June 28, 2005

VIA HAND DELIVERY
Honorable Kristi Izzo, Secretary
Board of Public Utilities
Two Gateway Center
Newark, NJ 07102

Re: In the Matter of the Deferred Balances Audit of Public Service Electric & Gas Company
Phase II: August 2002 -July 2003
Docket Nos. EX02060363 and EA02060366

Dear Ms. Izzo:

Enclosed please find the original and eleven copies of the reply comments of the Division of the Ratepayer Advocate (Ratepayer Advocate) on the above-referenced matter. Kindly stamp the extra copy as "filed" and return it in the enclosed, self-addressed stamped envelope. Thank you for your assistance.

The Ratepayer Advocate provides the within reply comments pursuant to the May 13, 2005 letter from the office of the Secretary of the Board of Public Utilities (Board or BPU) inviting interested parties to submit comments on the Phase II audit report of the Board's consultants, Mitchell & Titus, LLP and the Barrington-Wellesley Group, Incorporated (Auditors), concerning the deferred balances of Public Service Electric and Gas Company (PSE&G or Company). The only initial comments that the Ratepayer Advocate has received came from PSE&G. The Ratepayer Advocate incorporates by reference our June 13, 2005 initial comments in this letter and also provides this reply to the Company's June 13, 2005 initial

comments. Furthermore, on June 13, 2005 the Ratepayer Advocate sent to the parties a request concerning the provision of additional information to our office in order to facilitate and allow us to complete our review of this matter. Our office has not received any reply concerning our June 13 letter about being able to receive additional information that is not contained within the covers of the Phase II audit report. That matter should also be resolved before the Board closes the record concerning the Phase II audit report.

MARKET TRANSITION CHARGE (MTC) ISSUES

The Ratepayer Advocate has reviewed the June 13, 2005 initial comments by PSE&G concerning the six questions outlined in the May 13, 2005 letter from the office of the BPU Secretary, and we provide this reply. PSE&G objects to the Phase II audit report citing the Auditors' discussion concerning the "Unresolved Matter Between the BPU and PSE&G." *PSE&G initial comments, pages 1 and 2.* The Company's comments on this matter are completely inapposite and should be disregarded in their entirety. This unresolved matter is the subject of the six questions that the Board requested the parties to address in their initial comments and reply comments. Therefore, it is clear that the Board has already decided that not only should the discussion of this unresolved matter remain in the Phase II audit report, but that the record should remain open to complete the discussion of these issues after the parties have had sufficient time to be informed about them.

Background

As part of the restructuring agreement to transfer PSE&G's generating units to PSE&G's unregulated affiliate, PSEG Power, PSE&G received a cash advance of $540 million from PSEG Power toward the recovery of the generating units' stranded costs. This so-called "transfer premium" was to be used to reduce PSE&G's capitalization, and was to be repaid from the revenues collected by PSE&G from (1) its Market Transition Charge (MTC); (2) the amortization of its excess depreciation reserve; and (3) a 2 mil per kWh "retail adder" applied to the Basic Generation Service (BGS). If, at the end of the four-year Transition Period, these three revenue sources were not sufficient to fully repay the $540 million advance, the shortfall was to be absorbed by PSEG Power. If the $540 million were to be over-recovered, the excess revenue recovery was to be refunded to PSE&G's ratepayers by way of credits in the Societal Benefits Charge (SBC).

The Board's Restructuring Order of August 24, 1999 in Docket Nos. EO97070461, EO97070462, and EO97070463 (Restructuring Order) has the following language with regard to the above-described transfer premium:

> …PSE&G shall be provided with the opportunity to recover $540 million of its unsecuritized generation stranded costs on a net present value (8.42% discount rate) net of tax basis over the Transition Period. This recovery is to be accomplished via a 2 mil per kwh retail adder, an explicit Market Transition Charge (MTC), exclusive of the NTC, as discussed in Attachment 2 to the PSE&G Stipulation, and the amount funded by the excess distribution depreciation reserve amortization. [page 118, paragraph 13]
>
> At the end of the Transition Period, the recovery of the $540 million will be reconciled to actual collections based on actual sales, the net present value of recovery from both the MTC, exclusive of the NTC, and collections from the 2.0 mil per kWh retail adder for customers retained on BGS, and the depreciation amortization. In the event the company fails to collect $540 million, it will be at risk for any such shortfall. In the event the

> company collects over $540 million, it shall use any such overrecovery to reduce the Company's SBC at the end of the Transition Period when the SBC is reset and shall in no event be retained by PSE&G or remitted to GENCO [PSEG Power] or otherwise utilized to recover unsecuritized generation related stranded costs. [page 119, paragraph 14]

In the Phase I Deferred Balances proceeding, BPU Docket No. ER02080604 (Phase I Proceeding), PSE&G's proposed reconciliation of the revenue received during the Transition Period for the recovery of the $540 million transfer premium was presented in the testimony of its witness Robert C. Krueger, Jr. Specifically, Mr. Krueger's original Schedule RCK-D-9 showed that, based on actual data through July 31, 2002 and projected data for the remainder of the Transition Period, PSE&G had determined that the reconciliation of the actual revenues received for the recovery of the $540 million indicated an over-recovery of $205.1 million as the amount to be refunded to PSE&G's ratepayers via the SBC (see Attachment-1 to these Reply Comments). PSE&G's initial comments dated June 13, 2005 apparently use an MTC over-recovery amount that was subsequently updated to reflect actual Transition Period data through January 31, 2003, which update increased the MTC over-recovery from $205.1 million to $207.1 million (see Attachment-2 to these Reply Comments).

