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July 27, 2012

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

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

Dear Judge Jones:

Enclosed please find an original and one (1) copy of the Division of the Rate Counsel's Initial Brief in connection with the above referenced matter. Copies of the brief are being provided to the parties by electronic mail and hard copies are being sent by US Regular Mail to all parties on the attached service list.

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

Respectfully submitted,

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

I/M/O the Petition of ACE for Approval of Amendments to its Tariff to Provide For an Increase in Rates and Charges for Electric Service Pursuant to <u>N.J.S.A.</u> 48:2-21 and <u>N.J.S.A.</u> 48:2-21.2 and for Other Appropriate Relief
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STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW
BEFORE THE HONORABLE IRENE JONES

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

INITIAL BRIEF ON BEHALF OF THE DIVISION OF RATE COUNSEL

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PROCEDURAL HISTORY

On August 5, 2011 Atlantic City Electric Company ("ACE", "Atlantic" or the "Company") filed a petition and testimonies with the New Jersey Board of Public Utilities (the "Board" or "BPU") seeking a $58.395 million (including Sales and Use Tax "SUT") increase in its base rates for electric service and a $502,000 (including SUT) increase in the Company's Regulatory Asset Recovery Charges ("RARC"), pursuant to N.J.S.A. 48:2-21 and 48:2-2.1, to be effective on and after September 5, 2011. The Company also sought to modify the mechanism by which a previously Board ordered amortization of an excess depreciation reserve is reflected in customer rates.

In support of its base rate case, concurrent with its filing, ACE filed the testimony and exhibits of Anthony J. Kamerick (*P-4*), Julie M. Cannell (*P-1*), Vincent Maione (*P-3*), Kevin M. McGowan (*P-6*), Robert B. Hevert (*P-8*), Jay C. Ziminsky (*P-19*), Kathleen A. White (*P-2*), Elliott P. Tanos (*P-31*), and Joseph F. Janocha (*P-18*). On August 17, 2011, the Company filed the schedules of EPT-2 and EPT-6 which were omitted from previously distributed copies of Mr. Tanos' testimony.

The matter was transmitted to the Office of Administrative Law ("OAL") for evidentiary hearings on August 18, 2011 and was assigned to the Honorable Irene Jones, Administrative Law Judge ("ALJ"). On September 22, 2011, the Board issued an Order suspending the rates and charges.

On August 19, 2011, Public Service Electric and Gas Company ("PSE&G") filed a Motion for Participant Status in this matter. The Company filed a response opposing Participant Status for PSE&G on October 27, 2011. On November 4, 2011, PSE&G filed

a reply. On November 16, 2011, ALJ Jones issued an Order granting PSE&G's Participant Status in this proceeding pursuant to N.J.A.C. 1:1-16.6.

On September 7, 2011, Wal-Mart Stores East, LP and Sam's East, Inc. (collectively "Walmart") filed a Motion to Intervene in this matter. On December 6, 2011, ALJ Jones issued an Order that granted Intervenor Status to Walmart.

A pre-hearing conference was held before ALJ Jones on October 19, 2011 and a Prehearing Order was issued on November 15, 2011. In accordance with the schedule set forth in the Prehearing Order, discovery was propounded. Public hearings were held on March 22, 2012 and May 31, 2012 in Mays Landing.

On December 1, 2011, the Company submitted a letter motion requesting that the Board issue an Order to: (1) bifurcate the Company's involvement in a joint petition[1] with PSE&G filed with the Board on August 26, 2011 that sought authorization to defer actual storm restoration costs related to the then-impending Hurricane Irene, and (2) transmit the ACE portion of the bifurcated joint petition, along with all the Company-related discovery and responses, to the OAL with instructions to consolidate the matter with the Company's pending base rate case. PSE&G and the Division of Rate Counsel ("Rate Counsel") advised the Board that they did not oppose the request. On December 15, 2011, the Board granted the Company's letter motion.

On February 24, 2012, the Company updated its filing to reflect twelve months of actual results. On March 6, 2012, the Company filed workpapers supporting its updated revenue requirement projection that was filed on February 24, 2012.

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[1] In the Matter of the Petition of Public Service Electric and Gas Company and Atlantic City Electric Company's Request for Deferral Accounting Authority for Storm Damage Restoration Costs, BPU Dkt. Nos. EO11090518 and GO11090519

In a March 23, 2012 letter, the parties advised ALJ Jones that they had agreed to extend the filing date for Rate Counsel's and Intervenor's testimony to April 16, 2012. The Company's filing date for the rebuttal testimony was also moved to May 18, 2012.

Also on March 23, 2012, ALJ Jones directed the parties to comment on the consolidation of Atlantic's Infrastructure Investment Program ("IIP-1") proceedings, - the IIP-1 initial filing,[2] the IIP surcharge adjustment filing,[3] and the IIP-1 final reconciliation filing[4] - into the base rate case. By letter dated March 26, 2012, Rate Counsel advised the ALJ that it did not object to the consolidation of the IIP-I dockets into the base rate case.

On April 9, 2012, a letter was sent to ALJ Jones advising her that the parties agreed to further extend the filing date for testimony until April 23, 2012. On April 23, 2012, a letter was sent to ALJ Jones advising her that the parties agreed to further extend the filing date for testimony until April 25, 2012. The filing date for the rebuttal testimony was moved to May 23, 2012.

On April 25, 2012, Rate Counsel filed the testimonies of Matthew I. Kahal (*RC-1*), Andrea Crane (*RC-4*), David Peterson (*RC-5*), Charles Salamone (*RC-2*), and Roger Colton (*RC*-3). On that same day, Walmart filed the testimony of Steve W. Chriss. (Walmart-1)

On May 23, 2012, the Company filed the rebuttal testimonies and exhibits of Anthony J. Kamerick (*P-5*), Steven M. Fetter (*P-28*), Robert B. Hevert (*P-9*), Kevin M.

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[2] In the Matter of the Petition of Atlantic City Electric Company for Approval of Certain Energy Infrastructure Investments and Approval of Cost Recovery for Such Projects and Related Tariff Modifications Associated Therewith Pursuant to N.J.S.A 48:2-21 and N.J.S.A. 48:2-21.1, BPU Dkt. Nos. EO09010054 and ER09110924

[3] In the Matter of the Petition of Atlantic City Electric Company for Approval of an Update to the Cost Recovery Mechanism Associated with Its Capital Economic Stimulus Infrastructure Investment Program Pursuant to N.J.S.A. 48:2-21 and 48:2-21.1 (Adjustment to Infrastructure Investment Surcharge Tariff to Be Effective January 1, 2011), BPU Dkt. No. EO10110847

[4] In the Matter of the Petition of Atlantic City Electric Company for Final Reconciliation of Infrastructure Program Projects and Costs, BPU Dkt. No. EO11110846

McGowan (*P-7*), Jay C. Ziminsky (*P-20*), William M. Gausman (*P-10*), Charles R. Dickerson (*P-16*), Elliot P. Tanos (*P-32*), Joseph F. Janocha (*P-18*), and James I. Warren (*P-29*).

Evidentiary hearings, which included oral surrebuttal testimony on behalf of Rate Counsel, were held at the OAL on June 18, 19, 20, 21, 25, and 27, 2012.

According to the schedule set in the Pre-hearing Order, initial briefs were due on July 16, 2012 and reply briefs on July 30, 2012. The schedule was subsequently modified, initial briefs are now due on July 27, 2012 and reply briefs are due on August 10, 2012.

STATEMENT OF FACTS

ACE is a public utility corporation of the State of New Jersey and is subject to the jurisdiction of the Board. ACE maintains a regional office at 5100 Harding Highway, Mays Landing, New Jersey. The Company is a direct, wholly owned subsidiary of Conectiv, LLC, a Delaware limited liability company, and an indirect, wholly owned subsidiary of Pepco Holdings, Inc., ("Pepco", "PHI" or "Pepco Holdings") a Delaware corporation. ACE is engaged in the retail distribution and sale of electric energy for residential, commercial and industrial purposes within its defined service territory, which includes Atlantic, Cape May, and Salem Counties and parts of Burlington, Camden, Cumberland, Gloucester, and Ocean Counties in New Jersey. The Company is subject to the jurisdiction of the Board pursuant to N.J.S.A. 48:2-21 et seq.

Within its service territory, ACE serves approximately 547,000 customers.

The Company's electric base rates were last increased in May of 2010. At that time, the Company was granted an increase of approximately $ 20.0 million. In this case, filed on August 5, 2011, the Company initially filed for a base rate increase of $75.466 million, including sales and use taxes ("SUT"). *RC-4*, *p.2*. The Company proposed to partially offset this increase with a credit of $17.071 million (including SUT) relating to the amortization of excess depreciation expenses that were previously addressed by the BPU. *Id.* ACE proposed to transfer this credit from base rates to a separate, explicit item in the Company's tariff that would expire August 31, 2013, the end of the amortization period. *Id.* In addition, the Company requested a rate increase of approximately $501,000 (including SUT) in its Regulatory Asset Recovery Charge ("RARC"). *Id. at 3*

ACE's initial request would have resulted in an electric distribution revenue increase of approximately 20.7% in electric distribution rates. Id.

The Company's case is based on a test year consisting of the twelve months ending December 31, 2011. As originally filed, ACE's revenue requirement reflected actual results for three months and projected results for the last nine months of the test year (3+9). ACE subsequently updated its filing to reflect twelve months of actual results (12+0 Update). In that update, the Company increased its electric rate increase request to $96.587 million (including SUT) million and increased its RARC claim by an additional $182,000. Id. Accordingly, the Company is now seeking an increase in its electric distribution rates and RARC of approximately 28.0%. Id. The Company claims that the proposed rates are necessary to provide sufficient operating revenues to reflect increased investment in the Company's rate base; meet operating expenses, taxes and fixed charges; and provide a reasonable rate of return on the fair value of the Company's property. Petition ¶4.

As set forth more fully in the sections which follow, and in the testimony of Rate Counsel's witnesses, the Company's request is excessive and should be rejected. The Company's proposal includes, *inter alia*, an unreasonably high cost of equity, fails to apply appropriate rate treatment for the benefits associated with its participation as part of the PHI consolidated tax group, improperly includes post-test year plant additions and a prepaid pension asset in rate base, and proposes an inappropriate weather normalization adjustment. Rate Counsel asserts that in accordance with the analyses and recommendations set forth in the testimony of Rate Counsel's witnesses, a rate increase of approximately $5.474 million is an appropriate increase in base rates. *RC-4*, *Sch.*

ACC-1. If, as recommended by Rate Counsel, RARC amortization are rolled into base rates, the total increase granted to the Company should be $8.128 million. As set forth in the sections which follow, there is overwhelming evidence in the record which supports Rate Counsel's recommended adjustments to the Company's proposal.

ACE proposes a 10.75% return on equity, a .45% increase over its current ROE. *P-9*, p.3. Based on the analysis of Rate Counsel witness Matthew I. Kahal, Rate Counsel is proposing a return on equity of 9.5% including adjustments for poor reliability and customer service. Mr. Kahal's recommended return figure is based on the proper application of sound methodology and is consistent with interest rate trends and expected returns for electric distribution utilities. As discussed herein and in the testimony of Mr. Kahal, Atlantic bases its ROE recommendation on a flawed application of the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methodologies.

In addition, Rate Counsel urges the adoption of the 9.5% ROE to address ACE's poor reliability and customer service. The Company's reliability performance has been mediocre and electric service quality has been declining over time for the past ten years. *RC-2*, *p. 22*. The performance of some circuits on the system has been problematic for multiple years and customers on these circuits have been receiving a very poor degree of service reliability. *Id.* The Company has not allocated sufficient funding to address these concerns. *RC-2*, *p.14-15*. The Company also has persistently poor performance in customer service. The Company has consistently failed to meet agreed upon service metrics and has not expended sufficient funds to address these issues. Imposing consequences to bring about the necessary improvement through a lower ROE is both reasonable and necessary.

Rate Counsel also recommends a reduction in the Company's proposed rate base of $477,497,000. *RC-4*, *Sch. ACC-3*. These adjustments include the exclusion of inappropriate post test-year additions. Other adjustments which properly reflect a reasonable level of expenses and revenues associated with the provision of utility service include the exclusion of the costs for Incentive Compensation, the costs associated with the Company's Senior Executive Retirement Plan ("SERP"), and Corporate Restructuring costs. The pro-forma revenue and expense changes proposed by Rate Counsel amount to an increase of $5.474 million in pro-forma, electric base distribution revenue, exclusive of Rate Counsel's recommendation that the BPU should terminate the Company's Regulatory RARC and transfer the annual amortization amount of $2,647,316 into base rates.

The recommended adjustments also include a consolidated income tax adjustment, which is consistent with Board policy and completely absent from the Company's filing. Rate Counsel recommends a total consolidated income tax adjustment to rate base of $385.892 million. *RC-4*, *Sch. ACC-12*.

The entire $5.474 million revenue increase, exclusion of the RARC, recommended by Rate Counsel should be allocated among the Company's Residential and Street and Private Lighting customer classes, $4.956 million to the Residential class and $518,126 to the Street and Private Lighting class, as proposed by Rate Counsel witness David E. Peterson. *RC-5*, *p. 16*. Furthermore, Rate Counsel recommends that the Company's monthly service charge for Residential Service customers and for Monthly General Service customers should not be increased. Rate Counsel has no

objection to the Company's recommendation to begin eliminating the declining block rate for Residential customers during the winter heating season.

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

In sum, as set forth in the sections which follow, Rate Counsel respectfully submits that Rate Counsel's recommended adjustments and modifications to the Company's request be adopted by Your Honor and the Board.

POINT I

RATE COUNSEL'S RETURN ON EQUITY OF 9.5% AND PROPOSED CAPITAL STRUCTURE OF 47.98% COMMON EQUITY SHOULD BE ADOPTED RESULTING IN AN OVERALL RATE OF RETURN OF 7.88 % FOR ATLANTIC

The evidence in this proceeding on capital structure, return on equity and overall rate of return is found in the testimonies of experts offered by Rate Counsel, Walmart and the Company. For the reasons set forth in this brief, Rate Counsel respectfully submits that its recommendations, as more fully set forth in Rate Counsel witness Matthew I. Kahal's testimony, should be adopted, including a return on equity at 9.5% and a capital structure that includes $18 million of unamortized debt-related expenses and short-term debt. Company witness Kevin M. McGowan proposed a capital structure that excluded short-term debt and also, contrary to typical practice in New Jersey for setting capital structure, excluded $18.0 million in unamortized debt expense from the actual balance of long-term debt outstanding. The Company's proposed overall rate of return incorporates witness Robert Hevert's Return on Equity testimony recommendation of 10.75%, an inflated figure which is not in any way supported by his updated study results presented in his rebuttal testimony. Based on the evidence in this proceeding, Mr. Kahal's recommendations are more credible and fully supported and should be adopted by Your Honor and the Board.

A. Capital Structure

In his initial testimony, Company witness McGowan proposed a capital structure for rate making purposes comprised of 50.90 percent long term debt, at a cost rate of 6.50 percent for a weighted cost of debt of 3.31 percent, and 49.10 percent common equity, at

a cost rate of 10.75 percent for a weighted cost rate of 5.28 percent. *P-6, Sch. KMM-1.* Mr. McGowan's overall cost of capital was 8.59 percent. This was later updated to 8.56 percent based on the 12 + 0 filing and December 31, 2011 information.

Mr. Kahal calculated the Company's capital structure based on the Company's 12 + 0 filing along with other information. *RC-1, Sch. MIK-1.* Mr. Kahal recommended a capital structure for ratemaking purposes of 51.31 percent long term debt at a cost rate of 6.47 percent for a weighted cost of 3.32 percent, 0.71 percent short-term debt at a cost rate of 0.35 percent for a weighted cost of 0.00, and 47.98 percent common equity at a cost rate of 9.5 percent for a weighted cost rate of 4.56 percent, resulting in an overall rate of return of 7.88 percent.

This relatively minor difference in the capital structure calculation arises from the Company removing about $18 million of unamortized debt-related expenses, principally the unamortized balance of debt issuance expenses and reacquisition costs, from its actual balance of long-term debt outstanding. Atlantic also excludes its short-term debt from the capital structure and fails to properly account for it elsewhere in the ratemaking process. *RC-1*, p. 15

1. Short-term Debt Should Be Included in Capital Structure

The Company excludes short-term debt from its capital structure and fails to account for it elsewhere. Rate Counsel made an adjustment to recognize in capital structure $11.8 million of short-term debt, which is the average monthly reported balance for the period May through December 2011. *RC-1*, *p. 17*.

The Company argues that it is inappropriate to include short-term debt in the capital structure calculation as it is more appropriate to consider it as financing

Construction Work in Progress ("CWIP"), a non-rate base item that must be financed. *RC-15, RC-1,* p. 16. To be clear, Rate Counsel in this case does not object to the Company's stated position that short-term debt should be viewed as supporting CWIP instead of being included in capital structure. However, in responses to Rate Counsel's discovery requests, Atlantic indicates that this is not how the Company actually accounts for short-term debt. When questioned in discovery, the Company responded that it "does not directly assign short-term debt to construction work in progress (CWIP) for AFUDC accrual purposes." *RC 1,* p. 17. If the Company does not account for short-term debt as supporting CWIP, then it must be included in the capital structure. To do otherwise would be to totally ignore and fail to account for short-term debt – the Company's acknowledged cheapest source of capital.

The Company reports that its current AFUDC rate is 8.25% which is substantially higher than current short-term rates of less than 1%. The Company is authorized by the Board to maintain up to $250 million in short-term debt financing.[5] As Mr. Kahal testified in his oral surrebuttal, "They are going to be using short-term debt, they're going to be using a lot of it. It should be directly assigned to the financing of the construction work in progress. That way customers get the benefit of this very, very cheap short-term debt." *T164:L10-15* (June 18, 2012). Rate Counsel witness Andrea Crane included the costs associated with the Company's short-term credit facility in her revenue requirement recommendation because of Mr. Kahal's inclusion of short term debt in the capital structure. As Ms. Crane explains, "There is no rationale for including these [credit facility] costs in utility rates if ratepayers are not receiving any of the

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[5] I/M/O the Petition of Atlantic City Electric Company, Pursuant to N.J.S.A. 48:2-13 and N.J.S.A. 48:3-9 For Authority to Issue Up to $250 Million of Short-term Indebtedness Prior to January 1, 2014, BPU Dkt. No. EF11090577, Order, (Dec. 15, 2011)

benefits of this short-term credit facility…The Company cannot have it both ways, i.e., exclude short-term debt from the capital structure but include the costs of the credit facility in its revenue requirement." *RC-4*, *p. 62*. If Your Honor and the Board allow ACE to exclude short-term debt from its capital structure, then it should also make an adjustment to exclude all credit facility[6] costs from the Company's revenue requirement.

In addition, Ms. Crane's revenue requirement includes the credit facility costs on the entire $250 million of authorized short-term debt while Mr. Kahal has only included $11.8 million in his pro-forma Capital structure. If recovery is limited to recovery of credit facility costs, then only costs associated with the amount of short-term debt actually reflected in the Capital structure should be allowed. *RC-4*, *p. 63*. If in the other hand, Your Honor and the Board choose to exclude short-term debt from capital structure, it should direct Atlantic to directly assign its actual balance of short-term debt to CWIP for AFUDC accrual purposes – consistent with Atlantic's stated position that short-term debt supports CWIP. This directive would produce a result which is accurate, proper and entirely fair to both the Company and its ratepayers.

2. The $18 million Unamortized Debt Expense Should Be Included in Long-Term Debt

The Company proposes to exclude $18 million for unamortized debt-related expenses from its actual balance of long-term debt outstanding. This amount represents the unamortized balance of debt issuance and reacquisition costs associated with its long-term debt. This represents a non-standard adjustment and is contrary to typical practice

[6] A credit facility is a loan agreement arrangement between the utility borrower and the financial institution(s) (usually a bank) that provides the utility access to short-term funds and liquidity, when needed.

in New Jersey for setting capital structure. *RC-1*, *p. 15*. The Company, through its witness Mr. McGowan, stated that the Company was following the capital structure practices it employs in Maryland, and the District of Columbia. *T91:L6-18* (June 18, 2013). On cross examination, however, Mr. McGowan admitted that he had no knowledge of this adjustment having been adopted by the New Jersey Board of Public Utilities or mandated by the Federal Energy Regulatory Commission ("FERC"). *T90-92:L6-18* (June 18, 2013). Based upon prior Board policy and the absence of any convincing reason to change this policy, the Company's adjustment should be rejected.

3. Rate Counsel's Recommended Adjustments to the Company's Proposed Capital Structure Are Reasonable and Comport With BPU Policy.

The evidence in this proceeding clearly favors adoption of Rate Counsel's position on capital structure. The Company has proposed a capital structure that denies ratepayers the benefit of the very low cost short-term debt and has artificially reduced the amount of long-term debt in its proposed capital structure. *P-6, p. 3-4*; *RC-1, p. 15*. Both of these adjustments unreasonably increase the Company's overall cost charged to ratepayers. Even the Company concedes that Rate Counsel's recommended capital structure of 48 percent equity and 52 percent total debt is fully consistent with the Company's own capital structure target of an equity ratio "in the high 40s". Thus, Your Honor and the Board should include in the Company's capital structure the unamortized debt-related expenses (about $18 million) in the balance of long term debt outstanding and require inclusion of short-term debt in the capital structure thereby reducing the cost to ratepayers. If Your Honor and the Board decide to exclude short-term debt from the

capital structure and Atlantic's customers thereby fail to receive the benefits of short-term debt, then they should not be charged the costs associated with short-term debt, such as credit facility costs.

B. Return on Equity

Mr. Kahal recommends a return on equity ("ROE") for the Company of 9.5%. Mr. Kahal's expert opinion is based upon his straight-forward application of the widely accepted Discounted Cash Flow "DCF" model applied to a selected proxy group of utility companies with similar risk attributes to Atlantic. Mr. Kahal chose for his proxy group companies that closely reflect the Company's business model of a distribution utility. He supported his findings with a Capital Asset Pricing Model "CAPM" analysis. Mr. Kahal testified to his selection of his proxy group, the necessary assumptions he made, and why some companies were inappropriate for use in his proxy group. *RC-1, p.27-30*. Mr. Kahal indicated that he preferred the DCF model and used it as a basis for his ROE recommendation, believing it to be more reasonable than the result he obtained using the CAPM method. Mr. Kahal's 9.5% recommendation results in a ROE that is reasonable, fully reflects capital market requirements and risk, and will fairly compensate Atlantic's shareholders.

ACE's witness, Mr. Hevert recommends a 10.75% ROE for Atlantic based on three different methods – DCF, CAPM and the equity Risk Premium. Mr. Hevert's DCF analysis is flawed because he used an excessively optimistic assumed earnings growth rate and a proxy group comprised of vertically-integrated utilities that are inherently more risky than Atlantic and therefore serve only to improperly and artificially boost Mr. Hevert's ROE recommendation. Mr. Hevert recommends an unreasonably high ROE

that is 45 basis points higher than Atlantic's currently authorized ROE that was established in the Company's 2009 rate case, and 125 basis points above Mr. Kahal's recommendation, despite compelling evidence that the cost of capital has *declined* since the Company's previous base rate case in 2009. *RC-1*, *p.58.* Rate Counsel submits that Mr. Hevert's ROE is overstated and should be rejected in favor of Mr. Kahal's well-supported 9.5% ROE.

1. Mr. Kahal's Application of the Discounted Cash Flow and Capital Asset Pricing Methods

The DCF method is based upon the principle that the price of a stock will reflect the discounted stream of cash flows expected by investors. *RC-1*, *p. 25*. Mr. Kahal used the constant growth DCF model to determine his recommendations. This model is widely accepted and has consistently been used in setting equity rates in New Jersey. The constant growth DCF model assumes, for mathematical simplicity, that an investor's required ROE is equal to the dividend yield plus expected dividend or earnings rate of growth, and assumes further that the growth rate is constant for an indefinitely long period. This model is particularly applicable to regulated public utilities, which are more stable than unregulated companies.

To apply the model, Mr. Kahal selected a proxy group of utilities with attributes and a business risk profile similar to Atlantic. He chose his proxy group from companies that "are mostly or entirely electric (and in some cases combination electric/gas) distribution and transmission ('T&D') utilities," and therefore reasonably comparable to Atlantic. *RC-1*, *p.27*. For his proxy group, Mr. Kahal selected seven T&Ds that are

located in the mid-Atlantic or northeast, operate in Regional Transmission Organizations ("RTOs") and provide for retail access (with one exception), but are not considered "vertically integrated" nor do they have substantial unregulated generation. *Id.*

Mr. Kahal used his proxy group to measure the dividend yield component of the DCF formula over the six month period from September 2011 through February 2012. The proxy group average yield for this period was 4.26%. In order to properly incorporate the dividend the investor would receive over the first year after purchase of the stock, Mr. Kahal then applied the standard "half year" growth adjustment technique to calculate an adjusted dividend yield of 4.4%. *RC-1*, *p. 30*.

Mr. Kahal's next step in applying the DCF method was to estimate the growth rate. Mr. Kahal used five sources for projecting earnings growth rates. In Schedule MIK-4 attached to his Direct Testimony, Mr. Kahal showed his calculations which resulted in an average growth rate of 4.6% with a range of 4.2% to 5.0%. In addition, Mr. Kahal included a 0.1 percent flotation adjustment. *RC-1*, *p. 34*. Based upon his analyses Mr. Kahal reached the following conclusions for his proxy group:

> The adjusted dividend yield for the six months ending February 2012 is 4.4 percent for this group. Available evidence would support a long-run growth rate in the range of approximately 4.0 to 5.0 percent, as explained above. Summing the adjusted yield, growth rate range and including a 0.1 percent flotation adjustment produces a total return of 8.5 to 9.5 percent, and a midpoint result of 9.0 percent. Reliance on analyst earnings projections would tend to support a result toward the upper end of that range, while the sustainable growth rate produces a lower end DCF result.

