What's the harm of such redistributions?

A. Company consultants use these redistributions in conjunction with remaining life depreciation. It is possible through careful manipulation to assign more book reserve to large accounts with long lives, mains for example, and less to smaller accounts with shorter lives, computers for example. Suppose, for example, a company has a rate base consisting of two accounts: Mains, with a plant balance of $1000, and Computers, with an account balance of $100. Suppose further that Mains have a service life of 100 years and a remaining life of 50 years, and Computers have a service life of 10 years and a remaining life of 1 year. Finally, suppose that each account has a book reserve of $100, for a $200 total book reserve.

Under this scenario, the depreciation accruals for each account using the remaining life method would be as follows:

Mains: ($1000 - $100) /50 = $18

Computers: ($100 - $100)/1 = $0

Dr. Kateregga's methodology would re-allocate the total reserves of $200, based on the ratio of the "theoretical reserve" for each account ($500 for Mains and $90 for Computers to the total theoretical reserve ($590.) As a result, the book reserve for Mains would become $169.49, and the book reserve for Computers would become $30.51, resulting in

the same overall $200 book reserve, but with the following annual accruals:

Mains: ($1000 - $169.49)/50 - $16.61

Computers: ($100 - $30.51)/1 = $69.49

As shown in the above example, the total depreciation accrual would jump from $18.00 to $86.10 ($16.61 + $69.49.) The computer depreciation expense increases substantially, while mains depreciation expense is only impacted slightly.

Redistributions such as the one proposed by Dr. Kateregga could result in large increases in depreciation expenses for smaller accounts with shorter lives, which could drive an overall depreciation expense increase.

Q. Are Dr. Kateregga's redistributions necessary?

A. The reserve redistributions are not necessary, and Dr. Kateregga appears to acknowledge this. Dr. Kateregga specifically states:

> Although reserve records are typically maintained by various account classifications, the sum of all reserves [total] is the most important measure of the status of a company's depreciation practices and procedures.[57]

Q. Do you recommend an alternative to Dr. Kateregga's proposed redistribution of individual account reserves?

A. Yes. I recommend that E'town discontinue the use of remaining life depreciation and instead use whole-life depreciation.

Q. What is the difference between whole-life and remaining life depreciation rates?

A. A whole life rate is the reciprocal of the average service life. In other words, if the service life is 10 years, the whole life depreciation rate is one-tenth or 10 percent. The

[57] Exhibit P-6, p. 4.

remaining life technique is merely a mechanism to account for reserve imbalances resulting from changes to prior depreciation parameter estimates. A remaining life rate is the net plant (gross plant minus accumulated depreciation) divided by the remaining life of the plant account. In theory, a whole-life rate and remaining life rate are the same if there is no reserve imbalance. On the other hand, if a reserve imbalance does exist, the remaining life rate will be either higher or lower than the whole life rate depending on the direction of the imbalance.

Q. Does Dr. Kateregga agree that the difference between whole-life and remaining life depreciation is solely to amortize his reserve deficiency?

A. Yes. Dr. Kateregga states:

> Depreciation Rates recommended in the 2008 study were developed using a system composed of the straight-line method, vintage group procedure, remaining-life technique. This formulation of the accrual rate is equivalent to a straight-line method, vintage group procedure, whole-life technique with amortization of reserve imbalances over the estimated composite remaining life of each rate category.[58]

Q. Why do you propose replacement of remaining life depreciation with whole life depreciation?

A. I make this recommendation for several reasons. First, whole life depreciation is superior to remaining life depreciation for new additions to plant. While a remaining life rate may be adequate for existing plant, it is wholly inappropriate for new additions; it will create even more imbalances on a going-forward basis. A whole life rate is a superior rate because it is appropriate for both existing plant and new additions to plant. Second, I do not have any faith in the reserves Dr. Kateregga uses to calculate his remaining life

[58] Schedule KAK-1, p. 13, emphasis added.

depreciation rates. Most importantly, in the future, depreciation rates approved here may be used in calculations such as the Infrastructure rider. It is imperative that the whole life rate be used in those circumstances because they are applied to incremental plant, which by definition does not have any associated reserve imbalance.

Q. Can you demonstrate that whole life is superior to remaining life?

A. Yes. Consider an example in which a $1,000 asset initially assumed to have a 20-year life was depreciated using a 5% depreciation rate.[59] After 10 years, the accumulated depreciation would be $500 or 50 percent of the original $1,000 cost. Now assume, that at the end of 10 years, it is determined that the life is going to be 15-years rather than 20-years. The existing depreciation reserve is immediately deficient, based on the new life assumption. The new whole-life rate is 6.7 percent.[60] The remaining life rate, however, would be 10 percent.[61] The 6.7 percent whole-life rate reflects the life anticipated for both the original $1,000 asset and any additional assets going-forward. Hence, it is appropriate for all assets in the account. The 10 percent rate is only appropriate for the initial $1,000 asset; it is inappropriate for the new assets. Application of the 10 percent to new assets will create reserve excesses for those assets.

Q. Will the reserve excesses on new assets offset the reserve deficiency on the original assets?

A. In theory – yes. However, one should have confidence in the book reserve to begin with. E'town maintains its book reserve by FERC plant account.[62] In this case, Dr. Kateregga has redistributed book reserves among accounts. I do not have confidence in these

[59] 1/20 years = 5.0%
[60] 1/15 years = 6.7%.
[61] (100%-50%)/5 years=10%
[62] Response to RCR-DEP-24.

redistributed amounts.

Q. Have you accepted the remaining life technique in other proceedings?

A. Yes, I have accepted remaining life depreciation in numerous proceedings.

Q. If you have accepted remaining life depreciation in numerous proceedings, why are you proposing to discontinue its use in this proceeding?

A. Initially, my driving impetus was to eliminate confusion and controversy surrounding Dr. Kateregga's numerous depreciation reserve redistributions. However, after considering the relative merits of whole life with a separate amortization versus remaining life, I consider the former to be a theoretically superior approach and recommend that the Board adopt it.

Q. If a whole life rate is appropriate, how can the Board deal with a reserve imbalance?

A. If there is a significant reserve imbalance, as there is in this proceeding, the Board can adopt a separate amortization of the imbalance. This will provide the appropriate depreciation rate for both existing plant and new additions going forward, and still amortize the imbalance.

Q. Is there precedent for such an approach in New Jersey?

A. Yes. The Board approved settlements incorporating these features in the recent Rockland Electric (Docket Nos.ER02080614 and ER02100724) and Atlantic City Electric (Docket No. ER03020110 et. al.) rate cases.

Q. What do you conclude?

A. The Board should adopt whole life depreciation rates. Whole life depreciation rates are superior to remaining life depreciation rates. The use of whole life depreciation rates will eliminate controversy surrounding individual reserve redistributions. The Board should

separately amortize significant reserve imbalances at the total book level.

VI. SUMMARY OF RECOMMENDATIONS

Q. Have you prepared a summary of your recommendations?

A. Yes. Exhibit___ (MJM-8) shows the calculation of my recommended rates and expense. My recommended net depreciation and amortization expense for plant is $16.7 million, or $5.8 million less than the Company's current depreciation of $22.5 million, based on December 31, 2007 plant balances.[63] Exhibit___ (MJM-8) also shows my recommended $1.6 million amortization of the regulatory liability for cost of removal, thus resulting in a net $15.1 million depreciation and amortization expense.

Q. Does this conclude your testimony?

A. Yes, it does.

[63] Schedule KAK-1A, Statement B, page 5.

BEFORE THE STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW
BOARD OF PUBLIC UTILITIES

IN THE MATTER OF THE PETITION	**) BPU DKT. NO. GR09030195**
OF PIVOTAL UTILITY HOLDINGS, INC.	**) OAL DKT. NO. PUC-03655-2009N**
D/B/A ELIZABETHTOWN GAS FOR	**)**
APPROVAL OF INCREASED BASE TARIFF	**)**
RATES AND CHARGES FOR GAS SERVICE	**)**
AND OTHER TARIFF REVISIONS	

DIRECT TESTIMONY OF MICHAEL J. MAJOROS, JR.
ON BEHALF OF THE
NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE
DIVISION OF RATE COUNSEL

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Direct Testimony
Of
Michael J. Majoros, Jr.

