BEFORE THE STATE OF NEW JERSEY

BOARD OF PUBLIC UTILITIES

OFFICE OF ADMINISTRATIVE LAW

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

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

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I. INTRODUCTION

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

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

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

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

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

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

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

A. Yes. I have presented testimony in 110 other proceedings before the state regulatory commissions in Alabama, Arkansas, Colorado, Connecticut, Delaware, Indiana, Kansas, Maine, Maryland, Montana, Nevada, New Jersey, New Mexico, New York, Pennsylvania, South Dakota, West Virginia, and Wyoming, and before the Federal Energy Regulatory Commission. In addition, I have twice testified before the Energy Subcommittee of the Delaware House of Representatives on the issues of consolidated tax savings and tax normalization.

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

II. SUMMARY

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

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

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

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

Utility	Docket No.
South Jersey Gas Company	GR8704329
	GR03050413
	GR03080683
New Jersey-American Water Company	WR88070639
	WR91081399J

	WR92090906J
	WR94030059
	WR95040165
	WR98010015
	WR03070511
	WR06030257
ACE/Delmarva Merger	EM97020103
Atlantic City Electric Company	ER03020110
FirstEnergy/GPU Merger (JCP&L)	EM00110870
Jersey Central Power & Light	ER02080506
	ER05121018
Rockland Electric Company	ER02100724
	ER06060483
Public Service Electric and Gas	EM00040253
Exelon/PSE&G Merger	EM05020106
Conectiv/Pepco Merger (ACE)	EM01050308
Elizabethtown Gas Company	GR02040245
United Water New Jersey, Inc.	WR07020135

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

A. I was asked to assist Rate Counsel in analyzing New Jersey Natural Gas Company's ("NJNG" or "the Company) request for a rate base allowance for cash working capital. NJNG's request for a cash working capital allowance is based on a lead-lag study conducted by Michael P. Moscufo, Jr. The purpose of my testimony is to present the results of my analysis of Mr. Moscufo's lead-lag study to Your Honor and the Board and to recommend alternative ratemaking treatments for several items included in Mr. Moscufo's study. Based on my calculation of NJNG's cash working capital requirement I recommend that Ms. Crane incorporate a $35,887,00 allowance for cash working capital in her rate base determination, rather than the $51,127,000 allowance that is reflected in NJNG's proposed rate base.

III. CASH WORKING CAPITAL

Q. DID MR. MOSCUFO PROPERLY DEFINE CASH WORKING CAPITAL OR STATE THE REASON WHY IT IS APPROPRIATE TO INCLUDE A CASH WORKING CAPITAL ALLOWANCE IN RATE BASE?

A. No, he did not. On page 1 of his direct testimony in this proceeding (Exhibit P-5), Mr. Moscufo defines working capital as: "…the average amount of capital, over and above investments in plant and other separately identified rate base items provided by investors of NJNG, necessary to bridge the gap between the time expenditures that are required to provide service are made and the time collections are received for that service." By this definition, Mr. Moscufo appears to be including the entire gambit of working capital items, including prepaid expenses, inventories, materials and supplies, etc. But, no where in his testimony does he provide a cogent definition of the utility's "cash working capital" requirement, which is a smaller subset of the much broader working capital requirement. Nor did he provide a basis for including an allowance for cash working capital in rate base.

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

A. A cash working capital allowance should be included in rate base to compensate investors for investor-supplied funds, if any, used to provide the day-to-day cash needs of the utility. These cash needs can be measured in a lead-lag study. A lead-lag study measures the time between (1) the provision of service to utility customers and the receipt of revenue for that service by the utility, and (2) the provision of service by the utility and its disbursements to employees and suppliers in payment for the associated costs. The difference between the revenue "lag" and the expense "lead" is expressed in days. The difference, which can be either a net lag or a net lead, multiplied by the average daily cash operating expenses, quantifies the cash working capital required for, or available from utility operations.

In this proceeding, Mr. Moscufo is sponsoring a lead-lag study based on recently experienced lead and lag days and test period costs. Mr. Moscufo's lead-lag study, however, goes far beyond the measurement of NJNG's cash working capital requirement.