RC-1, p.34-35.

Mr. Kahal also employed the CAPM to derive a ROE reference point as a check on his DCF results. The CAPM is the method most used after the DCF for deriving cost of equity in utility rate cases. *RC-1*, *p.38*. The CAPM is a "risk premium" approach,

where the cost of equity is equal to the yield on a risk-free asset, plus a stock market risk premium multiplied by the company's "Beta," a measure of the firm's risk relative to the overall market. The risk premium is the amount by which the expected return on the overall stock market exceeds the yield on a risk-free asset.

Mr. Kahal's application of the CAPM methodology resulted in a cost of equity range of 6.7% to 8.8%, with a midpoint of 7.7%. *RC-1, p. 48.* Even though Mr. Kahal testified that he has not placed reliance on CAPM returns due to the unusual behavior of Treasury bond markets and the actions by the Federal Reserve to hold down interest rates, the 7.7 percent midpoint does confirm that his DCF estimate and ultimate ROE recommendation are conservatively high. *RC-1*, *p.40*. Accordingly, Mr. Kahal's use of both the DCF and the CAPM methods confirms that his recommended ROE of 9.5% will provide Atlantic with sufficient opportunity to earn the necessary overall return to attract equity capital and is fair to investors.

2. The Basis For Mr. Hevert's Recommended Return on Equity Is Not Clear From His Unnecessarily Complex Analyses

Mr. Hevert filed his direct testimony on August 5, 2011 and recommended a ROE for Atlantic of 10.75%. Mr. Hevert did not revise his recommended ROE of 10.75% in his Rebuttal Testimony, filed on May 23, 2012, which used updated market data through April 30, 2012, even though the updated data produced materially lower results. Mr. McGowan incorporated Mr. Hevert's ROE into his recommended overall rate of return of 8.59% (later revised to 8.56% in the Company's 12 + 0 Update). *P-6, p.2*; *RC-1*, *p.4*.

Mr. Hevert used the DCF, CAPM and Risk Premium methods to develop his recommendation and for each method he employed multiple variants. In his Direct Testimony, Mr. Hevert presented nine calculations that used the "constant growth" DCF method. In his Rebuttal Testimony, Mr. Hevert added a different DCF method, the more complex "Multi-Stage" version and thereby produced an additional nine calculations. *RC-1*, *p.43; P-9, p.33-34*. He presented eight separate CAPM calculations using differing risk-free rates (30-year Treasury bond yields), betas and market risk premium values. He presented three Risk Premium cost of equity calculations based on three different estimates of Treasury interest rates.

In addition, Mr. Hevert discussed two other factors that in his view play some role in the development of an appropriate ROE. First, he estimated the cost of stock flotation as adding 16 basis points to the Company's cost of equity. While noting that he did not recommend a specific 16 basis point adjustment, Mr. Hevert stated that he has "considered the effect of floatation costs, in addition to the Company's other business risks, in determining where the Company's ROE falls within the range of results." *P-8*, *p.46*. Mr. Hevert failed to provide any calculations that quantify the impact these considerations have on his ROE recommendation.

Second, Mr. Hevert presented a "size" analysis claiming that since Atlantic is smaller than his average proxy company it faces greater relative business risk. *RC-1*, *p.43*. However, in developing this argument, Mr. Hevert failed to consider that Atlantic is part of Pepco Holdings, Inc. and that equity investors can invest in Atlantic Electric only by purchasing Pepco stock, and in fact, Atlantic itself contributes to Pepco Holdings' size. Therefore, Mr. Hevert's analysis should have focused on the size of the

consolidated PEPCO, Atlantic's parent company, which is significantly larger than the most of the companies in Mr. Hevert's proxy group. *RC-1*, *p.53*.

In all, Mr. Hevert presented 29 different analytical calculations to determine the proper ROE for Atlantic, his results range from 8.63 percent to 11.47 percent. And yet, Mr. Hevert fails to inform us of the weights that he would attach to each of his various cost of equity studies to obtain his 10.75 percent ROE recommendation, undermining the value of his testimony. *RC-1*, *p.43.*

3. Mr. Kahal Identified Significant Flaws in Mr. Hevert's Analyses

Furthermore, Mr. Kahal's testimony raised a number of issues with Mr. Hevert's DCF analysis. Mr. Kahal found that as a result of Mr. Hevert's proxy group selection, his recommended ROE of 10.75 percent is overstated. *RC-1, pg.44.* As noted at the hearing, ACE is a regulated wires utility that has no generation assets. *T24:L20-23* (June 18, 2012*).* Yet Mr. Hevert's results were derived from a proxy group where all the companies were vertically integrated and therefore embody the risks associated with generation supply. This is improper as the Company's customers already pay for generation-related risks in their BGS or competitive retail supply contracts. Id. Thus, Mr. Hevert's proxy group overstates Atlantic's investment risk and would force the Company's ratepayers to pay for generation-related risks in their distribution rates. Id. Even Mr. Hevert seems to concede that as a general matter electric generation is viewed as being a riskier business than regulated electric utility distribution. *RC-16.*

Mr. Hevert's analysis, prepared in mid 2011, did not account for the subsequent decline in the adjusted dividend yield for his proxy group. Using more recent market

data, the proxy group adjusted dividend yield declined to 4.3 percent, a reduction of about 0.2 to 0.4 percent from Mr. Hevert's initial testimony where the dividend yield was 4.7 to 4.8 percent. *RC-1*, *p.45*.

The largest disparity between Mr. Kahal's and Mr. Hevert's DCF conclusions is due to the assumed earnings growth rates. Mr. Kahal used a range of growth rates with "fundamental" or earnings retention at the lower end and published securities analyst growth rates at the higher end. *RC-1*, *p.45.* Mr. Hevert chose to utilize only securities analyst growth rate estimates. *Id.* For Mr. Hevert's proxy group, these securities analyst growth rate estimates average 6.1 percent. In contrast, Mr. Kahal calculated a 5.5 percent growth rate for Mr.Hevert's proxy group from an average of five readily-available public sources. *Id.* Mr. Kahal's growth rate analysis is supported by *Blue Chip Economic Indicators* consensus indicating a long-term growth in nominal GDP of 5.1 percent per year through 2018 and 4.7 percent per year thereafter through 2023, demonstrating expectations of declining growth after the first five years. Mr. Hevert has used estimates of nominal GDP growth in a prior multi-stage DCF study. *RC-1*, *p.46*.

This information strongly indicates that a more up-to-date and reasonable DCF study would lower Mr. Hevert's Constant Growth DCF ROE estimate from 10.8 percent to a figure well below 10 percent. *RC-1*, *p.46*. In fact, when Mr. Hevert updated his calculations in his rebuttal testimony, his DCF mean results (i.e., the DCF results that incorporated the average of all three of his growth rate data sources) declined from 10.86% to 10.24%, using his proxy group. Despite the sharp decline, Mr. Hevert steadfastly refused to alter his original 10.75% recommendation. *T121:L10-20* (June 18, 2012).

Mr. Kahal also raised a number of issues with Mr. Hevert's CAPM analysis. Mr. Hevert used an unreasonably high risk free-rate based on the clearly erroneous assumption that the prevailing Treasury yield would increase significantly in the near term. Mr. Hevert used the then "current" Treasury Yield of 4.24 percent and then, assuming Treasury yields would move sharply upward, increased his estimated cost by about 0.5 percent to reflect a year-ahead forecasted yield. When this speculative assumption subsequently to be proved wrong, Mr. Hevert continued to employ the assumption that prevailing Treasury yields would increase. *RC-1*, *p.48.*

In addition, Mr. Hevert uses risk premium estimates that were based on the "Sharpe Ratio," i.e., the long-term historical risk premium, adjusted upwards to reflect increasing forwards market volatility measured relative to actual historic volatility. *RC-1*, *p.49*. These estimates are based on the forward market volatility indicators as of the time that Mr. Hevert prepared his testimony, August 2011. Subsequently, market volatility subsided thereby producing a much reduced CAPM estimate. Updating for this reduced volatility outlook would lower Mr. Hevert's 7.4 percent risk premium to a risk premium figure well below the historic 6.7 average. Mr. Kahal recommends against reliance on the Sharpe Ratio because it can produce wild swings in the utility cost of equity estimate using the CAPM analysis depending on the point in time within the past year when the analysis is conducted. Mr. Kahal believes that if the Sharpe Ratio is to be considered at all, it must use an updated forward market volatility measure and an updated cost free rate. *RC-1*, *p.50*. When Mr. Hevert updated his calculations in his rebuttal testimony, the CAPM average result went from 10.2% to 9.55%. Once again,

Mr. Hevert refused to alter his original 10.75% recommendation, despite this undeniable decrease. *T121:L10-20* (June 18, 2012)

Mr. Kahal also raised a number of issues with Mr. Hevert's Risk Premium Method. Mr. Hevert estimated a regression model in which the asserted historic electric utility risk premium is "explained" by the level of 30-year U.S. Treasury yield. Mr. Hevert originally used Treasury yield assumed values of 4.24, 4.78 and 5.65 percent to obtain Risk Premium-derived cost of capital estimates of 10.5 percent to 11.06 percent. After Mr. Hevert updated his calculations in his rebuttal testimony, the Risk Premium using then current Treasury yields went from 10.5% to 10.16%. Mr. Hevert, again, did not alter his original 10.75% recommendation, despite this decrease in his own results. *T121:L10-20* (June 18, 2012).

Furthermore, Mr. Kahal does not consider Mr. Hevert's the Risk Premium method to be either valid or reliable, and believes that, at best, it measures an industry-wide cost of capital. The industry, however, is mostly made up of vertically-integrated utilities, such as Mr. Hevert's own proxy companies. Atlantic is a much less risky distribution utility, and it therefore follows that its equity risk premium would be less than the industry average. *RC-1*, p.51. Atlantic also has far less business risk than Mr. Hevert's proxy group, nearly all of whom are vertically integrated and burdened with substantial generation or commodity risk.

C. Credit Ratings and Risk

The Company's major concern seems to be how credit agencies will react to a Board decision denying any portion of its requested relief. Rate Counsel maintains that

the Company's doomsday predictions are unsupported and cannot govern the decision in this case. PHI investor concerns, while relevant, do not trump ratepayers concerns.

When asked if the investment community is concerned about utility credit ratings, Executive Vice President and Chief Regulatory Officer of Pepco Holdings, Inc., Mr. Kamerick testified that "maintaining investment grade credit ratings is critical" and raised the specter of holding company downgrades through the cautionary tales of Ameren and Hawaiian Electric. *P-4, p.12-15*. In rebuttal, Mr. Kamerick warned: "if Rate Counsel's recommendation were to be adopted, it is very likely that the Company would be downgraded by the credit rating agencies." *P-5, p. 3*. Ms. Julie Cannell was hired by the Company to testify about "investors' perspectives and expectations" and cautions that if the credit rating agencies "believe that the utility's revenues will be diminished by adverse business or regulatory decisions, those rating agencies could lower their credit ratings for the utility." *P-1, p. 5*. Mr. McGowan, Vice President and Treasurer of Pepco Holdings Inc., advised that "the Company must primarily consider its financial integrity, as nominally reflected in its credit ratings and other key financial metrics." *P-3, p.5-6*.

This testimony is entirely speculative and does not provide a basis to deviate from our established law or Board policy. As discussed at the hearing, a review of the key credit rating metrics published by Moody's[7] and provided by Mr. McGowan in his rebuttal testimony, (*P-7*), shows that if the Consolidated Tax Adjustment ("CTA") proposed by Ms. Crane is adopted, the Company would still fall within the Moody's guidelines for all of these key metrics for BAA rating in 2012. In 2013, the only metric that would be below the BAA rating guideline would be the CFO to debt ratio, at 12.8

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[7] Moody's publishes three key indicative ratios that it uses in part to assess utility risk: Cash From Operations to Interest (CFO/Interest); Cash From Operations to Debt (CFO/Debt); Debt to Capitalization (Debt/Capitalization).

percent, slightly below the 13 to 22 percent guideline for the BAA category. *T36:L1-T40:L9* (June 25, 2012). Moreover, as testified to by Ms. Crane, these metrics are only guidelines, there is no hard and fast rule with regard to credit ratings. *T73:L6-16* (June 25, 2012). Ms. Crane explained:

> I've been doing this a long time and I've heard a lot of people testify that if you don't put CWIP in rate base our credit ratings going to be downgraded; if you don't give us our rate increase we're going to be downgraded; if you include a consolidated income tax adjustment we're going to be downgraded. There's an awful lot of things that go into credit ratings. For example, has the company entered into risky unregulated ventures; is the company spending too much on executive compensation; is the company well managed or not? The point is a lot of thing impact credit ratings. *T73:L17-T74:L4* (June 25, 2012).

Furthermore, Mr. Kahal, while agreeing with Ms. Cannell that credit ratings were important and the avoidance of a downgrade was a key objective, noted that PHI is ACE's source of equity capital, and therefore it is PHI's financial policies that will ultimately determine ACE's access to capital and funding amounts. *RC-1, p. 56.* Mr. Kahal disagreed with Ms. Cannell that maintaining ACE's access to capital necessarily requires an increased rate of return award, "particularly in an environment of declining capital costs." Id. at 56. Mr. Kahal then noted that ACE's credit ratings are both strong and stable, as are the PEPCO parent and other PEPCO utilities. Id. at 56. Mr. Kahal further noted that PEPCO's stock price will depend on the performance of PEPCO's other utility subsidiaries (ACE being the smallest), PEPCO management decisions and performance, and a host of other factors. Id. at 57.

Mr. Kahal concluded that the Board should not authorize a return on equity for Atlantic in order to prop up PEPCO's stock price as suggested by Ms. Cannell. Mr. Kahal argued that this was not a proper objective of regulation, nor was it needed to

maintain ACE's access to capital. Your Honor and the Board should also reject Ms. Cannell's proposal for a higher return, which she argues is necessary for investor confidence. In fact in 2010, the Company paid out 87% of its 2010 earnings in dividends, an unsustainable amount. *P-1, p. 30.* Mr. Kahal recommend that the Board set just and reasonable rates, including a fair return on the approved rate base that reflects investor requirements.

> Targeting a specific parent company stock price or setting rates to prop up the stock price is not a proper regulatory objective, nor is it particularly useful for ensuring ACE's financial soundness. The PEPCO Holdings stock price will depend on the performance of PEPCO's other utility subsidiaries (ACE being the smallest), PEPCO management decisions and performance and a host of other factors. PEPCO can provide ACE with equity capital, as needed, assuming management chooses to do so. Contrary to Ms. Cannell's assertions, there is no benefit to ACE customers from raising ACE's authorized return above the cost of capital, and there is no financial need to do so.
> *RC-1, p.57.*

ACE provides monopoly electric delivery service in its New Jersey service territory, subject to the regulatory oversight of the Board. There has been no indication in this proceeding of any material increase in business risk or financial risk relative to other utilities in recent years. ACE has none of the risks of investing in generating assets. While regulatory lag does exist, it is Rate Counsels position that in general New Jersey's regulatory climate is reasonable and fair to the utilities. The evidence in this proceeding demonstrates that Mr. Kahal's recommended 9.5 percent return on equity is very reasonable and a lower ROE award would not impair access to capital nor threaten investment grade credit ratings.

D. Service and Reliability Impact on Rate of Return

As discussed in detail in Point IV and Point V, Atlantic has consistently failed to meet minimum reliability standards due to insufficient investments. Rate Counsel maintains that it is appropriate to consider customer service and reliability issues in determining the rate of return. If there are no consequences to a utility when it fails to deliver on service, there will be insufficient incentives to do so. A recent application of this principle was demonstrated by the Maryland Public Service Commission when it decided Potomac Electric Power Company's ("PEPCO") Application for an electric distribution rate increase. I/M/O the Application of Potomac Electric Power Company for Authority to Increase its Rates and Charges for Electric Distribution Service, Order No. 85028, Case No. 9286, Maryland PSC, (July 20, 2012). In its Order, the Maryland PSC recognized the reliability and service related problems by ACE's affiliate, PEPCO, when it stated, at page 107; "Pepco's recommended 10.75% cost of equity is excessive and totally unjustified, especially in light of the Company's poor reliability performance over the last several years and our findings of historic system neglect…" Id. at 107. Applying its authority to address service and reliability issues through its decision on rate of return, the Maryland PSC stated directly, at p. 108:

> The Company must be held accountable, and cannot provide poor service and expect that its return on equity and overall rate of return will be unaffected, let alone increased. In a competitive market, for which regulation is intended to be a substitute, Pepco's continuing poor reliability would cause it to lose business and profits to its competitors. We cannot and will not allow Pepco, a monopoly distribution company, to reap growing profits while it provides subpar service to its customers. Id. at 108.

The Maryland PSC concluded, "We have no doubt that a monopoly company in a stable service territory with the potential of earning 9.31% on its equity will be able to

attract the necessary capital in the current low interest rate environment to meet its statutory requirements to provide safe and reliable service to its customers." Id. at 109. The Company must be held accountable and cannot provide poor service and expect that is return on equity and overall rate of return will be affected, let alone increased. ACE should not be allowed to reap growing profits while providing poor reliability and customer service. Accordingly, and as set forth in more detail in Points IV and V below, Rate Counsel recommends that the Board adopt Mr. Kahal's reasonable ROE of 9.5%.

E. Conclusion

In Sum, Your Honor and the Board should adopt Mr. Kahal's recommended ROE of 9.5 % and reject Mr. Hevert's recommended ROE of 10.75 percent. Specifically, Your Honor should make the following findings:

1. The appropriate capital structure is 51.31% long term debt, 0.71% short term debt and a 47.98% common equity.
2. That Mr. Kahal's ROE of 9.5% was developed using an appropriate proxy group and DCF analysis as previously accepted and approved by the Board;
3. That Mr. Kahal's CAPM analysis supports his ROE recommendation;
4. That Mr. Hevert used overly optimistic growth projections and an inappropriate vertically-integrated proxy group, and that his use of many methodologies and calculations, even if valid, fail to support his recommendation or provide a basis for his proposed ROE;
5. That Mr. Hevert failed to adjust his recommended ROE downward when his own update demonstrated a sharp decline in the utility cost of equity (i.e, a DCF

averaging 10.24 percent, CAPM calculations averaging 9.55 percent and Risk Premium based on then current Treasury yield of 10.16 percent); and

6. That in light of Atlantic's poor reliability and customer service performance, Your and the Board should adopt Mr. Kahal's recommended ROE of 9.5%.

POINT II

THE APPROPRIATE PRO FORMA OPERATING INCOME AMOUNTS TO $36,930,000 WHICH IS $5,561,000 MORE THAN ATLANTIC'S PROPOSED PRO FORMA OPERATING INCOME OF $31,369,000

On August 5, 2011, ACE filed a Petition with the Board seeking a base rate increase of $75.466 million, including sales and use tax. The Company proposed to partially offset this increase with a credit of $17.071 million (including SUT) relating to an excess depreciation reserve previously addressed by the Board. ACE proposed to transfer this credit from base rates to a separate tariff item that would expire on August 31, 2013. In addition, the Company requested a rate increase of approximately $501,000 (including SUT) in its Regulatory Asset Recovery Charge ("RARC") Atlantic's initial request would have resulted in an electric distribution revenue increase of approximately 20.7% on electric distribution rates.

ACE subsequently updated its filing to reflect twelve months of actual results (12+0 update). In that update, the Company increased its electric rate increase request to $96,587 million (including SUT) and increased its RARC claim by an additional $182,000.

A. Rate Counsel's Recommended Rate Base of $509,616,000 Should Be Adopted

Atlantic selected the twelve month period ending December 31, 2011 as the test year in this proceeding. *RC-4,* p.3. The Company's initial filing reflected actual results for three months and projected results for the last nine months of the year. On January 29, 2012, Atlantic filed an update to reflect twelve months of test year data (12+0 filing).

Rate Counsel witness Andrea C. Crane, in her testimony filed on April 25, 2012, recommended numerous rate base adjustments based on the 12+0 filing. In this brief, Rate Counsel is recommending a total electric rate base adjustment of $477,497,000 resulting in a rate base for the Company's electric operations of $509,616,000. *RC-4, Sch. ACC-3*. The rate base recommended by Rate Counsel included several adjustments to the Company's rate base claim. *RC-4, Schedule ACC-3*. Each of these adjustments is discussed below.

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

The Company's claim for electric utility plant in service is based on actual plant balances as of December 31, 2011 of $1,754,675,466. *P-20, Sch. JCZ-R-2*. In addition, the Company has proposed to include post-test year electric plant additions through June 30, 2012 of $55,077,543. *P-20, Sch. JCZ-17 a and b.*

Ms. Crane recommended that these post-test year plant additions be rejected and that no post-test year additions in rate base be approved in this proceeding. In her testimony, Ms. Crane explained that the proposed post-test year plant additions resulted in "a mismatch among the components of the regulatory triad used to set rates in this case." *RC-4, p.8.* The "regulatory triad" is a principle that when setting rates, rate base, revenues and expenses must be synchronized at a single point in time, to avoid manipulation of one or more of these components leading to a skewed and potentially unfair rate.

Specifically, Ms. Crane pointed out that while the Company had used projected plant in service balances as of June 30, 2012, claimed revenues were based on test year customer levels. *RC-4, p.8.* Similarly, depreciation reserves and deferred income tax

reserves, reserves that reduce rate base, should properly have been updated to reflect normal reserve additions through June 30, 2012. The Company subsequently updated projected revenues through June 30, 2012, but failed to adjust depreciation reserves or deferred income tax reserves for normal reserve additions through June 30, 2012.

Accordingly, Rate Counsel urges Your Honor and the Board to reject the Company's effort to add certain costs to rate base that were incurred after the end of the test year. The imbalance that results from the inclusion of only certain Company-selected post-test year items is unfair to ratepayers who will not be credited with contemporaneous savings. Rate Counsel recommends that Your Honor and the Board recognize the importance of the regulatory matching principle which provides that in order to correctly assess earnings, revenues and expenses from the same period must be compared. These post-test year plant additions should not be incorporated into rate base to maintain the careful balancing of rate base with revenues and expenses.

The Board has a long standing policy regarding post-test year adjustments. In re Elizabethtown Water Company Rate Case, BPU Docket No. WR8504330, Decision on Motion For Determination of Test Year and Appropriate Time Period For Adjustments, (May 23, 1985) (hereinafter Elizabethtown Water). In the Elizabethtown Water decision the Board established the general policy that the test year to be used in a base rate proceeding must be fully historical prior to the close of record in the proceeding. The Board also specified that only "known and measurable" changes that are "major in nature and consequence" occurring outside the test year would be allowed into rates. The Board defined the standard as follows:

> Known and measurable changes to the test year must be (1) prudent and major in nature and consequence, (2) carefully quantified through proofs

> which (3) manifest convincingly reliable data. The Board recognizes that known and measurable changes to the test year, by definition, reflect future contingencies; but in order to prevail, petitioner must quantify such adjustments by reliable forecasting techniques reflected in the record.

Id.

It is clear that the Company has not met the criteria specified by the BPU for the inclusion of post-test year projects in rate base. Atlantic has not limited its post-test year additions to projects that are "major in nature and consequence." Rather the Company has included in rate base all "post test year distribution-related plant that has been placed in service through April 2012" and "forecasted distribution related plant to be placed in service from May 2012 through June 2012." *P-20, p.18.* At the hearing, Company witness Gausman admitted that in making the adjustment for post-test year plant additions, the Company assumed that all projects were major in nature and consequence. *T39:L9-13* (June 19, 2012). So, included in the Company's request for post-test year plant additions are routine on-going projects such as installations associated with new accounts, the replacement of existing meters, and miscellaneous distribution blankets. *T41:L6-25* (June 19, 2012).

The Elizabethtown Water case does not grant a utility the ability to include any and all capital expenditures in its rate base for six months beyond the chosen test year. Rather, the Elizabethtown Water decision is a carefully tailored exception to allow rate recognition for certain post-test year additions that are major in nature and consequence. *Id.*

That routine on-going projects are not consider "major in nature and consequence" was confirmed by the Board in another water utility base rate case. In that case, Middlesex Water Company had proposed rate recognition for projected post-test

year plant additions totaling $3,816,558. I/M/O Middlesex Water Co. For Approval of An Increase in Its Rates For Water Service and Other Tariff Changes, BPU Docket No. WR00060362, Order Adopting in Part/ Modifying in Part/ Rejecting in Part/ Initial Decision, (June 6, 2001) (hereinafter Middlesex Water). In Middlesex Water BPU Staff determined that $1,949,398 out of the total projected post-test year additions of $3,816,558 represented non-major *routine* construction projects. The Board's Order stated:

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

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

The Board agreed, adopting ALJ's recommendation to exclude the routine post-test year plant additions. Because ACE seeks to include in rate base all additions through June 30, 2012 their request is simply an attempt to expand the test year to 18 months. This is not consistent with Elizabethtown Water or Middlesex Water and should not be approved by Your Honor and the Board.

Not only does the Elizabethtown Water decision limit post-test year projects to those that are "known and measurable" and "major in nature and consequence," such projects must also be "substantiated with very reliable data." Here, Atlantic has also failed to meet the requirement that post-test year plant additions be "carefully quantified through proofs which manifest convincingly reliable data." *RC-4, p. 10.* The Company

failed to provide any quantitative support for its claim in this filing beyond a schedule with general categories of projects and amounts. Id. In fact, when asked at the hearing to explain what projects were included in the category "ACE Additions and Improvements," the Company's witness was unable to answer. *T42:L2-8* (June 19, 2012).