I. INTRODUCTION

Background and Qualifications

Q. State your name.

A. Michael J. Majoros, Jr.

Q. Who is your employer, and what is your position?

A. I am Vice President of Snavely King Majoros O'Connor & Bedell, Inc. ("Snavely King"), located at 1111 14th Street, N.W., Suite 300, Washington, D.C. 20005.

Q. Describe Snavely King.

A. Snavely King is a small, diverse and veteran-owned Economic and Management Consulting firm founded in 1970 in Washington D.C. Snavely King conducts economic, accounting and technical analyses and research into the costs, rates, revenues, and economic performance of companies in the power, transportation, water and wastewater, public utility and telecommunications industries.

For almost four decades, Snavely King has analyzed and translated the effects of alternative regulatory ratemaking policies and free market practices into their practical cost and pricing consequences. The firm's clients include federal and state government agencies, businesses and individuals. Over the course of its 39-year history, members of the firm have participated in more than 1,000 proceedings before almost all of the state commissions and all Federal commissions that regulate prices in the utilities and transportation industries. Snavely King believes in accountability, fair competition and effective regulation.

Snavely King has also assisted a multitude of non-ratemaking organizations including the U.S. Department of Justice, U.S. Department of Defense, the General Services Agency, the U.S. Environmental Protection Agency, the Maryland Senate and House of Delegates, the Sierra Club and the National Parks Conservation Association.

Snavely King's subject matter experts include professional economists, MBAs, CPAs, attorneys, scientists, engineers, IT professionals, cost analysts and experts in utility finance and operations. Snavely King currently has a Washington D.C. complement of thirteen experts.

Q. Have you prepared a summary of your qualifications and experience?

A. Yes, Appendix A is a summary of my qualifications and experience. Appendix B is a tabulation of my appearances as an expert witness before state and Federal regulatory agencies.

Q. At whose request are you appearing in this proceeding?

A. I am appearing on behalf of the New Jersey Department of the Public Advocate, Division of Rate Counsel ("Rate Counsel").

Q. What is the subject of your testimony?

A. My testimony addresses depreciation.

Q. Do you have any specific experience in the field of public utility depreciation?

A. Yes, among other things, Snavely King specializes in the field of public utility depreciation. We have appeared as expert witnesses on this subject before the regulatory commissions of almost every state in the country as well as several Federal commissions. I have testified in over 100 proceedings on the subject of public utility depreciation,

including several appearances before the New Jersey Board of Public Utilities ("BPU" or "Board").

Q. How many times have you addressed public utility depreciation in New Jersey proceedings?

A. I have appeared in more than twenty New Jersey proceedings on the subject of public utility depreciation. These proceedings have addressed electric, gas, water, telephone and waste removal utilities.

Purpose of Testimony

Q. Explain the purpose of your testimony in this proceeding.

A. Rate Counsel asked me to review Elizabethtown Gas Company's ("E'town," or "the Company") depreciation-related testimony and exhibits. Company witness Dr. Kimbugwe Kateregga prepared E'town's depreciation testimony. I am to express an opinion regarding the reasonableness of the Company's depreciation proposal and, if warranted, make alternative recommendations.

E'town's Current Depreciation Rates

Q. When did the Board approve E'town's current depreciation rates?

A. The BPU established E'town's current depreciation rates in a 1987 rate case – Docket No. GR86121374.[1] Exhibit___ (MJM-1) contains a copy of selected pages from the ALJ's ruling establishing rates for all plant accounts in that proceeding. It also includes the rates themselves from the Direct Testimony of Robert Nottingham, the staff witness that calculated the rates.[2] The Board held these depreciation rates constant in E'town

[1] See RC-ET-IN-A-19 from Infrastructure Case, Docket No. EO09010049.
[2] See RC-ET-IN-A-19 and 20 from Infrastructure Case, Docket No. EO09010049.

Docket No. GR02040245.[3] The current depreciation rates are remaining-life depreciation rates based on plant and reserve balances as of December 31, 1985. The rates include a specific component for cost of removal. The cost of removal component is the direct cause of a $57 million regulatory liability I will discuss in more detail below.

E'town's Proposed New Depreciation Rates

Q. Has E'town proposed a change in the depreciation expense component of its revenue requirement?

A. Yes. Dr. Kateregga conducted a depreciation study based on December 31, 2007 balances in which he recommended an increase to the composite depreciation rate from 3.20 percent to 3.54 percent producing a $2,374,136 depreciation increase.[4] The increase resulted primarily from Dr. Kateregga's proposed changes to service life and net salvage parameters. Dr. Kateregga also proposed a redistribution of book depreciation reserves along with amortization of several general plant accounts.[5]

Q. Subsequently, did Dr. Kateregga update his depreciation study?

A. Yes. According to Dr. Kateregga:

> During the course of conducting the 2008 Depreciation study, it was observed that there was a significant reduction in retirement activity and net salvage reported for Accounts 376.00 – Distribution Mains and 380.00 – Distribution Services over the period 2005-2007. Subsequent to the completion of the study, the Company undertook an investigation of these accounts and concluded that activity reporting for the two accounts had been understated by a combination of process and software changes, employee attrition, and contractor turnover after AGL [Atlanta Gas Light] acquired ETG. The Company provided Foster Associates additional retirements and net salvage transactions that should have been reported between 2005 and 2007 to append to the

[3] Docket No. GR02040245, Order Adopting Stipulation and Initial Decision, issued November 20, 2002, p. 2.
[4] Schedule KAK-1, p. 4.
[5] Direct Testimony of Dr. Kimbugwe Kateregga ("Exhibit P-6"), pp. 7 and 9.

depreciation study database. Upon reviewing and incorporating the additional data, Foster Associates concluded that the resulting changes in parameters were significant and should be included as revisions to the filed study.[6]

Q. What are Dr. Kateregga's changes?

A. Dr. Kateregga incorporated E'town's additional data into his analyses and as a result, he changed three of his original recommendations as follows:

1. 376 – Mains: Changed future net salvage from -50% to -25%.
2. 380 – Services: Changed future net salvage from -75% to -50%.
3. 380 – Services: Changed projection life-curve from 45-R4 to 55-L3.[7]

Q. What are the results of these changes?

A. Dr. Kateregga's changes reduce his proposed accrual by $5.1 million.[8] As a result, instead of an increase, Dr. Kateregga now proposes to reduce the composite rate from 3.21 percent to 2.84 percent.[9]

Q. Have you reached a conclusion regarding E'town's proposed depreciation change?

A. Yes. I conclude that Dr. Kateregga's depreciation rates are still too high, even with his correction of the data error discussed above. He ignored the results of his own service life studies for E'town's largest account, Account 376-Mains, and failed to explain his proposal for that account. He also ignored the impact of E'town's substantial capital and maintenance plans and programs and its recently approved infrastructure investment

[6] Supplemental Direct Testimony of Dr. Kateregga ("Exhibit P-6A"), p. 1.
[7] Exhibit P-6A, p. 2.
[8] Id.
[9] Id., p. 3.

program on service lives for this account. [10] Dr. Kateregga's net salvage proposal perpetuates the erroneous inclusion of substantial un-incurred future inflation into current customers' rates. Finally, Dr. Kateregga's reserve redistribution is an unnecessary manipulation and corroborates a need to abandon remaining life depreciation and return to whole-life depreciation.

Q. Why is it important to establish the correct depreciation rates?

A. From an accounting and technical standpoint, it is important to establish correct depreciation rates to properly match depreciation expense to the appropriate period and to avoid a build-up of a depreciation reserve imbalance resulting from overcharging or undercharging depreciation to the proper periods. From a ratemaking standpoint, it is important to establish the correct depreciation to avoid overcharging or undercharging ratepayers for depreciation expense.

Relationship of Depreciation, Cash Flow and Plant Additions

Q. Please explain the relationship of depreciation to cash flow and plant additions.

A. Depreciation is an expense included in a utility's revenue requirement without a corresponding cash outlay. The higher the depreciation expense, the higher the revenue requirement and the resulting charges to customers. Unlike payroll expense, for example, for which a utility makes actual cash payments, no cash flows out of the utility for book depreciation expense. In other words, the utility collects depreciation expense in its revenues because it does not make a cash payment for the expense. The utility retains the cash flow for any use it chooses. The higher the depreciation, the more cash it keeps.

