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

In the Matter of:

THE PETITION OF ANDOVER UTILITY	**)**	
COMPANY FOR APPROVAL OF AN	**)**	**BPU DKT NO. WR09050413**
INCREASE IN RATES FOR WASTEWATER	**)**	**OAL DKT. NO. PUC-7548-09**
SERVICE AND OTHER TARIFF CHARGES	**)**	

DIRECT TESTIMONY OF ROBERT J. HENKES ON BEHALF OF THE NEW JERSEY DEPARTMENT OF THE PUBLIC ADVOCATE DIVISION OF RATE COUNSEL

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ANDOVER UTILITY COMPANY
BPU Docket No. WR09050413
Direct Testimony of Robert J. Henkes

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I. STATEMENT OF QUALIFICATIONS

Q. WOULD YOU STATE YOUR NAME AND ADDRESS?

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

Q. WHAT IS YOUR PRESENT OCCUPATION?

A. I am Principal and founder of Henkes Consulting, a financial consulting firm that specializes in utility regulation.

Q. WHAT IS YOUR REGULATORY EXPERIENCE?

A. I have prepared and presented numerous testimonies in rate proceedings involving electric, gas, telephone, water and wastewater companies in jurisdictions nationwide including Arkansas, Delaware, District of Columbia, Georgia, Kentucky, Maryland, New Jersey, New Mexico, Pennsylvania, Vermont, the U.S. Virgin Islands and before the Federal Energy Regulatory Commission. A complete listing of jurisdictions and rate proceedings in which I have been involved is provided in Appendix I attached to this testimony.

Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?

A. Prior to founding Henkes Consulting in 1999, I was a Principal of The Georgetown Consulting Group, Inc. for over 20 years. At Georgetown Consulting I performed the same type of consulting services as I am currently rendering through Henkes Consulting. Prior to my association with Georgetown Consulting, I was employed by the American Can Company as Manager of Financial Controls. Before joining the American Can Company, I was employed by the management consulting division of Touche Ross & Company (now Deloitte & Touche) for over six years. At Touche Ross, my experience, in addition to regulatory work, included numerous projects in a wide variety of industries and financial disciplines such as cash flow projections, bonding feasibility, capital and profit forecasting, and the design and implementation of accounting and budgetary reporting and control systems.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

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

II. SCOPE AND PURPOSE OF TESTIMONY

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

A. I was engaged by the New Jersey Division of Rate Counsel to conduct a review and analysis and present testimony in the matter of the petition of Andover Utility Company ("AUC" or "the Company") for an increase in its rates for wastewater service.

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

In developing this testimony, I have reviewed and analyzed the Company's May 21, 2009 filing, supporting testimonies, exhibits and workpapers; the Company's responses to initial and follow-up data requests by Rate Counsel and BPU Staff; and other relevant financial documents and data.

III. SUMMARY OF FINDINGS AND CONCLUSIONS

Q. PLEASE SUMMARIZE YOUR FINDINGS AND CONCLUSIONS IN THIS CASE.

A. I have reached the following findings and conclusions in this docket:

1. The appropriate pro forma rate base amounts to $207,009, which is $67,317 lower than the Company's proposed pro forma rate base of $274,326. Schedule RJH-1, line 1 and Schedule RJH-3.
2. The appropriate pro forma operating income is a negative amount of ($46,128), which represents an income amount that is $203,640 higher than the Company's proposed pro forma negative operating income of ($249,768). Schedule RJH-1, line 4 and Schedule RJH-6.
3. The appropriate overall rate of return for the Company is 8.36%, incorporating a recommended return on equity of 10.30%. This compares to AUC's proposed overall rate of return of 9.62%, including a requested return on equity rate of 12.00%. Schedule RJH-1, line 2 and Schedule RJH-2.
4. The appropriate Revenue Conversion Factor to be used for ratemaking purposes in this case is 1.32555. This factor has been used by both the Company and Rate Counsel. Schedule RJH-1, line 6 and footnote (2).
5. The recommended ratemaking components outlined above indicate the need for an annual rate increase of $84,085. This is $281,978 lower than the Company's proposed rate increase claim of $366,063. Schedule RJH-1, line 7. The recommended rate increase of $84,085 represents an overall rate increase of 22.61% over the test year pro forma revenues at current rates.