PSE&G's proposed Transition Period over-recovery amounts of $205.1 million (original) and $207.1 million (updated) included an over-recovery reduction of approximately $370 million for the carrying costs associated with the delay in securitization from January 2000 through January 2001. In the Phase I Audit of PSE&G's Deferred Balances case, Docket No. ER02080604, the Auditors concluded that the inclusion in PSE&G's proposed MTC over-recovery determination of the $370 million securitization delay-related carrying costs had not been authorized by a Board order. The Ratepayer Advocate also took issue with this item and

recommended in that case that PSE&G's quantified Transition Period MTC over-recovery amount should be (1) increased by $328.1 million by completely removing the net present value of the $370 million carrying charges; or, alternatively (2) increased by $173.1 million by replacing PSE&G's proposed carrying cost rate with the rate on 7-year constant maturities Treasury notes plus 60 basis points.

In its May 13, 2005 letter accompanying the release of the PSE&G Electric Deferral Audit Report – Phase II, the Board asked interested parties to respond to six specific questions regarding PSE&G's determination of the MTC over-recovery. The Initial Comments containing the response to these six questions were due June 13, 2005. The Reply Comments are due by June 28, 2005. Both PSE&G and the Ratepayer Advocate issued their respective Initial Comments on June 13, 2005. For all of the reasons outlined in its Initial Comments, the Ratepayer Advocate believed that "the preferable procedure should be for PSE&G to file its initial comments on the various issues and to provide responses to discovery requests in order for other interested parties to be able to file meaningful reply comments by the June 28, 2005 deadline." *Ratepayer Advocate initial comments, page 1.* PSE&G did not provide any meaningful responses to the two discovery questions issued by the Ratepayer Advocate to the Company on June 7, 2005.

The Ratepayer Advocate's reply comments on the May 13, 2005 Board questions regarding the determination of the Company's determination of the MTC over-recovery follow below. The comments are slightly out of sequence in that the Ratepayer Advocate has chosen to answer Board question 4 prior to answering Board questions 2 and 3.

Question No. 1

How was the net present value of the MTC over-recovery due ratepayers determined by PSE&G and was it consistent with the determination of the net present value of the MTC recovery due PSEG Power? Please explain in detail, and provide supporting documentation.

Answer:

PSE&G determined the net present value (NPV) of the MTC over-recovery due ratepayers in the same way as it determined the NPV of the MTC recovery due PSEG Power. *PSE&G initial comments, pages 3-4.* The Company's specific calculation methodology for the updated NPV analysis of the Transition Period MTC collections is detailed in Attachment 2 to these reply comments which is Schedule RCK-D-9 from the Phase I Proceeding. As shown in Attachment-2, the Company first determined the after-tax MTC collections in each month of the 4-year Transition Period from August 1999 through July 2003. Next, the Company accumulated all monthly after-tax MTC collections for each calendar year in the Transition Period, and then applied to these annual calendar year MTC accumulations annual discount factors based on an after-tax annual discount rate of 8.42%. The 8.42% discount rate represents PSE&G's then-allowed overall rate of return (10.08%), expressed net of tax. The NPV results of this annual discounting process are summarized below:

Cumulative MTC Collections in Calendar Year ($million)	Annual Discount Factor Based on Annual Rate of 8.42%	NPV Cumulative MTC Collections in Calendar Year ($million)
1999 (5 mos.): $151.050	0.96687	$146.046
2000 (12 mos.): 251.996	0.89178	224.727
2001 (12 mos.): 195.250	0.82253	160.599
2002 (12 mos.): 97.695	0.75866	74.117
2003 (7 mos.): 78.805	0.72371	57.033
Total $774.796		$662.522

Thus, based on this annual discounting approach, the Company concluded that, during the entire Transition Period, it collected after-tax MTC revenues of $662.522 million on a NPV basis as of August 1999. Next, the Company subtracted from this total NPV amount the $540 million[1] transition premium owed to PSEG Power, thereby leaving an after-tax NPV amount of $122.552 million as the MTC over-recovery due ratepayers. As the final step, by using a revenue conversion factor of 0.5915,[2] the Company converted this after-tax MTC over-recovery amount of $122.552 million into a total over-recovered revenue amount of $207.137 million[3].

Question No. 4

In determining the net present value of the MTC recovery, should the discount rate have been applied monthly or annually? Please explain in detail with supporting documentation.

Answer:

It is the Ratepayer Advocate's position that, in determining the NPV of the MTC recovery, the discount rate should have been applied monthly rather than annually. The reason is quite simple.