[10] In The Matter Of The Petition Of Pivotal Holdings, Inc. d/b/a Elizabethtown Gas For Approval Of A Utility Infrastructure Enhancement Cost Recovery Rider BPU Docket Nos. EO09010049 and GO09010053.

Depreciation provides cash flow to the utility. In this case, AGL's Treasury Department centrally manages E'town's cash. Consequently, E'town transfers its depreciation-related cash to AGL's "money pool." In other words, E'town's ratepayers pay depreciation to E'town, which then transfers the cash to AGL's "money pool."[11]

Q. What is the relationship between this cash flow and plant additions?

A. Utilities typically do not specifically relate their depreciation cash flow to plant additions. Nonetheless, utilities may assert that they need depreciation cash flow to finance capital additions. When rate base is increasing, utilities may suggest that ratepayers should pay higher depreciation to help finance the increase.

Q. Does E'town assert that any there is any relationship between plant additions and depreciation cash flow?

A. No, in fact, AGL specifically denies any relationship between plant additions and depreciation.[12]

Q. Is it true that accumulated depreciation expense is an offset to rate base, and therefore, ratepayers should acquiesce to higher depreciation rates without challenge?

A. No. Although accumulated depreciation expense is an offset to rate base, it does not follow that ratepayers should be indifferent to excessive depreciation rates. The residential ratepayers' marginal cost of borrowing is much higher than E'town's; residential ratepayers use credit cards with interest rates exceeding 30 percent. Given a choice, a residential ratepayer would prefer to keep his or her money to reduce or avoid

[11] August 4, 2009 discovery meeting at E'town (August 4th meeting) – conference with AGL accounting personnel.
[12] Id.

high cost credit card interest rather than reduce E'town's marginal cost of borrowing. If there is a special need to enhance E'town's cash flow to assist with plant construction, the Board should use a mechanism that provides accountability and transparency such as the enhanced Infrastructure Rider it just approved for E'town. [13]

Q. How have you structured the rest of your testimony?

A. I begin by summarizing my adjustments. Next, I discuss my plant life recommendations, including a discussion of the impact of E'town's current plans and programs, including the recently adopted infrastructure program, on plant lives. I then make a recommendation concerning E'town's cost of removal recovery and discuss a major regulatory liability resulting from its past application of such cost of removal recovery; make a proposal relating to the regulatory liability. I discuss Dr. Kateregga's proposed depreciation reserve redistribution and a change from remaining life depreciation to whole-life depreciation. Finally, I present my depreciation rate recommendations.

Summary of Adjustments

Q. What adjustments are you proposing to make to E'town's calculation of depreciation expense?

A. I propose one adjustment to Dr. Kateregga's plant service lives: 376-Mains. This life adjustment stems from the fact that Dr. Kateregga failed to consider his own statistical life study result. He also failed to consider E'town's capital and maintenance plans and programs, and to consider the results of the Infrastructure agreement.

After the life adjustment, I am also proposing two distinct but related cost of

[13] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009.

removal adjustments. Each of these adjustments relates in some way to one fundamental fact: Dr. Kateregga does not use proper accrual accounting to calculate his proposed depreciation rates. Dr. Kateregga's approach leads E'town to over-recover amounts associated with the future cost of removal ("COR") of retired plant.

Specifically, Dr. Kateregga's method of estimating the amounts collected in depreciation rates to fund the future removal of retired plant dramatically front-loads the effects of inflation. Predictably, this error leads to excessive depreciation expense and the accumulation of excessive depreciation reserves. I implement accrual accounting consistent with generally accepted accounting principles, which in turn provides intergenerational equity. I do this by eliminating future inflation from the cost of removal amounts charged to current periods.

Then I propose the reclassification and amortization of a $57 million regulatory liability that E'town has reported pursuant to Financial Accounting Standard No. 143 ("SFAS 143") resulting from past excess collections caused by over-estimates of the future cost of removing retired plant.[14]

Finally, I recommend whole-life depreciation. Whole-life depreciation is the superior approach and its use will eliminate the need to debate the propriety of redistributing book depreciation rates.

II. ADJUSTMENT TO SERVICE LIFE FOR MAINS

Service Lives

Q. What is a service life?

[14] See response to RCR-DEP-86.

A. A service life is the period between the date a utility places an asset in service and the date it retires the same asset from service. For mass property group accounts such as mains and services, service lives are determined for depreciation purposes based on statistical analyses of the average length of time investments recorded in a given account are likely to remain in the account before the corresponding property is retired.

Q. How did Dr. Kateregga estimate plant lives?

A. Dr. Kateregga conducted statistical life studies of E'town's plant accounts using the retirement-rate or actuarial method of plant life analysis. This approach relates dollars of retirements by age groups to dollars of plant exposed to retirements in the same age groups to calculate an "observed life table" ("OLT") The next step is to smooth and extend the observed life by matching it to a family of mathematical ("Iowa") curves by the process of least squared differences.

Q. Do you normally rely on statistical results?

A. Yes, I rely on statistical analyses when appropriate. I begin by conducting a complete life analysis with as much accurate data as I have and which covers the longest possible time. I make a decision about whether I have sufficient data for fitting. If yes, I fit Iowa curves to the complete OLT. I then consider the result of this process to represent the complete historical indication. Next, I attempt to determine whether that pattern will continue in the future, or whether I should consider other factors of asset mortality. If there were no other apparent factors, I would most likely recommend the historical result. If I identify other factors, I reflect those factors in a recommendation that can be compared the original OLT with the difference being explained by the existence of the other factors.

Q. What kind of other relevant factors do you consider?

A. In general, I consider wear and tear, decay, action of the elements, inadequacy, obsolescence, changes in the art, changes in demand and requirements of public authorities such as a Company's plans, programs and/or changes in its operating environment.

Disagreement with Dr. Kateregga

Q. Please explain your disagreement with Dr. Kateregga's service life proposal for account 376-Mains.

A. Exhibit___ (MJM-2) is a copy of Dr. Kateregga's statistical analysis of account 376-Mains, after he corrected it for missing retirement data that the Company provided to him after the completion of his 2008 depreciation study. His best-fit life is 120 years combined with an SC curve. Dr. Kateregga, however, proposes a 60-year life combined with an R3 Iowa curve to calculate the remaining life of E'town's account 376-Mains. This is about one-half the correct life, as shown in his analysis.

Q. Did Dr. Kateregga provide any reasons for proposing a life about one-half of what his data supports?

A. No. Data Request RCR-DEP-50 asked Dr. Kateregga to provide, for any accounts where he "did not base his service life/curve selection on the results of his retirement rate analysis," to explain why he did not do so, and to explain the basis for the life/curve combinations he selected. The response stated in its entirety: "Service life statistics were estimated as described in Schedule KAK-1." Schedule KAK-1 contains no discussion of the basis for his service life/curve selection for Account 376 or any other specific account.

Q. Please explain your proposed adjustment to Dr. Kateregga's service life proposal for Account 376-Mains.

A. I recommend an 80-year life for account 376-Mains. Although I am unaware of any specific reason unique to E'town for not using the 120-year best-fit life, I am recommending an 80-year life for two reasons. First, as shown in the exhibit, the indication from Dr. Kateregga's first-degree fit is 80 years. Second, it is at the upper end of lives used in the industry for this account, which is a conditional limit I would have considered had I done my own analysis.

Q. Please explain the Company's current plans and operating environment that you believe Board should recognize in its consideration of estimated future average service lives for Account 376-Mains.

A. Company witness Jodi Gidley indicates that among the primary drivers of E'town's proposed increase are increased investment in infrastructure over past several years, continued investment in improving service, and increased depreciation expense.[15] Ms. Gidley explains, "Since the [2004 E'town] acquisition in 2004, [E'town] has invested over $124 million in new capital to extend service, improve operations and system reliability and upgrade equipment used by our workforce."[16] In my opinion, investment programs such as these suggest longer service lives of E'town's infrastructure because its primary assets are pipes in the ground.