In I/M/O the Petition of Elizabethtown Gas Company for Approval of Increased Base Tariff Rates and Charges for Gas Service and Other Tariff Revisions, BPU Docket No. GR88121321 (February 2, 1990) (hereinafter "Elizabethtown Gas.") the Board explained what kinds of data are necessary to substantiate the inclusion of these projects into rate base. The Board stated:

> The Board FINDS that the company did not adequately support its post test year estimates with construction budgets, work orders or other reliable data and that the items have not been shown to be major in nature. The Company's testimony and schedules that are in the record do not provide sufficient reliable specific data as to the projects it considers major in nature nor the dollars associated with such projects. In addition, the Company did not supply progress reports or other reliable data in support of its requested post test year adjustments. Therefore, the initial Decision is HEREBY MODIFIED to exclude said adjustments.

Elizabethtown Gas Company, p. 3-4.

In this case, Atlantic has similarly failed to substantiate its claims with adequate data. Rate Counsel therefore recommends that Your Honor and the Board affirm the importance of the twelve month test year and disallow all post-test year plant additions proposed by the Company in this proceeding. Rate Counsel recommends Atlantic's rate base for the purpose of setting rates in this proceeding be based on the actual December 31, 2011 utility plant in service balances as set out in *RC-4, Sch. ACC-3*.

2. Plant Held for Future Use

The Company also included $6.275 million in plant held for future use in its proposed rate base. *RC-4, p.10*. Plant held for future use is property that is not currently used in the provision of utility service but which the Company claims has some potential to be used in the future to serve customers. *Id.* Approximately 75% of the Company's claim for plant held for future use relates to the Huron and the Maryland Avenue properties "purchased to support projected load growth from the forecasted expansion of new casinos in central and northern Atlantic City." *P-10, p.20.* Another parcel, the Tuckerton property is for a new substation with "project in planning" status and an in service date of May 31, 2018. *Id*. The "in-service" dates of these projects being planned in anticipation of future load growth may be overly optimistic in the face of Mr. Kamerick's statements regarding the Company's "flat customer usage growth" *P-5, p.5*. Indeed, it is not clear when, if ever, these proposed projects will be used and useful for utility service. Accordingly, Rate Counsel recommends that the Board reject the Company's inclusion in rate base of $6.275 million in plant held for future use.

3. Cash Working Capital ("CWC")

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

Ms. Crane has recommended a CWC requirement of approximately $83.266 million as reasonable when appropriate adjustments are made to the Company's proposed lead/lag study components. *RC-4*, *Sch. ACC-7*. In calculating the Company's CWC requirement, Ms. Crane made adjustments to several lead/lag components included in the Company's study. *Id.* Ms. Crane noted that the expenses related to non-cash items such as depreciation and amortization expense and deferred taxes should not be included in a lead/lag study. *RC-4, p.13*. As Ms. Crane pointed out, these expenses did not represent or require cash outlays during the lead/lag study period and were included inappropriately. Ms. Crane recommended that non-contractual return on equity costs should also be excluded from the lead/lag study. *Id.* Ms. Crane then revised the lead/lag study to reflect the lag on interest expense and increased the lag on payment of interest on customer deposits from 0 to 365 days. Finally, Ms. Crane revised the expense lag associated with Investment Tax Credits ("ITCs") from 0 days to 10.01 days.

a. Deferred Taxes

The Company's proposal to include deferred income taxes in the lead/lag study for purposes of determining the appropriate cash working capital requirement is contrary to BPU rate making policy. This policy was first established in a PSE&G base rate proceeding, BPU Docket No. ER85121163, and was reiterated in the Elizabethtown Gas base rate proceeding:

> Staff recommends that deferred taxes be excluded from the lead-lag study. Staff contends that this recommendation is consistent with prior Board treatment of deferred taxes, most notably in the PSE&G rate case, (Docket No. ER85121163) wherein the Board removed deferred taxes from cash working capital. The ALJ was persuaded by Staff's argument as to the proper rate making treatment for deferred taxes. The ALJ recommended that deferred taxes be deducted from operating revenues in the working capital allowance for purposes of this proceeding. Initial Decision p. 21. The Board

> FINDS the ALJ's determination on deferred taxes to be reasonable and consistent with Board policy. Therefore, the Board ADOPTS the ALJ's conclusion on this issue....

Elizabethtown Gas, p. 7.

Therefore, pursuant to the Board's long-standing policy on this issue, deferred taxes should be excluded from lead/lag studies when determining the Company's cash working capital.

b. Non-Cash Depreciation and Amortization Expenses

The CWC requirement of a company must be based on the timing differences between the payment of cash expenses and taxes and the receipt of cash operating revenues. *RC-4, p.15.* The expenses that relate to depreciation and amortization simply do not represent or require cash outlays by the Company during the study period used in the lead/lag analysis. Thus, it is Rate Counsel's position that the properly conducted lead/lag study should exclude non-cash depreciation expenses. *RC4, p.15.* The non-cash expense of depreciation and amortization does not produce a need for additional cash to be supplied by the investors during the lead/lag study period.

While Rate Counsel recognizes that this recommended lead/lag study treatment concerning depreciation and amortization expenses differs from current Board policy,[8] it believes that its recommended position is correct and urges its adoption by Your Honor and the Board. Cash working capital reflects the need for investor-supplied funds to meet the day to day expenses of operations that arise from the timing differences between when ACE must expend money to pay the expenses of operation and when revenues for utility service are received by the utility. *RC-4, p.15.* Only items for which actual out-of-pocket cash expenditures are made should be included in Atlantic's CWC allowance.

[8] See, e.g., I/M/O Middlesex Water Company, BPU Docket No. WR00060362, Order, June 6, 2001, p. 16.

Rate Counsel therefore recommends that the Board reconsider its current policy on this matter and exclude depreciation and amortization expenses from the lead/lag study for purposes of determining the Company's appropriate cash working capital in this case. *RC-4, Sch. ACC-7.*

c. The Return on Investment Capital

It is incorrect to include recognition of an alleged cash working capital requirement associated with a return on common equity. ACE is under no contractual obligation to make dividend payments to shareholders before collecting the corresponding revenue. *RC-4, p.15*. Moreover, as acknowledged at the hearing, when dividend payments are made, they are made on a quarterly basis, not on a daily basis which is the assumption inherent in the use of a zero lag. *T61:L13-15* (June 21, 2012). The Company's fundamental assumption that the common shareholder is entitled to the return on his/her equity investment at the exact instant that service is rendered is incorrect. The fact is that the shareholder receives his/her return through the quarterly payments of dividends and any gain in the Company's stock price. This is the mechanism by which the common shareholder is compensated in the real world. Moreover, there is no guarantee of any such return. The Company is under no contractual obligation to provide either dividends or to increase its stock price. That is the risk that investors take when they purchase common stock. Therefore, Rate Counsel recommends that the return on equity be removed from the lead/lag study.

d. Debt Interest Expenses

In its cash working capital calculation, the Company failed to reflect the fact that the revenue requirement includes a component for interest expense, which is a contractual obligation of the utility. *RC-4, p.16*. The rates paid by the Company's customers are set to produce, in addition to other amounts, the sums necessary to pay for the Company's interest expense to bondholders. *Id.* Since the Company pays its bondholders twice a year but collects revenues for such bondholder payments on a daily basis, the Company has the use of funds provided by ratepayers for interest expense as working capital during the interim period between interest payments. *Id.* The Company's ratepayers provide these funds continuously, in a steady stream, and not in a pattern that matches or coincides with the Company's liability for the expense. Ratepayers, not the Company, are correctly entitled to the benefit of funds collected from them earlier than would be warranted to pay the Company's interest expense. Ratepayers clearly should not be required to pay a return to shareholders on capital which ratepayers provide. It is settled regulatory policy that shareholders are not entitled to a return on capital which the shareholders have not provided. Federal Power Commission v. Hope Natural Gas, 320 U.S. 591 (1944), Bluefield WaterWorks v. Public Service, 262 U.S. 679 (1923). Accordingly, the actual interest lag should be reflected in the calculation of cash working capital. *RC-4, ACC-7.*

In the past, the Board has decided that long-term debt interest should not be included in a lead/lag study, assigning a zero (0) day lag to long-term debt payments because the Board felt that the return on investment is the property of investors when service is provided. See I/M/O Atlantic City Electric Company Increasing Its Rates for

Electric Service, BPU Docket No. 8310-883, Decision and Order, (August 17, 1984). However, this position is inconsistent with the manner in which other cash flow items are handled in a lead/lag study. The lead/lag study examines the actual cash flows, not the incurring of an expense or liability, in determining the Company's CWC requirement. *RC-4, p.15*. Long term debt interest expense should be treated in a similar manner. Interest payments are not due to bondholders until the payment dates specified in the bond indenture documents. *RC-16.* Bondholders are not entitled to receive daily interest payments since daily payments were not a component of the bond indentures.

In addition, bondholders considered the periodic nature of interest payments when they determined the interest rate that they would require to purchase the bonds. That rate is embedded in the Company's cost of capital. It is unreasonable to ask ratepayers to pay this actual interest rate, which reflects a premium required due to the payment lag, and then require ratepayers to also pay a cash working capital requirement based on the assumption that interest payments are made daily. *RC-4, p.16*.

Shareholders, on the other hand, have no contractual right to receive either dividends or growth in share price. Shareholders assumed the risk when they purchased common stock. In addition, companies generally retain a portion of their earnings rather than paying out all earnings as dividends. *RC-4, p.16.* Therefore, it is inappropriate to reflect a zero lag and to correspondingly increase the Company's cash working capital for the return on equity to account for that lag.

Moreover, Rate Counsel's recommendation is consistent with the Company's treatment of other similar accounts. The Company does not use a zero lag for revenues, even though the Company earns its revenues on the day that service is provided.

Similarly, the Company does not use a zero lag for payroll expense, even though employees earn their salaries each day that they work. Instead, revenue and payroll (and other cash expenses) are reflected in the lead/lag study based on when cash is actually received or paid. Thus, the lead/lag study examines the actual cash flows, not the incurring of an expense or liability, in determining the Company's cash working capital requirement. Interest expense should be treated in a similar manner.

e. Interest on Customer Deposits and Investment Tax Credits

Rate Counsel witness Andrea Crane recommended that the lag on payment of interest on customer deposits be increased from 0 days to 365 days. *RC-4, p.17.* ACE used an expense lag of 0 days based on the fiction that customers are paid interest daily on their customer deposits. *Id.* But interest on customer deposits is not paid on a daily basis. According to the Company's tariff, the Company reviews residential customer accounts annually to determine if the customer is entitled to a return of the customer deposit. *Id.* Commercial customer accounts are reviewed every two years. The Company pays interest on the deposit at the time that the deposit is returned to the customer. Therefore, the expense lag associated with customer deposits is at least 365 and could be longer depending on the mix of residential versus commercial customers. *Id.* Accordingly, Ms. Crane reasonably reflected a 365 day expense lag in her CWC calculation. *RC-4, Sch. ACC-7.*

Ms. Crane also recommended that the expense lag associated with Investment Tax Credits (ITCs) be adjusted from 0 days to (10.01) days. *RC-4, p. 18.* ACE does not receive the reduction in taxes associated with the ITCs on a daily basis but rather at the time that taxes are paid. Therefore, Ms. Crane recommended that Your Honor and the

Board utilize the same expense lag for ITCs as is used for current income taxes, that is (10.01) days. *RC-4, Sch. ACC-7.*

f. CWC Conclusion

In summary, based on the above described approach and based upon the cash operating expenses and taxes recommended by Rate Counsel in this case, Your Honor and the Board should adopt a positive lead/lag study cash working capital requirement of approximately $83.3 million. *RC-4, Sch. ACC-7.* This is approximately $20.8 million less than the cash working capital requirement of approximately $104.1 million claimed by the Company. *RC-4, ACC-3.*

4. Unamortized Balances – Credit Facility Costs and Hurricane Irene

ACE is requesting recovery for certain costs relating to a PHI credit facility.[9] The Company's claim for recovery includes annual recurring maintenance costs associated with the credit facility, as well as amortization of closing or start-up credit costs. *RC-4, p. 19*. In addition, ACE is requesting that the average balance of unamortized costs be included in rate base and that shareholders be permitted to earn a return on this balance at the Company's overall cost of capital. *Id.* The Company claims that Your Honor and the Board should include the unamortized balance of credit facility costs in rate base because "PHI's other utilities . . . all have authorized the amortization of the jurisdiction cost of the credit facility with rate base treatment of the unamortized balance. *P-25, p. 19.*

The Company has also proposed to amortize the costs associated with Hurricane Irene over three years and seeks to have that unamortized balance also be included in rate

[9] A credit facility is a loan agreement arrangement between the utility borrower and the financial institution(s) (usually a bank) that provides the utility access to short-term funds and liquidity, when needed.

base. *RC-4, p. 27.* Ms. Crane recommended that the costs associated with Hurricane Irene be included in the development of normalized storm damage costs and that therefore there was no basis to include the unamortized balance in rate base. *RC-4, p.28.* However, even if the Board should decide to allow recovery of the Hurricane Irene costs through a three year amortization, there is no basis to require ratepayers to pay a return on these costs based on the Company's overall cost of capital as well as income taxes on that return. This is because all returns must be grossed up for associated income taxes so that ratepayers are charged approximately $1.65 for every additional dollar of return awarded to the Company.

The Company is fully compensated for the credit facility start up costs through the amortization expense reflected in the rates set in this proceeding. *RC-4, p.19.* Similarly, the Company will recover costs incurred due to Hurricane Irene either through an amortization or normalization of those costs. *RC-4, p.28.* The Company is asking ratepayers to pay not only those costs but to pay shareholders a return on any costs that are not immediately recovered in rates. *RC-4, p.28.* This is inappropriate. Shareholders are compensated at a higher rate than debt holders because of certain risks assumed by shareholders, including operational risks associated with variable weather conditions. *RC-4, p.28.*Shareholders do not have the right to expect that all unanticipated costs will be fully reimbursed, along with carrying costs, given the premium rate of return that is allowed in the Company's authorized cost of capital. *RC-4, p.28.* In fact, shareholders receive a premium over bondholders due to the fact that shareholders take more risk than bondholders, including the risk of lower returns or no returns at all. The Company's

request would eliminate that risk but still require ratepayers to compensate shareholders for it. This request should be denied.

Moreover, permitting these costs to be included in rate base will require ratepayers not only to pay to shareholders a return on the unamortized balances but also to pay the income taxes associated with that return. The BPU has not in the past routinely included unamortized balances in rate base and there is no reason to do so now.

5. Prepaid Pension Asset / OPEB Liability

ACE has proposed in this filing to increase rate base by more than $35.9 million to reflect a prepaid pension asset. This adjustment would increase rates by $4.5 million. *RC-4, Sch. ACC-34*. The Company also made an adjustment to decrease rate base by $15.3 million, the amount by which accumulated OPEB costs exceed the associated contributions and market returns. *RC-4, p.17.* In the case of the OPEB adjustment, the adjustment results in a rate base deduction because the accumulated liability is greater than the contributions and market returns. The OPEB adjustment can be thought of as the mirror image of the prepaid pension asset adjustment. Rate Counsel urges disallowance of both adjustments.

To determine the appropriate amount of pension expense to include in utility rates, the New Jersey BPU uses the accrual methodology set forth in the Statement of Financial Accounting Standards ("SFAS") 87. *RC-4, p.20.* This methodology requires a company to accrue pension costs over the working life of the employee.

Under SFAS 87, each year, a company's pension expense is calculated to determine the amount of pension expense that must be recognized for financial reporting purposes based on the demographics of the company's employees, likely retirement age,

expected future return on pension assets, future payrolls, the appropriate discount rate and other factors. *RC-4, p. 21*. The calculation is a snapshot in time, influenced by events in the past as well as future expectations, with a gradual true up of past estimates with actual results. If the pension expense is positive, the pension plan is considered underfunded at a given point in time from an actuarial perspective and additional amounts must be accrued. If the pension expense is negative, then the plan is over-funded at a given point in time and ratepayers receive a credit in cost of service due to the fact that the pension expense was higher than necessary in prior years.

A few regulatory commissions use the "cash methodology," setting a company's pension expense for ratemaking purposes based on the amount of cash contributions required to be made to the pension fund. The actual cash funding of the plan is governed by the requirements of the Employee Retirement Income Security Act ("ERISA"), the Pension Protection Act ("PPA"), and the Internal Revenue Service ("IRS"). The Company's proposal in this proceeding mixes these two methodologies, using SFAS 87 to determine pension expense but also requiring ratepayers to pay a return on contributions to the plan. The result would be charging ratepayers twice and should be rejected by Your Honor and the Board.

Your Honor and the Board should recognize that it is the consistency of using SFAS expense for ratemaking purposes that assures that, over the life of the plan, the expenses recognized pursuant to SFAS 87 will equate to the contributions made to the pension plan. While there are different assumptions and formula used to determine SFAS expense and required cash contributions, the goal of both methodologies is the same, to recognize the Company's liability with regard to pension costs and to ensure that these

costs are properly funded. If the Company's proposed hybrid approach is adopted, ratepayers will be penalized by paying twice

The Company has wide discretion each year as to whether or not to make a contribution to the pension fund. In the past ten years, ACE has made cash contributions to its pension plan in only three years, with contributions ranging in amount from $0 to $60 million. *RC-4, App. C. RCR-A-32.* Ratepayers should not be penalized and forced to pay a return on contributions to the pension plan because of these funding decisions made by Company management. Many factors will influence a company's pension funding decisions including tax considerations, the availability of cash and the company's financial position. ACE's funding decisions are dependent, at least in part, on its ability to manage its earnings and/or to minimize its tax expense. Accordingly, rates should be set based solely on the cost of pension expense approved by the BPU pursuant to SFAS 87, not on random decisions made by Company management.

The flip side of this issue is Atlantic's proposed adjustment to reduce rate base by the amount by which accumulated OPEB costs exceed the associated contributions and market returns. For ratemaking purposes, OPEB costs, like pension costs, are based on actuarial formulas that attempt to recover these costs over the working lives of the employees. *RC-4, p. 29.* The BPU has used the actuarial method for recovery of OPEB costs since it adopted SFAS 106 for ratemaking purposes. *Id.* Similar to the discussion with regard to pension costs, the actual cash outlay associated with OPEBs can vary each year from the cost recognized for ratemaking purposes. Consistent with her recommendation that the BPU continue to utilize that actuarial methodology for pension costs and reject the Company's claim to include the prepaid pension asset in rate base,

Ms. Crane recommended that Your Honor and the Board reject the Company's proposal to include the OPEB liability in rate base. In sum, as with the prepaid pension asset, as the BPU has adopted the accrual methodology, it is not appropriate to consider the cash implications for ratemaking purposes given the flexibility that utilities have with regard to funding and given the impact of market returns on the calculations of the OPEB liability.

6. Conclusion

(1) Rate Counsel's recommended rate base of $509,616,000 should be adopted. *RC-4, Sch. ACC-3.*

(2) Your Honor and the Board should affirm the importance of the twelve month test year and disallow $54.352 million in post-test year plant additions proposed by the Company in this proceeding. *RC-4, Sch. ACC-3.*

(3) Your Honor and the Board should reject the Company's inclusion in rate base of $6.275 million in plant held for future use. *RC-4, Sch. ACC-3.*

(4) Your Honor and the Board should adopt a positive lead/lag study cash working capital requirement of approximately $83.3 million. This is approximately $20.8 million less than the cash working capital requirement of approximately $104.1 million claimed by the Company. *RC-4, Sch. ACC-3.*

(5) Your Honor and the Board should reject the Company's inclusion in rate base of $1.329 million in unamortized credit facility costs. *RC-4, Sch. ACC-3.*

(6) Your Honor and the Board should reject the Company's proposal to include in rate base a prepaid pension asset of more than $35.9 million. *RC-4, Sch. ACC-3.*

(7) Your Honor and the Board should reject the Company's proposal to include in rate base $5.127 million in unamortized storm damage costs associated with Hurricane Irene. *RC-4, Sch. ACC-3.*

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

B. Consolidated Income Tax

1. Rate Counsel's Proposed Consolidated Tax Adjustment Fully Conforms With Board Precedent and Provides a Benefit to Ratepayers in Exchange for the Holding Company's Use of Ratepayer Funds to Subsidize Unregulated and Unprofitable Entities

Atlantic City Electric does not file its federal income tax return on a stand-alone basis but rather files as a part of a consolidated tax group of which Pepco Holdings Inc. ("PHI") is the common parent. *P-29, p. 5.* Rate Counsel witness Andrea Crane has calculated a rate base Consolidated Tax Adjustment, fully consistent with long standing BPU precedent, of $385,892,000. *RC-4, ACC-12.* This Consolidated Tax Adjustment results in a revenue requirement adjustment of approximately $51.5 million. *RC-4, ACC-34.* This adjustment of $51.5 million is partially offset by tax savings relating to interest synchronization, resulting in a net adjustment of $42 million.

By filing a consolidated return, the tax loss benefits generated by one group member can be shared by the other group members, resulting in a reduction in the effective federal income tax rate. The New Jersey Courts have made clear that if funds contributed by Atlantic's customers contribute to a tax savings for PHI's consolidated companies, then Atlantic's ratepayers are entitled to share in those savings. In re Lambertville Water Company, 153 N.J. Super. 24, 28 (App. Div. 1979), rev. in part on other grounds 79 N.J. 449 (1979). Atlantic has proposed not to share these savings with ratepayers. Rather, according to the Tax Sharing Agreement Atlantic has entered into with PHI, Atlantic pays to the parent the amount of tax it would pay if it filed on a stand alone basis. *RC-4, p. 33.* A portion of those funds are then contributed to the members of the consolidated group that incurred tax losses. The filing of a consolidated return

lowers PHI's overall tax liability and thus the regulated and profitable utility subsidiaries, like Atlantic, subsidize PHI's unregulated or unprofitable ventures. This strategy is so effective that PHI had the largest negative effective tax rate for the period 2008-2010 according to the study published by Citizens for Tax Justice and the Institute on Taxation and Economic policy. *RC-77.*

In order to address this subsidy and the requirement that ratepayers share in the savings, the BPU has, since 1951, used a consolidated tax adjustment when setting rates for New Jersey utilities.[10] The consolidated tax adjustment methodology adopted by the Board is referred to as the rate base method, and provides that when a utility belongs to a consolidated tax group, the utility's rate base is reduced by the accumulated tax benefits allocated to the utility based on the utility's share of total positive taxable income.[11]

This rate base method as approved by the Board does not directly reduce the income tax expense included in a utility's revenue requirement, but rather treats these accumulated benefits as cost free capital.[12] Rate Counsel witness, Ms. Crane, used the Board's rate base methodology to calculate her recommended consolidated tax adjustment to rate base of $385,892,000 in this proceeding. *RC-4*, *p. 35*. Fully consistent with the methodology adopted by the Board in RECO, Ms. Crane first aggregated from 1991 through 2011 taxable income or loss for each PHI affiliate. *RC-4.* For each year, the taxable income or loss for the group of companies that had an aggregated (1991-present) taxable loss was then multiplied by that year's annual federal income tax rate, in

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[10] I/M/O the Petition of Atlantic City Electric for Approval of Amendments to its Tariff to Provide for an Increase in Rates and Charges for Electric Service, BPU Dkt No. ER90091090J, Order Adopting in Part and Modifying in Part the Initial Decision, (Oct. 20, 1992) ("ACE 1992 Decision").

[11] I/M/O Verified Petition of Jersey Central Power and Light Company, BPU Dkt. Nos. ER02080506, et.al, Final Order (May 17, 2004) ("JCP&L 2004 Decision").

[12] I/M/O the Petition of Rockland Electric Company, BPU Dkt Nos. ER02080614, ER02100724, Decision and Order, (April 20, 2004)("RECO.")

order to determine the annual income or loss for the year. The annual tax benefit for those companies that had aggregated net losses was then aggregated. Adjustments were made for any alternative minimum tax ("AMT") paid by the group. The resulting aggregate benefit was then allocated among all the companies that had a 1991-present aggregated positive taxable income, based on each entity's share of the aggregated positive taxable income. This resulted in an allocation of 31.35% to Atlantic. *RC-4, p.36, ACC-12.*

Atlantic did not include a consolidated tax adjustment in its direct case but presented three rebuttal witnesses on this issue: Mr. Kevin M. McGowan, Vice President and Treasurer of PHI; Mr. Steven M. Fetter, President of Regulation Unfettered; and, Mr. James I. Warren, a tax partner with the law firm of Miller and Chevalier Chartered (M&C) in Washington D.C.

McGowan's Rebuttal Testimony

Mr. McGowan, in his rebuttal testimony, focused on the aggregate tax losses used by Rate Counsel witness Andrea Crane to calculate the appropriate CTA. Mr. McGowan claims that tax benefits due to losses generated by affiliates acquired prior to the Conectiv merger should not be shared with Atlantic's ratepayers. *P-7, p.7*. Mr. McGowan argued that Rate Counsel's proposed CTA "equates to a misappropriation of value from investors who have invested money and assumed risk in the investment and instead directs this value to an entirely different group that has made no investment and bears no risk in the investment." *P-7, p.7-8*.

Losses generated by PHI subsidiaries prior to the 2002 Conectiv merger are not included in Rate Counsel's CTA adjustment. *T23:L15-T24:L3* (June 25, 2012). Thus,

Mr. McGowan's testimony on this point does not justify any change in the CTA calculated by Ms. Crane. Further, Mr. McGowan erroneously argues that Atlantic's ratepayers assume no risk from these loss-generating investments. But in fact, as acknowledged by the Company's tax attorney at the evidentiary hearings, Atlantic could be held accountable for the payment of the entire amount of tax due from the consolidated group. *T59:L3-10* (June 25, 2012). Finally, if there is a misappropriation of value, it is due to the Company's position that it need not share consolidated tax saving with ratepayers. During the period 2008 through 2010 PHI paid no federal income tax, despite profits of close to $1.0 billion. *RC-77*. It did so using ACE's tax liability which was fully paid by ratepayers.