First, it should be made clear that a discount factor used in a present value analysis represents a time value of money and, in this instance, represents the return presumed to be earned by PSE&G on the available cash flows from the MTC collections. The MTC revenues during the Transition Period were billed and collected by PSE&G on a monthly basis, with the monthly collections clearly shown on Schedule RCK-D-9 in the testimony of PSE&G witness, Mr. Krueger, in the Phase I Deferred Balances proceeding. Since the cash flows from the MTC collections became available to PSE&G on a monthly basis, PSE&G has been able to

[1] Similar to the amount of $662.522 million, the transition premium amount of $540 million is also stated on a NPV basis as of August 1999.
[2] Inverse of combined federal and state income tax rate of 0.4085.
[3] Calculation: $122.552 / 0.5915

immediately earn a return on these MTC revenues from the moment they were collected in each month. Applying the discount rate to the monthly MTC collections gives appropriate recognition to the fact that PSE&G has actually enjoyed the immediate returns on these monthly MTC collections during the Transition Period. The Company's proposed annual discounting approach assumes that PSE&G does not earn a return on its monthly MTC collections during the calendar year. Rather, it assumes that PSE&G will not start earning a return until all monthly MTC collections have been accumulated at the end of the calendar year. This assumption is wrong and completely inconsistent with financial reality.

The appropriate monthly discounting process to use is to take $1/12^{th}$ of the annual after-tax discount rate of 8.42% (equal to a converted monthly discount rate of 0.70167%) and apply this monthly discount rate to PSE&G's monthly after-tax MTC collections during the Transition Period. On Schedule RPA-1 in Attachment-3, the Ratepayer Advocate has calculated that the total Transition Period after-tax MTC collections of $774.796 million have a present value as of August 1999 of $681.766 million when discounted on a monthly basis using a monthly discount rate of 0.70167%. This after-tax NPV value of $681.766 million is $19.244 million higher than PSE&G's calculated after-tax NPV value of $662.522 million based on the Company's proposed annual discounting approach. Using the same revenue conversion factor of 0.5915, this higher after-tax value of $19.244 million translates into a higher MTC revenue over-recovery of $32.534 million. Thus, based on the monthly discounting approach, PSE&G's calculated MTC over-recovery of $207.137 million would be higher by $32.534 million, or $239.671 million.

PSE&G claims in its June 13, 2005 initial comments that its proposed use of the annual discounting approach is in accordance with the Board's Restructuring Order. Specifically, on page 9 of its initial comments, PSE&G states:

> A review of the language and context of the Board's Restructuring and Rate and Deferral Orders makes clear that, contrary to the Energy Staff's Position in the instant dispute, those Orders included:
>
> 1) a determination that the net present value calculation of the Company's MTC recovery would be on an annual, rather than monthly basis; ….

This PSE&G claim is based on its reading of the language on page 118, paragraph 13 of the Restructuring Order that "PSE&G shall be provided with the opportunity to recover $540 million of its unsecuritized generation stranded costs on a net present value (8.42% discount rate) net of tax basis over the Transition Period." Thus, since the Board's Order mentions an annual discount rate of 8.42%, PSE&G believes that, therefore, the Board meant to use the annual discounting approach in determining the NPV of the MTC collections. The Ratepayer Advocate submits that this Board language does not at all require, or even suggest, that all monthly MTC collection should be accumulated for each Transition Period calendar year and then discounted on an annual basis. The 8.42% rate was stated in the Order to indicate what the ***annualized*** rate should be in making NPV calculations with regard to the MTC collections and was not meant to require that the annual discounting method should be used. There is nothing unusual about converting an annualized earnings or discount rate to a monthly rate by dividing the annualized rate by twelve. And there is nothing unusual or unorthodox about applying such a monthly rate if cash flows are realized on a monthly basis rather than on an annual basis. As a matter of fact, this practice of converting an annual rate to a monthly rate (by taking $1/12^{th}$ of the annual rate) and applying the monthly rate to monthly cash flows rather than annual cash flows has been used by the Board in numerous regulatory matters involving interest or present value calculations.

For example, in many restructuring related matters, Board Orders have ruled that interest be calculated on under- or over-recovery balances based on the *annual* rate on 7-year constant

maturities Treasury notes plus 60 basis points. However, in making the interest calculations, the Board required that interest be calculated on monthly under- or over-recovery balances at a monthly interest rate equal to $1/12^{th}$ of the annual rate on 7-year constant maturities Treasury notes plus 60 basis points.

On page 8 of its June 13, 2005 initial comments, PSE&G states that recalculating the Company's MTC over-collection would be "inconsistent with the Restructuring Order." This claim is apparently based on the fact that the Restructuring Order does not specify the exact methodology of calculating the MTC over-recovery. In this regard, the Ratepayer Advocate notes that the previously discussed carrying charges on the delay of securitization that were allowed to be included in the determination of the MTC over-collection, and significantly reduced the MTC over-collection calculations, were also considered to be "inconsistent with the Restructuring Order" to the extent that the consideration of these carrying charges was not provided for in the Order. Thus, the Board has previously allowed MTC reconciliation-related calculation aspects that were not specifically covered in the Restructuring Order, if these calculation aspects were considered equitable and appropriately justified. The Board should do the same in this instance by re-calculating the MTC over-recovery based on the monthly discounting approach.