IV. REVENUE REQUIREMENT ISSUES

A. CASE OVERVIEW

Q. PLEASE PROVIDE AN OVERVIEW OF THIS BASE RATE FILING.

A. The Company's initial tariff was established in its first rate case, Docket No. WC94080364, which was approved by the Board on August 15, 2001. The tariffs and rates established in that Docket are still in effect today.

On May 21, 2009, AUC filed this base rate case with the request for a rate increase of $366,063, representing an overall rate increase of 98.43% over the test year pro forma revenues at current rates. Based on the rate design proposed by AUC in this case, the requested rate increase would result in the following percentage increases for the Company's three customers:

- Rolling Hills Condominium Association	167.33%
- Andover Intermediate Care Center	58.26%
- Andover Nursing Home	123.97%

The Company's proposed test year in this case is calendar year 2008, containing 12 months of actual data. The proposed revenue requirement in this case is based on rate base balances stated as of the end of the test year, December 31, 2008, with no projected post-test year additions. The Company annualized its test year depreciation expenses based on the actual test year-end depreciable plant balances. The Company's proposed pro forma operating income is based on the actual 2008 test year operating results, adjusted for changes claimed to be known and measurable.

Q. WHAT IS THE STARTING POINT OF YOUR ANALYSES IN THIS TESTIMONY?

A. I have used the Company's filing data as the starting point of my analyses in this testimony. The following testimony and the accompanying Schedules RJH-1 through RJH-9 describe all of the recommended adjustments made by me to this starting point in order to arrive at Rate Counsel's overall recommendations regarding AUC's adjusted test year rate of return, rate base, operating income, the resulting revenue requirement, and the recommended rate design.

B. OVERALL RATE OF RETURN

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED OVERALL RATE OF RETURN IN THIS CASE.

A. Since all of the funds that were utilized to build and operate the Company were provided by the stockholders, AUC has proposed a hypothetical capital structure containing 50% debt and 50% equity. For the debt cost, AUC has assumed a cost rate of 7.23%, representing the average yield of Moody's reported A and Baa rated corporate bonds for utilities as of March 10, 2009. The Company has proposed the use of a common equity return of 12.00% "based upon recently filed water rate cases."[1] As summarized on Schedule RJH-2, AUC's proposed capital structure ratios and capital cost rates produce a requested overall rate of return number of 9.62%.

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[1] Testimony of Mr. Prettyman, page 14, line 22.

Q. ARE YOU TAKING EXCEPTION TO THE COMPANY'S PROPOSED HYPOTHETICAL STRUCTURE OF 50% DEBT AND 50% EQUITY?

A. No. Given the circumstances surrounding AUC's historic and current capitalization, I believe that the use of a hypothetical capital structure with 50% debt and 50% equity is reasonable for ratemaking purposes in this case.

Q. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE COMPANY'S PROPOSED DEBT COST RATE OF 7.23%?

A. Yes. As described previously, the Company's proposed debt cost rate of 7.23% represents the average yield of Moody's reported A and Baa rated corporate bonds for utilities as of March 10, 2009. In its response to RCR-30, the Company has confirmed that this same average corporate bond yield in the month of July 2009[2] has declined to 6.42%. I recommend that this more recent, updated debt cost rate be used for ratemaking purposes in this case.

Q. DID THE COMPANY CONDUCT A RETURN ON EQUITY STUDY IN SUPPORT OF ITS REQUESTED RETURN ON EQUITY RATE OF 12.00%?

A. No. As shown in the Company's response to RCR-9, Company witness Prettyman simply selected 10 water utility filings made in 2008 and 2009 in jurisdictions across the nation[3] in which these utilities requested return on equity numbers averaging around 12.00%. Based on this selective information, Mr. Prettyman proposes that the return on equity for AUC be

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[2] Which is the most recent monthly information available at the time this testimony was prepared.
[3] Including New Jersey, Pennsylvania, Delaware, Kentucky, Iowa, California and Illinois.

set at 12.00%. It should also be noted that Mr. Prettyman does not indicate the return on equity numbers that were actually *authorized* by the regulators of these 10 selective water utilities.