Company witness Donald F. Carter describes E'town's service area and construction program.[17] He describes significant capital expenditures that I expect will

[15] Direct Testimony of Jodi Gidley ("Exhibit P-1"), p. 4.
[16] Id., p. 6.
[17] Direct Testimony of Donald F. Carter ("Exhibit P-2"), p. 4.

increase the expected service lives of the Company's investments in mains. The Union Division is a relatively mature service area where E'town makes a majority of capital expenditures to replace and upgrade aging infrastructure. E'town is currently into the 4th year of a 5-year Pipeline Replacement Program ("PRP") developed to accelerate the replacement of 8-inch elevated pressure ("EP") cast iron pipeline.[18] A majority of E'town's 2009 capital expenditures related to pipeline replacements are associated with completing the 8-inch PRP.[19] E'town's Northwest Division is a newer distribution system that is experiencing more growth than the Union Division. Most of the Northwest Division capital expenditures are associated with new business and DOT/Municipal relocation work.[20]

In past few years, an important part of E'town's capital spending program has been ongoing replacement of small and large diameter EP cast iron mains. In 2007, the Company completed a program whereby it fully replaced all of its 4- and 6-inch EP cast iron mains.[21] Beginning in 2006, E'town increased its annual spending on the replacement of large diameter EP mains in order to replace all of its 8-inch EP cast iron at a total cost of $35 million (scheduled completion in 2009.)[22]

Q. Has the Company embarked on any additional programs that will extend plant lives?

[18] Id.
[19] Id.
[20] Id.
[21] Id., p. 5.
[22] Id.

A. Yes. On October 16, 2008 New Jersey Governor Jon Corzine announced an Economic Stimulus Plan.[23] As part of that plan, he called on New Jersey gas and electric utilities to assist in promoting economic recovery in the State by increasing planned investments in necessary and beneficial utility infrastructure. In response, the BPU encouraged utilities to formulate plans for enhanced investments in infrastructure.[24] E'town's proposal was finalized and agreed to in the Board's April 28, 2009 Decision and Order Approving Stipulation in Docket Nos. EO09010049 and GO09010053. As stated in the Order:

> Looking generally at all of the infrastructure settlements before the Board, and at ETG's in particular, the Board FINDS that the infrastructure programs reviewed today, if successfully executed, will both increase employment in the State and enhance the reliability of the utilities' distribution systems. Only capital projects which enhance the reliability, safety and security of each utility's distribution system are eligible under these programs as Qualifying Projects. These are projects originally scheduled for future years which can be brought forward into the 2009-2010 time period because they have already been researched and planned by the companies. In the absence of this program, most of the projects would be completed, but only in future years.[25]

There are four projects included in E'town's Utility Infrastructure Enhancement Program:

- Replace 29 miles (20 in year 1 and 9 in year 2) of Elevated Pressure ("EP") ten-inch and twelve-inch cast iron main at an estimated cost of $25.2 million. According to the Company this will improve the reliability of E'town's system, as this type of main is prone to graphitic corrosion.

[23] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, p. 1.
[24] BPU Docket Nos. EO09010049, et al., Order Designating Commissioner, issued January 29, 2009, p. 1.
[25] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, p. 7.

- Replace 41.9 miles (11.4 in year 1 and 30.5 in year 2) of low-pressure four-inch cast iron main at an estimated cost of $15.6 million. The benefits are the same as those for the 10-inch and 12-inch EP replacement described above.
- Construct 6 miles of high pressure ("HP") eight-inch main between Sparta Township in Sussex County and Franklin Township in Hunterdon County, allowing elimination an existing 24-mile one way feed, at an estimated cost of $4.8 million. This project creates redundancy between the Vernon and Sussex gate stations.
- Construct 20 miles of HP twelve-inch main between Washington Township and Newton Township in Sussex County at an estimated cost of $14.8 million. This will permit interchangeability of supply between Tennessee, Transcontinental Gas Pipe Line LLC and Columbia Gas Transmission System.[26]

Q. What is the impact of the Infrastructure Program?

A. The Infrastructure Program in combination with E'town's other enhanced capital and maintenance programs will lengthen certain plant lives, thus reducing depreciation expense. They will lengthen plant lives because after completion, the need for immediate replacements, leaks for example, should lessen and the result of that should be longer statistical life indications. In other words, the fewer the retirements, the longer the service lives. At a minimum, it is clearly unreasonable to assume that service lives will become shorter as Dr. Kateregga has done.

[26] BPU Docket Nos. EO09010049 and GO09010053, Decision and Order Approving Stipulation, issued April 28, 2009, Appendix A.

E'town is replacing old, worn out inferior technologies with new modern technologies that do not have the design flaws of the assets they are replacing.[27] A majority of E'town's mains replacements are with current generation plastic pipe. Although some earlier generations may have experienced certain flaws, I am unaware of any problems relating to the current generation.[28] It is unreasonable to assume that the current plastic replacements will have a shorter life than the metallic pipes they are replacing.

Q. Is it true that these programs relate to larger diameter mains, which constitute a relatively small percentage of E'town's total miles of mains?

A. Yes, most of these relate to larger mains; but even though they constitute a small percentage of the miles, they represent a large percentage of investment dollars.

Q. Does E'town agree that Dr. Kateregga should have considered these programs in his life estimates?

A. Exhibit___ (MJM-3) is a Company response from the Infrastructure case. At a minimum, the Company recognizes that such capital, maintenance and infrastructure plans are normally considered in conjunction with a depreciation study.[29]

Q. Are you certain that Dr. Kateregga <u>did not</u> take any of this into consideration?

A. Yes. Data Request RCR-DEP-51 asked the Company to "Identify and explain all Company programs which might affect plant lives." Dr. Kateregga responded that,

[27] Confirmed in August 4th on-site meeting.
[28] Id.
[29] Infrastructure Case RC-ET-IN-A-11

"There are currently no Company programs that materially affect plant lives."[30] I disagree.

III. PROPER REFLECTION OF COST OF REMOVAL IN DEPRECIATION RATES

Excessive Cost of Removal in E'town's Depreciation Rates

Q. Please provide some background regarding your adjustment to remove inflation from Dr. Kateregga's future cost of removal estimates.

A. One of the components of Dr. Kateregga's depreciation rates is a current estimate of future cost of removal. He expressed this estimate as a ratio applied to the current plant balance. A cost of removal ratio increases the overall depreciable cost because it allocates a portion of the estimated future removal cost to each year of the asset's service life. This process is, by definition, accrual accounting.

Q. Do you object to this process?

A. No, I do not object to this process if properly applied.

Q. Has Dr. Kateregga properly implemented accrual accounting principles in developing his cost of removal estimates?

A. No. Dr. Kateregga uses a front-loaded approach that increases the current estimate of future costs of removal for a substantial amount of future inflation. In other words, Dr. Kateregga's approach charges current ratepayers on an undiscounted basis for future inflation – an un-incurred expense. Dr. Kateregga justifies this approach by erroneously claiming that charging current ratepayers for un-incurred future inflation is "accrual accounting." I disagree with Dr. Kateregga. Accrual accounting consists of matching revenues costs to the periods incurred, as opposed to cash basis accounting, which

[30] See response to RCR-DEP-51.

recognizes revenues and expenses when received or disbursed. Dr. Kateregga's approach fails that fundamental test because it front-loads future inflation to current periods, thus failing to match it to the periods incurred. That is why GAAP specifically precludes Dr. Kateregga's approach, as I explain below.

Q. How does Dr. Kateregga's approach result in inflated future cost of removal estimates?

A. Dr. Kateregga bases his future cost of removal estimates on the relationship of current cost of removal expenditures in today's dollars versus the original cost of the plant being retired expressed in old historical dollars. He calculates a ratio of current cost of removal (in today's dollars) to original cost of plant (in historical dollars). This ratio includes a substantial amount of prior cost/price increases, primarily labor, driven by inflationary pressure. He then applies that ratio to today's plant balances to project the future cost of removal. His calculation extrapolates all of the past inflation into the future and then assigns a portion of that future inflation to current costs.