Question No. 2

How should the ratepayer MTC over-recovery have been booked during each year of the transition period, i.e., as an allocated portion of the estimated net present value of the over-recovery as of August 1, 1999, as determined and booked by PSE&G, or as the estimated over-recovery occurring in each year of the transition period, in that year's dollars?

Answer:

This question goes to the issue as to how much of the MTC recovery during the Transition Period should be discounted back to August 1, 1999 in the determination of the dollar value of the MTC over-recovery. PSE&G is of the position that all Transition Period MTC recoveries should be discounted. On the other hand, the Ratepayer Advocate believes that only the Transition Period MTC recovery amount needed to recover the $540 million transfer premium should be discounted back to August 1, 1999. Once the NPV amount of $540 million has been collected, any MTC revenues collected after that point in time should be treated as normal over-recovery that would receive the same treatment that has been prescribed by the Restructuring Order for other over- and under-recoveries incurred during the Transition Period. What this means is that these MTC over-recoveries should be deferred at undiscounted, nominal dollar values.

PSE&G's calculation methodology incorrectly discounts all MTC over-recoveries collected through July 2003 back to the NPV as of August 1, 1999, even though the ratepayer refunds for these MTC over-recoveries take place starting on August 1, 2003. This calculation method inappropriately assigns to PSE&G -- rather than to the ratepayers -- all earnings on the MTC over-recovery amount during the 4-year Transition Period from August 1, 1999 to August 1, 2003. Once enough MTC revenues have been collected that, on a discounted basis, would equal the $540 million transfer premium value as of August 1, 1999, it makes no sense, from either a sound financial or logical viewpoint, to continue to discount the subsequently collected MTC over-recoveries to a present value as of August 1, 1999 and then use that discounted value as the basis for the determination of the MTC over-recovery ratepayer refund starting on August 1, 2003.

On Schedule RPA-2 in Attachment-4, the Ratepayer Advocate has calculated that, based on the monthly discounting approach, the $540 million after-tax NPV transition premium is fully recovered through MTC collections from August 1999 until sometime in the month of December 2001. The bottom of Schedule RPA-2 also shows that, based on the annual discounting approach used by PSE&G, this full recovery point in time occurs one month later, in January 2002. All MTC collections after those months represent MTC over-recoveries for which there no longer is any need or reason to discount back to August 1999. As stated before, those over-recovered MTC collections should be deferred at undiscounted, nominal dollar values. The monthly undiscounted MTC recoveries collected after December 2001[4] and through July 2003 are shown in the first column of Schedule RPA-3 in Attachment-5 and amount to a total undiscounted pre-tax MTC over-recovery amount of $312.155 million. This is $105.018 million higher than the pre-tax MTC over-recovery amount of $207.137 million calculated via PSE&G's "total discounting" methodology. Of this $105.018 million pre-tax MTC over-recovery difference, $32.534 million is due to the use of the monthly (vs. annual) discounting calculation method (calculated on Schedule RPA-1). The remaining $72.484 million difference is due to the premise that all MTC collections after full recovery of the $540 million NPV transition premium be accrued at undiscounted, nominal dollar values, similar to the treatment prescribed by the Restructuring Order for other over- and under-recoveries incurred during the Transition Period.

The monthly undiscounted MTC recoveries collected after January 2002 (the month of full recovery of the $540 million NPV amount based on PSE&G's annual discounting approach) total approximately $298.395 million,[5] which is $91.258 million higher than the pre-tax MTC

[4] December 2001 is the month of full recovery of the $540 million NPV transfer premium based on the monthly discounting approach.

[5] Total pre-tax MTC over-recovery of $312.155 million less December 2001 pre-tax MTC over-recovery of $13.760 million.

over-recovery amount of $207.137 million calculated via PSE&G's "total discounting" methodology.

In its June 13, 2005 initial comments, PSE&G asserts that the Board's Restructuring Order included "a determination that discounting the MTC collections to its August 1, 1999 value should continue throughout the four year transition period, without regard to whether or not the Company was fully reimbursed…"[6] PSE&G bases this assertion on the following statement made in paragraph 14, page 119 of the Board's August 1999 Restructuring Order:

> At the end of the Transition Period, the recovery of the $540 million will be reconciled to actual collections based on actual sales, the net present value of recovery from both the MTC, exclusive of the NTC, and collections from the 2.0 mil per kWh retail adder for customers retained on BGS, and the depreciation amortization.