Q. HAVE YOU CONDUCTED A RETURN ON EQUITY STUDY TO DETERMINE AUC'S RETURN ON EQUITY RATE TO BE USED FOR RATEMAKING PURPOSES IN THIS CASE?

A. No, I have not. My recommended equity return rate of 10.30% reflects a rate that has actually been authorized by the Board in recent water and wastewater utility rate cases in New Jersey, including the following proceedings:

Utility	BPU Docket	Decision	ROE Rate
Roxbury Water	WR09010090	Jul-09	10.30%
United Water W. Milford	WR08100928	Apr-09	10.30%
United Water Arlington Hills	WR08100929	Apr-09	10.30%
United Water New Jersey	WR08090710	Apr-09	10.30%
Applied Wastewater Mgmt	WR08080550	Mar-09	10.30%
Pinelands Water	WR08040282	Dec-08	10.30%
Pinelands Wastewater	WR08040283	Dec-08	10.30%
New Jersey-American Water	WR08010020	Dec-08	10.30%
EDC	WR07090715	Jun-08	10.30%

Thus, during the last 12 months, the Board has consistently authorized return on equity rates of 10.30% for large and small utilities alike. I see no compelling reasons why the Board should deviate from this ROE number in the instant rate case.

Q. WHAT IS YOUR RECOMMENDED OVERALL RATE OF RETURN BASED ON THE PREVIOUSLY DISCUSSED RATE OF RETURN ADJUSTMENTS?

A. As shown on Schedule RJH-2, based on the previously discussed adjustments to the

Company's proposed overall rate of return, I recommend that an overall rate of return of 8.36% be used for ratemaking purposes in this case.

C. RATE BASE

Q. PLEASE SUMMARIZE THE COMPANY'S PROPOSED PRO FORMA RATE BASE AND YOUR RECOMMENDED RATE BASE ADJUSTMENT.

A. The Company's proposed pro forma rate base of $276,906 is summarized by specific rate base component on Schedule RJH-3. All of the Company's proposed pro forma rate base balances except those for cash working capital represent actual balances as of the end of the test year, December 31, 2008. The claimed cash working capital requirement is calculated based on a formula method.

As shown on line 4 of Schedule RJH-3, I recommend that the Company's cash working capital claim of $69,897 be disallowed for ratemaking purposes in this case. The reasons for this recommendation will be discussed in more detail below.

- Cash Working Capital

Q. PLEASE EXPLAIN WHY YOU RECOMMEND THAT THE COMPANY'S PROPOSED CASH WORKING CAPITAL CLAIM BE DISALLOWED IN THIS CASE.

A. I believe that the most accurate method to approximate a utility's cash working capital

("CWC") requirement is a properly performed lead/lag study. However, the Company's proposed CWC requirement of $69,897 is not based on a lead/lag study; rather, it is based on the application of the so-called "one-eighth method." Under this method, the cash working capital is presumed to be equal to 1/8th of the Company's operation and maintenance expenses. The Company never made any attempt to measure its revenue collection lag and the payment lags of its largest expenses, not even on a sampling basis.[4] I believe that the one-eighth method has many drawbacks and is an inappropriate method to estimate a utility's cash working capital. For example, this method is potentially very inaccurate; has no discernable relationship to any feasible CWC requirement; and always results in a positive cash working capital requirement, even in cases where a utility actually has negative cash working capital requirements.

Q. DO YOU BELIEVE THAT THE COMPANY MAY ACTUALLY HAVE A NEGATIVE CASH WORKING CAPITAL REQUIREMENT?

A. Yes. The Company bills its customers *in advance* rather than in arrears. What this means is that the Company is experiencing a revenue collection *lead* rather than a revenue collection lag, i.e., the Company is billing and collecting its revenues in advance of the services that are rendered for these same revenues. By contrast, the Company is paying the majority of its expenses associated with the services rendered *after* the services are rendered. The combination of the Company's revenue collection lead and expense payment lags would indicate a negative cash working capital requirement for AUC.

[4] See the response to RCR-13 in which the Company confirms that an analysis of payment lags for each of its O&M expense categories has not been made.

