PROCEDURAL HISTORY

On April 30, 1997 the Board of Public Utilities ("Board" or "BPU") issued an Order adopting and releasing its Final Report on electric industry restructuring entitled *"Restructuring the Electric Power Industry in New Jersey Findings and Recommendations"* ("Final Report"). The Final Report set forth the Board's goals and requirements for the deregulation of the generation segment of the traditional electric utility monopoly. The goal was to deregulate generation and increase competition in both retail and wholesale markets in order to (l) reduce electric rates for all ratepayers; (2) expand choices of services and products for all consumers; and (3) foster competition. The Final Report required the four electric utilities to make three restructuring filings by July 15, 1997: (1) a stranded costs filing; (2) a rate unbundling filing; and (3) a filing addressing functional restructuring and other important policy issues.

In mid-September 1998, the New Jersey Legislature introduced comprehensive legislation that restructured the monopoly electric and natural gas industries in the State. Two identical bills, Senate Bill 5 (S-5) and Assembly Bill 10 (A-10), drafted by the BPU, contemplated full retail competition by mid-1999 and 5% rate reductions for all electric utility customers by August 1999 with a 10% rate reduction by August 2002.

After extensive legislative hearings which continued through the end of 1998, and review of several revised versions of the bill, P.L. 1999, C. 23, the *Electric Discount and Energy Competition Act* ("Act" or "EDECA")[1] was signed into law on February 9, 1999.

As required by the Final Report, the four utilities filed restructuring filings in July 1997 and, as a result of those proceedings, the Board issued a Final Decision and Order approving Jersey Central Power & Light Company's ("JCP&L" or "Company") unbundled rates into their various

[1] Later codified as *N.J.S.A.* 48:3-49 *et seq*.

components pursuant to EDECA including the establishment of separate delivery charges as well as a non-bypassable Market Transition Charge ("MTC") and a non-bypassable Societal Benefits Charge ("SBC"). *In the Matter of Jersey Central Power & Light Company d/b/a GPU Energy- Rate Unbundling, Stranded Costs, and Restructuring Filings*, Final Decision and Order, BPU Docket Nos. EO97070458, EO97070459, and EO97070460, (Order Dated March 7, 2001) ("Final Order").

On March 13, 2002, JCP&L filed a petition with the Board for a review of all actual and projected costs and expenditures incurred and to be incurred by JCP&L relating to environmental remediation of its former manufactured gas plant ("MPG") sites. *I/M/O JCP&L For Review and Approval of Costs Incurred for Environmental Remediation of Manufactured Gas Plant Sites and For an Increase in the Remediation Adjustment Clauses of its Filed Tariff in Connection Therewith,* BPU Dkt. No. ER02030173 ("2002 RAC").

On July 17, 2002, JCP&L filed a petition seeking a declaratory ruling by the Board confirming the prudency and recoverability in customer rates of costs incurred in connection with the State-mandated consumer education program. *I/M/O Consumer Education Program on Electric Rate Discounts and Energy Competition,* BPU Dkt. No. ER02070417 ("2002 CED"). The costs deemed prudent by the Board in the CED filing will be incorporated as part of JCP&L's Societal Benefits Charge.

Pursuant to the Board's directive in the Final Order, JCP&L filed two petitions with the Board on August 1, 2002. The Company was seeking approval of proposed changes to its unbundled rate schedules ("2002 Rates Filing") and costs relating to its respective deferred balances, including their MTC, SBC and recovery of above-market Non-Utility Generator ("NUG") expenses. ("2002 Deferred Balances Filing") The Company filed two recovery alternatives, a pro forma increase in revenues of $153 million or approximately 7.8% if the proposed deferred balance is securitized and recovered over 15 years or $279 million or approximately 14.3% if the proposed deferred balance is recovered over four years.

In support of its base rate and deferred balances cases, the Company filed the testimony of Michael J. Filippone (Overview of the Rates and Deferred Balances Filings), Richard F. Preiss (Revenue Requirement), Thomas C. Navin (Capital Structure), Roger A. Morin (Return on Equity), Mark A. Hayden (Cost of Service/Class Allocation), Sally J. Cheong (Rate Design/Tariff Issues), Paulette R. Chatman (Service Company Relationships, Charges and Allocations), Stacey L. Kaplan (Incentive Compensation), Michael J. Swartz (Lead/Lag Study), Lawrence E. Sweeney (Capital Additions), Susan D. Marano (MTC Deferred Balance Accounting/Ratemaking), Charles A. Mascari (Basic Generation Strategy and Approach Cost of Providing BGS Service), and Dean W. Stathis (Basic Generation Strategy and Approach Cost of Providing BGS Service)

Included with the 2002 Rate filing and 2002 Deferred Balances filing, was a motion to consolidate the 2002 RAC and 2002 CED dockets. JCP&L contended that the RAC and CED dockets involve the review and approval of costs associated with the deferred balances. The motion requested that all four proceedings be consolidated for the purposes of conducting public and evidentiary hearings.