Q. HOW DO MR. MOSCUFO'S LEAD-LAG CALCULATIONS OVERSTATE NJNG'S CASH WORKING CAPITAL REQUIREMENT?

A. Mr. Moscufo overstates NJNG's cash working capital requirement in three significant ways. First, Mr. Moscufo's treatment of employee benefit costs in his lead-lag analysis fails to reflect prudent cash management principles by not effectively using allowed "grace periods" within which to make certain insurance premium payments. Second, Mr. Moscufo improperly includes non-cash expenses in his lead-lag analysis. Non-cash expenses, however, do not create a requirement for working capital. The non-cash expenses that are included in Mr. Moscufo's study are the uncollectible accounts expense, the deferred income tax expense and the depreciation expense. Combined, the inclusion of these non-cash expenses in the lead-lag study significantly overstates the Company's actual working cash requirement. Third, Mr. Moscufo's lead-lag study improperly measures the cash transactions associated with the Company's capital costs. That is, his analysis fails to properly consider the expense leads associated with NJNG's payment of the interest expense.

Q. LOOKING AT THE FIRST ISSUE THAT YOU HAVE RAISED, WHAT IS THE ISSUE WITH RESPECT TO THE COMPANY'S PAYMENT OF EMPLOYEE BENEFITS?

A. NJNG has policies with an insurance carrier, MetLife, who provides life, accidental death and dismemberment, long-term disability and temporary disability benefits to the Company's employees. These policies specify that premium payments are due on the first day of each month. But, a 31-day grace period is also provided. That is, premium payments are not considered delinquent until 31-days after the first day of the month. NJNG, however, does not make effective use of the grace period that MetLife extends to it. In fact, the Company often times makes premium payments prior to the due date. The Company's early payment of premiums is reflected in Mr. Moscufo's lead-lag study.

This issue presented in this regard is that it is unreasonable to charge ratepayers for the cash working capital consequences of NJNG's voluntary early premium payments. A prudent cash management strategy dictates that the utility make full and effective use of all grace periods offered by vendors. That aside, whether or not NJNG chooses to takes advantage of the working capital benefits arising from grace periods offered by its vendors, ratepayers should not be penalized if the Company chooses to ignore those benefits.

Q. HOW DO YOU CORRECT FOR THIS DEFICIENCY IN MR. MOSCUFO'S LEAD-LAG STUDY?

A. On Exhibit___(DEP-2), Schedule 1, I recalculated the composite expense lead days associated with all employee benefits. The new composite expense lead day amount, 29.1 days, was determined by reflecting in the lead-lag day analysis the 31-day grace period for premium payments for life, accidental death and dismemberment, long-term disability, and temporary disability insurance, as shown on Schedule 2 of my exhibit. My adjustments increase the composite expense lead days for employee benefits from the 27.7 days reflected in Mr. Moscufo's study to 29.1 days, which is reflected in my schedules.

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

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

On page 4 of his direct testimony in this proceeding (Exhibit P-5), Mr. Moscufo explained that his allowance for uncollectible accounts expense measures the "….average number of days each accrued dollar is included in the reserve for doubtful accounts…" A lead-lag study, however, is intended to measure actual cash flows, not accounting accruals. The average lag in customer payments, including late paying customers, is measured in the revenue lag portion of the study. All that is necessary and appropriate to complete the lead-lag study is to measure the timing of NJNG's payment of cash expenses. Accounting accruals and amortizations, however, are not cash expenses.

No one will dispute that uncollectible accounts represent a legitimate expense in an accounting sense given that the expense reduces net income. But, the accounting accrual for uncollectible accounts is not a source of working capital as portrayed in Mr. Moscufo's lead-lag study. To see the obviously fallacy of including the uncollectible accounts expense in the lead-lag study one need only answer the question: How does a customer who does not pay his utility bill become a source of working capital for the utility? If that were the case, we should be encouraging all customers to not pay their utility bills. Obviously, this is an absurd result. Uncollectible accounts expenses should not be included in the lead-lag study. On my Exhibit___(DEP-1), I recalculated NJNG's cash working capital requirement after excluding uncollectible accounts expenses.

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

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

Q. MR. MOSCUFO ARGUES THAT BECAUSE INVESTOR CAPITAL WAS EXPENDED WHEN PLANT ASSETS WERE ACQUIRED THIS JUSTIFIES INCLUDING DEFERRED TAXES IN THE LEAD-LAG STUDY (MOSCUFO DIRECT TESTIMONY, PAGE 5). HOW DO YOU RESPOND TO HIS ARGUMENT?