Q. WHAT IS YOUR RECOMMENDATION BASED ON THE FOREGOING FINDINGS AND CONCLUSIONS?

A. For the reasons previously enumerated, I recommend that AUC's cash working capital level be set a $0 for ratemaking purposes in this case. This is a conservative recommendation as it is my belief that this Company has in fact a negative cash working capital requirement.

Q. IS YOUR CASH WORKING CAPITAL RECOMMENDATION CONSISTENT WITH BOARD RATEMAKING POLICY?

A. Yes. In the most recent Parkway Water Company base rate proceeding, BPU Docket No. WR05070634, the Board made the following ruling in denying Parkway's proposed CWC requirement that was based on an O&M formula method:

> Having reviewed the record and the ALJ's Initial Decision, the Board HEREBY ADOPTS the RPA's recommendation that it is inappropriate to utilize the 1/8 method of O&M formula for computing a working capital allowance. The Board accepts the arguments of the RPA in that the Company could have used a sampling technique of certain expenses to produce data to determine whether a working capital allowance is required. The Board HEREBY APPROVES RPA's recommendation and DENIES the inclusion of any working capital allowance in rate base.

D. OPERATING INCOME

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

A. The Company's proposed negative pro forma operating income of ($249,768) is summarized by specific operating income component on Schedule RJH-4. As shown on this schedule, I have recommended a negative pro forma test year operating income amount of ($46,128) by making a number of O&M expense adjustments and associated payroll tax and income tax adjustments which have the effect of increasing the Company's proposed pro forma test year operating income by a total amount of $203,640. Each of these recommended operating income adjustments will be discussed in detail below.

- **<u>Salary and Wage Expense</u>**

Q. WHAT IS THE COMPANY'S CLAIMED PRO FORMA SALARY AND WAGE EXPENSE IN THIS CASE AND HOW DOES IT COMPARE TO THE COMPANY'S ACTUAL SALARY AND WAGE EXPENSES BOOKED BY AUC FROM 2005 THROUGH THE 2008 TEST YEAR?

A. The Company's total pro forma salary and wage expense claimed for ratemaking purposes in this case amount to $241,997.[5] By contrast, the Company's actual salary and wage expenses from 2005 through the 2008 test year were as follows:

- 2005	$106,809
- 2006	$111,767
- 2007	$124,959
- 2008	$116,740

Thus, the Company's proposed pro forma salary and wage expense of $241,997 is more than double the actual salary and wage expenses booked in the test year, as well as in the three years prior to the test year.

[5] Exhibit P-2, Schedule 7 and SIR-12, page 3 of 21.

Q. WHAT ARE THE REASONS FOR THIS CLAIMED SALARY AND WAGE EXPENSE INCREASE?

A. The reasons are that in this case, the Company, for ratemaking purposes, has allocated to AUC administrative and general salaries of almost $120,000 associated with employees that are on the payroll of AUC's affiliates, Andover Nursing Home and Andover Intermediate Care Center, that previously have never been allocated to AUC.

Q. HAVE YOU PRESENTED A BREAKOUT OF THE COMPANY'S CLAIMED PRO FORMA SALARY AND WAGE EXPENSE OF $241,997 THAT MAKES THIS ISSUE MORE CLEAR?

A. Yes. On Schedule RJH-6, I show that the Company's proposed pro forma salary and wage expense of $241,997 breaks out as follows: (1) $110,042 in wages for three full-time plant operations/maintenance employees that are on AUC's payroll; (2) $9,774 in allocated salary for a plant supervisor who is an employee of the Andover Nursing Home; (3) $17,181 in allocated salary for office and accounting employees of Andover Nursing Home and Andover Intermediate Case Center; and (4) $105,000 in allocated compensation for the officers of the Company who are listed as employees of Andover Nursing Home.[6]

Q. DO YOU AGREE WITH THE FIRST SALARY AND WAGE EXPENSE COMPONENT OF $110,042 FOR THE THREE PLANT OPERATIONS/MAINTENANCE EMPLOYEES?

A. Yes. These employees are in the full-time employ of AUC and are actually on the

[6] See response to WR-7.

Company's payroll. The claimed pro forma wages of $110,042 for these three employees represent a reasonable level when compared to the actual 2008 test year wages of $104,040.