The four cases were forwarded to the Office of Administrative Law ("OAL") on August 22, 2002 as a contested matter and assigned to the Honorable Irene Jones Administrative Law Judge, ("ALJ Jones"). A joint pre-hearing conference was held before ALJ Jones on October 31, 2002 and a Pre-hearing Order consolidating the increase in base rates and approval of deferred balances relating to its MTC and SBC for plenary hearings at the OAL was entered on December 5, 2002. In a separate Order issued on the same date, ALJ Jones set plenary hearing dates for 2002 RAC. In accordance with schedule set forth in the Pre-hearing Orders, consolidated public hearings were held in Toms River and Manalapan on December 10, 2002 and Morristown on January 6, 2003, respectively. Additional public hearings were held in Freehold Township and Toms River on March 13 and Morristown on March 21, 2003.

In addition to the Company, the parties to this proceeding are the Staff of the Board ("Staff"), the New Jersey Division of the Ratepayer Advocate ("Ratepayer Advocate") and several other parties. New Jersey Independent Energy Users Associates ("NJIEU") Green Mountain Energy Corporation ("Green Mountain"), Co-Steel-Sayreville ("Co-Steel")[2], United States Department of Defense and Other Federal Executive Agencies ("DOD/FEA"), New Jersey Commercial Users ("NJCU") and New Jersey Transit Corporation ("NJ Transit") were granted intervenor status. Public Service Electric and Gas Company ("PSE&G"); PPL Energy Plus, LLC ("PPL") and Rockland Electric Company ("RECO") were granted participant status.

The Direct Testimony of Richard LeLash (RAC Issues) was filed on behalf of the Ratepayer on December 13, 2002. On December 20, 2002, the Ratepayer Advocate filed the Direct Testimonies of David Peterson (Revenue Requirements), Basil Copeland (Return on Equity), John Stutz (Rate Design/Tariff Issues), Barbara Alexander (Service Quality Reliability), Peter Lanzalotta (Engineering Reliability), Michael J. Majoros (Depreciation Expense), Paul Chernick (Basic Generation Service Allocation), James A. Rothschild (Securitization) and David Nichols (Demand Side Management). On the same day, intervenors NJCU filed the Direct Testimony of Dr. Dennis Goins, DOD/FEA filed the Direct Testimony of Kenneth L. Kincel, Co-Steel Raritan, Inc. filed the Direct Testimony of Howard Gorman and Darren MacDonald. Intervenor NJ Transit filed the Direct Testimony of Theodore S. Lee on February 5, 2003.

On January 24, 2003, the Company filed Rebuttal Testimonies of Michael J. Filippone, Richard F. Preiss, Thomas C. Navin, Roger A. Morin, Mark A. Hayden, Sally J. Cheong, Paulette

[2] On October 23, 2002, Co-Steel Inc officially merged with the North American operations of Gerdau, SA and changed its name to Gerdau Ameri Steel Corp. throughout these proceedings the Company continued to be referred to as Co-Steel. *CS-3*.

R. Chatman, Stacey L. Kaplan, Michael J. Swartz, Lawrence Sweeney, Charles A. Mascari, Dean W. Stathis, Christopher Siebens, Timothy H. Schad, Lewis F. Petty and Frank Graves. On February 28, 2003, JCP&L filed updated the schedules of several testimonies to reflect actual data for the test year ending December 31, 2002.

In compliance with the Board's directive at the Agenda Meeting held on July 23, 2002, a letter was sent from the Division of Audits and Division of Energy pursuant to *N.J.S.A.* 48:2-16.4 requesting bids from auditors/consultants to initiate management audits on each of the four New Jersey investor-owned electric utility companies. The auditors were to focus on the restructuring-related deferred balances of electric utilities. The firms of Mitchell & Titus LLP ("M&T") and Barrington-Wellesley Group ("BWG") were hired to assist with the review of JCP&L. Pursuant to the Board's letter, the audit reports were to be transferred to the OAL on January 15, 2003. By letter dated March 18, 2003, a copy of the auditors' report was transferred from the Board to ALJ Jones and copies were provided to the parties in the proceeding.

Evidentiary hearings were held at the OAL on February 13, 14, 20, 21, 25, 26, 27, and March 3, 4, 5, 6, 7, 11, 12, 14, 17, 18, 19, 2003. On April 15, 2003, ALJ Jones held a settlement conference with the parties to discuss possible settlement issues regarding the 2002 RAC. Evidentiary hearings relating to the audit were held on April 28, 2003, at which time representatives from the audit firms were cross examined.

During a conference call on April 2, 2003 with the parties and ALJ Jones, the briefing schedule was set. Initial briefs are due on May 2, 2003, and reply briefs are due on May 16, 2003.

POINT I. <u>COST OF CAPITAL</u>

YOUR HONOR AND THE BOARD SHOULD ADOPT AN OVERALL RATE OF RETURN OF 8.16% FOR THE COMPANY, REFLECTING A CONSOLIDATED CAPITAL STRUCTURE, AN ESTIMATED 9.5% RETURN ON EQUITY BASED ON AN ANALYSIS OF COMPARABLE COMPANIES, AND A 35 BASIS POINT ADJUSTMENT FOR THE UNUSUALLY LOW EQUITY RATIO IN THE CONSOLIDATED CAPITAL STRUCTURE.