A. No one will dispute that investors expended funds at the time the Company acquired its plant assets. Contrary to Mr. Moscufo's *non sequitur* reasoning, however, this undisputed fact supports my position on deferred taxes rather than his. The cash transaction with investors associated with plant in service giving rise to deferred taxes has already occurred in the past. There is no further cash outlay from either investors or the Company that is in any way connected with the deferred taxes from that point on. No working capital is needed by the utility for this item. Thus, there is no justification for a cash working capital allowance for deferred income taxes.

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

A. Like deferred income taxes, depreciation is a non-cash expense. Once again, the cash transaction associated with a plant asset occurred when the asset was first acquired. No additional investor-supplied funds for working capital purposes are required following the initial investment. Rather, the depreciation expense is an accounting accrual established to provide a systematic means for the utility to recover the cost of a plant asset over its useful service life. The utility, however, does not write out a check at the end of each month for "depreciation expense" to investors. For that reason, depreciation expense is said to represent a significant source of cash flow for the utility even though it is a non-cash expense as far as

NJNG's cash working capital requirement is concerned. Therefore, it is not appropriate to include depreciation expense in the lead-lag study.

Q. HOW ARE CAPITAL COSTS REFLECTED IN MR. MOSCUFO'S LEAD-LAG STUDY?

A. Mr. Moscufo included a line item in his lead-lag study for return on invested capital with a zero-day expense lead. This line item is intended to recover a working capital allowance for both the common equity return and debt interest.

Q. SHOULD THE COMMON EQUITY RETURN BE INCLUDED IN A LEAD-LAG STUDY?

A. No. In his lead-lag study, Mr. Moscufo treats the common equity return as if NJNG compensates stockholders on a daily basis. The fact is that compensation is received by stockholders in two forms; i.e., through quarterly dividend payments, if any, and through capital appreciation, if any, upon the sale of the stock. If one were to measure the actual delay in the cash outlay by the utility to stockholders, one would refer to the quarterly dividend payments that are being paid, and not simply assume a zero lag as Mr. Moscufo has done. But, because there is no contractual requirement for New Jersey Resources to pay fixed quarterly dividends to stockholders, the common equity return should not be included in the cash working capital measurement in the first place.

Q. HOW DID MR. MOSCUFO'S TREAT OF INTEREST EXPENSE IN HIS LEAD-LAG STUDY?

A. Mr. Moscufo simply lumped NJNG's interest expense in with the common equity return and applied a zero-day lag to NJNG's return on invested capital.

Q. SHOULD INTEREST EXPENSE BE TREATED IN THIS MANNER?

A. No. Unlike quarterly dividend payments, there are contractual requirements associated with NJNG's debt issuances that obligate the Company to make fixed interest payments on certain dates. In this respect, debt interest more closely resembles NJNG's other cash operating expenses. Therefore, the payment lead for NJNG's interest expenses should be separately recognized in the lead-lag calculation. Typically, long-term debt interest is paid semi-annually, creating a

91.25-day expense lead. NJNG also has several EDA bonds outstanding and well as short-term debt in its proposed regulatory capital structure. These appear to require NJNG to make monthly interest payments. I am presently awaiting NJNG's response to an information request that will allow me to accurately measure NJNG's actual weighted average expense lead days associated with its interest payments. For purposes of my presentation now, however, I have included a 91.25-day expense lead for NJNG's interest expense, as a placeholder. I will provide an updated lead-lag summary once I get the information necessary to make a more accurate calculation of the interest expense lead days.

Q. HAVE YOU MADE AN INDEPENDENT DETERMINATION OF NJNG'S CASH WORKING CAPITAL REQUIREMENT?

A. Yes. My summary cash working capital calculation is shown on Exhibit___(DEP-1). In this calculation, I used my adjusted lead and lag day determination for employee benefits expense and NJNG's claimed test period (9+3 update) cash operating expenses. I excluded the non-cash expenses, however. I also calculated a separate expense requirement for interest expense. Using this approach, I calculated that NJNG's cash working capital requirement is $35,887,000. This is $15,240,000 less than the allowance that Mr. Moscufo calculated. Of course, my schedule will need to be updated later in this proceeding to properly synchronize the cash operating expenses that are incorporated into the lead-lag study with those that are approved for ratemaking purposes in the Board's final order.

Q. DOES THIS CONCLUDE YOUR TESTIMONY AT THIS TIME?

A. Yes, it does.