Fetter's Rebuttal Testimony

Company witness Steven Fetter testified in this proceeding, as he has in other proceedings, that an unfavorable decision reached in this proceeding on the CTA could have a negative effect on the Company's credit ratings. While a utility's credit rating should certainly be of some concern to regulators, the impact on credit rating should not be the driver behind a Board decision. As noted by Ms. Crane at the hearing:

> I've been doing this a long time and I've heard a lot of people testify that if you don't put CWIP in rate base our credit ratings are going to be downgraded; if you don't give us our rate increase we're going to be downgraded; if you include a consolidated income tax adjustment we're going to be downgraded. There's an awful lot of things that go into credit ratings.
>
> . . .
>
> So you can't look at one issue like a credit rating in isolation and be afraid essentially of credit rating agencies. The credit rating agencies would like to believe that they drive regulators. And my view is that regulators in fact should drive credit rating agencies. *T73:L17-T74:L23* (June 25, 2012)

Warren's Rebuttal Testimony

Mr. Warren in his rebuttal testimony found fault not with Ms. Crane's calculation but with the Board's use of a consolidated tax adjustment in any form. In fact, at the hearing, Mr. Warren conceded that Ms. Crane's calculation of a consolidated tax adjustment appeared to be consistent with the calculation used by the Board in the RECO decision. *T61:L1 – 9* (June 25, 2012). But, Mr. Warren, ignoring existing law and long standing Board precedent, declares that in making a consolidated tax adjustment, New Jersey has rejected "the Accepted Wisdom of the Vast Preponderance of Its Fellow Regulators." *P-29, p.27.* The "accepted wisdom of the vast preponderance of fellow regulators" notwithstanding, in New Jersey there is no issue as to whether a utility must share the tax benefits associated with the consolidated tax saving with utility ratepayers. As noted by the Board in an earlier ACE decision:

> The record demonstrates that this Board implemented a policy to make consolidated tax adjustments in public utility rate cases at least as early as 1951. These adjustments, which impute to utility ratepayers a share of the tax benefits realized by the holding company by virtue of the filing of a consolidated tax return, have been implemented over the past 40 years following a number of different methodologies, as delineated in the Initial Decision. As further described by the ALJ, the courts have on a number of occasions upheld such adjustments by the Board, indicating generally that a utility is not entitled to collect a certain amount of tax expense from ratepayers merely because that amount may have been paid to the holding company based upon the statutory income tax rate applied to utility income. To the extent that the utility is part of a larger conglomerate of regulated and unregulated companies which derives net tax benefits as a consequence of utility net income, the utility ratepayers are entitled to have rates reflect a computation of those benefits. In re Lambertville Water Company, 153 N.J. Super. 24, 28 (App. Div. 1979), rev. in part on other grounds 79 N.J. 449 (1979)

The law on this issue and the Board's policies implementing it are also a matter of fairness. While Atlantic's ratepayers are paying the full tax liability of the Company, the Company is not in fact paying that amount to the IRS. Indeed, between 2008-2010, PHI had a negative tax rate of 57.6%, the lowest rate of the 280 Fortune 500 companies included in the study. *RC-77*. When viewed from this perspective, the failure to make a consolidated tax adjustment equates to a misappropriation of value from ratepayers who are legally entitled to an equitable and appropriate sharing of consolidated tax benefits. ACE 1992 Decision. Accordingly, Mr. Warren's recommendation to eliminate the CTA should not be adopted.

Mr. Warren also argued that the BPU's accepted consolidate tax methodology was "egregiously flawed" and "not a technically accurate tool." *P-29, p.28-29*. Mr. Warren then identified what he termed "five major problems" with the Board's methodology. *P-29, p. 29*. Each of those "problems" is discussed below.

The first "flaw" in the Board's methodology as identified by Mr. Warren was the "failure to observe the tax law with regard to the treatment of tax losses." *P-29, p.30*. Mr. Warren explains that this could result in tax losses incurred by PHI after the Conectiv merger being offset by ACE's pre-merger income. This "flaw" has been previously addressed and rejected by the Board. In the RECO decision, the Board stated:

> The Board agrees with Staff that RECO's argument that it would be improper to consider data from the period prior to the date of the merger between O&R and Con-Ed (i.e. July 1999) is not valid. RECO's positive net income during the years 1991-1999 clearly produced tax savings for its parent company in those years, and RECO's customers should not be denied their share of these savings simply because of a subsequent merger of its parent with ConEd.
> RECO, p. 64.

Similarly, in this case, Atlantic's customers should not be denied their share of tax savings simply because Conectiv merged with PHI. At the time of the merger, New Jersey's consolidated tax methodology was well established and should have been considered by PHI in merger negotiations. PHI presumably made the calculation at the time that the merger was to its benefit, in spite of New Jersey's known regulatory policy on consolidated tax savings. While federal income tax policy may not allow the use of the pre-merger income to offset post-merger losses, certainly regulatory policy may look at these losses from a different perspective and direct that pre- and post-merger consolidated tax savings be shared with ratepayers.

The second "flaw" identified by Mr. Warren is what he terms the failure of the Board's consolidated tax adjustment "to consider the economic consequences" of Net Operating Loss ("NOL") carry-forwards. *P-29, p. 29.* That is, that the Board's methodology does not take into account the fact that not all of the tax losses have been utilized to actually reduce taxes. While it is true that the Board could have modified its consolidated tax benefit to consider tax loss carry-forwards, the fact remains that the Board has adopted a methodology that does not make this adjustment. *RC-4, p.36*. Mr. Warren has provided Your Honor and the Board no compelling reason to change this methodology in this case for ACE.

Mr. Warren next argues that any consolidated tax adjustment should be limited to a period that matches the tax loss carry-forward period. Mr. Warren further testified that the tax loss carry-forward period has expired for tax years 1991 through 1997 and therefore, those years should be removed from the computation. *P-29, p. 34*. As discussed above, the Company has cited no previous case in which the Board limited its

consolidated tax adjustment based on the expiration of the net operating losses. The Company has cited no BPU decision that would indicate that the Board expected to limit the time period over which these losses would be considered in calculating the consolidated tax adjustment. In fact, the Board has made it clear in several consolidated tax decisions that the appropriate starting point is 1991. For example, in JCP&L's most recent base rate case the Board explained:

> As a result of making a consolidated tax filing during the years 1991-1999, GPU, JCP&L's parent company during that time period, as a whole paid less federal income taxes than it would have if each subsidiary filed separately, thus producing tax savings. The law and Board policy are well-settled that consolidated tax savings are to be shared with customers. Moreover, the New Jersey courts have confirmed that the BPU has "the power and the function to take into consideration the tax savings flowing from the consolidated return and determining what proportion of the consolidated tax is reasonably attributable to [the utility].

JCP&L 2004 Decision, p.45.

Thus, long standing Board policy is that the consolidated tax adjustment calculation should begin at 1991. Atlantic's argument that this policy should be changed in this case is unsupported by the record and should be rejected.

Mr. Warren argues further that Ms. Crane's application of the Board's methodology fails to properly account for entities that have been dissolved by liquidation. Mr. Warren argues that an asset that was merged or liquidated would always remain as a loss for the purpose of the consolidated tax adjustment calculation. *P-29, p.37.* Although his testimony is not clear, presumably Mr. Warren would argue that these entities should be removed from the CTA calculation.

This argument has been previously addressed and rejected by the Board. Indeed, the schedules attached to the RECO Order clearly show that affiliates that had been sold or liquidated were included in the Board's methodology. *RC-4, p. 35-36.* And this

makes sense. The fact that the unregulated entities may no longer be a part of the consolidated tax group does not negate the fact that, when they were, some benefit was provided to these companies by the utility through the filing of a consolidated tax return. The utility did not get the benefit back when the affiliate was sold. ACE's position attempts to charge the utility's ratepayers for the holding company's decision to divest these assets. In the RECO decision, the Board decided otherwise.

Finally, Mr. Warren argues that the Board's methodology improperly includes transmission and generation operations and that the calculation should consider distribution operations only. However, the Company's proposed transmission adjustment has not been adopted by the Board in previous proceedings. The Board's methodology set out in the RECO Order makes no adjustment for transmission. *RC-4, p. 35-36.*

Moreover, while transmission may no longer be regulated by the BPU, it is still a regulated service. The Federal Energy Regulatory Commission ("FERC") sets formula rates and sets a return on equity. The Company claims therefore that the BPU is not the proper authority to make such any transmission adjustment. However, although transmission rates are set by FERC, the rates are paid by New Jersey ratepayers. It is certainly within the Board's authority to include in its calculation of a consolidated tax adjustment the tax benefits afforded to PHI through regulated transmission rates. In fact, ratepayers will never have the opportunity to share in the consolidated tax benefits generated by the transmission operations unless the BPU returns these benefits to ratepayers through distribution rates, as FERC does not make a consolidated tax adjustment. *P-29, p. 9.* New Jersey courts have decided that New Jersey ratepayers are entitled to share in the benefits of the consolidated tax filing. If transmission assets are

removed from this calculation, then regulated rates are subsidizing unregulated and unprofitable ventures with no benefit to New Jersey ratepayers.

Generation assets on the other hand are only included for the period of time during which rates were bundled. In Ms. Crane's calculation, the generation assets were not included with the utility after rates were unbundled in restructuring. The consolidated tax adjustment looks back and examines what happened in prior years. The "structural separation" of the generation assets in 2000 did not erase the income tax benefit associated with the generation assets from prior years and therefore any tax benefits associated with the generation assets were allocated to the utility during the period of bundled rates and are appropriately included in Rate Counsel's consolidated tax adjustment. This is fully consistent with the "look back" perspective of the Board's consolidated tax benefit.

Mr. Warren made one additional recommendation to the Board based on the "specific facts of ACE's situation." *P-29, p. 39.* Mr. Warren recommended that losses incurred by PHI affiliates engaged in leveraged leasing should not be included in the CTA calculation, especially in the case of ACE where the investments in these assets were made prior to the Conectiv merger. Mr. Warren argues that these lease transactions "are priced to reflect the cash flows generated by the tax losses that are embedded in their structure." According to Mr. Warren, if the tax benefit is "commandeered" by a consolidated tax adjustment, "the investment itself is impaired." *Id.* Therefore, Mr. Warren argues, "any CTA calculation should proceed without including the group members engaged in the business of leveraged leasing." *Id.*

As discussed by Ms. Crane at the hearing, PHI certainly knew at the time of the merger the New Jersey BPU's policy on tax sharing and must have considered that policy during the merger process.

> PHI is a sophisticated company, presumably it did its due diligence when it acquired Conectiv. And to somehow now state that a consolidated tax adjustment should not apply because PHI had unregulated entities that were involved in leasing activities or other types of activities that tended to create losses, you know, I find that ludicrous. I mean PHI knew what it was getting into, or should have known what it was getting into, when it bought Conectiv. And, it decided to proceed with that merger in spite of the fact that it was going to file a consolidated return with all of these entities. And so, you know, I don't – I just don't believe that that is a defense as to why there shouldn't be a consolidated tax adjustment.

T77:L18-78:Ll13 (June 25, 2012).

Moreover, this argument, as with many of the other arguments made by ACE in this case, has been made in other proceedings and rejected by the Board each time.

> The Board has the responsibility to balance the interests of both ratepayers and investors, both in general and specific to this matter. While there may have been a period of time where investors might have reasonably expected that the board would not make consolidated tax adjustments, it is clear that at some point during the 1988-1991 timeframe, investors should reasonably have expected that prospective consolidated tax adjustments would or at least could be made. Indeed, investments are inherently risky and, in any event, the Board's ratemaking authority with respect to [ACE] cannot be driven by the non-utility investment decisions of the holding company. The Board's decision should be based on the principle of fairness to all stakeholders. ACE 1992 Decision, p. 8.

The Board's policy on the sharing of tax benefits is long standing and well documented and reflects the decision of New Jersey courts that require a sharing. ACE is not entitled to a different consolidated tax adjustment than the other utilities in this state and ACE ratepayers should not be subsidizing affiliate losses through a Tax Sharing Agreement without receiving some benefit in return. At this point, it is clear that there is a benefit to

PHI in filing a consolidated tax return or PHI would not be doing so. Ratepayers are entitled to share in that benefit.

2. Conclusion

In sum, ACE files as part of PHI's consolidated income tax filing pursuant to a tax sharing agreement. To share with ratepayers the benefits of this tax sharing agreement, Rate Counsel witness Andrea Crane has calculated a rate base consolidated tax adjustment, fully consistent with BPU precedent, of $385.9 million. This consolidated tax adjustment results in a revenue requirement adjustment of approximately $51.5 million, with, after interest synchronization, a net adjustment of $42 million. *RC-4, ACC-3.*

C. Revenue Adjustments

1. Pro Forma Revenue Adjustments

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

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

The purpose of a weather normalization adjustment is not to forecast or predict weather for a particular year but to determine what customer usage would be, assuming 'normal' weather. *RC-4, p. 43.* The Company utilized a 20-year period to determine normal weather in calculating its weather-normalized revenue. *P-20, p. 3*. Rate Counsel recommends that the Board adjust the sales projections of Atlantic's pro forma revenue claim based on a thirty-year period of normal weather data, rather than the twenty-year time period used by the Company.

Weather normalization using the thirty-year standard for normal weather is based on several objective scientific and statistical reasons. First, a standard using thirty years of normal weather is more appropriate because it is based upon and consistent with the meteorological science used by the National Oceanic and Atmospheric Administration ("NOAA")[13] and other weather experts. *RC-62.* In particular,

> The thirty-year normal has been established by [NOAA], the government organization charged with establishing and recording the climatic conditions of the United States. The thirty-year standard is the objective standard, established by the government body responsible for determining normal weather conditions. Moreover, the thirty-year standard is the international standard adopted by the United Nation's World Meteorological Organization ("WMO"). The thirty-year normal is used for a wide range of applications and it has served as the standard in utility regulation for some time.

RC-4, *p. 40*

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[13] NOAA, an agency with the U.S. Department of Commerce, is responsible to collect, forecast and distribute "meteorological information in the interests of agriculture and commerce." 15 U.S.C. § 313; see 33 U.S.C. §§ 311, 1101: 15 U.S.C. § 1503b, Reorganization Plan No. 4 of 1970; http://www.noaa.gov/about-noaa.html (last viewed 3/15/10).

The use of the NOAA standard is consistent with the principle that each administrative agency should exercise its delegated authority within its area of expertise. *See*, City of Newark v. Natural Resource Council, 82 N.J. 530, 539, cert. denied, 449 U.S. 983, 101 S.Ct. 400, 66 L.Ed.2d 245 (1980) (agency exercise of its statutorily delegated duties presumed reasonable). In the United States, NOAA, the agency with expertise and responsibility for tracking, analyzing, and reporting weather statistics, has determined that normal weather should be defined as the arithmetic mean computed over a thirty-year period of time. *RC-4*, *p. 41*. Using this objective standard ensures consistency by avoiding case-by-case litigation of the appropriate standard. *Id. p. 42*.

Secondly, tor several important statistical reasons, longer time periods, such as 30 years, are preferable for weather normalization data. As Ms. Crane explained:

> longer time periods tend to average out weather and temperature extremes much better than shorter periods. [O]ne particularly cold or warm winter … has a much greater effect upon a twenty-year average than it does upon a thirty-year average. In fact, a single data point has a 5% impact on a twenty-year average, but only a 3.3% impact on a thirty-year average. Therefore, the effect of a single data point is 50% greater with a twenty-year average than with a thirty-year average. [A] shorter time period may fail to include extreme weather in computing average degree days. It is normal and customary to have a very cold or a very warm winter every so often, and the data base should include these extremes.

RC-4, *p. 41-42*.

Further, statistical measures of central tendency, such as an average, require thirty data points for a normal distribution.

> The use of thirty data points has its basis in the central limit theorem, which states that if the sample size has at least thirty data points, then the distribution of sample means is normal, resulting in a normal distribution centered around the mean with a standard deviation that decreases as the sample size increases.

RC-4, *p. 42*.

It is also important to use good standard weather data. As Ms. Crane testified:

> Utility rates are based upon normal operating conditions. If revenues are based on an accurate, consistent and widely-accepted standard for normalizing weather, in some years the Company's revenues will be less than normal, in some years the Company's revenues will be greater than normal, but over time, the Company's revenues will reflect normal weather and the Company will receive the opportunity to earn its fair rate of return. *RC-4*, *p. 41- 42*.

In summary, Rate Counsel recommends that the Board adjust the sales projections of Petitioner's pro forma revenue claim based on a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its original test year revenue forecast. This is the period used by NOAA, the independent government body with expertise who should be selecting the time period used to define normal weather. Rate Counsel's recommendation to utilize the NOAA 30 year standard, will increase the Company's pro forma revenues by $262,000, as shown in *RC-4, Sch-14*.

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

The Company adjusted its pro forma test year revenue based on the assumption that customer usage will decline in the future from its actual test year weather-normalized consumption. *P-20, p.5*. The Company examined the decline in usage between 2010 and 2011 and then made an adjustment to its weather normalized 2011 sales to reflect a lower consumption level after the test year.

Rate Counsel recommends that the Board reject this adjustment for two reasons. First, this adjustment is entirely speculative. Any declines in customer usage that occurred in 2011 are fully embodied in the test year results. To make a further post-test year adjustment based on mere supposition about future customer usage violates the

Elizabethtown Water standard that post-test year changes must be "known and measurable."

Moreover, as discussed in Ms. Crane's testimony, electric industry sales have generally been increasing as customers acquire more electric appliances and more sophisticated communication devices. While this growth may have slowed in the test year due to generally poor economic conditions, there is no reason to believe that usage will continue to trend downward. Therefore, the Company's adjustment is contrary to past experience with regard to electric usage.

Finally, the Company claims in rebuttal testimony that the decline in usage has continued into 2012. But, as pointed out at the hearings, the updated numbers did not include the 2012 summer months and Atlantic is a summer peaking utility. *T27:L7-28:13* (June 21, 2012). Certainly, the sweltering heat waves that have continued to torment New Jersey residents in June and July this year have had a positive impact on customer usage numbers. And yet, the Company would certainly dispute any adjustment proposed by Rate Counsel to increase usage numbers based on this two- month period.

Accordingly, the Company's adjustment to reduce actual test year consumption for speculative future declines in usage should be rejected. This adjustment results in an increase in net revenues of $1,724,000 (*RC-4, Sch. ACC-15*) and reduces the proposed rate increase by $1,728,000. *RC-4, Sch. ACC-34*.

4. Conclusion

Rate Counsel recommends that the Board adjust the sales projections of Petitioner's pro forma revenue claim to reflect a thirty-year period of normal weather data, rather than the twenty-year time period used by Petitioner to determine its pro forma

revenue forecast. Rate Counsel's recommendation will increase the Company's pro forma revenues by $262,000

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

D. Expense Adjustments

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

The Company's claim is based on projected payroll costs for the twelve months from July 2012 through July 2013. *P-20, p. 6*. These projected costs include, for union employees, annual payroll increases of 2% and for non-union employees, annual increases of 3.0%. The Company's claim includes increases that do not take effect, in some cases, until March 2013. *Id.*

Rate Counsel witness Andrea Crane recommended that only test year salary and wage increases be included in the Company's revenue requirement and that all post-test year increases be excluded from the Company's revenue requirement. As noted by Ms. Crane, the Company has included post-test year increases that reflect salary and wage levels through June 2013, or 18 months beyond the end of the test year. These adjustments reach too far beyond the test period and distort the regulatory triad of synchronizing rate base, revenues, and expenses. Accordingly, Your Honor and the Board should limit salary and wage increases to the increases that occurred during the test year, annualized to reflect a full year of costs. This adjustment results in a reduction expense of $1,881,000 (*RC-4, Sch. 16*) and a reduction in the Company's proposed rate increase of $1,886,000 (*RC-4, Sch. 34*).

2. Incentive Compensation

ACE has included $2.462 million of non-officer incentive compensation costs in its revenue requirement claim. *RC-4, p. 49.* These incentive compensation costs include PHI's Annual Incentive Plan ("AIP") and the PHI Management Recognition Award Program ("MRAP"). *RC-4, App. C, Response to RCR-A-24*. Rate Counsel witness Andrea Crane recommended that Your Honor and the Board remove these costs from the Company's revenue requirement. After adjusting for the percentage expensed, this adjustment reduces the Company's pro forma operating expense by $1,307,000 (*RC-4, ACC-17*) and reduces the proposed rate increase by $1,310,000 (*RC-4, ACC-34*) .

PHI's MRAP works "[t]o design and implement a consistent PHI wide recognition program to reward management employees for significant contributions to the success of the business that are above and beyond day to day responsibilities." *RC-4, App. C, Response to RCR-A-24, Attachment 1*. Full time management employees, excluding executive compensation participants, are eligible for an MRAP award. ACE managers are considered for the MRAP based on standards including the "[i]dentification of significant cost savings or revenue generating opportunities" and [c]ontributions that have elevated PHI's image in the community and in the industry." *RC-4, App. C, Response to RCR-A-24, Attachment 1*. ACE has not provided any information regarding a benefit to New Jersey ratepayers through the attainment of these awards. The avowed focus of the award is "the future of PHI's business" rather than measurable benefits to utility service such as reliability or safety improvements. Id. There is nothing in the record showing benefit to ACE customers - either through improved utility performance

or lower ACE distribution rates - as a factor contributing to the granting of a MRAP. Accordingly, ratepayers should not be charged for these awards in distribution rates.

All PHI management employees who do not participate in any other incentive plans are eligible to participate in the AIP. *RC-4, App. C, Response to RCR-A-24, Attachment 1*. As acknowledged at the hearings, the incentive payout has an earning threshold, "[t]he fact is this: ACE will not provide incentive compensation to its employees if the Company does not meet or exceed its earnings threshold." *T73:L11-21* (June 21, 2012). For Utility Operations managers, no incentives will be awarded if the Utility Operations' earnings fail to reach a specified earnings threshold. *Id*. As the Company's witness explained at the hearing, the Utility Operations' earnings are not Atlantic's earnings but rather are based on the combined earnings of the PHI companies.

> Q. This sentence says, "ACE has instituted a 93 percent and 90 percent earnings threshold for utility operations and corporate service employees, respectively." Are you saying now that PHI has instituted a 93 percent and 90 percent earnings threshold for utility operations and corporate service employees?
>
> A. Within that incentive plan there are various businesses, the power delivery business as well as corporate service organizations, they all have different scorecards which I believe we provided in a recent data request.
>
> Q. So is the compensation of ACE employees ties to the earnings of other PHI companies?
>
> A. The PHI annual incentive plan has an earnings per share trigger, PHI is a publicly traded company for which an earnings trigger must be met, and the other companies are not publicly traded.
>
> Q. So the fact that incentive compensation has been paid, does that mean that PHI has reached 93 percent of its overall earnings target?
>
> A. To trigger the annual incentive payment PHI would have had to meet a certain earnings per shareholder.

T73:L11-21 (June 21, 2012).

While the Company argues that incentive compensation is a necessary component of the overall compensation package, incentive compensation isn't paid unless financial targets are met. This means that no matter how good an employee is, or how hard they work, they cannot get incentive compensation unless the financial parameters are met. Fortunately for those employees however, incentive compensation payments, ranging from $2.29 to $2.36 million, have been awarded for the past five years, indicating apparently, that PHI has been meeting its earnings per share financial targets for payment of incentive compensations. *RC-4, App. C, Response to RCR-A-24, Attachment 3*; *T71:L1-13* (June 21, 2012).

The Company has provided little in the way of objective criteria for determining the eligibility of employees for incentive compensation, other than the earnings threshold of the AIP. While the Company claims that "safety metrics" is one of the objectives on the Employee Scorecard, there is nothing in the record in this proceeding to indicate how much weight that factor is given over the Financial Scorecard goal of "spending less that budgeted amounts for O&M." *P-20, p. 32*. Indeed, the Company concludes "[t]he Company's annual incentive plan is intended to support the PHI Way and PHI's Blueprint for the Future and align employees with key business goals and executive area balanced scorecards." *RC-4, App. C, Response to RCR-A-24, Attachment 1*. Where improved utility service for ACE customers fits into that plan is anyone's guess.

As discussed above, the AIP is heavily weighted toward the achievement of certain financial objectives, no payout being made unless certain financial goals are met. Incentive plans that are based largely on earnings criteria are not sufficiently related to the provision of safe and reliable utility service to justify passing this cost onto

ratepayers. If incentive compensation programs are tied to increased corporate and shareholder earnings, then the corporate shareholders, not ratepayers, should pay for these programs. To do otherwise violates all sense of fairness to the ratepayers of the regulated entity.

Indeed, Rate Counsel's position in this proceeding is fully consistent with Board policy. In reviewing similar incentive programs established by Jersey Central Power and Light Company, the Board found:

> We are persuaded by the arguments of Staff and Rate Counsel that, at this time, the incentive compensation or bonus expenses should not be recovered from ratepayers. The current economic condition has impacted ratepayers' financial situation in numerous ways, and it is evident that many ratepayers, homeowners and businesses alike are having difficulty paying their utility bills or otherwise remaining profitable. These circumstances as well as the fact that the bonuses are significantly impacted by the Company achieving financial performance goals, render it inappropriate for the Company to request recovery of such bonuses in rates at this time. Especially in the current economic climate, ratepayers should not be paying additional costs to reward a select group of Company employees for performing the job they were arguably hired to perform in the first place.

I/M/O of the Petition of Jersey Central Power & Light, BPU Docket No.ER91121820J, Decision and Order, (June 15, 1993), p.4. .