Based on the above-quoted Restructuring Order language, PSE&G concludes that "there were no requirements to book any ratepayer over collection on a monthly or annual basis…"[7] and that "it is clear that in issuing the Restructuring Order, the Board directed that MTC collections would be calculated via an annual discounting throughout the transition period…"[8] The Ratepayer Advocate disagrees with PSE&G's assertions and conclusions. Nowhere in the Restructuring Order does the Board require that ***all*** MTC collections in the Transition Period, including any potential MTC over-collections, must be discounted back to their August 1, 1999 value in the determination of the ratepayer refund of over-collections. Since the Restructuring Order is not specific on what exact MTC over-collection calculation method should be used, PSE&G has come up with its own "interpretation" of the Order, and has boldly concluded that the Board really meant to order that all Transition Period MTC collections, even the MTC over-

[6] PSE&G's 6/13/05 Comments, page 9, point 2).
[7] PSE&G's 6/13/05 Comments, page 4, Answer to Question 2.
[8] PSE&G's 6/13/05 Comments, last paragraph of page 10.

collections, should be discounted back to August 1, 1999 in determining the ratepayer refund amount. The Board Restructuring Order statement that "At the end of the Transition Period, the recovery of the $540 million will be reconciled to actual collections based on actual sales, the net present value of recovery from both the MTC, exclusive of the NTC, and collections from the 2.0 mil per kWh retail adder for customers retained on BGS, and the depreciation amortization" does not prescribe the reconciliation methodology that PSE&G has used.

On the contrary, the Ratepayer Advocate submits that this Board-ordered reconciliation process implied that present value discounting should be applied to all MTC collections required to pay back the August 1999 transfer premium of $540 million and that all Transition Period MTC collections after this point be booked and accrued at undiscounted, nominal values. Not only is this the correct reconciliation approach based on sound financial principles, it is also consistent with the reconciliation approach prescribed by the Restructuring Order for other Transition Period over- and under-recoveries. For example, any over- or under-recoveries for such Transition Period rates as PSE&G's Non-utility Generation Transition Charge (NTC), Social Programs, Decommissioning, and DSM rates were booked and deferred at undiscounted, nominal dollar values.

The premise that NPV discounting should be limited to just those MTC collections needed to fully recover the $540 million transfer premium as of August 1999 and not to the overcollected amounts after full recovery would appear to be supported by PSE&G's own statement in the third paragraph on page 8 of its June 13, 2005 initial comments that:

> In exchange for paying a "transfer premium" of $540 million, Genco [PSEG Power] received the right to collect market transition charge ("MTC") revenues during the Transition Period, but only until it was reimbursed the $540 million premium. Any collections above that figure would be retained by Public Service

to be refunded to customers after the end of the transition period….
[emphasis supplied]

Question No. 3

Should interest have been booked on the ratepayer MTC over-recovery occurring in each year of the transition period, and if so, what is the appropriate rate? If not, why not.

Answer:

The Ratepayer Advocate believes that interest should have been accrued, at a rate equal to the rate on 7-year constant maturities Treasury notes plus 60 basis points, on all cumulative monthly undiscounted (nominal value) MTC over-recovery balances booked after the point in time that the $540 million NPV amount has been fully recovered. From the moment PSE&G collects MTC over-recoveries that are due ratepayers, the earnings power of the deferred over-recovered MTC balances also belongs to the ratepayers and any earnings accrued on these deferred balances should be passed on to the ratepayers along with the deferred MTC over-recoveries themselves. The Ratepayer Advocate takes the reasonable position that, while it is appropriate to use a rate of 8.42% for discounting purposes in calculating the recovery of the $540 million NPV stranded cost amount, this 8.42% overall rate of return rate would no longer be appropriate to use as an earnings rate once the stranded costs are fully recovered. Instead, the earnings rate to be applied to the deferred MTC over-recovery balances accumulated after the recovery of the $540 million NPV stranded cost should be the rate on 7-year constant maturities Treasury notes plus 60 basis points, the Board-approved rate for accruing interest on deferred balances during the Transition Period. *Restructuring Order, pages 117 and 118.*

On Schedule RPA-3 in Attachment-5, the Ratepayer Advocate has calculated, in accordance with the above-described methodology, the total interest amount accrued on the average monthly deferred MTC over-recovery balances from December 2001 (the point in time

that the $540 million NPV amount was fully recovered based on the monthly discounting approach) through July 2003, the end of the Transition Period. As shown on this schedule, the calculations indicate total interest accruals of $13.193 million. If the Board agrees with the Ratepayer Advocate that interest should be accrued on all deferred MTC over-recovery balances and flowed through to the ratepayers, this increases the total ratepayer refund amount by that same amount, approximately $13.2 million.

Question No. 5

Is it appropriate to adjust the determination of the MTC recovery to reflect the fact that under IRS rulings and court decisions, monies properly belonging to ratepayers, such as fuel cost overrecoveries, are not taxable? See United States Tax Court decision, in Florida Progress Corporation and Subsidiaries v. Commissioner of Internal Revenue, No. 2961-97, June 30, 2000; affirmed Florida Progress Corp. and Subsidiaries, v. C.I.R., 348 F.3d 954 (11th Cir. Oct. 21, 2003) (No. 02-14910,02-14911). Please explain in detail, with supporting documentation.