Q. DO YOU AGREE WITH THE SECOND SALARY AND WAGE EXPENSE COMPONENT OF $9,774 FOR THE ALLOCATION OF THE PLANT SUPERVISOR'S PAYROLL EXPENSE?

A. Yes. The allocated payroll expense of $9,774 would appear reasonable and consistent with the actual allocated payroll expenses of $9,152 in 2007 and $9,700 in the 2008 test year as reported in AUC's 2007 and 2008 Annual Reports to the BPU.[7]

Q. DO YOU AGREE WITH THE THIRD SALARY AND WAGE EXPENSE COMPONENT OF $17,181 FOR THE ALLOCATED SALARY OF ADMINISTRATIVE EMPLOYEES THAT ARE NOT ON THE PAYROLL OF AUC?

A. No, I do not. As confirmed in the response to RCR-36(a), AUC is part of a large business operation involving over 20 commercial enterprises, including AUC, nursing homes, gymnasium and multiple real estate ventures. The response to RCR-36(b) states that AUC represents only 1.5% of the total combined business operation. Notwithstanding this fact, SIR-12, page 3 shows that the proposed administrative salary of $17,181 represents a composite allocation of approximately 9% of the total annual salary of $197,066[8] for the administrative employees allocated to AUC. This newly proposed allocation is

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[7] See attachments to RCR-37.

[8] Office Manager - $68,900; Payroll Clerk - $50,362; Asst Office Manager - $50,504; AP Clerk - $27,300. Total is $197,066.

significantly higher than the administrative salaries that have historically been allocated to AUC. Specifically, the administrative salaries allocated to AUC have been at an annual level of $3,000 for each of the years 2005 through 2008. In its response to WR-8, the Company concedes that the proposed allocation ratios in this case are purely based on estimates since no specific time sheets are kept. There is therefore no valid basis for the assumed 9% composite allocation ratio used by AUC to claim the new allocated salary level of $17,181.

Q. WHAT ALLOCATED SALARY LEVEL FOR THE ADMINISTRATIVE FUNCTION DO YOU RECOMMEND?

A. I recommend the continuation of the $3,000 administrative salary allocation which has historically been used by AUC and reported to the BPU.[9] The basis for this recommendation is shown under footnote (2) of Schedule RJH-6. As shown there, I applied the 1.5% AUC allocation ratio[10] to the total annual salary of $197,066 for the administrative employees allocated to AUC. This produces an annual expense allocation of $2,956, or $3,000 on a rounded basis.

Q. DO YOU AGREE WITH THE FOURTH SALARY AND WAGE EXPENSE COMPONENT OF $105,000 FOR THE ALLOCATED COMPENSATION OF THE OFFICERS AND CORPORATE COUNSEL OF THE COMPANY?

A. No. The proposed salary allocation consists of $40,000 for Company President Carla

[9] See page 31 of the Annual BPU Reports attached to the response to RCR-37.
[10] As discussed previously, AUC represents 1.5% of the total business operation for which the administrative function is responsible.

Turco-Kipiani; $40,000 for Company Vice President Jerry Turco, Jr.; and $25,000 for Company General Counsel Craig Goodstadt. This is the first time that the Company is attempting to allocate this officer and counsel compensation to AUC. Up until this point, no officer salary or corporate counsel salary had ever been allocated to AUC. In RCR-25, the Company was asked the following questions regarding the proposed total salary allocation of $105,000:

> With regard to the $105,000 payroll allocation for the President, VP and General Counsel shown on Attachment SIR-12, page 3, please provide the following information:
>
> a. Provide the total annual compensation levels for these 3 employees in each of the years 2006, 2007 and 2008.
> b. Explain the allocation basis underlying the allocations of $40,000, 40,000 and $25,000 to Andover Utility.

The Company's response to this request was as follows:

> As stated in response to WR-7, the amounts represent a reasonable amount for a company of this size. The officers are responsible for the overall operation of the Company and ongoing viability of the Company.
>
> Because the Company is a small portion of the Officers/Stockholders business operation, it would not be appropriate to apply a percentage of time to their total compensation as that amount would far exceed what the Company is requesting in this proceeding.