The Board also denied a utility's request to include incentive compensation costs in rates in the 2001 Middlesex Water Company base rate case. In rejecting the ALJ's recommendation to share incentive compensation costs 50%-50% between ratepayers and shareholders, the Board reiterated the policy set forth in the JCP&L decision by stating: "The language in the Board's JCPL 1993 Order is especially appropriate today when consumers are still faced with increasing energy costs, as well as other increased costs." I/M/O the Petition of Middlesex Water Company for Approval of an Increase in its Rates for Water Service and Other Tariff Changes, BPU Docket No. WR00060362, Order

Adopting in Part/Modifying in Part/ Rejecting in Part Initial Decision, (June 6, 2001). And again, in 2003, the Board denied recovery of incentive compensation from New Jersey ratepayers, stating:

> The Board continues to believe that incentive or "bonus" compensation should not be paid for by New Jersey ratepayers. New Jersey ratepayers are entitled to safe, adequate and proper utility service at just and reasonable rates, and should not, in our view, be required to pay incentives or bonuses for the utility to provide such service. Some New Jersey ratepayers continue to face many of the same economic difficulties which existed at the time the Board formulated the above policy, and which, in the Board's view, justify its continuance. Accordingly, the Board HEREBY ORDERS that all of RECO's proposed incentive compensation should be disallowed from rates.[14]

As correctly observed by the Board in the Middlesex case, denial of ACE's incentive compensation recovery request is especially appropriate today when the state is faced with record unemployment levels and stagnant or decreasing wage levels. The Company itself has claimed that "[t]he United States and, indeed, the world economies are or have been in recession and are grappling with a very serious financial crisis" as justification for some of its requests for extraordinary recoveries in this case. *P-1, p. 11, 39.* Given rising energy costs and current economic conditions ratepayers should not have to shoulder the additional burden of over $2 million in bonuses included in rates. Accordingly, Rate Counsel recommends that the Company's proposed incentive compensation expenses of $2.462 million be disallowed for rate making purposes in this case.

3. Payroll Tax Expense

In conjunction with the recommended adjustments for salaries and wage expense and for incentive compensation, an adjustment must also be made to eliminate the

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[14] I/M/O the Verified Petition of Rockland Electric Company for Approval of Changes in Electric Rates, BPU docket No. ER02100724, Final Decision and Order, (April 20, 2004), p. 71.

associated payroll tax expense. Rate Counsel's expert Andrea Crane calculated this adjustment by applying the statutory social security and medicare tax rates to her recommended adjustments for salary and wage increases and for incentive compensation expenses. This adjustment results in a reduction in both the operating expense and the revenue requirement of $244,000. *RC-4, Sch. ACC-18 and ACC-34.*

4. Supplemental Executive Retirement Program (SERP) Expense

In this proceeding, the Company is seeking recovery for $1,293,614 in expenses associated with the PHI Supplemental Executive Retirement Program. These costs relate to supplemental retirement benefits for key executives that are over and above the normal retirement programs provided by PHI for its employees. These programs generally exceed various limits imposed on retirement programs by the IRS and therefore are considered "non-qualified" plans. Rate Counsel urges the Board to reject the Company's proposal that PHI SERP expenses be recovered from ratepayers.

The Company claims that the SERP allows the Company to "make up for IRS limits which cap the amount of salary that the Company may use in calculating benefits." *P-20, p. 40*. According to the Company, because of the IRS limit, "executives do not receive equitable pension contributions, relatively speaking, when compared with the typical company employee." *P-20, p. 40-41*. In other words, because PHI executive compensation is so generous, their pension contribution would be above that amount that the IRS allows, if, on a percentage basis, the contributions equated with a "typical" PHI employee. The Company is therefore asking, based on a questionable definition of "equity," that ratepayers make up the difference.

By way of example, Mr. Joseph M. Rigby, Chairman, President and CEO in 2011, was paid a salary of $880,000. *RC-70, p. 48*. In addition, Mr. Rigby was granted $2,264,926 in Stock Awards, $748,000 in non-equity incentive plan compensation, and $757,729 for "all other compensation." *Id.* "All other" includes Company matching contributions under the Retirement Savings Plan and Company matching contributions on deferred compensation. Mr. Rigby's "Change in pension valuation and nonqualified deferred compensation earnings" grew from $588,975 in 2010 to $2,511,103 in 2011. *Id.*

Mr. Rigby participates in the Pepco Holdings Retirement Plan as well as the SERP. At December 31, 2011 the present value of his accumulated pension benefits was $1,994, 602 for the Pepco Holdings Retirement Plan with $3,934,718 in accumulated benefits under the SERP. *Id. at 55*. Mr. Kamerick's accumulated benefits under the Pepco Holdings Retirement Plan total $2,022,063 while the SERP adds additional value of $3,859,475. *Id.*

Rate Counsel does not object to the Company offering SERP benefits to these named executives officers whose retirement benefits are "limited" by the IRS. Rate Counsel does object, however, to including these excessive benefits in rates. Accordingly, Rate Counsel recommends that the Board exclude the SERP benefit from Atlantic's distribution rates, thereby reducing the Company's revenue requirement by $1,296,000 (*RC-4, Sch. 34*).

5. Medical Benefit Expense

The Company's medical expense claim is based not on actual costs incurred in the test year but rather on projected benefit expense increases of 8.0 percent for medical and 5.0 percent for dental and vision benefits. The Company indicated that these projections

were based on a study performed by Lake Consulting, its benefit plan consultant, on medical premium trends.

Rate Counsel witness Andrea Crane recommended that the Board disallow these post-test year adjustments to the Company's Medical Benefit expense. These projected increases are speculative and not supported with the "convincingly reliable data" mandated by the Board in the Elizabethtown Water Order for the inclusion of post-test year adjustments.

First, the Company's reliance on the Lake Consulting study is misplaced. A study depicting general cost trends does not rise to the Elizabethtown Water standard of a known and measureable change. Moreover, the referenced study provides no data that is specific to ACE or PHI. Rather the study is based on trends in medical premiums by several major insurance companies and reflects trends in Virginia, Maryland, and the District of Columbia. There is no information about trends in medical premium costs in New Jersey. Indeed, the Company's response to Staff discovery request C-AREV-61 shows a decrease in costs in 2011. Thus, the Company's claim that medical costs will increase in 2012 is pure speculation.

Furthermore, it is not clear that costs will increase in light of the significant changes the Company has made to its medical benefits programs, presumably in an effort to contain costs. The Company has increased co-pays and plan deductibles; has eliminated a standard indemnity plan and an EPO plan; and has added an Health Maintenance Organization. *RC-63*. PHI has increased employee contributions for management employees toward the goal of an 80-20 cost share in 2012. Id. Accordingly, given these changes and the fact that the Company has not supported its

claimed post-test year adjustment, Rate Counsel recommends that the Board deny the Company's pro forma adjustment relating to medical expenses thereby reducing the Company's operating expenses by $624,000 (*RC-4, Sch. 20*) and it revenue requirement by $625,000. *RC-4, Sch. ACC-34.*

6. Corporate Restructuring Expense

Atlantic has proposed to charge New Jersey ratepayers $5.668 million in severance costs related to the sale of Conectiv Energy and the phase out of Pepco Energy Services. *P-19, p.26, JCZ-22*. Of this $5.668 million, $5.072 million has been allocated to distribution rates. The Company has proposed to amortize this allocation over three years for an annual amortization expense of $1.691 million.

Rate Counsel objects to the inclusion of these severance costs in ACE's distribution rates. This reorganization was driven by PHI's corporate goal to sell or otherwise terminate its competitive businesses. The employees that were terminated were obviously not necessary to the provision of safe, adequate and reliable utility service, otherwise they would still be employed by PHI. The Company's adjustment is an attempt to have regulated utility ratepayers pay for severance costs associated with employees that previously served competitive businesses. Any severance costs incurred by PHI should have been recovered in the selling price of the competitive businesses that were sold and/or therefore should be absorbed by shareholders. Ratepayers should not be required to provide severance costs for employees that were not necessary in the past and who will not be necessary in the future. This adjustment reduces the Company's

operating expense by $1,677,000 (RC-4, Sch. 21) and its revenue requirement by $1.681 million (*RC-4, Sch. 34*).

7. Rate Case Expense

Atlantic has elected to charge New Jersey ratepayers the entire bill for prosecuting this base rate proceeding, amortized over a three-year period. The Company proposes rate case expenses from this rate case of $511,000, amortized over 3 years. Rate Counsel does not dispute the expense amount or the 3 year amortization. Rate Counsel does assert, however, that Atlantic's rate case expenses should be shared 50/50 between shareholders and ratepayers, an approach that is both equitable and consistent with firmly entrenched Board policy.

The theory behind the 50/50 sharing approach is that a utility's primary motivation in filing a rate case lies in adding shareholder value. Given this motivation, it is entirely appropriate that rate case expenses be borne in part by the Company's shareholders. This recommendation is entirely consistent with long-established Board policy. The Board has ruled in numerous rate cases that it is appropriate to have shareholders and ratepayers share the responsibility of the resulting rate case expenses. See, e.g., I/M/O Pinelands Water Company and Pinelands Wastewater Company, BPU Docket No. WR00070454 and WR00070455, Order, (August 1, 2001); I/M/O the Petition of Pennsgrove Water Company, BPU Docket No. WR98030147, Order, (June 24, 1999). The Board has repeatedly said that a sharing of rate case expense "is appropriate because a portion of that expense, which we have determined to be fifty percent, is a cost of maintaining the stockholder's investment which cost should

reasonably be borne by the investor." I/M/O Hackensack Water Company, BPU Docket No. 815-447, Final Decision and Order, (January 12, 1983). This is especially true given the amount of time and effort the Company has expended on presenting the shareholder's perspective in this case. Accordingly, Atlantic's shareholders should be required to pay 50% of the Company's rate case expenses. This adjustment reduces the Company's annual operating expense by $85,000. *RC-4, Sch. ACC-22* and reduces its revenue requirement by a similar amount (*RC-4, Sch. 34*).

8. Non-Recurring Expense

The Company's test year costs include a non-recurring cost of $1,323,976 relating to sick leave accrual for ACE's unionized employees. These employees are being transitioned to a sick leave policy that is similar to that offered to Potomac Electric Power Company's union employees. The transition to this new policy required ACE to take a one time charge related to the change in sick leave policy.

Rate Counsel witness Andrea Crane recommended that the Company be denied recovery in base rates for this non-recurring cost. Non-recurring costs are generally excluded from a regulated utility's revenue requirement. Utility rates are designed to be prospective and to reflect a normalized level of future costs, not recovery of previously-incurred costs. Accordingly, Atlantic's revenue requirement should be adjusted to remove non-recurring sick leave accrual policy costs. This adjustment reduces the Company's operating expense by $1,197,000 (*RC-4, Sch. ACC-23)* and reduces its revenue requirement by $1,200,000 (*RC-4, Sch. 34*).

9. Credit Facilities Expense

In this proceeding, ACE has requested a rate base adjustment of $1.329 million and an operating expense claim of $760,000 relating to the short-term credit facility operated by PHI. Rate Counsel's position regarding the rate base adjustment was discussed in a previous section in this brief. In this section the focus will be on two adjustments to the Company's claim recommended by Rate Counsel witness Andrea Crane.

The first adjustment relates to the Company's inclusion of test year costs of $91,428 of closing costs related to short-term credit facilities that expired during the test year. In addition to these closing costs related to the old credit facility, Atlantic has included $238,248 relating to closing costs of the new facility, executed in August 2011. In her testimony, Ms. Crane recommended that costs for the expired short-term credit facility be eliminated from the Company's revenue requirement. Ms. Crane reasoned that as this credit facility has been replaced, it is no longer providing any benefit to Atlantic's ratepayers. To the extent that there are unrecovered costs associated with that facility, these costs should be borne by the Company's shareholders.

The second adjustment recommended by Ms. Crane relates to the Company's calculation of on-going maintenance costs. These costs are based on annualizing costs incurred in the last quarter of the test year, 2011, over a 92-day period. Annualizing these costs therefore results in recovery of costs for 368 days rather than the 365 days that would reflect a normal calendar year. Rate Counsel witness Crane corrected this calculation to reflect costs based on a 365 day year. This correction eliminated $11,000 of on-going credit facility costs, based on the assumption used by the Company that $250

million of short-term debt will be available at an annual cost of 0.2%. *RC-4, Sch. ACC-24*.

It is important to note that the Rate Counsel has included the adjusted credit facility costs in our proposed revenue requirement based on our recommendation that short-term debt be included in the capital structure. If the Company's position is adopted and short-term debt is excluded from capital structure, then all credit facility costs should be eliminated from the revenue requirement. There is no basis upon which to include these costs if ratepayers are not receiving any of the benefits associated with the credit facility. The only way ratepayers could see any benefit from the short-term credit facility is by including short-term debt and its associated weighted cost in the capital structure. Accordingly, if Your Honor and the Board decide to allow the Company to exclude short-term debt from its capital structure, an adjustment must be made to exclude all credit facility costs from its revenue requirement. The Company cannot have it both ways, it cannot deny ratepayers the benefit of low cost short-term debt while at the same time charging ratepayers the cost associated with this debt.

As a final note, Rate Counsel's adjustments are based on the Company's position that credit facility costs are based on a credit line of $250 million, although Rate Counsel witness Matt Kahal has only included $11.8 million in short-term debt in his pro forma capital structure. Thus, while Rate Counsel has based its revenue requirement on the entire $250 million, Your Honor and the Board could reasonably choose to limit recovery of credit facility costs to costs associated with the amount of short-term debt actually reflected in the capital structure. Rate Counsel would support such an adjustment.

10. Storm Damage Expense

Atlantic has proposed to normalize storm damage costs based on a three-year average of actual costs incurred, excluding costs for Hurricane Irene. The Company has also proposed to amortize the costs incurred for Hurricane Irene over a three-year period and to include the unamortized balance in rate base.

Rate Counsel does not object to the Company's proposal to normalize storm damage costs based on a three-year average of actual costs incurred. Rate Counsel believes, however, that the costs incurred for Hurricane Irene should be included in this normalization. Since the Company is proposing a three-year amortization period for Hurricane Irene costs, there is no reason to exclude Hurricane Irene from the normalization adjustment. On the other hand, if Your Honor and the Board should determine that a longer recovery period is more appropriate for the recovery of Hurricane Irene costs, then Rate Counsel would agree that these costs should be removed from the Company's normalization adjustment and amortized as a separate adjustment over the approved amortization period.

In fact, Your Honor and the Board may want to consider a longer amortization period. The Company argues that the Hurricane Irene costs should be accounted for separately because "a storm like Irene [] only comes along every 50 or 100 years." *P-20, p.25*. So a longer amortization period may be appropriate. In either case, as discussed above in the Rate Base section of this brief, Rate Counsel would object to the inclusion of any unamortized balance in rate base.

Rate Counsel's adjustment has no impact on the Company's operating expense, since a three-year amortization period was proposed by the Company for costs associated with Hurricane Irene, the same period used by the Company to normalize costs.

11. Meals and Entertainment Expense

The Company has included in this filing approximately $70,500 of meals and entertainment expenses that are not deductible on the Company's income tax return. These are costs that the IRS has determined are not appropriate deductions for federal tax purposes. The Company explains that these expenses were incurred "during the normal course of business" (*P-20, p. 36*.) but fails to explain why they should be recovered from ratepayers when the IRS has determined that they are not deductible for income tax purposes. Rate Counsel recommends that Your Honor and the Board deny the Company's request for recovery of these costs. If these costs are not deemed to be reasonable business expenses by the IRS, it seems appropriate to conclude that they are not reasonable business expenses to include in a regulated utility's cost of service. This recommendation will reduce the Company's operating expense by $64,000 (*RC-4, Sch.25)* and its revenue requirement by $64,000. *RC-4, Sch.34.*

12. Membership Dues Expense

The Company has included in its test year claim $406,020 for costs related to dues in several organizations. Ms. Crane found that most of the organization whose costs were included in this claim engaged in some lobbying activities, the costs of which should not be charged to ratepayers. *RC-4, p.66*. Ms. Crane noted that the largest expenditures were for dues for EEI, the New Jersey Utilities Association ("NJUA"), New

Jersey Shares, the Corporate Executive Board, and the Conference Board. While the Company made an adjustment to eliminate a portion of the dues associated with EEI that relate to lobbying, it did not make any other adjustments related to lobbying. However, with the exception of New Jersey Shares, all of these organizations undertake at least some lobbying. In addition, many of the other dues were for various Chambers of Commerce, which clearly engages in lobbying activities. Ms. Crane noted that in addition to lobbying cost, most of these organizations also engage in other activities that should not be charged to ratepayers, such as public affairs, media relations, and other advocacy initiatives. *Id.*

Lobbying expenses are not necessary for the provision of safe and adequate utility service, if the utility were to immediately cease contributing to these types of efforts, utility service would in no way be disrupted. Accordingly, Ms. Crane recommended that the costs associated with lobbying activities be disallowed. This recommendation is in accordance with long-standing Board policy that lobbying expense is not "an appropriate expense to impose on ratepayers." I/M/O the Petition of Jersey Central Power and Light Company, BPU Docket No. ER91121820J, Final Decision, (June 15, 1993), p.19. This recommendation will reduce the Company's operating expense by $40,000 (*RC-4, Sch.26)* and its revenue requirement by $40,000. *RC-4, Sch.34.*

13. Advertising Expense

Rate Counsel is recommending that one expenditure included in the Company's advertising cost claim be disallowed. Specifically, ACE has included $25,000 in advertising costs relating to the Company's sponsorship of the Atlantic City Convention Center. P-20, p.39. Rate Counsel witness Andrea Crane recommended that these costs

be disallowed as these costs relate to institutional advertising and are not necessary for the provision of safe and reliable regulated utility service. *RC-4, p.67-68.*

The Board's policy regarding institutional advertising and public relations expenses was first established more than 30 years ago in its 1977 and 1980 Orders in BPU Docket No. 7512-1254. In the more recent JCP&L case cited above the Board reiterated its advertising policy:

> Based upon the Board's advertising policy, the following expenses should be excluded from Petitioner's EEI allocation factor for the foregoing reasons;
>
> a. Legislative Advocacy, Regulatory Advocacy and Legislative Policy Research should be excluded because these meet the Board's definition of political advertising.
>
> b. Promotional advertising, Institutional advertising and Public relations expenditures should be excluded from the factor because these expenses were specifically excluded by the Board in its 1977 Order.
>
> JCP&L, BPU Docket No. ER91211820J, June 15, 1993, page 9

Accordingly, these expenses should be removed for ratemaking purposes as they are related to activities that have nothing to do with the provision of safe, adequate and reliable service. The primary purpose of these expenses is to enhance the Company's image as a good corporate citizen by prominently displaying the ACE name throughout the Atlantic City Convention Center. Therefore these costs should be the responsibility of shareholders, not ratepayers. This recommendation will reduce the Company's operating expense by $23,000 (*RC-4, Sch.27)* and its revenue requirement by $23,000. *RC-4, Sch.34.*

14. Interest On Customer Deposits

The Company agrees with Ms. Crane's adjustment to use the 2012 annual interest rate on customer deposits of 0.13% and has reflected this change in rebuttal testimony. *P-20, Sch. JCZ R-19.*

15. Depreciation Expense

Ms. Crane made two adjustments to the Company's claim for pro forma depreciation expense. First, Ms. Crane eliminated the depreciation expense reflected in the Company's filing associated with post-test year plant additions. *RC-4, Sch. ACC-29.*

In addition, Ms. Crane made an adjustment to the Company's filing to reflect the parties agreement that the company would retain the annual cost of removal expense of $2.935 million, which was previously approved by the BPU and which is currently being collected in utility rates. *RC-4, p.69 Sch. ACC-30; P-20, Sch. JCZ R-14.*

16. Interest Synchronization

At the hearing the Company witness agreed with Rate Counsel's interest synchronization methodology.

> Q. With regard to interest synchronization that you discuss on page 29 of your rebuttal testimony, am I correct that you don't disagree with Ms. Crane about the methodology to be used to calculate the interest synchronization adjustment but you do disagree with the interest that Ms. Crane uses?
>
> A. We use different numbers.
>
> Q. Would you agree that interest synchronization is a fallout adjustment and would depend on the level of rate base and rates set down by the Board to be appropriate?
>
> A. Yes.

T62:L2-14.

Thus, the interest synchronization adjustment should be recalculated based upon the rate base and weighted cost of debt approved by the Board.

17. BPU/Rate Counsel Assessment

Ms. Crane made one adjustment to the Company's Revenue Multiplier. Ms. Crane noted that the Company had used the statutory cap of 0.25% for both the BPU and Rate Counsel assessments included in the revenue multiplier. *RC-4, p. 71*. Ms. Crane noted that as the actual assessments have traditionally been less than the statutory cap, Ms. Crane determined that the appropriate assessment rate would be the actual rate, calculated as a percentage of utility revenue. Accordingly, Ms. Crane's revenue multiplier reflects the current BPU assessment of 0.1875% and the current Rate Counsel assessment of 0.0353%.

At the hearing the Company's witness agreed that upon further reflection and information, "it certainly is reasonable to have those rates reflect the actual cost of the BPU and Rate Counsel operating costs as opposed to a more random percentage. *T80:L20 – T81:L5* (June 21, 2012) Thus, the Board should approve Rate Counsel's adjustment and utilize the current assessment rates in determining the Company's revenue requirement. This current rate should be applied to the level of pro forma revenue found by the Board to be appropriate.

18. Conclusion

As discussed above and as demonstrated in the testimony, Rate Counsel respectfully requests that Your Honor deny Atlantic's request as shown in its 12+0 update for an

increase of $90,268,000 in its distribution rates.[15] Rate Counsel recommends Your Honor adopt Rate Counsel's recommended revenue requirement deficiency of $5,475,000. Specifically Rate Counsel recommends operating income adjustments:

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

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

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

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

(5) In conjunction with the recommended adjustments for salaries and wage expense and for incentive compensation expense, an adjustment must also be made to

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

eliminate the associated payroll tax expense. This adjustment results in a reduction in both the operating expense and the revenue requirement of $244,000.

(6) Rate Counsel recommends that the Board exclude the SERP benefit from Atlantic's distribution rates, thereby reducing the Company's revenue requirement by $1,296,000.

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

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

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

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

(11) Rate Counsel's proposed adjustments for Credit Facility costs should be adopted and reduce the Company's revenue requirement by $93,000.

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

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

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

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

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

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

E. **Regulatory Asset Recovery Charge (RARC)**

1. **Current RARC Overview**

In its initial filing the Company stated that its RARC was designed to recover Board approved regulatory assets[16] which are not directly related to the current provision of electric power supply. *P-17, p. 19.* Company witness Joseph F. Janocha listed the following regulatory assets as currently being recovered through the RARC:

a. Asbestos Removal Costs;
b. SFAS 106 – Pension OPEB Costs;
c. 2008 Management Audit Costs ;
d. Deferred Nuclear Fuel Rod Legal Costs; and
e. Non-Utility Generation ("NUG") Buyout Costs.
P-19, p. 20.

Pursuant to Exhibit C to the Order in the Company's last base case, the Company is currently recovering an annual revenue requirement of $2,607,993 relating to these items.[17]

2. **Proposed RARC Additions**

The Company, in this proceeding, has proposed to add six additional "regulatory assets" to be recovered through the RARC:

a. Preferred Stock Redemption Costs;
b. Long-Term Capacity Adjustment Pilot Program ("LCAPP") Administrative Expenses;
c. PJM Default Assessment Charges;

[16] A regulatory asset is "an asset recorded on the books of an electric public utility or gas public utility pursuant to the SFAS, No.71, entitled 'Accounting for the Effects of Certain Types of Regulation,' or any successor standard and as deemed recoverable by the Board." N.J.S.A. 48:3-51.

[17] I/M/O the Petition of Atlantic City Electric Company For Approval of Amendments to its Tariff to Provide For an Increase in Rates and Charges for Electric Service Pursuant to N.J.S.A. 48:2-21 and N.J.S.A. 48:2-21.1 and For Other Appropriate Relief, BPU Dkt. No. ER09080664, Decision and Order Approving Stipulation and Adopting Initial Decision, (May 12, 2010) Exhibit C, p. 2.

d. Medicare Part D Costs; and
e. Management Audit Costs;
f. New Jersey Department Of Transportation ("NJDOT") Consulting Costs.

P-19, p. 20.

Ms. Crane did not oppose recovery of three of these items, the preferred stock redemption costs, the LCAPP costs and the Management Audit costs. Ms. Crane noted that the Board had previously approved recovery of the preferred stock redemption costs over a 15 year amortization period, for an annual cost of $11,149. Ms. Crane further noted that the deferral of the LCAPP costs had previously been authorized by the Board and the Company's proposed four-year amortization for these costs was reasonable. Finally Ms. Crane noted that management audit costs have traditionally been amortized by the BPU. *RC-4, p.77*

Rate Counsel recommends however that the Company's request for RARC recovery for PJM default costs, the Medicare Part D tax change costs and the NJDOT outside consulting fees should be denied. The PJM member default costs and the Medicare tax change costs were not incurred during the test year. The PJM member default costs were incurred from January 2008 to September 2009 while the Medicare tax change occurred in March 2010. Thus, these costs are clearly outside the test year. If the Company wanted to defer these costs for future recovery, it should have requested approval for deferred accounting treatment from the Board. It did not do so. Moreover, there is no reason to treat these costs differently from other unanticipated costs that arise from time to time. With regard to the DOT consulting fees, the Company incurred less than $50,000 of such costs. Rate Counsel does not believe that this expenditure rises to the level that warrants extraordinary ratemaking treatment.

The Company believes that "abnormal, non-recurring costs that the Company has minimal to no capability to otherwise avoid and/or mitigate" are appropriate for recovery through the RARC. *RC-60*. However, as acknowledged by Company witness Janocha at the hearing, the risk of recovery for abnormal, non-recurring costs is a risk that is assumed by shareholders in exchange for a higher rate of return. *T16:L2-7* (June 21, 2012).