Answer:

Based on its review of the above-referenced court ruling, it is the Ratepayer Advocate's understanding that this ruling is favorable to the utilities in that they decide that over-recovery balances to be refunded to customers are not taxable as income in the determination of the utilities' income tax liabilities. This, in turn, reduces the utilities' deferred tax liabilities and increases the utilities' accumulated deferred income tax balances that represent cost-free capital to the utilities. Thus, the Ratepayer Advocate is of the understanding that, as a result of these favorable court rulings, MTC over-recoveries during the Transition Period are not taxable,[9] and therefore reduce PSE&G's deferred tax liabilities and increase PSE&G's cost-free capital in the

[9] As previously discussed in these Reply Comments and shown on Schedule RPA-4, MTC over-recoveries did not start accruing until December 2001 (based on monthly discounting approach) or January 2002 (annual discounting approach). These dates fall after the June 30, 2000 date of the United States Tax Court ruling in Docket No. 2961-97.

form of accumulated deferred income taxes. It is the Ratepayer Advocate's position that any tax benefits resulting from the non-taxable status of MTC over-recoveries during the Transition Period should accrue to the ratepayers and should be incorporated in the determination of the total ratepayer refund amount from MTC over-recoveries. Unfortunately, the Ratepayer Advocate does not have the necessary data available to quantify the impact of these tax benefits on the determination of the total MTC over-recovery balance to be refunded to the ratepayers.

In answer to the above-stated Board question no. 5, PSE&G states in its June 13, 2005 initial comments (page 5) that "The cited tax court decision does not affect the Company's calculation of the MTC over collection." PSE&G does not further explain, or provide source documentation in support of, this position in its Comments. The May 13, 2005 BPU Secretary's letter required the Company to "explain in detail, with supporting documentation" its position on this issue, but PSE&G has completely failed to provide any explanation or supporting documentation in its initial comments.

As a result of the above-discussed information, including the Ratepayer Advocate's understanding of this tax issue, the Ratepayer Advocate recommends that the Board order PSE&G to provide the following information:

1. Any deferred tax "reversal" entries actually booked by PSE&G as a result of the cited tax court decisions, not only related to MTC over-recoveries, but also related to other Transition Period over-recoveries for, for example, NTC, Social Programs and Decommissioning rate components of the total SBC rate, as well as the exact timing and an explanation for the reasons of these tax reversal bookings;

2. Detailed explanations and relevant source documentation in support of PSE&G's claim that this tax issue does not affect the MTC over-recovery calculation; and
3. Calculations showing the impact of these tax benefits on the determination of the total MTC over-recovery balance to be refunded to the ratepayers under the assumption that the cited court decision *does* affect the amount of the MTC over-collection.

The Ratepayer Advocate requests that the Board permit our office and other parties to file additional comments on this issue when PSE&G has complied with the Board's direction on this issue.

Question No. 6

Are there other MTC quantification issues the Board should consider? Please list them and provide the reasons why the Board should consider them, with appropriate rationales and documentation.

Answer:

There are other issues that the Board should consider when determining how much the MTC over-recoveries should be and how and when it will be refunded to ratepayers. One of the issues is that the current record before the Board concerning the MTC over-recoveries in this Phase II audit review only has actual monthly data through January 31, 2003.[10] PSE&G's June 13, 2005 initial comments apparently use actual monthly data through January 31, 2003 and estimated monthly data through the balance of Year 4, *i.e.*, through July 31, 2003. *PSE&G initial comments, pages 12-13.* In order to provide a comparison using consistent data, the

[10] Page III-2 of the Phase II audit report contains a summary of the MTC over-recovery as of July 31, 2003, but is not broken out into monthly data.

Ratepayer Advocate's calculations attached to these reply comments are based on actual data through January 31, 2003 and PSE&G's estimates of the remaining MTC recoveries from February 1, 2003 through July 31, 2003. This data is contained in the record in the Phase I Proceeding.[11] The Ratepayer Advocate requests that the Board direct PSE&G to update Mr. Krueger's schedules concerning the MTC and other deferred balances recoveries on a monthly basis through the end of the fourth year of the Transition Period, i.e., July 31, 2003. Once that data is provided on a monthly basis, the Ratepayer Advocate can update its schedules to provide the correct MTC over-recoveries refund that is due to ratepayers. There are also other MTC issues that should be addressed as follows.

PSE&G complains about the Board's review of the MTC recovery calculation and alleges that this review is an exercise in impermissible "retroactive ratemaking." *PSE&G initial comments, page 6.* However, the concept of retroactive ratemaking more commonly applies to the utility's base rates rather than the deferred accounting that is applied to other non-base-rate recovery clauses such as PSE&G's deferred balances. Normally, when the Board sets the expenses that a utility may have the opportunity to recover in its base rates, the Board and any parties do not have the right to look back in time and match the actual base rate recoveries with the forecast items that the Board included in base rate recovery. On the contrary, when the Board directs that a particular rate recovery clause will receive deferred accounting treatment, the purpose of that treatment is to compare the eventual amounts recovered from customers to the allowed amounts that the Board previously ordered should be recovered, otherwise known as a "true-up" or "reconciliation" process. That is the process that we are engaged in presently. This

[11] The data in the Phase I Proceeding was updated with actual results through February 28, 2003, but PSE&G's June 13, 2005 initial comments apparently do not use that additional month of actual data. As stated above, the Ratepayer Advocate's reply comments will also use the data through January 31, 2003 to provide a comparison consistent with the Company's data in its June 13, 2005 initial comments.

process does not violate the principle of retroactive ratemaking and, therefore, the Board should disregard PSE&G's argument on this matter entirely.