Q. What is the effect of Dr. Kateregga's approach?

A. Dr. Kateregga's inflated future cost of removal rates result in a $2.6 million annual charge for future costs of removal versus the $0.6 million E'town incurs on average. This type of difference has resulted in a $57 million cost of removal regulatory liability that will increase by at least $2 million each year.[31]

Q. What adjustment is necessary to correct this flaw?

A. In order to develop the *current* dollars needed to cover the future cost of removal, Dr. Kateregga should have used the present value of the projected higher future costs that

[31] See response to RCR-DEP-86.

reflect inflation. He should have discounted those inflated amounts back to their present value. Alternatively, rather than inflating current costs to projected future costs and then discounting them back to present value, the same end can be reached by removing inflation from the projected future removal costs in the first instance.

Q. Have variants of this approach been approved in this jurisdiction?

A. Yes, several recent New Jersey rate cases reflect variants of this net salvage method. In Rockland Electric Company's 2002 rate case, I recommended the use of a net salvage allowance based on the average costs of removal actually incurred by the company over a 5-year period. The BPU endorsed my testimony regarding the use of a net salvage allowance rather than reflecting inflated future costs of removal in rates, although the Board used the average net salvage over a 10-year period, as recommended by Staff, instead of the five-year average I recommended.[32]

In Jersey Central Power & Light Company's 2002 rate case, the BPU agreed with me that the inclusion of inflated net salvage in depreciation rates was inappropriate. The Board adopted my recommendation of a $4.8 million net salvage allowance, based on the cost of removal included in JCP&L's test year budget for transmission, distribution and general plant.[33]

Atlantic City Electric Company also uses the net salvage allowance method to accrue net salvage pursuant to the settlement in the last rate case.[34] However, their previous rates did not have a provision for net salvage at all.

[32] I/M/O Rockland Electric Company, BPU Docket Nos. ER02080614 and ER02100724, Initial Decision, June 10, 2003 and Summary Order, July 31, 2003.
[33] I/M/O Jersey Central Power & Light Company, BPU Docket Nos. ER0208056, ER0208057, EO02070417 and ER02030173, Summary Order, August 1, 2003.
[34] I/M/O Atlantic City Electric Company, BPU Docket Nos. ER03020110, ER04060423, EO03020091 and EM02090633, Decision and Order Adopting Initial Decision and Stipulation of Settlement, May 26, 2005.

Q. Have any other Commissions accepted a similar net salvage allowance approach?

A. Yes. The Pennsylvania Public Utility Commission uses the normalized net salvage allowance as a matter of course. Most recently, the Delaware Public Service Commission adopted the normalized net salvage allowance approach based on the five-year average for Delmarva Power & Light, the largest electric utility in that state.[35]

Q. Can you demonstrate that using the present value approach constitutes accrual accounting and that Dr. Kateregga's approach does not constitute accrual accounting?

A. Yes. Exhibit___ (MJM-4) is a chart I designed to demonstrate those facts. It compares the collection of inflation using Dr. Kateregga's approach versus the present value accrual approach. As you can see, both Dr. Kateregga's approach and the present value approach accumulate the same amount of inflation expense at the end of the asset's life, but only the present value approach matches inflation to the periods incurred. Dr. Kateregga's approach front-loads future inflation costs into current periods, and by doing so extracts excess payments from ratepayers. Dr. Kateregga's approach overcharges ratepayers in the early years and undercharges ratepayers in the later years. This flies in the face of the "intergenerational equity" concept and accrual accounting; it stands them on their heads.

Q. Is Dr. Kateregga's approach required under the Uniform System of Accounts ("USoA")?

A. No, nothing in the USoA requires depreciation rates based on inflated future costs.

[35] I/M/O Delmarva Power & Light Company, Docket No. 05-304, Findings, Opinion and Order No. 6930, Issued June 6, 2006, page 87.

Q. Have ratepayers been harmed by Dr. Kateregga's approach?

A. Yes. As will be explained below, New Jersey ratepayers have paid E'town $57 million more than the Company's actual cost of removal and cost of removal requirements.

Q. Does Dr. Kateregga acknowledge this excess?

A. No. Dr. Kateregga does not acknowledge the excess.

Q. What do you recommend?

A. The Board should reject all of Dr. Kateregga's inflated future cost of removal estimates because he should have measured them on a present value basis.

Q. Did you ask Dr. Kateregga to calculate these present value ratios?

A. Yes. I asked him to do this in Data Request RCR-DEP-44. Dr. Kateregga admitted that his net salvage estimates incorporate future inflation, but he stated, "Absent a per-unit net salvage analysis, it is not possible to calculate the present value of future inflation from [his] historical ratios. Dr. Kateregga did not conduct a per-unit net salvage analysis."[36]

Q. Have you calculated Dr. Kateregga's future net salvage ratios on a present value basis?

A. Yes, pages 7 and 8 of Exhibit___ (MJM-8) contain those calculations. I removed the inflation from each of Dr. Kateregga's estimates. Using the Handy-Whitman Index, I measured the inflation incurred from 1999 to 2007, i.e., the 9 years Dr. Kateregga included in his net salvage studies. I used that to discount his proposals.

Q. Are your estimates perfect?

A. No estimate is perfect, but at least my estimates are theoretically superior to Dr. Kateregga's for the very simple reason that I did not include future inflation in the

[36] Response to RCR-DEP-44.

estimate. My estimates represent the present value of my future cost of removal estimates.

Q. Have you compared your future cost of removal estimates to those of Dr. Kateregga?

A. Yes. Pages 7 and 8 of Exhibit___ (MJM-8) compare my present value estimates to Dr. Kateregga's inflated estimates.

IV. REGULATORY LIABILITY RESULTING FROM EXCESSIVE COST OF REMOVAL CHARGES

Accounting Changes Requiring Reporting of Regulatory Liability

Q. Have any significant accounting changes taken place since the 1987 Order in BPU Docket No. GR86121374?

A. Yes. In 2002, the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standard No. 143, which addresses asset retirement obligations ("AROs") associated with long-lived plant.[37] SFAS No. 143 focuses primarily on legal obligations to incur a cost when an asset is retired. In this testimony I will refer to such obligations as legal asset retirement obligations ("legal AROs"). As an example, nuclear decommissioning trust funds result from a legal ARO. SFAS No. 143 considers such obligations to be a component of the original cost of the asset. It requires capitalization and depreciation of the discounted fair value of the estimated asset retirement cost over the asset's life. As the legal ARO liability increases due to inflation, it is "accreted" to income. In other words, SFAS No. 143 matches inflation to the period incurred. This matching, in turn, constitutes accrual accounting.

[37] FERC Order No. 631 is that agency's implementation of SFAS No. 143 for regulatory purposes for utility operations subject to that agency's jurisdiction.

Q. Is the legal ARO liability you just discussed a regulatory liability?

A. No. The SFAS No. 143 liability for legal AROs is the estimated current amount of the cost of the legal obligations associated with the retirement of an asset. It is not a regulatory liability.

Q. Does E'town owe the SFAS No. 143 legal ARO liability to ratepayers?

A. No. The legal SFAS No. 143 ARO liability is the estimated amount that E'town would legally be required to spend if it retired an asset today.

Q. Explain the regulatory liability that E'town does owe to ratepayers as reported in its Annual Report to Shareholders and Form 10 Ks.

Although SFAS No. 143 focused primarily on legal AROs, it also identified a significant regulatory liability resulting from public utilities' past inclusion of inflated future cost of removal and dismantlement factors in depreciation rates. FERC identified these amounts as "non-legal" AROs, meaning that the utilities do not have actual legal obligations and liabilities to incur these costs in the future. Consequently, they are not a capital cost of the asset. SFAS No. 143 requires reporting of non-legal AROs as liabilities to ratepayers-if the requirements of SFAS 71 are met.[38]

SFAS No. 143 applies to all entities subject to GAAP. That includes both competitive non-regulated entities as well as regulated public utilities such as E'town. In general, GAAP does not allow entities in general to include estimated future removal costs, inflated or not, in their depreciation rates. Regulation, on the other hand, has allowed public utilities to include allowances for removal costs in depreciation rates.

Upon implementation of SFAS No. 143, GAAP required these utilities to

[38] SFAS No. 143, paragraph B.73.

determine their SFAS 143 liability for legal AROs and compare that amount to what they had actually collected for future removal costs through depreciation rates. SFAS No. 143 requires reclassification of any excess from accumulated depreciation to a Regulatory Liability account.