Moreover, the BPU should consider for recovery only test year costs, unless an expenditure was previously approved for deferred accounting treatment by the BPU. Mr. Janocha acknowledged at the hearing that the Company always has the option to petition the Board for deferred accounting when the Company incurs an abnormal non-recurring cost but had not done so for the costs it was now seeking to recover through the RARC. *T16:L20 – T17:L7* (June 21, 2012). Thus, Rate Counsel believes that these costs should not be granted special treatment and the Company's request for recovery should be denied.

In addition to recommending that only three of the six new deferrals be approved, Rate Counsel witness Andrea Crane also recommended two adjustments relating to the RARC balance at the end of the test year. *RC-4, p. 78.* In its 12+0 Update, the Company claimed that the RARC was under-recovered by $1,379,106 at December 31 2011. *RC-4, p. 73.* Ms Crane first noted that in Atlantic's last base rate case, the BPU determined that that the RARC would be over-recovered by $3.7 million when new rates went into effect. The BPU Order in that case directed the Company to credit the RARC "with the entirety of the over recovered balance as of that date." ACE did not credit the RARC with the entire $3.7 million as required in the Board Order but rather has been crediting the RARC

with $76,590 per month. *RC-4, p. 79.* Thus, to date, the RARC has not yet been credited with the entire $3.7 million. Therefore, Ms. Crane's first adjustment was to credit the RARC balance with the entire $3.7 million as of the effective date of the BPU Order in the prior case.

The second error in the Company's existing RARC balance relates to the Statement of Financial Accounting Standard 106 ("SFAS 106") costs.[18] Since the Company's last base rate case, Atlantic has been amortizing approximately $2.5 million annually relating to the SFAS 106 implementation costs instead of the $1.54 million authorized by the Board. Ms. Crane found that rather than the $1,379,106 RARC under-recovery claimed by the Company, the RARC was over-recovered by $138,166. *RC-4, p.80.* At the hearing, Company witness Janocha agreed with Ms. Crane's findings and acknowledged that the proper corrections had been made in his rebuttal testimony. *T11:L1-4* (June 21, 2012).

Rate Counsel recommends that this over-recovery be used to offset the LCAPP costs of $121,927 and management audit costs of $128,935, for a net cost for these two new items of $112,696. Assuming a four-year amortization period, this would result in an increase in RARC costs of $28,174, in addition to the previously-approved preferred stock amortization costs of $11,149. Given the existing RARC costs of $2,607,993 approved in the last case, Rate Counsel recommends that an annual recovery of $2,647,316 be approved.

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[18] SFAS 106 changed the practice of accounting for Post-Retirement Benefits Other Than Pension cost. Atlantic is amortizing the costs of this change through the RARC pursuant to BPU Order. I/M/O an Inquiry Into the Methods of Implementation of FAS-106 Pursuant to BPU Dkt. No. AX96070530 Phase II Atlantic City Electric Company, BPU Dkt. No. ER97080562, Phase II Decision and Order, (Dec. 31, 1997)

3. Elimination of the RARC

Finally, Rate Counsel recommends that the Board consider the elimination of the RARC. With each rate case, the Company has attempted to expand the RARC to include costs that are well outside of the test year, that do not have a material impact on the Company, and/or that are normal and customary costs incurred in the provision of utility service. The RARC is becoming a "catch-all" mechanism used by Atlantic to recover certain costs on a guaranteed dollar-for-dollar basis. This special treatment is not afforded the other utilities in this state, as Atlantic is the only utility with a RARC. To the extent that similar types of costs are recovered by other utilities in New Jersey, those companies typically recover such costs through base rates over some appropriate amortization or normalization period.

Recovering such costs through the RARC guarantees dollar-for-dollar recovery and therefore shifts the risk of recovery from shareholders to ratepayers. This is contrary to the way in which utility rates are established for the majority of non-fuel operating and maintenance expenses. Utilities are provided with an opportunity, but not a guarantee, to earn a return and to recover their prudently incurred costs. Moreover, the traditional ratemaking process is designed to provide an incentive to utilities to minimize costs between base rate cases. If utilities are guaranteed dollar for dollar recovery, they lose this incentive to minimize costs.

4. Conclusion

In sum, Rate Counsel recommends that Your Honor and the Board reject Atlantic's attempt to expand the RARC to include any expense that it finds "reasonable"

and instead terminate the RARC and move the Board approved amortizations into base rates. Accordingly, Rate Counsel recommends that:

- Previously BPU authorized amortization expense of $2,607,993 should be transferred to base rates.

- Preferred stock redemption costs should be included in base rates, based on the 15 year amortization period previously approved by the BPU for an annual amortization expense of $11,149.

- LCAPP costs and management audit costs should be recovered in base rates over a four year amortization period. The over-recovery of $138,166 should be used to offset a portion of the LCAPP and Management Audit fees. These costs total $250,862. Accordingly $112,696 ($250,862-138,166) should be included in base rates, amortized over four years, for an annual amortization expense of $28,174.

- Adoption of these recommendations will result in a total base rate increase of $2,647,316.

RC-4, p.80. Sch. ACC-35.

F. Miscellaneous

1. Infrastructure Investment Program Surcharge

On October 16, 2008, New Jersey unveiled a plan to stimulate New Jersey's economy in response to the 2008 economic crisis. *P-15*, *p.1*. As part of this plan, the State encouraged utilities to formulate plans to enhance investments in its infrastructure. Id at p. 2. In response, on January 30, 2009, Atlantic filed a petition requesting that the Board approve its IIP-1. *Id*. The Board approved Atlantic's proposal to accelerate 16 Qualified Projects budgeted at $27.6 million over two years to help stimulate the economy, create jobs and to improve reliability. *P-15*, *p. 3*. Pursuant to the terms of the April, 2009 stipulation signed by the parties the rates were interim subject to refund until the next base rate case:

> 21. The Parties further stipulate that, in the context of the Company's next base rate case, the Qualifying Projects and the IIS rate will be subject to a full and thorough examination. The parties further stipulate that, if required, full evidentiary hearings with respect to the Qualifying Projects and related costs will take place in that base rate case proceeding.
>
> 22. The parties further stipulate that, during the Company's next base rate case, the net capitalization amount of the Qualifying Projects, if deemed to be reasonable and prudent, will be rolled into the Company's rate base and the related IIS charge will be terminated. *P-15*, *p. 8 of stipulation.*

On October 11, 2011, Atlantic filed a Verified Petition with the Board in support of the final reconciliation of the Company's Infrastructure Program. In that filing, requested that the Board approve rate base addition of approximately $26.3 million of the IIP-1 investments. Petition, BPU Dkt. No. EO11110846, p. 4. The IIP-1 reconciliation docket was subsequently consolidated into the base rate case docket. The issue before Your Honor and the Board is whether the Qualified Projects are reasonable and prudent and should be rolled into the Company's rate base. In addition, the Company is proposing that there be a reconciliation of its IIP-1 revenue requirement and IIP-1 surcharge revenues when new base rates are established with any deferred balance being recovered from or returned to ratepayers over a subsequent 12-month period. ACE has proposed to make a compliance filing relating to this reconciliation when it makes its compliance filing in the base rate case.

After reviewing data obtained from the Company in connection with the Qualified Projects, Rate Counsel has several concerns. First, as the data obtained through discovery shows, the Company's IIP-1 has created 59 incremental jobs compared to the 92 incremental jobs projected by the Company. *RC-2*, *p. 19, Exhibit CPS 9*. Rate Counsel witness Mr. Salamone noted, "overall the Company has spent approximately 95% of the projected costs while creating only 64% of the projected incremental jobs."

Id. In response to Mr. Salamone's observation, Atlantic's witness Mr. Gausman claimed that, "There was never a 'guarantee' that a specific number of jobs would be created by or in the IIP-1." *P-10*, *p. 16*. However, it was clear to all parties from the start that job creation was a major goal of the Economic Stimulus Plan.[19]

Of the 16 projects reviewed by Rate Counsel in this proceeding, Mr. Salamone found that the Mercury Vapor Project, which consisted of replacing 6,000 street lights for approximately $2 million, "may have questionable prudency." *RC-2*, *p. 19*. This conclusion was based on two findings: First, that under a cost benefit analysis, the program is not cost effective and the savings would only appear to support about 50% of the cost to implement the project. Second, the Mercury Vapor program was projected to create 11 incremental jobs but in reality the program created 7.6 jobs or 69% of the anticipated job creation.

Rate Counsel's concern about Atlantic's performance is compounded by the Company's plans to extend the IIP-1 program. In his direct testimony Mr. Kamerick states Atlantic's vision for IIP-2:

> The Company intends to request an extension to its Infrastructure Investment Program (IIP-1) filing that was submitted to the Board on January 30, 2009 and approved in a negotiated settlement on April 29, 2009. In that filing, which is anticipated to be filed by the end of September, [2011] the Company will further discuss the impact of regulatory lag, provide details on the capital projects included under the extension of the IIP-1, and propose as a recovery mechanism the extension of the current Infrastructure Investment Surcharge to help mitigate the significant negative effects that ACE is experiencing due to regulatory lag.

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[19] Kenneth J. Parker, President of Atlantic letter to Victor Fortkeiwicz, Board's Executive Director dated January 20, 2009 "Job Creation – Ken Esser's January 5, 2009 e-mail emphasized the importance of job creation as a result of investment in infrastructure improvement and spending on energy efficiency programs." *RC-25*, *p. 2*. See also, IIP-1 Order dated April 16, 2009, "In addition to providing positive benefits to the provision of safe, adequate, and proper service, the proposed Qualifying Projects are designed to create direct jobs." *P-15*, *p. 8*.

> As will be explained in that filing, such mechanism can be implemented without diminishing the Board's oversight authority. *P-4, p. 9.*

In fact, an IIP-2 petition was filed by Atlantic on October 18, 2011 requesting $244.3 million over the next three years. What was a one time stimulus program to create jobs during an economic crisis has turned into a request for a permanent clause to address "regulatory lag." This expansive view must be rejected by Your Honor and the Board. A strong message that limits the program to its original intent and re-emphasizes the fundamentals of job creation, prudency and cost effectiveness should be given to the Company. With respect to the prudency review and the petition to roll into rate base the cost of the 16 programs, despite the concern set forth herein Rate Counsel does not object to including the $26.3 million of IIP-1 projects in rate base. Rate Counsel does not object to Atlantic's proposal to make a compliance filing relating to this reconciliation when it makes its compliance filing in the base rate case. Rate Counsel agrees that this is a reasonable approach. However, Rate Counsel respectfully request that the proposed IIP-2 Petition filed by Atlantic and under review by the Board under a separate docket should be rejected.

2. Request For Storm Damage Deferral

On August 26, 2011, Atlantic filed a Joint Petition with Public Service Electric and Gas Company seeking deferred accounting treatment for costs associated with Hurricane Irene. <u>I/M/O the Petition of Public Service Electric and Gas Company and Atlantic City Electric Company's Request for Deferral Accounting Authority for Storm Damage Restoration Costs</u>, BPU Docket Nos. EO11090518 and EO11090519 ("Deferral Petition). On December 1, 2011, Atlantic filed a letter with the Board requesting that

the Board bifurcate Atlantic's interests from the Deferral Petition and consolidate that portion of the Deferral Petition with the Company's pending base rate case. The BPU granted the Company's request and consolidated Atlantic's portion of the Deferral Petition with this base rate case.

As discussed earlier, Rate Counsel is recommending that storm damage costs, including the costs associated with Hurricane Irene, be normalized based on a three-year average. Thus, no further action is necessary with regard to recovery of Hurricane Irene costs or with regard to the Company's request to defer these costs.

3. Basic Generation Service ("BGS") Administrative Costs

In a recent BGS proceeding, the Board directed Board Staff to "examine, as an additional area, the administrative expenses that are being charged to ratepayers relating to BGS in each of the EDCs next base rate cases."[20]

The EDCs receive tranche fees from BGS suppliers that are intended to compensate the utilities for at least a portion of their BGS administrative costs.
The tranche fees received by the other three EDCs cover the vast majority of their BGS administrative costs. For the period July 2008 through June 2011, PSE&G recovered 100% of its BGS administrative costs through tranche fees, JCP&L recovered approximately 94.4% of its administrative costs through tranche fees and Rockland recovered approximately 89.5%. However, during this time period, ACE recovered only 33.8% of its BGS administrative costs through tranche fees. For the period July 2008 to June 2011, ACE claimed BGS administrative costs of $2,580,296 but received only $873,900 in tranche fees from BGS suppliers.

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[20] I/M/O the Provision of Basic Generation Service for the Period Beginning June 1, 2012, BPU Docket No. EO11040250, Decision and Order, Nov. 9, 2011, p. 11

Ms. Crane found that the vast majority of BGS administrative costs incurred by the other EDCs relate to charges from NERA, which runs the BGS auction, and charges for Boston Pacific, the consultant to the BPU. *RC-4, p.85*. On the other hand, the vast majority of BGS administrative costs charged by ACE – more than $1.7 million - relate to internal labor costs. *RC-4, App. C. RCR-A-166.*

Ms. Crane noted that it is difficult to determine whether some of the internal labor costs being charged through the BGS charge were also being charged in other clauses or in base rates. This is especially true given the proliferation of clause and surcharge mechanisms that ratepayers are now paying. From a practical standpoint, it is simply not possible to verify labor costs for every clause and for base rates, given the fact that an employee's payroll costs can be allocated to a number of different surcharge mechanisms, and the allocation percentage can change over time. In addition, as the vast majority of BGS administrative costs charged by the other utilities are recovered through tranche fees, it appears that ACE is the only EDC charging large amounts of internal labor costs to the BGS.

Accordingly, Rate Counsel recommends that ACE should be directed to stop charging internal labor costs to the BGS. Instead these costs should be recovered in base rates. As the BGS rates for the upcoming year have already been approved, and these rates include internal labor costs, Rate Counsel is not recommending any quantitative adjustment to ACE's revenue requirement in this proceeding. However, ACE should be directed not to include internal labor costs in future BGS proceedings and instead those costs should be included in test year charges in the Company's next base rate case. This

will facilitate review of labor costs and make ACE’s BGS administrative costs comparable to the administrative costs being charged by the other EDCs.

4. Excess Depreciation Reserve Amortization

Since June 1, 2005, Atlantic has been amortizing an excess depreciation reserve balance of approximately $131 million over 8.25 years. This amortization should be completed by August 31, 2013. The Company has been amortizing this refund through base rates, i.e., base rates currently reflect an annual credit associated with this amortization. In this case, ACE has proposed to transfer this amortization from base rates to a separate, explicit tariff rate, with a termination date of August 31, 2013.

Rate Counsel is not opposed to the Company’s request to transfer this amortization to a separate tariff rider, given the magnitude of the amortization and the fact that it will expire shortly. However, Rate Counsel is opposed to an automatic termination of this rider. Instead, Rate Counsel recommends that the Company be required to make a status filing on June 1, 2013, at which time ACE should report on how much of the excess reserve has been refunded to date and how much is expected to be refunded by August 31, 2013. Any party with concerns regarding the amount refunded could request at that time a continuation of the rider until such concerns are resolved by the BPU. Rate Counsel believes this position provides a reasonable balance between the Company’s desire to terminate the rider at August 31, 2013 and Rate Counsel’s objective to ensure that the appropriate amounts are ultimately refunded to ratepayers.

5. AFUDC Rate

As discussed in the testimony of Rate Counsel witness Matthew Kahal the Company has excluded short-term debt from its capital structure. The Company claims that short-term debt should be viewed as funding Construction Work in Progress (CWIP) a non-rate base item that must be financed. *RC-1, p. 16.* The Company goes on to reference the FERC formula in which "short-term debt is assumed to fund CWIP." *Id.* Thus, the Company seems to suggest that it is proper to exclude short-term debt from the ratemaking capital structure because it is fully accounted for in the financing of CWIP through the rate used to calculate the Allowance for Funds Used During Construction ("AFUDC"). The Company's claim that short - term debt is accounted for in the AFUDC is contradicted by the AFUDC rate of 8.25% used by the Company.

> Q. What is the Company's current interest rate for short-term debt?
>
> A. ACE's current interest rate is around 35 to 40 basis points.
>
> Q. So that's .035% is that correct?
>
> A. That's correct. That's for daily or weekly commercial paper issuances.
>
> Q. And during the construction period the company accrues an allowance for funds used during construction, or AFUDC, is that correct?
>
> A. That is correct.
>
> . . .
>
> Q. So to the extent that the company is financing construction with short-term debt, it is charging ratepayers a return of 8.25 percent but may only be paying a financing cost of .035%, is that correct?
>
> A. No, it's not. The AFUDC rate is a combination of both return on equity and a cost of debt, it just depends on the level of short-term debt balances relative to CWIP; and so it just depends on the balances at that time. But again, the BPU set this rate, and we use the rate that's set by the BPU.

> Q. Do you know how often this rate, the AFUDC rate, is updated by the company? Is it updated monthly?
>
> A. The rate is set by the BPU. That's the rate we use.

T12:L1 – T14:L24 (June 25, 2012).

In a discovery response the Company cited to a BPU Order dated October 26, 1993 as the Board Order that set the 8.25% AFUDC rate. It is Rate Counsel's position that the use of this out-dated AFUDC rate is improper and the Company should use an AFUDC rate that more properly reflects the actual costs. As noted by Ms. Crane at the hearing:

> That's the way the FERC implements the formula. The rate is updated each month to reflect the actual balance for CWIP and the actual debt costs. Usually it does reflect the cost of equity that is approved in the prior rate case, so presumably whatever cost of equity is approved in this case will be used in the FERC formula going forward.
>
> I would just clarify, this has no impact on the revenue requirement in this particular case. This would simply specify how the company calculates AFUDC going forward. It could have a significant impact on the company's investment balances in its next base rate case. But certainly using a formula that was approved years and years and years ago without doing any monthly updates is unacceptable.

T72:L14 – T73:L5 (June 25, 2012).

Accordingly, Rate Counsel recommends that Your Honor and the Board should direct the Company to use the FERC formula to calculate its AFUDC rate going forward. Further, the Company should be required to update its AFUDC rate on a monthly basis to more accurately reflect current costs. In this way, the Company will no longer be overcharging ratepayers by using an inflated AFUDC rate and ratepayers will begin to receive some of the benefit of very low short-term debt rates.

6. Conclusion

Rate Counsel recommends that ACE should be directed to stop charging internal labor costs to the BGS and instead those costs should be included in test year charges in the Company's next base rate case.

Rate Counsel is not opposed to the Company's request to transfer the depreciation reserve amortization to a separate tariff rider with the condition that the rider not automatically expire but that the Company be required to make a status filing on June 1, 2013, at which time ACE should report on how much of the excess reserve has been refunded to date and how much is expected to be refunded by August 31, 2013.
Rate Counsel recommends that Your Honor and the Board should direct the Company to use the FERC formula to calculate its AFUDC rate going forward and that the Company should be required to update its AFUDC rate on a monthly basis to more accurately reflect current costs. In this way, the Company will no longer be overcharging ratepayers by using an inflated AFUDC rate and ratepayers will begin to receive some of the benefit of very low short-term debt rates.

POINT IV

ATLANTIC HAS FAILED TO MEET MINIMUM RELIABILITY STANDARDS DUE TO INSUFFICIENT INVESTMENT IN RELIABILITY

The statutes governing utilities in the State expressly require Atlantic to provide safe adequate and proper service at just and reasonable rates. N.J.S.A. 48:2-21 and N.J.S.A. 48:2-23. As shall be shown, Atlantic consistently fails to provide adequate service to its customers. When confronted with this failing, the Company asks the Board and its customers to wait, yet again, for the Company to turn its performance around. The Board and Atlantic's customers have waited long enough and the Board should adjust the Company's authorized ROE for its consistently poor performance.

As discussed more fully in the ROE section supra, the New Jersey courts have held that the Board has in its discretion the power to lower a utility's rates to encourage better performance. See, Lakewood Township 54 N.J. Super 371 (App. Div. 1959). The Board as recently as 2003 reduced the ROE of a utility for poor reliability performance. In the last JCP&L base rate case the Board reduced the utility's return from 9.75% to 9.5%:

> The Board will use the allowed return on equity as the most direct and powerful signal that they can send to the company to improve their system reliability and do it as soon as practicable. The Board **ORDERS** that the Company's return on equity be reduced from the 9.75% allowed above to 9.50%, a reduction of 25 basis points, until such time as the Company provides sufficient evidence to the Board that they have made the necessary improvements required to maintain system reliability.[21]

[21] I/M/O The Verified Petition of Jersey Central Power & Light Company for Review and Approval of an Increase in and Adjustment to its Unbundled Rates and Charges for Electric Service and For Approval of Other Proposed Tariff Revisions In Connection Therewith,. Docket No. ER02080506 –Final Order p. 39.

Therefore, there is legal precedent to support Rate Counsel's recommendation that the Board consider ACE's persistent failure to achieve minimum reliability standards to adopt Mr. Kahal's reasonable recommended ROE of 9.5%.

A. Atlantic Has Failed to Meet Minimum Reliability Standards

Atlantic's reliability has historically failed to meet the Board's minimum reliability performance standards. The Company has had ample opportunity to allocate the necessary resources to address these problems but continues to miss the mark. Although the Company has instituted several reliability improvement programs to address its unacceptable SAIFI and CAIDI levels,[22] the data provided during this proceeding have not supported the Company's contention that things are improving and Atlantic's customers are enjoying better reliability due to greater allocation of resources.

In 2009 the Board approved Atlantic's Infrastructure Investment Program ("IIP-1") which allowed Atlantic to accelerate 16 planned capital improvement projects ("Qualified Projects") worth approximately $27.6 million[23] in two years to help stimulate the economy, create jobs and to improve reliability. Docket No EO09010054, *P-15,* pp. 9-10. These programs were to be incremental in nature in order to avoid double recovery. Id. The Board permitted the Company to recover the associated revenue

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[22] The Board uses two indices to measure the electric utilities reliability performance:
SAIFI (System Average Interruption Frequency Index) represents the average frequency of sustained interruptions per customer during the reporting period.
CAIDI (Customer Average Interruption Duration Index) represents the average time in minutes required to restore service to those customers that experienced sustained interruptions during the reporting period. See, N.J.A.C. 14:5-1.2 and N.J.A.C. 14:5-8.7

[23] The Board approved 16 Qualified Projects with a cost estimate of $27.6 million. With cost overruns and Federal Stimulus grant monies, the net cost of the Infrastructure Program requested by Atlantic is now $26.3 million. I/M/O the Petition of Atlantic City Electric Company for Approval of a Captial Economic Stimulus Infrastructure Investment Program and an Associated Cost Recovery Mechanism Pursuant to N.J.S.A. 48:2-21 and 48:2-21.1 (Final Reconciliation of Infrastructure Program Projects and Costs) BPU Docket No. EO11110846 October 11, 2011 Petition of Atlantic p. 2.

requirement for these investments contemporaneously, through the IIP-1 surcharge, instead of having to wait for the Company's next base rate case. Id.

In addition, in response to the Board's 2010 Audit by Overland Consulting ("Overland") and Rate Counsel's concerns expressed in Atlantic's last base rate case, Atlantic proposed a Reliability Improvement Program ("RIP"), which was an initiative designed to address several service quality issues by targeting "six specific areas for improvement and enhanced investment." *P-14*, p. 15 of Stipulation. The RIP, which was subsequently approved by the Board on May 16, 2011 was a five year plan that would reduce SAIFI 20% from 2009 levels to 1.3 or less. Id. at 7.

Similarly, the Company committed to reducing SAIDI[24] by 25% from 2009 levels to 160 minutes. *Id*. According to Atlantic's RIP Summary attached to the RIP stipulation approved by the Board, the Company projects that it will increase its average annual reliability spending budget by 16.4% or $8.1 million per year over the next five years. *P-14*, Exhibit C Attachment 2 page 1 of 2 Stipulation.

Atlantic's 2011 Annual System Performance Report ("2011 Performance Report") submitted to the Board in May of 2012 shows that once again Atlantic failed to meet the SAIFI minimum reliability level in 2011 despite all the additional funding for reliability programs since 2009. *RC-20*, B1.B2. "Minimum Reliability Level." Atlantic excuses its poor recent performance by noting:

> It is important to remember the RIP is a 5 year plan. It is unrealistic to expect the Company to meet its targets less than 1 year after the plan's initial approval. ACE may experience dips and peaks along the path towards meeting its goals; however, we believe that, with increased

[24] SAIDI System Average Interruption Duration Index- SAIDI represents the total average time that customers on a system are interrupted.

> spending and focus on targeted areas for improvement, we will meet our reliability objectives.
> *P-10* p. 8.

This argument fails to acknowledge that Atlantic continues to be bound by the minimum reliability standards established by the Board. Having instituted the RIP to address persistent failures, the Company cannot now use the program to argue that it is exempt from meeting the Board's minimum reliability levels for another 5 years.

With another failure under its belt in 2011, Atlantic attempted to counter its poor reliability performance by relying on minimal data available for 2012. Company witness Mr. William Gausman, Senior Vice President of PEPCO Holdings Inc., included three charts that show the Company's 2012 performance data from January to April is slightly better than the same period in 2009. *P-10*, p. 6-7. However, considering that the winter of 2012 was the mildest in recent years, the slight increase in reliability for that year is more likely due to warmer weather conditions than to Atlantic's efforts to improve reliability. *RC-21*.

Moreover, as noted by Rate Counsel witness Mr. Salamone, some customers have consistently suffered from poor reliability service. When questioned whether some customers have seen significantly worse reliability performance than others, Mr. Salamone testified in the affirmative:

> Yes. Based on response to data inquiry RCR-REL-17 there have been a number of circuits that have been routinely among the worst performing circuits in the Company's system. Exhibit CPS 6 below is a list of circuits that have been on the worst performing circuit list for multiple years. One circuit (NJ0242 Winslow) has been on the worst performing list for four out of the last five years. Additionally there were four circuits that were among the worst performers for three out of the last five years and an additional 18 circuits that were worst performers for two out of five years. *RC-4*, p. 12

Atlantic's response to the evidence demonstrating its failure to address these persistent problems was to minimize their importance. When questioned during cross examination by the Company about the number of customers that are actually served by these feeders, Mr. Salamone stressed the importance of all of the utility's customers:

> Q. And a single feeder with twenty-six hundred customers is pretty small in the grand scheme of things, isn't it?
>
> A. Not for the twenty-six hundred customers, if you are experiencing very high rates of failure year after year after year after year, I would have to imagine that you have twenty-six hundred customers that feel rather abandoned at this point. *T82:L25; T83:L1-7* (June 19, 2012).