In RCR-35, the Company was asked to provide the number of hours spent by Ms. Carla Turco-Kipiani, Mr. Jerry Turco, Jr. and Mr. Craig Goodstadt on the overall operation of AUC in each of the years 2005 through 2008, including actual source documentation in support of this information. The Company's answer to this request was as follows:

> Ms. Kipiani, Mr. Turco and Mr. Goodstadt do not keep timesheets and therefore the amount of hours spent specifically for AUC can not be determined.

Finally, in RCR-36, the Company was asked the following additional questions regarding the proposed $105,000 expense allocation:

> c. Provide the current annual total compensation of the Officers/Stockholders.
> d. Explain how the allocated salary amount of $105,000 was derived from the total compensation amount to be provided in response to part (c) above.

The Company's responses to these two questions were as follows:

> c. The Company respectfully requests that because of the nature of Ms. Kipiani and Mr. Turco's total operation of over 20 commercial enterprises that their total compensation is not relevant to these proceedings and should remain confidential.
> d. The allocated salary is not based upon a formula or strict percentage of total salary requested in part c. As stated in response to WR-7, it represents a reasonable amount for a company of the size of AUC and is appropriate to be included in rates.

Q. WHAT IS YOUR RECOMMENDATION WITH REGARD TO THIS ALLOCATED SALARY CLAIM OF $105,000?

A. Based on the previously described findings, I recommend that this Company-proposed salary allocation of $105,000 be rejected by the Board. The Company has withheld the total current compensation of the officers. The officers keep no time sheets to keep track of how much time they actually spend on the operation of AUC, nor does the General Counsel. The only basis for the claimed $105,000 expense allocation is that "it is a reasonable amount for a company the size of AUC." As previously discussed, AUC only represents 1.5% of the overall business operation of the officers. Given this tiny proportion, to consider a $105,000 compensation allocation "a reasonable amount for a company the size of AUC" is unrealistic and unreasonable. In fact, I find it disturbing that almost one-third of the

Company's overall rate increase request in this case consists of these newly proposed salary allocations for which there is no basis whatsoever.

- **<u>Waste Disposal Expense</u>**

Q. PLEASE EXPLAIN THE RECOMMENDED WASTE DISPOSAL EXPENSE ADJUSTMENT SHOWN ON SCHEDULE RJH-5, LINE 3.

A. The Company's proposed pro forma waste disposal expenses include $7,657 for an assumed 10% fuel surcharge. In response to RCR-39, the Company has confirmed that since January 2009 this fuel surcharge is no longer being charged to AUC, and that it would be appropriate not to reflect this surcharge for ratemaking purposes in this case unless the 10% fuel surcharge is reinstated prior to the close of record in this case. Since this fuel surcharge is currently not being charged, I have removed the $7,657 expense from this case.

- **<u>Employee Benefit Expense</u>**

Q. PLEASE DESCRIBE THE COMPANY'S PROPOSED POSITION WITH REGARD TO ITS EMPLOYEE BENEFIT EXPENSE.

A. While the Company's actual 2008 test year employee benefit expense amounts to $9,485 and the actual employee benefit expense for the most recent 12-month period ended 6/30/09 amounts to $14,279,[11] the Company has proposed pro forma employee benefit expenses of $106,065 for ratemaking purposes in this case. As shown on Exhibit P-2, Schedule 10, this

[11] See response to RCR-33.

proposed expense of $106,065 consists of $18,531 for worker's compensation and life/health insurance, and $87,534 for the proposed amortization of certain past self-insurance expenses. With regard to these latter expenses, SIR-12, page 8 shows that the Company incurred the following self-insurance expenses from 2004 through 2008:

2004	$ 6,417
2005	196,883
2006	10,777
2007	44,011
2008	4,514
Total	$262,601

The Company is proposing to defer these past expenses in this case and amortize them to the ratepayers over a 3-year amortization period, resulting in the proposed annual amortization expense of $87,534.

Q. DO YOU AGREE WITH THE COMPANY'S PROPOSED PRO FORMA EMPLOYEE BENEFIT EXPENSE THAT YOU JUST DESCRIBED?

A. While I agree with the Company's proposed worker's compensation and life/health insurance expense of $18,531, I recommend that the proposed amortization expense of $87,534 be rejected by the Board for rate consideration.