Q. What was the logic for this reclassification?

A. If a non-regulated entity had mistakenly included cost of removal in its depreciation rates in the past, its depreciation rates would have been overstated and it would have understated its net income by virtue of the overstated depreciation expense. Consequently, SFAS No. 143 required the non-regulated entity to record a cumulative adjustment as an increase to income or shareholders' equity.

At the same time, GAAP recognizes the relationship between regulated utilities' costs and prices and, instead of requiring them to take these prior excess collections into income, they were required to report them as regulatory liabilities owed to ratepayers.[39] SFAS No. 143 specifically requires reporting of non-legal AROs as regulatory liabilities to ratepayers, if the requirements of SFAS No. 71 are met.[40]

Q. What conditions create a regulatory liability using GAAP?

A. SFAS 71, ¶11, provides that a regulator's rate actions impose a liability on the utility to its customers (regulatory liability) if the regulator provides "current rates intended to recover costs expected to be incurred in the future with the understanding that if those costs are not incurred, future rates will be reduced by corresponding amounts."[41] For Commission-regulated utilities, this "understanding" has been implicit. Nevertheless, the

[39] FERC identified these amounts as "non-legal" asset retirement obligations, meaning that the utilities do not have actual legal obligations and liabilities to incur these costs in the future. (FERC Order No. 631, Para. 36.)
[40] SFAS No. 143, paragraph B.73.
[41] SFAS No. 71, ¶11 and 11(b).

understanding is sufficiently clear that, in response, E'town has created a regulatory liability for GAAP financial reporting purposes. Now that SFAS No. 143 has identified the amounts, we should recognize them as the regulatory liabilities they are.

Q. Does E'town have any regulatory liabilities relating to non-legal AROs?

A. Yes. The responses to S-RDEP-10 and RCR-DEP-86 provided the E'town portions of AGL's December 31, 2006, 2007 and 2008 regulatory liabilities for cost of removal:

E'town Regulatory Liabilities Resulting from Non-Legal AROs
($millions)[42]

Year Ended 12/31	Amount
2006	$ 50.5
2007	54.6
2008	57.0

This table shows that E'town's regulatory liability grew from 2006 to 2007 and again from 2007 to 2008. While E'town did not provide the information for prior years, there is no doubt in my mind that it has grown each year since its inception.[43] In other words, since the regulatory liability has grown for AGL overall, I believe it has also grown for E'town because nothing has changed. It continues to collect the excess as plant continues to grow.

Q. What causes E'town's regulatory liability to be such a large number?

A. It is a large number due to the inflated cost of removal ratios that underlie all those prior collections. It is an excess caused primarily by something that should never have been charged to ratepayers in the first place — inflation that has not been incurred.

Q. What causes E'town's regulatory liability to increase each period?

[42] Responses to S-RDEP-10 and RCR-DEP-86.
[43] See responses to S-RDEP-10 and RCR-DEP-88.

A. E'town's cost of removal collections exceeds its actual cost of removal expenditures each period. Hence, the balance grows and grows. In other words, E'town's cost of removal regulatory liability has increased each period because E'town continually collects substantially more cost of removal cash from its customers than it actually spends, just as Dr. Kateregga proposes to continue in this proceeding.

Need for Board Recognition of the Regulatory Liability

Q. Should the Board officially recognize this regulatory liability in rates?

A. Yes. The Board should recognize E'town's non-legal ARO reserve as a regulatory liability for regulatory and ratemaking purposes. Although E'town has recognized these amounts as regulatory liabilities in its annual GAAP reports, it has not done so for regulatory and ratemaking purposes.

Q. Should the Board require separate identification and reporting of these amounts?

A. Yes. It is critical that the Board require E'town to explicitly identify and report this regulatory liability and all related activity in all future reports, rate cases and depreciation studies that it files. The Board should require prominent disclosure of its explicit recognition of this amount as an intrastate regulatory liability in E'town's future regulatory reports to the BPU to ensure sufficient recognition of and transparency concerning these amounts.

They are hidden from the ratemaking process and regulatory scrutiny in New Jersey unless they are separately identified and reported. Were it not for my testimony, the issue would not have come before the Board in this proceeding even though E'town has built a $57 million regulatory liability for gas plant with no explicit plan either to return the money or to spend the money for cost of removal.

Q. Would it be sufficient to report the item as a "deferred credit"?

A. No. A deferred credit is an accounting mechanism that defers income on the balance sheet, which is then ultimately flowed into income over time. Treatment as a deferred credit would fail to address the core issue. As I indicated, E'town will take a deferred credit into income. A deferred credit does not have the ratemaking status of a regulatory liability. A regulatory liability is an amount owed to ratepayers. E'town collected the money at issue here for a particular purpose and if not used for that purpose it should reduce future rates, as described in SFAS No. 71, ¶11. However, E'town could easily assert in the future that ratepayers have no claim to a deferred credit. The Board must specifically recognize and require reporting by E'town of the $57 million as a regulatory liability for regulatory and ratemaking purposes.

Q. What is wrong with continuing to record the regulatory liability as accumulated depreciation?

A. E'town and all utilities consider accumulated depreciation to represent the measure of their capital that they have recovered from their ratepayers. As simplistic as it sounds, utilities consider any amount in accumulated depreciation to be "their money" even if they collected it for an estimated un-incurred future cost.

Q. Is it true that ratepayers are better off because accumulated depreciation is a rate base deduction?

A. No, that is not true. Accumulated depreciation is indeed a rate base deduction, but a regulatory liability can (and should) also be a rate base deduction. This is a false distinction between the two approaches.

Q. Does E'town agree that its collections for non-legal AROS result in a regulatory liability?

A. E'town agrees that it has a regulatory liability for GAAP purposes since it reported it in its GAAP financial statements. However, it does not agree that it has a regulatory liability for regulatory accounting and ratemaking purposes. In Exhibit___ (MJM-5) E'town denies that it has any regulatory liability for its excess collections.[44] Furthermore, on August 4, 2009 I had a discussion with both E'town and AGL personnel. AGL denied having a liability to ratepayers and E'town said the $57 million represented capital recovery.[45]

E'town's response explains why it is necessary for the Board to recognize the regulatory liability. It denies the obvious in this rate proceeding.

E'town's GAAP financial statements report a $57 million regulatory liability for cost of removal as of December 31, 2008. Given that E'town can only create a regulatory liability consistent with the letter and spirit of SFAS No. 71, the Company must have determined (at least for financial reporting purposes) that, in its management's judgment, the amounts it has collected but not yet spent for costs of removal are "probable" of being credited to ratepayers through the ratemaking process. SFAS No. 71 clarifies that the phrase "credited to ratepayers" means "if those costs are not incurred, future rates will be reduced by corresponding amounts."[46] E'town does agree that both GAAP and the SEC recognize this fact, and in order to get a "clean" audit opinion, it must report the amount as a regulatory liability as long as it remains regulated, and subject to cost-based rate

[44] Response to RCR-DEP-92.
[45] August 4th meeting.
[46] SFAS No. 71, ¶11b.

base/rate of return regulation.

Q. Why did you emphasize the proviso "as long as it remains regulated and subject to cost-based, rate base/rate of return regulation"?

A. The Edison Electric Institute and several individual utilities fought hard before FASB and FERC to avoid the identification and reporting of the regulatory liability that I have just described. They won at the FERC level and lost at the FASB level. I am concerned because, if E'town were to be deregulated or if regulation were to change from "cost-based" to some form of alternative "price-based" regulation, history tells us the Company would have every interest in immediately transferring its $57 million regulatory liability into its GAAP income. This amount could well disappear from the scene unless the Board protects it on behalf of ratepayers.

Q. Why do you believe that E'town would transfer its $57 million non-legal regulatory liability into GAAP income?

A. E'town will transfer the regulatory liability into GAAP income because that is what GAAP requires. If utilities are deregulated, or if regulation changes significantly, the provisions of SFAS No. 71 will no longer apply. The regulatory liability amount will flow immediately and explicitly to GAAP income, because SFAS No. 143 requires it to flow to income if it is not payable to ratepayers. This is what electric utilities did when their production plants were deregulated.