While everyone certainly hopes the allocation of additional funds will ultimately produce the required reliability improvements, what is certain is that the 2011 Performance Report documents the Company's inability to pass the Board's lenient minimum reliability standards. This poor performance is unacceptable and should not be without consequence.

B. Atlantic's Reliability Problems Are Long Standing

Atlantic's 2011 failure to meet its minimum reliability levels must be examined from a historical context. Atlantic's current failures are a continuation of performance problems that have existed for a number of years. Pursuant to Board regulations, Atlantic must submit an annual report of its reliability performance using SAIFI and CAIDI. Yearly data filed by Atlantic with the Board pursuant to N.J.A.C. 14:5-8.7 in its Annual System Performance Report show that Atlantic has a long history of reliability problems. For example, the 2007 Annual System Performance Report ("2007 Performance Report") that provides the Company's performance data for 2000-2007 shows that from 2003 through

2007, Atlantic was unable to meet its SAIFI Minimum Reliability Level. *RC-22*. Similarly, the 2007 Performance Report shows that in 2006, Atlantic did not meet its CAIDI Minimum Reliability Level. As noted above, the Board uses two indices to measure the electric utilities reliability performance. See, N.J.A.C. 14:5-1.2 and N.J.A.C. 14:5-8.7. SAIFI measures the average number of times a customer across the entire utility system experiences an outage in each given year and CAIDI measures the average length of time that a customer is out of service in minutes. The chart below shows the Company's performance from 2003 to 2007:

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

	SAIFI	**CAIDI**
Atlantic Minimum Reliability Level	1.13	132
2003	134 (Failed)	104
2004	114 (Failed)	95
2005	139 (Failed)	113
2006	171(Failed)	148 (Failed)
2007	149 (Failed)	111

*Data from *RC-22* - 2007 Atlantic System Performance Report

When describing the significance of the Minimum Reliability Level set by the Board, Rate Counsel's expert witness Mr. Salamone observed:

> I think the Board is fairly explicit in their statutes that those standards are in fact minimum standards, not standards that a company should seek to maintain, but in fact a set of standards that the company should seek to exceed. And again in the past eight years, it is only four years or so that the Company has succeeded in meeting that minimum standard. *T71 -72* (June 19, 2012).

Atlantic's 2011 Performance Report which provides the Board with data from 2002 through 2011 further supports Rate Counsel's position that Atlantic's performance has been unacceptable. Not only did Atlantic fail to meet the SAIFI Minimum Reliability Level in 2011, SAIFI numbers are actually higher in the last four years than they were in the beginning of the reporting period from 2002 to 2004. *RC-20* , B3/B4/B5/B6 Atlantic Electric -All Districts. This means that Atlantic customers continue to have frequent outages. While changes to the regulations lowered the minimum reliability benchmark in 2008, Atlantic has continued to fail.[25] As Rate Counsel's witness Mr. Salamone states:

> I might note that that index -- that that minimum reliability standard as established by the Board was changed in 2008 and provided a fifty percent greater leeway in terms of increased frequencies of interruptions that customers might experience, and even with that relaxing of performance requirement the Company has once again failed to meet those minimum requirements. *T71:L20-25; T72:L1-2* (June 19, 2012).

This additional leeway has created an illusion of improvement of the Company's CAIDI and SAIFI, but even with the relaxation of the standard in 2008, Atlantic is still unable to pass the minimum acceptable level of reliability. *RC-20*, B3/B4/B5/B6 Atlantic Electric -All Districts.

The Management Audit of Atlantic completed by Overland Consulting on behalf of the Board in February 2010 provides additional insight into Atlantic's continued poor performance. ("Overland Management Audit") *RC-23*. Overland was retained by the Board to complete a management audit which is statutorily required every 3-6 years. N.J.S.A. 48:2-16.4. Overland reviewed among other things, Atlantic's System Reliability

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[25] Before 2008 the minimum reliability level for SAIFI and CAIDI were calculated using the electric utilities' 10 years average between the years 1990 to 1999 with two standard deviation. The current benchmark is set at 5 year average between the years 2002 to 2006 with two standard deviation. N.J.A.C. 14:5-8.9.

for the years 2006 and 2007. In its review, Overland was extremely critical of Atlantic's performance stating that "[T]he lack of consistent commitment of funding for service quality and reliability projects has led to subpar performance metrics." *RC-23*, p.1-1. Overland goes on to note that:

> Cutting reliability programs to meet short-term budget targets sends the wrong message to employees. Frequent funding changes also reduces the cost effectiveness of the programs. ACE should increase the priority given to reliability initiatives so funding does not fluctuate significantly from year –to-year based on temporary cost containment objectives."

Id. at p. 15-4.

To remedy the Company's deficiencies, Overland made several key recommendations:

1. PHI should prepare a comprehensive reliability improvement plan by March 31, 2010;

2. ACE should increase its vegetation management funding;

3. ACE should provide consistent stable funding for reliability initiatives;

4. ACE should improve the metrics it uses to measure reliability;

5. ACE should include more information in its Annual System Performance Report.

Id., at p. 15-3 to 15-4.

The record demonstrates that decisions impacting reliability are being made by the corporate parent. Atlantic's reliability witness Mr.Gausman, Senior Vice President of PEPCO Holdings Inc., testified that he is in charge of reliability for all the utility subsidiaries in the PEPCO family of companies. *T7:L3-9* (June 19, 2012). This has not led to the investment of sufficient resources in reliability. Overland noted of PEPCO Holding that "none of its operating companies compared favorably to their peers in reliability benchmark surveys." *RC-23, p.* 15-2. Indeed, Overland's criticisms of Atlantic were echoed by the Maryland Public Service Commission when it penalized Atlantic's

affiliate, Potomac Electric and Power Company ("Pepco") one million dollars for reliability failures in 2011.[26] The Maryland Commission observed that Pepco's "low level of reliability stems directly from its poor vegetative management practices" (Maryland Order p. 2); the Commission also noted that "the Company's 2011 reliability expenditures were increased due to many years of imprudently inadequate expenditures and neglect (Maryland Order p. 3).[27] The similar observations made by both Overland for Atlantic and the Maryland Commission for Pepco suggest that the parent company PEPCO Holding may have an overall strategy that shortchanges reliability investments of its utilities to help bolster the corporate bottom line.

PEPCO's efforts to explain away their reliability failures should be rejected. As stated earlier, the 2007 Performance Report clearly shows that Atlantic failed to meet its minimum reliability benchmark between 2003- 2007 for SAIFI, and 2006 for CAIDI. However, the Company reported to the Board in its 2011 Performance Report that Atlantic passed the minimum reliability benchmarks for the very same years 2002-2007. When questioned about the inconsistency, Mr.Gausman replied that the Company reached back and applied the more lenient standard adopted by the Board in 2008 to Atlantic's performance prior to the change in the regulation:

> Q. But you failed, you conceded that you failed earlier at the time when the old regulations applied, you conceded that you had failed, so isn't this chart somewhat deceptive in the sense that you are saying that now you passed?

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[26] I/M/O of an Investigation Into the Reliability and Quality of the Electric Distribution Service of Potomac Electric Power Company, Case No. 9240 (December 21, 2011) ("Maryland Order")

[27] Similar to the RIP five year plan that was proposed by the Atlantic in New Jersey and adopted by this Board in 2011, during the public outcry of Pepco's failed reliability performance in 2010, "Pepco unveiled its Reliability Enhancement Plan ("REP") that proposed to invest approximately $250 million over five years to improve system reliability.

> A. Well, the standard was changed because it was determined that the new method for calculating the data is more, I believe is more responsive or representative of the actual performance, so once the standard was changed and we calculated the new requirements that's the standard that we used for reporting purposes.
>
> Q. Going forward, but you used it to go backwards, historically?
>
> A. We are showing our performance relative to the new standard in the past, yes.

T21:L10-25 (June 19, 2012).

This manipulation of the regulation and the data should be rejected. Recasting its past performance as anything but a failure under the Board's then-applicable regulation is nothing more than an attempt to deny the very real reliability problems Atlantic's customers face. You Honor and the Board must hold the Company accountable as the Maryland Commission did, in order to ensure safe, adequate and proper service for Atlantic's customers.

C. Atlantic's Poor Reliability Performance is Due to Its Failure to Make Investing in the Company's Infrastructure a Priority

Contrary to the finding made by the Overland, the Company claims that it has made sufficient investments to the utility's infrastructure to meet their statutory mandate to provide safe, proper and reliable service. To support this assertion that the Company has sufficiently invested in Atlantic's infrastructure, Mr. Kamerick, Senior Vice President and Chief Financial Officer of Pepco Holdings, Inc. claims that: "[i]n 2006 through 2010, expenditures on reliability construction totaled $266 million or 57% of total distribution capital." *P-4*, *p. 10*. However, closer examination of Mr. Kamerick's claim shows that the Company did not spend the entire $266 million on reliability. For example, out of that $266 million, $173 million was for "emergency spending." *RC-2*, *p. 15 Exhibit CPS*

7. As described by Mr. Gausman, this spending goes to addressing outage conditions and equipment failure conditions:

> A. Reliability emergency are a series of projects that are performed generally in response to either a failure of the equipment due to storm damage or through some type of inspection program where we identify pieces of equipment that need to be replaced.

T25:L15-20 (June 19, 2012).

While the Company classifies these expenditures as for "reliability" they are not truly investments in reliability but rather the cost of fixing or replacing equipment that has failed. Where a company's failure to invest in reliability results in outages it would be a cruel irony to label the cost of restoring service as "reliability" spending. In short, the cost of replacing equipment that is used until it fails should not be considered reliability maintenance expenditures.

Furthermore, out of the $266 million cited by Mr. Kamerick, approximately $26.3 million was spent as part of the State's economic stimulus program, which allowed Atlantic to accelerate 16 planned capital improvements projects in two years to help stimulate the economy, create jobs and to improve reliability. IIP-1 Order. Approximately $20 million of the $26.3 million is included in Mr. Kamerick's reliability expenditure claims. *RC-2*, *p.15*. Absent New Jersey's Economic Stimulus Plan, it is unlikely the Company would have increased its capital investment over this time period. As Mr. Salamone opined:

> The true level of investment in reliability through distribution system improvements that the Company committed to of its own accord amounts to a total of $73 million over the past five years or little more than $14 million a year. This reveals that the Company spends very little on reliability investments and, in fact, only allocates about 27% of its total distribution capital to improve system reliability on a planned basis. *Id*.

As these numbers show, Overland's comments that "[T]he lack of consistent commitment of funding for service quality and reliability projects has led to subpar performance metrics" is supported by the record in this proceeding. *RC-23*, *p. 1-1*. The poor performance is attributable to lack of funding and the Company's failure to make reliability a top priority.

D. Conclusion

Therefore, we respectfully request that Your Honor and the Board Order determine the following:

1) Adopt Mr. Kahal's reasonable recommended ROE of 9.5% as discussed in the ROE section supra with the possibility of lowering the ROE further if reliability metrics do not improve.
2) Penalize the Company if Atlantic is unable to improve the circuits that repeatedly appear on the Worst Performing Circuits List within 1 year.
3) Penalize the Company if it is unable to meet the RIP target SAIFI and SAIDI levels in 5 years.
4) Consider whether the Board should initiate a rulemaking to establishing a statewide Minimum Reliability Level applicable to all electric utilities in New Jersey. *RC-2*, p.16.
5) Order Atlantic to accurately report the years when the Company fails the Board's Minimum Reliablity Levels in all future Annual System Performance Report

POINT V

ATLANTIC'S CUSTOMER SERVICE CONTINUES TO DETERIORATE AND IT HAS NOT DEVOTED SUFFICIENT RESOURCES TO IDENTIFYING OR ADDRESSING ITS PROBLEMS

A. Good Customer Service Is an Essential Obligation of a Public Utility. Identifying, Studying and Planning to Address the Root Causes of Problems Can Improve Customer Service

New Jersey law requires that a public utility provide its customers safe, adequate and proper service at just and reasonable rates. N.J.S.A. 48:2-21; N.J.S.A. 48:2-23; N.J.A.C. 14:3-3.1(a). New Jersey courts have long held that this statute requires all public utilities to exercise good company management, honest stewardship and diligence. In re Valley Road Sewerage Co., 285 N.J. Super. 202, 210 (App. Div. 1995), aff'd, 154 N.J. 224 (1998) (quoting In re Board's Investigation of Tel. Cos., 66 N.J. 476, 495 (1975)). Public utility companies also must comply with Board regulations, including those governing customer service. E.g., N.J.A.C. 14:3-3.8(b) (utility must keep service appointments); N.J.A.C. 14:3-7.7(b)(1) (25% maximum down payment for a deferred payment agreement).

Specific Board Orders also require ACE to meet certain customer service standards. These include Service Level Guarantees under the July 2, 2002 Board Order resolving the Company's 2002 merger proceeding (Docket No. EM01050308) (the "2002 Merger Order") and obligations under the April 19, 2011 Stipulation of Settlement resolving Phase II of the Company's last base rate case (Docket Nos. ER09080664 & EA07100794) (the "2011 Stipulation"), adopted by Board Order May 16, 2011, *P-14*.

Unfortunately, as detailed below, ACE has failed to uphold its customer service obligations. The Company's customer service has deteriorated over the past few years, with its service metrics poor and getting worse. When confronted with this failing, the Company asks that the Board and its customers to wait, yet again, for the Company to improve its performance. Despite ACE's claims to the contrary, it has not made progress on improving its customer service.

The Board and Atlantic's customers have waited long enough. Your Honor and the Board should penalize the Company for its consistently poor performance with a reduction in its authorized ROE and direct further measures as set forth below. As discussed in the ROE section, supra, the Board has the discretionary power to lower a utility's rates to encourage better performance. Lakewood Township v. Lakewood Water Co., 54 N.J. Super 371 (App. Div. 1959); I/M/O The Verified Petition of Jersey Central Power & Light Company for Review and Approval of an Increase in and Adjustment to its Unbundled Rates and Charges for Electric Service and For Approval of Other Proposed Tariff Revisions In Connection Therewith,. BPU Docket No. ER02080506, Final Order, (July 25, 2003), p.39. Therefore, there is legal precedent to support Rate Counsel's recommendation that the Board consider ACE's persistent failure to provide adequate customer service to adopt Mr. Kahal's reasonable recommended ROE of 9.5%.

Mr. Roger Colton testified on behalf of Rate Counsel to the wide variety of ACE's customer service problems including how the Company's own data show the inadequacy of its customer service in three categories: 1) ACE's non-compliance with its Service Level Guarantees ("SLGs") under the 2002 Merger Order, 2) the dissatisfaction of ACE's customers with its call center service; and 3) ACE's misuse of notices of

disconnection for non-payment. Mr. Colton included in his testimony management initiatives that other utilities have employed to effectively identify and address similar problems. These techniques are very similar to those recommended in the Board-mandated management audit of the Company by Overland Consulting two years ago. The most significant problems are discussed below using Mr. Colton's analytic framework for clarity.

B. ACE Has Not Complied With Its 2002 Merger Order Service Level Guarantees

Mr. Colton testified how the Company's own data establishes its recurring failure to comply with its SLGs under the 2002 Merger Order regarding the number of complaints filed about Atlantic with the Board. ACE was unable to rebut the evidence presented by Mr. Colton.

1. The Company's Customer Complaints Far Exceed the 2002 Merger Order Maximum

The Company continues to exceed by a wide margin the maximum number of customer complaints set in the 2002 Merger Order. Mr. Colton testified that, "contrary to the [SLG] in the 2002 Merger Order that the Company's complaint level would not exceed 1,500 per year, the Company now exceeds its SLG by nearly 50%." *RC-3*, *p. 5.*

Mr. Colton stated that ACE's customer complaint volume cannot be "attributed solely to the economic downturn that hit the country in 2008," *RC-3*, *p. 10- 11*, since ACE's complaint level began to climb before the recession and has continued to climb as the recession has moderated. He opined that ACE "is not devoting adequate resources to an effort to undertake an accurate root-cause analysis of the increasing number of

complaints. As a result, the level of compliance with this Company-agreed SLG continues to deteriorate." *RC-3*, *p. 5*.

The Company failed to rebut or even explain this huge disparity in the number of customer service complaints or its responsibility for its poor performance. In response, ACE offered preliminary data from the first five months of this year that, it claimed, "demonstrate that progress is being made." *P-16*, *p. 4;* see *RC-51*. However, the Company's own data demonstrate that it has not made progress in reducing complaints. From January through May 2012, ACE received 662 complaints, which is the highest number for January through May for 2008 through 2010, each of which resulted in annual totals substantially in excess of the merger-approved 1,500 per year. Complaints about ACE during the first five months of 2012, projected for a full year, would result in the highest annual number in the last five years. *T83:L3-20* (June 20, 2012); *T116:L1 - T119:L1* (June 20, 2012); see *T52:L9 - T54:L4* (June 20, 2012).

2. The Company Has Failed to Keep All Scheduled Appointments

ACE also has not honored its obligation, under Board regulations and the 2002 Merger Order, to keep all scheduled customer service appointments. Board regulations state:

> If the utility is unable to ensure that the service call will occur within the four-hour period provided under [N.J.A.C. 14:3-3.8(a)], the utility shall inform the customer at the earliest possible time, and in no case later than the close of business on the business day prior to the scheduled appointment. A utility shall not cancel an appointment with a customer after the close of business on the business day prior to the scheduled appointment, unless the utility can show good cause. N.J.A.C. 14:3-3.8(b) (emphases added).

The 2002 Merger Order incorporated that obligation as an SLG and included penalties on failure to meet the standard. ACE admits, though, that it has failed to uphold this guarantee, and has not shown good cause for its failure. In 2011, for example, ACE reported that it failed to keep 80 of 643 scheduled appointments, keeping 83.67% of its appointments rather than 100%. *RC-3*, *p. 18 - 19*; *RC-3*, *Sched. RDC-2*. As Mr. Colton testified,

> I find that, contrary to the SLG in the 2002 Merger Order that the Company would "honor *all* mutually agreed face-to-face service related appointments with customers," the proportion of service appointments met continues to fall well short of the performance to which ACE agreed in this SLG in the Merger Order. *RC-3*, *p. 5*.

The Company presented no evidence to rebut its failure to honor all scheduled face-to-face appointments.

Mr. Colton explained the impact on consumers of missed service appointments. In addition to failure to achieve the utility service purpose of the appointment, such as restoring lost service, a missed appointment causes additional adverse effects for the customer such as lost income, lost paid or unpaid leave time, and the annoyance of waiting for service that fails to arrive. *RC-3*, *p. 19 - 20*. Mr. Colton also opined that the existing compensation of $25 per missed service appointment is inadequate either to compensate customers for the value of their lost time or to sanction and deter ACE's poor performance. Id. at p. 20.

C. ACE's Customers Are Not Satisfied With Its Call Center Service

The Company has not kept its commitment to conduct the "moment of truth" customer satisfaction surveys that it agreed to perform in the 2011 Stipulation, *P-14*. Mr. Colton testified:

> I find that, contrary to the Company's agreement under the 2011 Order to undertake "moment of truth" surveys to measure customer satisfaction with all aspects of customer service interactions, and contrary to the representation that such surveys would begin in January 2012, as of April 2012, no results from such surveys have yet been forthcoming. The "moment of truth" surveys required by the 2011 Order are necessary to determine *how* and *why* the Company's customer service activities are resulting in ongoing low levels of customer satisfaction. *RC-3*, *p. 5*.

ACE has conducted annual or biannual transactional customer satisfaction surveys, through Market Strategies International ("MSI"). These are the antecedents to the "moment of truth" surveys that the Company agreed to perform in the 2011 Stipulation. *RC-3*, *p. 22 – 23*; *RC-34*; *RC-35*. The MSI survey data is limited, however, since "only one-fifth of the customers surveyed [20%] had contacted the Company with billing questions or complaints and only one-in-twenty of the customers surveyed [5%] had contacted the Company for payment arrangements." *RC-3*, *p. 24*. This is far below the portion of ACE customers who have complained [74% to 79%] about its credit and collection practices. *RC-3*, *p. 10*. The MSI surveys, although limited, still provide support for the premise that customers are dissatisfied with ACE's service. This dissatisfaction underscores the need for the "moment of truth" surveys. *RC-3*, *p. 23*; id. at p. 24 - p. 26. Mr. Colton found that these "moment of truth" surveys would be "at least a first step in engaging in an improvement process." Id. at p. 26; see *P-14*, p. 6-7.

Based on the MSI surveys, ACE admits that its performance is among its lower-rated peers, describing itself as "generally a 3rd quartile performer among its 'Peer' utilities." *RC-36*, "PEPCO Holdings, Inc., Residential Customer Satisfaction Research Program: Fall 2011," p. 13. In fact, the Board's auditors already recommended that the Company engage in a "Strategic Planning" process, in the Overland Management Audit

BPU Docket No. EA07100794. *RC-3*, *p. 57*. Mr. Colton opined that, "[u]sing the basic management process articulated in the Overland Management Audit to develop appropriate responses to the customer service issues I have identified above would help ACE address its customer service problems." *RC-3*, *p. 57*. He also noted that "basic management techniques are available, and have been employed by other utilities, that would address each of the problems I identify." *RC-3*, *p. 7*; id. at p. 55, – p. 56; *T105:L3-20* (June 20, 2012).

Other than showing that ACE needs to improve its customer service, it is unclear how the Company uses or indeed can use its peer survey data to plan and achieve that improvement. The Company's own data shows that, "the vast majority [74% to 79%] of the complaints about ACE involve credit-related issues," *RC-3*, p. 10, lines 6-12, and ACE surveys few of those customers, *id.* at p. 24.

1. The Company's Deferred Payment Arrangement Failure Rate of 90% Is Due To Atlantic's Inflexible Practices

Mr. Colton found that "the failure rate of the Company's deferred payment arrangements ("DPAs") is extraordinary." *RC-3*, p.6, lines 2-3. He explained that

> [t]he Company does not appear to offer payment plans that consider the financial circumstances of the customer. For example, the deferred payment plan terms offered to residential customers require down-payments that appear to be excessive. Roughly 90% or more of the Company's deferred payment arrangements end in default. *RC-3*, *p. 6*.

Mr. Colton characterized this extraordinary DPA failure rate as "disturbing." *T84:L1-12* (June 20, 2012).

The Company has never acknowledged that its 90% DPA failure rate is a customer service problem. In seeking to justify making no changes to its DPA process

from the economic downturn in 2008 until 2011, Mr. Dickerson said "the measures that the company had in [e]ffect for that time they thought w[ere] sufficient." *T24:L13-15* (June 20, 2012). Mr. Dickerson described the processes yielding a 90% DPA failure rate as "fair and adequate" and "very, very generous." *T25:L3 – T26:L1* (June 20, 2012). Mr. Dickerson also said that the processes that yielded a 90% DPA failure rate "were proven and acceptable measures to get people to pay their bill." *T24:L17-19* (June 20, 2012). The numbers of both service disconnection notices and service disconnections for nonpayment have increased between 10% and 20% from September 2008 to September 2011, but the Company dismissed these increases as "not significant." *RC-3*, *p. 48*; id. at p. 48. Although the number of service disconnection notices has increased to the current level of 50,000 annually, the Company has stated that this increase was simply "to be expected." Id. at p. 48.

Mr. Colton testified that, as a condition of entering into a DPA, the Company continues to collect down payments from its customers of 25% of the total amount owed. This is the maximum down payment allowed under Board regulations. N.J.A.C. 14:3-7.7(b)(1). Even after ACE agreed, in the 2011 Stipulation, to exercise flexibility in down payment demands, its own data shows that it continued to collect an average down payment of 25% of the amount owed. *RC-3*, *Sched. RDC-4*. Mr. Colton also testified that ACE has not shown flexibility in the length of the term of its DPAs. *RC-3*, *p. 28-*. 29. The average DPA term was nine months in both 2010 and 2011. *RC-3*, Sched. RDC-4. The Company also did not adjust the average amount of a DPA installment payment; in fact, the average rose from $65 per month in 2010 to $69 per month in 2011. *RC-3*, *p.*

29. The Board should require the Company to present specific modifications to its DPA practices so that actual "flexibility" can be measured in the future.

During the hearing, Mr. Dickerson modified the response to RC-40, testifying that the Company "considered but rejected the idea of changing the script" for DPAs between the economic downturn in 2008 and the 2011 Stipulation. *T35:L4 - T37:L19* (June 20, 2012). Other than considering but rejecting a change in its "script," the Company admits that it did not modify or even consider modifying any policies, practices or procedures relating to DPAs despite its 90% DPA failure rate and admitted deterioration in the real and measurable economic challenges facing its customers. *RC-39*; *RC-40*; *T33:L22 - T34:L17* (June 20, 2012).

Not surprisingly, as DPAs fall into default, both the incidence and level of ACE's residential customer arrears continue to increase, as do the numbers of disconnections of service for nonpayment and of notices of disconnection of service. *T83:L24 - T84:L15* (June 20, 2012).

Concerning the failure rate of DPAs and the increase in disconnections, Mr. Dickerson cited one recent change in the Company's shutoff practices: now, when a customer makes a partial payment within 15 days of a suspension notice, ACE removes the customer from the field activity process. *RC-37*; *T76:L6-18* (June 20, 2012). Mr. Dickerson neglected to mention, though, that a customer must make a minimum payment of at least 75% of the outstanding balance for the shutoff to be stopped. *RC-33*. ACE has not changed or even considered changing that practice. *RC-43*; *RC-44*.