In fact, as PSE&G itself admits, this true-up process was activated at the Company's own request when it formulated the Stipulation of its restructuring cases and included in that Stipulation the concept that once the $540 million premium was recovered from ratepayers, the Company would defer any over-recovery amount and refund it to ratepayers at a later time. *PSE&G initial comments, pages 8 and 10.* Therefore, the Company cannot now complain that the Board should not comply with this true-up process that the Company itself proposed and the Board approved in the restructuring dockets.

PSE&G's arguments concerning *res judicata* and collateral estoppel are akin to its argument concerning retroactive ratemaking and should also be disregarded. The Board is obviously not looking back at its previous orders in an attempt to rewrite them, but is only seeking to ensure that the utility has correctly applied the deferred accounting process to the MTC recovery and that ratepayers receive all the refund that is due to them. As a matter of fact, if the Board should adopt PSE&G's new arguments and denies ratepayers their full refund, then it is the Company itself that would have accomplished a rewriting of previous Board Orders. Obviously the Board should not permit that result.

The Company also argues that the Board Order in Phase I of PSE&G's Deferred Balances proceeding settled once and for all the MTC over-recovery amount that should be refunded to ratepayers. *PSE&G initial comments, page 12.* That argument overlooks the fact that Phase I of the Deferred Balances audit only formally covered the first three years of the Transition Period and specifically deferred a full accounting of Year 4 of the Transition Period until this Phase II review. Also, the record in the Phase I Proceeding did not contain actual data

through July 31, 2003 for the entire Year 4 of the Transition Period. Therefore, the Board Order in the Phase I Proceeding could not have resolved completely the MTC over-recovery issue. This Phase II audit process is the proceeding in which that reconciliation and correct calculation of the MTC over-recovery should be completed. When the Board issued its order in the Phase I audit, it could only have been issuing an order temporarily effective until the Phase II audit process was complete. PSE&G knew this fully well when the Phase I Order was issued and should not complain about the proper completion of this Phase II process now. The Company's arguments on this issue are clearly incorrect and should be denied.

PSE&G also complains that the Phase II audit report should not include the paragraph on page III-3 concerning the "Carrying Cost due to Delay in Securitization." *PSE&G initial comments, page 2.* The Company believes that the Auditors did not address this issue in the Phase II audit, but only in the Phase I audit. This complaint could be made about much of the background information in the Phase II audit report and, indeed, in most of the Company's June 13, 2005 initial comments. The Auditors included this information in a list of other background information that describes how the deferred balances reached their present state. It makes no sense for PSE&G to pick and choose which information among the other background information that it would not like to see mentioned in the Phase II audit report. PSE&G's complaint is completely unsupported in logic and should be denied. The information on the $370 million that PSE&G deducted from the MTC over-recovery that both the Auditors and our office contested is vital to understanding how the MTC deferred balance got to its present state and should remain in the Phase II audit report.

Further, it is entirely relevant to PSE&G's assertion on pages 4 to 5 in its June 13, 2005 initial comments that there should be no interest charged on any year's MTC over-recovery or

under-recovery. If PSE&G is correct about this lack of interest on the MTC recovery, then there is no basis for PSE&G to have deducted the $370 million from the MTC deferred balance for carrying costs due to the delay in securitization. The Ratepayer Advocate pointed out this discrepancy during the Phase I Proceeding and PSE&G contested our position. PSE&G should not now be allowed to posit a completely different argument now that the Phase I Proceeding has been decided. If PSE&G's argument that there should be no carrying charges on the MTC recovery is accepted, then the Board should also reverse the $370 million that PSE&G deducted from the MTC over-recovery due to ratepayers.[12]

NON-UTILITY GENERATION (NUG) CONTRACT COST RECOVERY AND RESTRUCTURING AND RENEGOTIATION

There are other issues that the Ratepayer Advocate believes would be fruitful for further examination and consideration by the parties and the BPU. These items are mentioned in the Phase II audit report and in the June 13, 2005 Ratepayer Advocate's initial comments. These issues relate to the Company's NUG contracts cost recovery and PSE&G's efforts to restructure and renegotiate its NUG contracts.