After that, E'town could assert that any attempt by the Board to get the money back constitutes an unlawful taking. The urgency for the Board to declare this as a regulatory liability for regulatory and ratemaking purposes has never been so great. Therefore, E'town must specifically designate this amount as a regulatory liability for

ratemaking purposes.

Q. Do you have any evidence to corroborate the money is at risk?

A. Yes. Two recent events have underscored the need to protect this money: the impending move from GAAP to International Financial Reporting Standards ("IFRS") and a filing by Georgia Power asking to amortize its cost of removal regulatory liability back to itself.

Q. Please explain your concerns regarding IFRS.

A. Any time a company moves away from rate base regulation its regulatory liabilities are at risk. For instance, upon adoption of alternative regulation, the telephone industry took $11.5 billion of its excess collections into equity. The U.S. is moving towards adopting IFRS in place of GAAP. Currently IFRS does not provide for regulatory liabilities, such as the cost of removal liability. However, on July 23, 2009 the International Accounting Standards Board ("IASB") published for public comment an Exposure Draft on Rate-Regulated Activities. Based on this Exposure Draft, regulatory assets and liabilities will be allowed but they must be reported "at the expected present value of the cash flows to be recovered or refunded as a result of regulation, both on initial recognition and at the end of each subsequent reporting period."[47] This major accounting change will put the $57 million into further jeopardy, as it means that utilities will take into income all amounts over the present value of the liability.

Exhibit___ (MJM-6) contains two recent articles from the Public Utilities Fortnightly.[48] The first article is by Mr. Ferguson who is a depreciation witness that regularly testifies on behalf of utilities and regularly advocates that they continue to

[47] IASB July 2009 Exposure Draft – Rate-regulated Activities, p. 9.
[48] John Ferguson, "Fixing Depreciation Accounting", Public Utility Fortnightly, October 2008, pp. 16-20 and Scott Hartman, "Ready for IFRS?", Public Utility Fortnightly, January 2009, pp. 10-16.

collect the excess cost of removal I have discussed. In November 2008, Mr. Ferguson proposed that when these companies move to the new set of accounting standards, IFRS, the utilities should transfer the regulatory liabilities to their equity accounts. In the second article, Mr. Hartman from the accounting firm of Ernst & Young says the same thing.

Q. Is IFRS something new?

A. The accounting profession and the SEC have been considering a switch from GAAP to IFRS for some time.

Q. What will be the effect?

A. In my opinion, what GAAP has brought – i.e., identification of the SFAS No. 143 Regulatory Liability - IFRS will take away by transferring it to equity – at least to the extent the actual regulatory liability exceeds the present value of the refundable cash flow.

Q. But won't that be merely for financial purposes?

A. Once E'town takes that money into income, there is no longer any remedy for ratepayers. E'town may consider any regulatory attempt in the future to recover the money, whether through depreciation or otherwise, as a "taking" of property or "confiscation of capital."

Q. Please discuss the recent filing by Georgia Power.

A. On June 29, 2009 Georgia Power filed a request with the Georgia Public Service Commission asking the Commission to approve and enter an Accounting Order allowing the Company to amortize over 18 months approximately $324 million of the Company's

retail regulatory liability for costs of removal to partially offset operating expenses for 2009 and 2010.[49] I have attached the Company's request as Exhibit___ (MJM-7).

In Georgia Power's 2001 base rate case, the Commission changed the method the Company uses to collect for cost of removal. It bases the allowance on the 10-year historical average of its actual removal costs. The Commission did not make any changes or requirements relating to the existing cost of removal reserve.[50] Georgia Power's June 29, 2009 Application requested that approval to transfer the bulk of its cost of removal regulatory liability from account 108 – Accumulated Depreciation to account 254 – Other regulatory liabilities and then begin amortizing that regulatory liability over 18 months.[51]

Q. Did Georgia Power propose to amortize that regulatory liability back to ratepayers, as one would expect regarding the amortization of a regulatory liability (an amount owed to ratepayers)?

A. No. Georgia Power was not proposing to amortize the amount back to ratepayers. Georgia Power was asking to amortize the amount into its own income between rate cases.[52]

> By amortizing the other COR over the 18-month period in addition to the many cost controls already initiated, the Company's expenses would be reduced without impairing the Company's ability to fulfill its asset removal obligations on a timely basis. This adjustment would move the Company's retail return on equity closer to the 10.25 percent lower end of the ROE range allowed by

[49] Georgia Power Company's Request for an Accounting Order to Amortize a Portion of Its Regulatory Liability for Accrued Removal Costs, GA PSC Docket No. ____-U, issued June 29, 2009, p. 1. Attached as Exhibit___ (MJM-7). It is my understanding this was resolved without being docketed.
[50] Id., p. 7.
[51] Id.
[52] Id., pp. 7-8.

> the Commission, which the Company believes will help support the capital market access it currently enjoys.[53]

Q. What does this mean?

A. Georgia Power demonstrated its intent on taking the over-collections for cost of removal into its own income without recognizing this in its service rates to customers. Despite prior claims that the collections were necessary to ensure they would have sufficient funds available to remove retired plant when needed, it wants to keep the money. It also showed a willingness to admit that collecting cost of removal based on average experience is not going to lead the Company to certain financial ruin, as some have claimed. Finally, it underscores the need for the Commission to be proactive in protecting the money for ratepayers.

Q. Would Georgia Power's proposed amortization have any other negative impacts on ratepayers?

A. Yes. Georgia Power's proposal to remove these amounts from accumulated depreciation outside of a rate case would increase both depreciation expense and rate base, without any benefit flowing to ratepayers. Ratepayers would lose all the excess money they provided to Georgia Power for inflated future removal costs and rate base will increase.

Q. What would happen to rate base under Georgia Power's proposal?

A. Rate base would immediately increase between rate cases. Ratepayers would lose the excessive money they paid for cost of removal and Georgia Power would penalize them with a correspondingly higher rate base.

Q. Is E'town aware of the Georgia Power application?

[53] Id., pp. 7-8.

A. I am not sure about E'town employees, but on August 4, 2009, AGL accounting personnel explained that they were aware.[54]

Q. What is the appropriate treatment of E'town's non-legal ARO regulatory liability?

A. The Board must separate E'town's non-legal ARO regulatory liability from accumulated depreciation. The appropriate accounting entry is a debit to account 108 - Accumulated Depreciation and an equivalent credit to account 254–Other regulatory liabilities.

Q. Do you have any recent examples?

A. Yes. New Jersey Natural Gas recently agreed in Settlement to reduce its overall depreciation rate from the previously approved 3.0 percent to 2.34 percent, and to amortize to income the costs associated with the non-legal asset retirement obligation ("ARO") of approximately $79 million over 48.26 years, resulting in an annual amortization of $1.649 million.[55] The settlement properly reflected the amortization in customer rates.

In New Jersey American Water's recent case, the parties stipulated in Settlement that the Company's water composite depreciation rate would remain at 2.33%. This reflected a $48,000,000 return to customers at $1,200,000 per year over forty (40) years, of "Non-Legal Asset Retirement Obligation." It also included, an Average Net Negative Salvage Allowance method calculated over 5 years.[56]

[54] August 4th on-site meeting.
[55] I/M/O New Jersey Natural Gas Company, BPU Docket No. GR07110889, Stipulation of Settlement on Revenue Requirement, Policy Issues and Depreciation Rates, July 30, 2008, p. 5, item B.
[56] I/M/O New Jersey American Water Company, Inc., BPU Docket No. WR08010020, Stipulation, issued November 12, 2008, p. 5.

Return of the Existing Regulatory Liability to Ratepayers

Q. What should the Board do with E'town's regulatory liability on a going-forward basis?

A. The Board should amortize it back to ratepayers over the average remaining life of E'town's plant, but it is critical that service rates reflect the amortization. Otherwise, the amount should remain as a rate base reduction in perpetuity.

Q. Is the amortization a form of retroactive ratemaking?

A. No. It is merely an amortization netted against depreciation expense.

Q. What amortization period do you recommend?

A. I propose a remaining life amortization period, which would set the annual amortization amount to approximately $1.6 million per year.