Q. WHY DO YOU MAKE THIS RECOMMENDATION?

A. I make this recommendation for several reasons. First, the Company never petitioned the Board for approval and, therefore, never received Board approval to defer these past costs as a regulatory asset when they were incurred in each of the years 2004 – 2008. Second, these costs were booked as expenses in the years that they were incurred and, therefore, are no longer on the Company's books at this time. Finally, the Company's proposal to charge these past costs to its future ratepayers represents inappropriate retroactive ratemaking. These costs will not be incurred during the rate effective period of this case; rather, they were incurred in the past between rate cases and the Company's attempt to shift these past costs to future ratepayers creates a clear case of intergenerational inequity.

Q. WHERE DO YOU REFLECT YOUR RECOMMENDATION IN YOUR TESTIMONY SCHEDULES?

A. My recommendation is reflected on Schedule RJH-5, line 4 where I show that I have reduced the Company's proposed employee benefit expense by $87,534.

- **<u>Rate Case Expense</u>**

Q. PLEASE DESCRIBE THE COMPANY'S PROPOSED RATE CASE EXPENSES CLAIMED IN THIS CASE.

A. As summarized in the first column of Schedule RJH-17, the Company has proposed total rate case expenses for the current case of $75,000 to be amortized over a 3-year period for an annual rate case expense amortization amount of $25,000. The Company has not proposed to share these estimated rate case expenses on a 50/50 basis in accordance with Board ratemaking policy. The proposed rate case expenses of $75,000 include $40,000 for the consulting services of Mr. Prettyman, $5,000 for transcripts and notices expenses, and $30,000 for legal expenses. The legal expenses of $30,000 represent an estimate of the time spent on the case by Mr. Goodstadt, the Company's General Counsel.

Q. DO YOU RECOMMEND THAT ADJUSTMENTS BE MADE TO THE COMPANY'S PROPOSED RATE CASE EXPENSE AMORTIZATION AMOUNT?

A. Yes. I recommend that two adjustments be made to the Company's proposed rate case expense amortization approach. First, I recommend that the Company's proposed legal expense of $30,000 be reduced to a more reasonable expense level. The $30,000 legal expense estimate assumes that Mr. Goodstadt will spend approximately 261 hours[12] on this small and uncomplicated rate case. Given that this case is mostly in the hands of rate case consultant Gary Prettyman, I believe that this estimate is unreasonable. While I also believe that Mr. Prettyman's rate case fee of $40,000 is quite high, I have not taken exception to this fee amount in order to be conservative. However, considering the rather uncomplicated nature of this rate case, as well as the involvement of Mr. Prettyman, I believe that a legal expense estimate of $7,500 is more reasonable than the $30,000 estimate proposed by the Company. This legal expense estimate assumes approximately 65 hours of Mr. Goodstadt's time and is more in line with the Company's stated objective to minimize its legal costs in this rate case.[13]

Second, I recommend that the rate case expenses found to be appropriate in this case be shared between ratepayers and shareholders on a 50/50 basis in accordance with long-standing and well-established Board policy.

[12] The response to RCR-21 indicates that Mr. Goodstadt's hourly rate for this case is $115. The total estimated legal expense of $30,000 therefore assumes 261 hours of Mr. Goodstadt's time.
[13] See page 9, lines 21-22 of the direct testimony of Mr. Prettyman.

Q. WHAT IS THE IMPACT OF YOUR RECOMMENDATIONS ON THE COMPANY'S PROPOSED PRO FORMA TEST YEAR OPERATING EXPENSES?

A. As shown on Schedule RJH-7, the recommended annual rate case amortization expense amounts to $8,750 which is $16,250 lower than the Company's proposed rate case amortization expense level of $25,000.

- **Payroll Taxes**

Q. PLEASE EXPLAIN THE RECOMMENDED PAYROLL TAX ADJUSTMENT SHOWN ON SCHEDULE RJH-4, LINE 4.

A. This recommended tax adjustment represents the payroll tax impact of my recommended salary and wage adjustments that were previously discussed in this testimony. As shown, in footnote (2) of Schedule RJH-4, the recommended payroll tax adjustment is calculated by applying the approximate payroll tax rate of 8% to the recommended salary and wage adjustment summarized on Schedule RJH-5, line 1.