Mr. Colton testified that more flexibility to accommodate individual circumstances can decrease payment defaults. *RC-3*, *p. 49*. However, all of the evidence

in this proceeding shows irrefutably that the Company did and does nothing to offer DPAs that consider the financial circumstances of its customers.

2. The Company Has Not Adapted Its Customer Service Practices to Its Customers' Increasing Economic Hardships

The Company admits that it is aware that the employment and economic challenges facing its residential customers are "real and measurable," and have grown worse since the national economic recession hit in 2008. *P-16, p. 4*; *T12:L13 - T13:L1* (June 20, 2012). The Company's response to these increasing economic hardships, however, was both inadequate and ineffective.

The Company failed to adapt its customer service practices, or to consider doing so, or even to quantify the scope of the problem, in response to its customers' increasing economic hardships. *T85:L2 - T86:L11* (June 20, 2012); *RC-31*; *RC-32*; *RC-38*; *RC-37*; *T13:L14 - T14:L4* (June 20, 2012). ACE made no effort to measure those real and measurable challenges for use in structuring customer service. *RC-31*; *T13:L14 - T14:L4* (June 20, 2012).

The Company reports that its only customer service action, in response to its customers' worsening employment and economic challenges from the recession, was to send four separate mailings to its then-delinquent customers, during a three-week period in May 2008, offering a twelve-month DPA. *RC-32*; *T15:L8-24* (June 20, 2012). Other than those mailings in May 2008, the Company did not add, modify or discontinue any of its customer service policies, practices or procedures, or even consider doing so, until it sought a rate increase in its last base rate case. ACE also did not modify or even consider modifying any policies, practices or procedures regarding the response to and treatment

of customer service-related complaints to the Board, despite the deterioration in the real and measurable economic challenges facing its customers. *RC-45*; *RC-46*.

Mr. Dickerson testified that ACE helps its "customers experiencing financial difficulties" by encouraging them to seek help from "state and federal programs to help customers who are otherwise unable to pay their utility bills and fuel costs." *P-16*, *p. 6*, lines 20-23; see *T47:L20 - T48:L2* (June 20, 2012). First, payment-troubled status is not synonymous with low-income status. When asked for a list of state and federal programs that are available to non-low-income customers, Mr. Dickerson could not name a single such program, stating only that Atlantic is not entitled to inquire into its customers' income level. *RC-56*.

Second, despite Mr. Dickerson's rebuttal testimony that ACE "offers to connect [payment-troubled customers] with energy grant funding agencies. . .," *P-16*, *p. 7*, line 1, the Company does not really do that. Instead, "customers are provided with information on where to find information on Federal or state programs where they might receive assistance. . ." *RC-56* (emphasis added). "We not only provide them information, we suggest that they avail themselves of those services." *T47:L25 - T48:L2* (June 20, 2012).

ACE tried to blame its failure to effectively assist its customers on its allegedly unique demographics. The Company claimed that its customers suffer lower income and higher unemployment than other New Jersey utility customers. *P-16*, *p. 4*; *T48:L8-18* (6/20/12). ACE admitted on cross-examination, however, that it did not analyze the demographics of other New Jersey utilities' customers, *T48:L19 - T49:L18* (June 20, 2012), or consider differences in the cost of living in different areas of the state, *T50:L5-8*

(June 20, 2012). In fact, ACE does not even serve many New Jersey municipalities with large low-income and unemployed populations. *RC-49*; *RC-50*; *T49:L19 - T50:L4* (June 20, 2012). For example, Atlantic does not serve Hudson, Essex or Passaic Counties or the City of Camden. *RC-49*; *RC-50*.

As part of a rate case settlement in 2011, the Company agreed to prepare a Customer Service Improvement Plan ("CSI Plan") incorporating certain measures to improve its customer service. That CSI Plan was incorporated into the 2011 Stipulation. *P-14*, Ex. B. Starting on or about June 3, 2011, the Company started to implement three new customer service practices: a) it began to offer DPAs to customers who had a prior bankruptcy filing (on June 3, 2011); b) it began outgoing automated calls to all customers 5 days prior to their disconnect date (in July 2011); and c) it began outgoing automated calls to all customers 60 or more days in arrears (on August, 2, 2011). *RC-32*; *RC-37*; *RC-38*; *T20:L20 - T22:L8* (June 20, 2012); *T23:L8 - T26:L1* (June 20, 2012). It remains to be seen whether these three actions will be sufficient to reduce the number of customer complaints about the Company's service. However, as discussed above, the preliminary data for 2012 provided by the Company does not demonstrate any progress.

D. The Company Mis-Uses Notices of Disconnection for Non-Payment

The Company claims that Board rules compel it to issue 60 or more shutoff notices for every shutoff it actually performs. *P-16*, *p. 6*. On cross examination Mr. Dickerson admitted that there is no such Board regulation. *T44:L24 - T45:L7* (June 20, 2012). In fact, Board regulations merely require notice to the customer before a utility discontinues service for nonpayment, within certain timing and content criteria. N.J.A.C. 14:3-3A.3; see *T87:L1-14* (June 20, 2012).

Atlantic claims that issuing more shutoff notices reduces its bad debt exposure. Mr. Dickerson offered no data in support of this argument. The Company admits that it has no information that issuing more shutoff notices reduces bad debt or increases residential payments. *RC-53*; *RC-54*; *RC-55*; *RC-52*. Mr. Colton testified that, in fact, ACE's practice of issuing 60 or more shutoff notices for each shutoff it actually performs is counter-productive. It increases the direct costs of collection activities and continuously issuing false shutoff notices has the effect of increasing nonpayment by teaching people to ignore the Company's collection efforts. *T87:L15 - T89:L3* (June 20, 2012); *RC-3*, *p. 58*; id. at p. 64-69.

ACE concedes that it does not use a "disconnect notice" to inform customers of a pending disconnection of service. According to Mr. Dickerson, "the purpose, if I may, of a disconnect notice is to inform a customer that their account is delinquent relative to their balance and obligation to Atlantic City Electric." *T67:L15-18* (June 20, 2012).

The Company did not modify or even consider modifying any policies, practices or procedures relating to how or when to issue disconnect notices, or how or when to disconnect service, despite the admittedly real and measurable economic challenges facing its customers since 2008. *RC-41*; *RC-42*; *RC-43*; *RC-44*.

In summary, while the Company's customer service continues to deteriorate, Atlantic has not devoted sufficient resources to identify or address the causes of the problem. Accordingly, Your Honor and the Board should require the Company to live up to its existing customer service obligations, impose stricter customer service reporting and measurement requirements on Atlantic, and reduce the Company's allowed Return

on Equity to the range recommended by Rate Counsel for its egregious failures to meet its customer service obligations.

E. Conclusion

As discussed above, the Board has the authority to reduce the Return on Equity of a regulated public utility company due to poor performance of its service obligations. In addition to reducing the Company's Return on Equity, Rate Counsel recommends that Your Honor and the Board direct the Company to take the following measures:

a. Take action to reduce the number of customer complaints to the Board below the 1,500 per year maximum to which the Company agreed in the 2002 Merger Order.

b. Increase its flexibility in its DPA terms, such as increasing their length and reducing the amounts required for a down payment and for installment payments, to reduce its DPA failure rate.

c. Issue clear and believable notices of disconnection for nonpayment at a meaningful time and in a meaningful manner, such that notices inform customers of a scheduled disconnection of service.

d. Conduct the moment of truth surveys that the Company already has committed to perform.

e. Design and conduct research to identify the root causes of its customer complaints.

f. Increase the current compensation of $25 per missed service appointment to compensate customers for the value of their lost time and to sanction and deter ACE for its poor performance.

g. Establish objective measurable metrics to assess its performance on each of these issues.

h. Report to the Board and Rate Counsel within three months its performance relative to its objective measurable metrics on each of these issues.

POINT VI

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

Rate Counsel presented the testimony of David Peterson, *RC*-5, who reviewed and analyzed the Petition, and the testimonies of Mr. Elliott P. Tanos, who presented ACE's Cost of Service Study ("COSS"), and Mr. Joseph F. Janocha, who presented ACE's proposed distribution of the increase among the classes of service and rate design. Mr. Tanos prepared a COSS for the year ended March 31, 2011, in which he allocated ACE's service related costs among nine classes of service. *P-31*, *p. 3*, *P-31*, *p. 7*. Mr. Janocha relied on Mr. Tanos' COSS to propose realigned class revenue responsibilities. *P-17*, *p.* 25.

The most significant rate design change for an individual rate class proposed by Mr. Janocha is a steep increase in the residential monthly service charge from a $2.73 monthly service charge (including Sales & Use Tax) to a charge of $5.74 regardless of kWh usage, representing a 110 percent increase. Mr. Janocha also proposed to reduce the differential between the first and second rate blocks for Residential customers in the winter heating season in an effort to move towards eliminating the declining block rate. *RC-5*, *p. 7*.

Board Staff and the Company differ on the appropriate method to use to allocate an increased revenue requirement. The Company, through Mr. Tanos, favors the class diversified demand allocation method. In the past, Board Staff has supported the peak and average allocation method. I/M/O The Petition of Jersey Central Power & Light Company for Approval of an Amendment to its Tariff to Provide for an Increase in Rates

and Charges for Electric Service, BPU Docket No. ER89110912J, Order Adopting and Modifying Decision Concerning Rate Design Issues, (April 9, 1992) ("JCP&L 1992 Board Order"), *S-10*; *T108:L15-109:19* (June 27, 2012). Mr. Tanos prepared cost studies in this case reflecting both cost allocation methods. While Rate Counsel did not endorse either allocation method, Mr. Peterson testified that both allocation methods produce similar results in this case. *RC-5*, *p. 13*. Under both cost allocation methods, rates for the Residential class yield a rate of return that is 62% (under the peak demand allocation method) or 66% (under the peak and average allocation method) of the system-wide average rate of return. *RC-5*, *p. 8*. Therefore, Rate Counsel does not object to the use of either method in this case.

A. Moving Each Customer Class Closer to Its Cost of Service is Not Objectionable Provided That Doing So Does Not Result in a Disproportionate Impact on Any Class

Mr. Janocha's proposed distribution of ACE's claimed revenue deficiency attempts to move each class closer to its cost of service by moving the class unitized rates of return closer to 1.0. Applying Mr. Janocha's proposed increase for the Residential class and the Street and Private Lighting class to the peak and average allocation method results in a unitized rate of return for the Residential class that is nearly identical to (and still below 1.0) the unitized rate of return produced under ACE's preferred class diversified peak demand allocation method. Therefore, Mr. Peterson does not object to Mr. Janocha's proposed distribution of the increase.

Mr. Peterson found that Mr. Janocha's proposed spread of the rate increase was reasonable, based on the Company's claimed cost of service. Since Rate Counsel has provided evidence that ACE's revenue deficiency is significantly lower than that

calculated by ACE, Mr. Peterson used Mr. Janocha's allocation method as a guide to allocating among the rate classes the $5.474 million revenue increase recommended by Rate Counsel. Mr. Peterson found, however, that setting class returns in this manner would result in "excessive revenue increases for the Residential and Street and Private Lighting rate classes," while reducing revenue from all other rate classes. *RC-5*, *p. 16*.

Mr. Peterson found that trying to produce Mr. Janocha's target unitized rate of return for the Residential and Street and Private Lighting classes under Rate Counsel's recommended revenue increase results in disproportionately large rate increases for those two classes. To achieve Mr. Janocha's goal of "unity" (i.e., a unitized rate of return of 1) in the Residential class would require a revenue increase of approximately $11.2 million, or roughly twice the overall increase that Rate Counsel recommends. To achieve unity in the Street and Private Lighting class would require a revenue increase for that class of more than 3.5 times the system-wide average percentage increase. Accordingly, Mr. Peterson recommended that the Company should maintain present rate levels (i.e., zero increase) for all classes of service except for the Residential and Street and Private Lighting rate classes. *RC-5*, *p. 16*.

If the Board approves the $5.474 million revenue increase recommended by Rate Counsel, Mr. Peterson recommends that it be allocated entirely among the Company's Residential and Street and Private Lighting electric distribution rate classes, based on the relative size of the allocated rate base for each class. *RC-5*, *p. 16*. Mr. Peterson set forth Rate Counsel's proposed allocation of its recommended rate increase, $4.956 million for Residential class and $518,126 for Street and Private Lighting class in his testimony. *RC-5*, *Ex. DEP-2*. Mr. Peterson's proposed allocation would avoid a disproportionately

large rate increase for the Residential and Street and Private Lighting rate classes, while achieving Mr. Janocha's goal of moving the unitized rate of return for each rate class closer to unity. *RC-5*, *p. 16- 17*.

B. The Board Should Not Increase the Company's Residential Service Charge from $2.73 to $5.74.

ACE claims that its cost of service study supports a $13.96 monthly customer service charge for Residential class customers. *P-18*, *Sched. JFJ-2, p. 1*. This amount was determined by dividing all costs that Mr. Tanos classified as "customer related" by the annual number of bills generated for Residential class customers. Mr. Peterson testified, however, that the Board typically does not include all customer-classified costs in the determination of the monthly service charge. *RC-5*, *p. 19*.

> My understanding is that the Board has taken a restrictive view of what costs are recognized in a monthly service charge. I am advised that the Board generally allows only costs that vary directly and linearly with the number of customers served in the calculation of the monthly service charge. It is for this reason that the residential service charges for all New Jersey electric utilities remain relatively low. *RC-5*, *p. 19*.

The JCP&L 1992 Board Order explained the purpose and evolution of the Board's policy on classifying certain costs as customer related:

> The objective of this evolutionary refinement of customer cost classification has been the exclusion of demand and energy costs from the customer charge, as well as costs which are not clearly classifiable to any cost component. The practical consequence of this evolution has been a narrowing for <u>all</u> New Jersey electric utilities of costs and expenses deemed customer related, consistent with this Board's policy that <u>customer costs are those which vary linearly and directly with the number of customers, unaffected by either demand or energy consumption</u>. *S-10*, p. 6 (emphases added); <u>see</u> *T109:L2; T110:L20* (June 27, 2012).

Nevertheless, Mr. Janocha proposed to significantly increase the monthly service charge for Residential customers by 110 percent, from the current $2.73 to $5.74. *RC-5, p. 18*. This is in spite of the fact that Mr. Janocha made no attempt to measure those costs that vary linearly and directly with the number of customers, in accordance with the Board's prior rulings on this issue. *T70:L4-10* (June 27, 2012). The reason offered by Mr. Janocha for the large increase in the monthly customer service charges was that the present Residential class monthly service charge fails to recover all costs that Mr. Tanos classified in his COSS as customer-related. *RC-5*, *p. 18*. Clearly, Mr. Janocha's reasoning is at odds with the Board's prior rulings on this issue.

Moreover, even if prior precedent were not an issue, the Board generally applies the principle of gradualism in rate design, i.e., adherence to cost of service results in executing rate design should not result in burdensome rate increases for customer classes and individual customers. The Board has explained this principle:

> It has been the long-standing policy of the Board to temper interclass revenue allocations with the concern for rate gradualism; i.e., customers should not be saddled with burdensome bill increases for the sake of moving class rates to unity sooner rather than later. *RC-82*, *p.19*.

Gradualism thus factors into the degree to which rate classes can be moved toward the cost of providing service in any single rate case.

Mr. Janocha's proposed increase in Residential customers' monthly service charge of 110 percent violates the principle of gradualism and results in ACE having the highest monthly service charge among the State's four regulated electric utilities. *RC-5*,

p. 20.[28] This 110 percent increase also would contradict Mr. Janocha's purported support for the principle of gradualism: he stated, for example, that he proposed limiting rate increases "so that no class received 1.5 times the overall average percent distribution percent increase." *T74:L8-20* (June 27, 2012); see *T82:L7-11* (June 27, 2012). The adverse effects of ACE's proposed increase in its Residential monthly service charge would fall disproportionately on small volume users, who Mr. Janocha estimates are approximately 21 percent of its Residential customers. *RC-5, p. 9, lines 7-12; RC-5, p. 20.* Such disproportionate impact would be at least unfair if not discriminatory to the Residential customer class, especially low-volume Residential customers. Accordingly, Mr. Peterson recommended no increase in the Residential monthly service charge.

Mr. Peterson also objected to Mr. Janocha's proposed 25% increase in the monthly service charge for Monthly General Service customers. This increase is not only disproportionate relative to other customer classes, but is unnecessary: in Mr. Peterson's opinion, the Board should allocate the entire $5.474 million revenue increase recommended by Rate Counsel among the Company's Residential and Street and Private Lighting customer classes. Therefore Mr. Peterson did not recommend any change in the revenue requirement for the Monthly General Service class but recommended maintaining the existing monthly service charge for those rate classes at their present levels. *RC-5, p. 9.* Mr. Peterson had no objection to Mr. Janocha's recommendation to begin eliminating the declining block rate for Residential customers during the winter heating season. *RC-5, p. 7.*

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[28] ACE's current Residential monthly service charge of $2.73 is in line with the other electric utilities in New Jersey, which range from a low of $2.20 to a high of $3.88. *RC-5, p. 20, Table 6.*

C. Conclusion

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

a. The entire $5.474 million revenue increase recommended by Rate Counsel should be allocated among the Company's Residential and Street and Private Lighting customer classes, $4.956 million to the Residential class and $518,126 to the Street and Private Lighting class.

b. Rate Counsel does not object to the use of either the class diversified demand allocation method or the peak and average allocation method in this case, because they produce similar results here. However, Board Staff has supported the peak and average allocation method in the past.

c. The Company's monthly service charge for Residential Service customers should not be increased.

d. The Company's monthly service charge for Monthly General Service customers should not be increased.

e. Rate Counsel has no objection to Mr. Janocha's recommendation to begin eliminating the declining block rate for Residential customers during the winter heating season.

CONCLUSION

As discussed above and as demonstrated in the testimony, Rate Counsel respectfully requests that Your Honor and the Board deny Atlantic's request for an increase in its electric rates. Rate Counsel recommends that Your Honor and the Board adopt Rate Counsel's revenue requirement of $8.128 million without RARC, as well as the following adjustments:

Cost of Capital

(1) Atlantic's return on equity should be set at 9.5% with an overall rate of return of 7.88%, reflecting Rate Counsel recommended adjustments to the Company's proposed capital structure.

(2) The appropriate capital structure is 51.31% long term debt, 0.71% short term debt and a 47.98% common equity.

Rate Base Adjustments

(3) The appropriate rate base for Atlantic is $509,616,000, approximately $477,497,000 less than the Company's proposed rate base of $987,112,000.

(4) Post test year plant additions of $54,352,000 should be excluded from the Company's rate case. The appropriate post test year plant additions adjustment results in a revenue requirement adjustment of approximately $5,643,000, which includes the impact of the associated depreciation reserve adjustment and the deferred income tax reserve adjustment.

(5) Plant held for future use of $6,275,000 should be excluded from the Company's rate base. This adjustment results in a revenue requirement adjustment of approximately $838,000.

(6) Rate Counsel's recommended cash working capital requirement of approximately $83,300,000 should be adopted. This adjustment results in a revenue requirement adjustment of $2,778,000.

(7) The Company's proposal to include $1,329,000 in unamortized credit facility costs in rate base should be rejected. This adjustment results in a revenue requirement adjustment of $177,000.

(8) The Company's proposal to include in rate base a prepaid pension asset of more than $35.9 million should be rejected. This adjustment results in a revenue requirement adjustment of $4.795 million.

(9) The Company's proposal to include in rate base $5.127 million in unamortized storm damage costs associated with Hurricane Irene should be rejected. This adjustment results in a revenue requirement adjustment of $0.685 million.

(10) The Company's proposal to decrease rate base by $15.317 million to reflect the OPEB liability should be rejected. This adjustment results in a revenue requirement adjustment of ($2.045 million).

(11) Rate Counsel's recommended Consolidated Tax Adjustment, fully consistent with BPU precedent and long established methodology, is $385.9 million. This consolidated tax adjustment results in a revenue requirement adjustment of approximately $51.5 million, which, after interest synchronization is a net adjustment of $42 million.

Revenue Adjustments

(12) Rate Counsel recommends that the Board adjust the sales projections of Petitioner's pro forma revenue claim to reflect a thirty-year period of normal weather

data, rather than the twenty-year time period used by Petitioner to determine its pro forma revenue forecast. Rate Counsel's recommendation will increase the Company's pro forma revenues by $262,000

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

Expense Adjustments

(14) Your Honor and the Board should limit salary and wage increases to the increases that occurred during the test year, annualized to reflect a full year of costs. This adjustment results in a reduction in the Company's proposed rate increase of $1,886,000.

(15) Rate Counsel recommends that the Company's proposed incentive compensation expenses of $2.462 million be disallowed for rate making purposes in this case. This adjustment results in a reduction in the Company's proposed rate increase of $1,310,000.

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

(17) Rate Counsel recommends that the Board exclude the Supplemental Executive Retirement Plan Expense (SERP) benefit from Atlantic's distribution rates, thereby reducing the Company's revenue requirement by $1,296,000.

(18) Rate Counsel recommends that the Company's pro forma adjustment relating to medical expenses be rejected thereby reducing the Company's revenue requirement by $625,000.

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

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

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

(22) Rate Counsel's proposed adjustments for Credit Facility costs should be adopted thereby reducing the Company's revenue requirement by $93,000.

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

(24) Rate Counsel recommends that Your Honor and the Board deny the Company's request for recovery of certain meal and entertainment costs that are not deemed to be reasonable business expenses by the IRS. This recommendation reduces the Company's revenue requirement by $64,000.

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

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

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

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

Regulatory Asset Recovery Charge

(29) Rate Counsel recommends that Your Honor and the Board reject Atlantic's attempt to expand the RARC to include any expense that it finds "reasonable" and instead terminate the RARC and move the Board approved amortizations into base rates.

- Previously BPU authorized amortization expense of $2,607,993 should be transferred to base rates.

- Preferred stock redemption costs should be included in base rates, based on the 15 year amortization period previously approved by the BPU for an annual amortization expense of $11,149.

- LCAPP costs and management audit costs should be recovered in base rates over a four year amortization period. The over-recovery of $138,166 should be used to offset a portion of the LCAPP and Management Audit fees. These costs total $250,862. Accordingly $112,696 ($250,862-138,166) should be included in base rates, amortized over four years, for an annual amortization expense of $28,174.

- Adoption of these recommendations will result in a total base rate increase of $2,647,316.

(30) Rate Counsel recommends that ACE should be directed to stop charging internal labor costs to the BGS and instead those costs should be included in test year charges in the Company's next base rate case.

(31) Rate Counsel is not opposed to the Company's request to transfer the depreciation reserve amortization to a separate tariff rider with the condition that the rider not automatically expire but that the Company be required to make a status filing on June 1, 2013, at which time ACE should report on how much of the excess reserve has been refunded to date and how much is expected to be refunded by August 31, 2013.

(32) Rate Counsel recommends that Your Honor and the Board should direct the Company to use the FERC formula to calculate its AFUDC rate going forward and that the Company should be required to update its AFUDC rate on a monthly basis to more accurately reflect current costs. In this way, the Company will no longer be overcharging ratepayers by using an inflated AFUDC rate and ratepayers will begin to receive some of the benefit of very low short-term debt rates.

Reliability

(33) Mr. Kahal's reasonable recommended ROE of 9.5% should be adopted with the possibility of lowering the ROE further if reliability metrics do not improve.

(34) Penalize the Company if Atlantic is unable to improve the circuits that repeatedly appear on the Worst Performing Circuits List within 1 year.

(35) Penalize the Company if it is unable to meet the Reliability Improvement Plan target SAIFI and SAIDI levels in 5 years.

(36) Consider whether the Board should initiate a rulemaking to establishing a statewide Minimum Reliability Level applicable to all electric utilities in New Jersey.

(37) Order Atlantic to accurately report the years when the Company fails the Board's Minimum Reliability Levels in all future Annual System Performance Reports.

Customer Service

(38) The Company should be directed to reduce the number of customer complaints to the Board below the 1,500 per year maximum to which the Company agreed in the 2002 Merger Order.

(39) The Company should be directed take measures to reduce the failure rate of its Deferred Payment Arrangements, such as increasing the length and reducing the amounts required for a down payment.

(40) The Company should be required to issue clear and believable notices of disconnection for nonpayment at a meaningful time and in a meaningful manner, such that notices inform customers of a scheduled disconnection of service.

(41) The Company should be directed to conduct the moment of truth surveys that the Company already has committed to perform.

(42) The Company should be required to design and conduct research to identify the root causes of its customer complaints.

(43) Your Honor and the Board should increase the current compensation of $25 per missed service appointment to compensate customers for the value of their lost time and to sanction and deter ACE for its poor performance.

(44) The Company should establish objective measurable metrics to assess its performance on each of these issues and report to the Board and Rate Counsel within three months its performance relative to its objective measurable metrics on each of these issues.

Rate Design

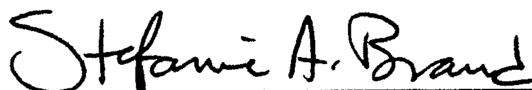
(45) The entire $5.474 million revenue increase recommended by Rate Counsel should be allocated among the Company's Residential and Street and Private Lighting customer classes, $4.956 million to the Residential class and $518,126 to the Street and Private Lighting class.

(46) Rate Counsel does not object to the use of either the class diversified demand allocation method or the peak and average allocation method in this case, because they produce similar results here. However, Board Staff has supported the peak and average allocation method in the past.

(47) The Company's monthly service charge for Residential Service and for Monthly General Service customers should not be increased.

(48) Rate Counsel has no objection to elimination of the declining block rate for Residential customers during the winter heating season.

Respectfully submitted,



Stefanie A. Brand
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Dated: July 27, 2012