V. RESERVE REDISTRIBUTION AND WHOLE LIFE VERSUS REMAINING LIFE DEPRECIATION

Q. Dr. Kateregga proposes a redistribution of book reserves. Do you agree with this adjustment?

A. No.

Q. Please explain the controversy and confusion surrounding Dr. Kateregga's reserve redistributions.

A. E'town maintains its book reserve by plant account. Because Dr. Kateregga proposes remaining life depreciation, the level of the reserve for each individual account becomes critical.

Q. What is the difference between the recorded book reserves and Dr. Kateregga's redistributed reserves?

A. The recorded book reserves are what are on E'town's books. Dr. Kateregga's redistributed reserves result from shifting recorded book reserves according to his individual computed theoretical reserves. This shifting is not necessary, it is subjective, and it gives rise to potential disputes about the propriety and magnitude of his redistributions.

Q. What's the harm of such redistributions?

A. Company consultants use these redistributions in conjunction with remaining life depreciation. It is possible through careful manipulation to assign more book reserve to large accounts with long lives, mains for example, and less to smaller accounts with shorter lives, computers for example. Suppose, for example, a company has a rate base consisting of two accounts: Mains, with a plant balance of $1000, and Computers, with an account balance of $100. Suppose further that Mains have a service life of 100 years and a remaining life of 50 years, and Computers have a service life of 10 years and a remaining life of 1 year. Finally, suppose that each account has a book reserve of $100, for a $200 total book reserve.

Under this scenario, the depreciation accruals for each account using the remaining life method would be as follows:

Mains: ($1000 - $100) /50 = $18

Computers: ($100 - $100)/1 = $0

Dr. Kateregga's methodology would re-allocate the total reserves of $200, based on the ratio of the "theoretical reserve" for each account ($500 for Mains and $90 for Computers to the total theoretical reserve ($590.) As a result, the book reserve for Mains would become $169.49, and the book reserve for Computers would become $30.51, resulting in

the same overall $200 book reserve, but with the following annual accruals:

Mains: ($1000 - $169.49)/50 - $16.61

Computers: ($100 - $30.51)/1 = $69.49

As shown in the above example, the total depreciation accrual would jump from $18.00 to $86.10 ($16.61 + $69.49.) The computer depreciation expense increases substantially, while mains depreciation expense is only impacted slightly.

Redistributions such as the one proposed by Dr. Kateregga could result in large increases in depreciation expenses for smaller accounts with shorter lives, which could drive an overall depreciation expense increase.

Q. Are Dr. Kateregga's redistributions necessary?

A. The reserve redistributions are not necessary, and Dr. Kateregga appears to acknowledge this. Dr. Kateregga specifically states:

> Although reserve records are typically maintained by various account classifications, the sum of all reserves [total] is the most important measure of the status of a company's depreciation practices and procedures.[57]

Q. Do you recommend an alternative to Dr. Kateregga's proposed redistribution of individual account reserves?

A. Yes. I recommend that E'town discontinue the use of remaining life depreciation and instead use whole-life depreciation.

Q. What is the difference between whole-life and remaining life depreciation rates?

A. A whole life rate is the reciprocal of the average service life. In other words, if the service life is 10 years, the whole life depreciation rate is one-tenth or 10 percent. The

[57] Exhibit P-6, p. 4.

remaining life technique is merely a mechanism to account for reserve imbalances resulting from changes to prior depreciation parameter estimates. A remaining life rate is the net plant (gross plant minus accumulated depreciation) divided by the remaining life of the plant account. In theory, a whole-life rate and remaining life rate are the same if there is no reserve imbalance. On the other hand, if a reserve imbalance does exist, the remaining life rate will be either higher or lower than the whole life rate depending on the direction of the imbalance.

Q. Does Dr. Kateregga agree that the difference between whole-life and remaining life depreciation is solely to amortize his reserve deficiency?

A. Yes. Dr. Kateregga states:

> Depreciation Rates recommended in the 2008 study were developed using a system composed of the straight-line method, vintage group procedure, remaining-life technique. This formulation of the accrual rate is equivalent to a straight-line method, vintage group procedure, whole-life technique with amortization of reserve imbalances over the estimated composite remaining life of each rate category.[58]

Q. Why do you propose replacement of remaining life depreciation with whole life depreciation?

A. I make this recommendation for several reasons. First, whole life depreciation is superior to remaining life depreciation for new additions to plant. While a remaining life rate may be adequate for existing plant, it is wholly inappropriate for new additions; it will create even more imbalances on a going-forward basis. A whole life rate is a superior rate because it is appropriate for both existing plant and new additions to plant. Second, I do not have any faith in the reserves Dr. Kateregga uses to calculate his remaining life

[58] Schedule KAK-1, p. 13, emphasis added.

depreciation rates. Most importantly, in the future, depreciation rates approved here may be used in calculations such as the Infrastructure rider. It is imperative that the whole life rate be used in those circumstances because they are applied to incremental plant, which by definition does not have any associated reserve imbalance.

Q. Can you demonstrate that whole life is superior to remaining life?

A. Yes. Consider an example in which a $1,000 asset initially assumed to have a 20-year life was depreciated using a 5% depreciation rate.[59] After 10 years, the accumulated depreciation would be $500 or 50 percent of the original $1,000 cost. Now assume, that at the end of 10 years, it is determined that the life is going to be 15-years rather than 20-years. The existing depreciation reserve is immediately deficient, based on the new life assumption. The new whole-life rate is 6.7 percent.[60] The remaining life rate, however, would be 10 percent.[61] The 6.7 percent whole-life rate reflects the life anticipated for both the original $1,000 asset and any additional assets going-forward. Hence, it is appropriate for all assets in the account. The 10 percent rate is only appropriate for the initial $1,000 asset; it is inappropriate for the new assets. Application of the 10 percent to new assets will create reserve excesses for those assets.

Q. Will the reserve excesses on new assets offset the reserve deficiency on the original assets?

A. In theory – yes. However, one should have confidence in the book reserve to begin with. E'town maintains its book reserve by FERC plant account.[62] In this case, Dr. Kateregga has redistributed book reserves among accounts. I do not have confidence in these

[59] 1/20 years = 5.0%
[60] 1/15 years = 6.7%.
[61] (100%-50%)/5 years=10%
[62] Response to RCR-DEP-24.

redistributed amounts.

Q. Have you accepted the remaining life technique in other proceedings?

A. Yes, I have accepted remaining life depreciation in numerous proceedings.

Q. If you have accepted remaining life depreciation in numerous proceedings, why are you proposing to discontinue its use in this proceeding?

A. Initially, my driving impetus was to eliminate confusion and controversy surrounding Dr. Kateregga's numerous depreciation reserve redistributions. However, after considering the relative merits of whole life with a separate amortization versus remaining life, I consider the former to be a theoretically superior approach and recommend that the Board adopt it.

Q. If a whole life rate is appropriate, how can the Board deal with a reserve imbalance?

A. If there is a significant reserve imbalance, as there is in this proceeding, the Board can adopt a separate amortization of the imbalance. This will provide the appropriate depreciation rate for both existing plant and new additions going forward, and still amortize the imbalance.

Q. Is there precedent for such an approach in New Jersey?

A. Yes. The Board approved settlements incorporating these features in the recent Rockland Electric (Docket Nos.ER02080614 and ER02100724) and Atlantic City Electric (Docket No. ER03020110 et. al.) rate cases.

Q. What do you conclude?

A. The Board should adopt whole life depreciation rates. Whole life depreciation rates are superior to remaining life depreciation rates. The use of whole life depreciation rates will eliminate controversy surrounding individual reserve redistributions. The Board should

separately amortize significant reserve imbalances at the total book level.

VI. SUMMARY OF RECOMMENDATIONS

Q. Have you prepared a summary of your recommendations?

A. Yes. Exhibit___ (MJM-8) shows the calculation of my recommended rates and expense. My recommended net depreciation and amortization expense for plant is $16.7 million, or $5.8 million less than the Company's current depreciation of $22.5 million, based on December 31, 2007 plant balances.[63] Exhibit___ (MJM-8) also shows my recommended $1.6 million amortization of the regulatory liability for cost of removal, thus resulting in a net $15.1 million depreciation and amortization expense.

Q. Does this conclude your testimony?

A. Yes, it does.

[63] Schedule KAK-1A, Statement B, page 5.