- **Income Taxes**

Q. HOW DID YOU DERIVE THE RECOMMENDED PRO FORMA INCOME TAXES TO BE USED FOR RATE MAKING PURPOSES IN THIS CASE THAT ARE SUMMARIZED ON SCHEDULE RJH-4, LINE 9?

A. As shown on Schedule RJH-8, I have used the exact same methodology and calculation components as those used by the Company to derive the recommended pro forma income taxes. My recommended pro forma income taxes are different from the Company's proposed pro forma income taxes only because of the recommended adjustments made by me in the areas of operating revenues, operating expenses and pro forma interest (see Schedule RJH-8, lines 1 and 2). These are not income tax issues per se. They merely represent the "flow-through" impact on income taxes resulting from all taxable income adjustments reflected in this testimony.

E. RATE DESIGN

Q. HOW ARE THE COMPANY'S CURRENT ANNUAL RATES DISTRIBUTED OVER ITS THREE CUSTOMERS, THE ROLLING HILLS CONDOMINIUM ASSOCIATION, ANDOVER INTERMEDIATE CARE CENTER, AND ANDOVER NURSING HOME?

A. As shown at the top of Schedule RJH-9, the Company's current annual rates have the following distribution among the three customers:

Rolling Hills Condominium Association	29.553%
Andover Intermediate Care Center	58.370%
Andover Nursing Home	12.077%

This rate design, which was established effective 8/15/01 in the Company's first rate case and was based upon a settlement among the parties in that case, produced the current monthly rate of $35.50 per unit for the Condominium Association, and monthly rates of $18,090 and $3,743 for the Andover Intermediate Care Center and Andover Nursing Home, respectively.

Q. WHAT RATE DESIGN IS THE COMPANY PROPOSING IN THE CURRENT CASE FOR ITS THREE CUSTOMERS?

A. Since there are no records to determine the actual flows from each of the three customers, the Company in this case projected these flows utilizing projected initial flow criteria contained in N.J.A.C. 7:14A-23.3. Based on these projected flows, the Company came up with the following annual rate distribution among its three customers:

Rolling Hills Condominium Association	38.815%
Andover Intermediate Care Center	46.553%
Andover Nursing Home	13.632%

As shown in the middle part of Schedule RJH-9, based on the rate increase request of $366,000 in this case, this Company-proposed rate design results in a monthly rate of $94.90 per unit for the Condominium Association, and monthly rates of $28,629 and $8,383 for the Andover Intermediate Care Center and Andover Nursing Home, respectively. These proposed monthly rates represent increases of 167.33% for the Condominium Association, 58.26% for the Andover Intermediate Care Center, and 123.97% for the Andover Nursing Home. The Company claims that the reason for the significant increase in the proposed Rolling Hills Condominium Association rate distribution and decrease in the proposed Andover Intermediate Care Center rate distribution is that the Condominium Association's rate distribution was "artificially kept lower" in the settlement of the prior rate case.

Q. WHAT RATE DESIGN ARE YOU RECOMMENDING IN THE CURRENT CASE FOR THE THREE CUSTOMERS?

A. As shown at the bottom portion of Schedule RJH-9, I recommend the continuation of the current rate design, i.e., a rate distribution of 29.553% for the Condominium Association, 58.370% for the Andover Intermediate Care Center, and 12.077% for the Andover Nursing Home. As previously mentioned, the actual flows from each of the three customers are not known. The Company's proposed rate design is based on projected initial flow criteria from the New Jersey Administrative Code that may have no relationship whatsoever with the actual flows of the three customers. At least the current rate design has previously been considered and agreed to by the parties that were involved in the Company's prior rate case. I see no good reason why this previously agreed upon rate design should now be changed based on factors that may have no valid basis.

Schedule RJH-9 shows that, based on Rate Counsel's recommended rate increase of $84,085, my recommended rate design results in a monthly rate of $43.53 per unit for the Condominium Association, and monthly rates of $22,180 and $4,589 for the Andover Intermediate Care Center and Andover Nursing Home, respectively. These proposed monthly rates represent equal increases of 22.61% for each of the three customers.

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

A. Yes, it does.