The first issue is mentioned on page VII-3 of the Phase II audit report and relates to a conceptual proposal that PSE&G received from a power marketer near the end of the Phase II audit period to undertake a comprehensive restructuring of the Company's entire remaining

[12] In the Phase I Proceeding, the Ratepayer Advocate's expert witness Robert Henkes calculated that the NPV of the $370 million would have been approximately $328.1 million. The Ratepayer Advocate also argued in the alternative that, if the Board should allow interest on the MTC recovery, it should deny PSE&G's use of its overall allowed rate of return as the interest rate (8.42% after tax) and should instead use the same interest rate the Board ordered for the NTC and SBC, which was the seven-year constant maturities Treasury rate at that time plus 60 basis points (approximately 6.7%) This correction would have increased the MTC over-recovery by a NPV of $173.1 million. *See the Ratepayer Advocate Initial Brief, pages 59-62, in the Phase I Proceeding.*

NUG contracts. The Phase II audit report notes that "[t]he Company did not pursue the proposal until after the Phase II period", but the report does not mention the outcome of PSE&G's pursuit of that proposal. The Ratepayer Advocate urges the Board to require PSE&G to provide the parties full information concerning the proposal received and detailed information concerning the Company's pursuit of that proposal and the current status of that proposal. The Ratepayer Advocate requests the ability to provide further comments concerning this issue after receiving such information.

The second issue concerns the Company's efforts to restructure and renegotiate the three NUG contracts with El Paso Merchant Energy Company (El Paso). On page VII-5, the Phase II audit report stated:

> When El Paso had liquidity problems in 2002, PSE&G approached El Paso to see if the latter's need for liquidity might make it amenable to buyouts of its NUG contracts. PSE&G's overtures to El Paso were met with interest. However, the liquidity problems resulted in high turnover in El Paso personnel, making it difficult for PSE&G to re-initiate restructuring discussions.

The Phase II audit report does not specify the outcome of these discussions with El Paso and whether or not the discussions are continuing. The Ratepayer Advocate urges the Board to require PSE&G to provide complete information concerning the discussions held with El Paso and to provide an update to the status of those discussions. The Ratepayer Advocate requests the ability to provide further comments concerning this issue after receiving such information.

The Phase II audit report also mentions on page V-3 an adjustment to add to the Non-Utility Generation Transition Charge (NTC) revenues recovered for the energy received from the St. Lawrence contract. PSE&G's initial comments do not discuss this matter and the Phase II audit report itself has scant information on this matter. In our initial comments dated June 13, 2005, the Ratepayer Advocate recommended that the Company address this issue in its initial

comments and that our office receive additional information as needed in order to review this issue. *Ratepayer Advocate initial comments, pages 3 and 4.* Perhaps the Company's reply comments will provide additional information on this issue and the Ratepayer Advocate can then supplement our filing with additional comments once we have received sufficient information concerning the revenues from the St. Lawrence contract.

The Phase II audit report discusses whether or not PSE&G is maximizing the value it could receive for the electric power from its NUG contracts. The items discussed on this issue include whether the Company should be monitoring the prices in PJM's day-ahead energy markets as well as the spot market and whether the Company should consider allocating the NUG contract energy to its BGS supply requirements rather than selling the output into the PJM markets. The Ratepayer Advocate believes that the Board should consider whether these issues might better be discussed in a more full manner and in a complete context in the Board's dockets on the BGS auctions. The Auditors' comments on this issue seem to discuss the matter only in the prospective mode, so that any change in how the NUG contract energy is treated would not affect the rate recovery of the Year 4 Transition Period Costs.

OTHER ISSUES

PSE&G apparently objects to the Auditors' citation of the Liberty Consulting Group audit of PSE&G concerning competitive services offerings and the Company's compliance with the BPU's affiliate relations standards. *PSE&G initial comments, page 2.* The utility concludes that no references should be made to prior or future affiliate standards audits. However, the Company does not state any reason for this objection. It does not seem objectionable to the Ratepayer Advocate that the Auditors include factual assertions about the Liberty audit, and we

believe the Board should overrule PSE&G's objections and allow this information to remain in the audit report.

PSEG also objects to the Auditors' inclusion of information concerning Jersey Central Power and Light Company (JCP&L) and Atlantic City Electric Company (ACE). *PSE&G initial comments, pages 2 and 3*. The Company's reasons for its objections are unpersuasive and do not lead to the conclusion that the information should not remain in the Phase II audit report. Furthermore, PSE&G incorrectly alleges that the last paragraph on page VII-8 of the Phase II report is "in conflict with Finding #5 on page VII-5 …." Finding #5 says, "The company [sic] acted reasonably in seeking to maximize revenues from the resale of NUG power." However, the text that PSE&G finds objectionable also states that "the company [sic] was not unreasonable in continuing to eschew the day-ahead market even if it had monitored market prices." The Ratepayer Advocate does not see any conflict between the two sections of the Phase II audit report and believes that the Board should permit the text to remain in the report.

CONCLUSION

The Ratepayer Advocate respectfully urges the Board to adopt the conclusions contained in our initial and reply comments in this matter and to require PSE&G to supplement its filings with the additional information that is necessary to complete a full review of the Phase II audit report. After the Ratepayer Advocate and other interested parties have received the additional information from PSE&G, the Ratepayer Advocate respectfully urges the Board to provide additional time for our office and the other interested parties to file additional comments concerning the new information provided by PSE&G. We also request that the Board require PSE&G to provide responses to our earlier discovery requests as mentioned in our June 13, 2005

letter regarding the discovery process for our review of the Phase II audit report and responses to additional discovery as needed.

Respectfully submitted,

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