A. Capital Structure

1. Overview

Regulated companies such as JCP&L typically have utilized three sources of capital to capitalize their utility assets: common stock, preferred stock, and long-term debt. *R-41,* p. 8. The rate of return for a regulated utility is usually based on the costs of each of the individual sources of capital, weighted by the proportion each component represents in the overall capital structure. *Id.* The costs of JCP&L's long-term debt and preferred stock can be directly measured from the interest rate and related costs on various issuances of debt and preferred stock, and are not a subject of controversy. The issues to be determined by Your Honor and the Board are (1) the proper capital structure for ratemaking purposes, and (2) JCP&L's cost of common equity.

JCP&L is proposing to use a modified "stand-alone" capital structure and a 12 percent return on common equity, resulting in a proposed overall rate of return of 9.89%. *JC-5,* p. 8-9, 12; *JC-6,* p. 4. This proposal substantially exaggerates JCP&L's actual cost of capital. The proposed "stand-alone" capital structure deprives ratepayers of the benefits of the lower capital cost of the $4.5 billion in long-term debt issued by JCP&L's parent, FirstEnergy Corporation ("FirstEnergy"), to finance the GPU Energy ("GPU")-FirstEnergy merger. *I/M/O the Joint Petition of FirstEnergy Corp. and Jersey Central Power & Light Company, d/b/a/ GPU Energy, for Approval of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief,* BPU

Docket No. EM00110870, (Order dated Oct. 9, 2001) *("Merger Order")* at p. 22 The proposed 12.0% return on common equity is based on methodologies that substantially overstate the Company's actual cost of capital. The unreasonableness of this result is readily apparent when one considers that the Company's proposed return on equity is only 20 basis points lower than the 12.2% return allowed by the Board in the Company's last base rate case in 1993, when interest rates were substantially higher than today. *I/M/O Petition of Jersey Central Power & Light Co for Approval of Base Tariff and Charges for Electric Service and Other Tariff Revisions,* BRC Docket No. ER91121820J, Final Decision and Order Accepting in Part and Modifying in Part Initial Decision, appended Initial Decision at p. 64 (June 15, 1993).

Ratepayer Advocate witness Basil Copeland has properly determined Company's cost of capital using a consolidated financial structure, and a cost of equity capital based on a combination of correctly applied methodologies. Based on Mr. Copeland's analysis, the Ratepayer Advocate is recommending a return on common equity of 9.5% plus an upward adjustment of 35 basis points to compensate shareholders for the risks inherent in FirstEnergy's highly leveraged capital structure. The overall rate of return, using FirstEnergy's consolidated financial structure, is 8.16%.

The Ratepayer Advocate's recommendations are consistent with the Board's recent expression of policy with regard to rate of return in its March 6, 2002 decision in the Unbundled Network Element proceeding, *I/M/O the Board's Review of Unbundled Network Elements Rates, Terms and Conditions of Bell-Atlantic-New Jersey, Inc.*, BPU Docket No. TO00060356, Decision and Order (March 6, 2002) (cited hereinafter as the *UNE Decision*), *R-44*. In that decision, the Board adopted the Ratepayer Advocate's proposed consolidated capital structure for Verizon New Jersey, as well as the Ratepayer Advocate's proposed 10% return on equity, based on methodologies similar to those presented by the Ratepayer Advocate's witness in this proceeding. *Id.*, p. 39.

The Ratepayer Advocate's recommended rate of return is reasonable and consistent with the Board's policy. For the reasons explained in detail below, Your Honor and the Board should adopt the Ratepayer Advocate's recommended rate of return and reject the inflated proposals presented by JCP&L.

2. JCP&L's Overall Rate of Return Should be Based on a Consolidated Capital Structure, Rather Than the Hypothetical Capital Structure Proposed by JCP&L. The Ratepayer Advocate's Proposed Consolidated Capital Structure Fairly Balances the Interest of Ratepayers and Shareholders, and is Consistent With the Board's Recent UNE Decision.

JCP&L is proposing to determine an overall rate of return based on the capital structure of JCP&L, with two adjustments to reverse certain accounting impacts of the GPU-FirstEnergy merger. Your Honor and the Board should adopt instead a consolidated capital structure, which passes on to ratepayers the lower capital costs of the debt issued to finance the GPU-FirstEnergy merger.

As explained in Mr. Copeland's prefiled direct testimony, FirstEnergy financed the GPU merger by issuing $4.5 billion of long-term debt, with an average weighted cost of about 6.5%. *R-41,* p. 5. None of this low-cost debt is reflected in the stand-alone capital structure proposed by Company witness Thomas Navin. Instead, Mr. Navin is proposing to "unwind" the effects on JCP&L's capital structure of the purchase accounting associated with the GPU-FirstEnergy merger. *JC-5,* p. 8. JCP&L's capitalization was increased by approximately $1.6 billion, primarily due to including goodwill as an asset on the Company's balance sheet and reflecting an associated increase in common equity. *Id.,* p. 5. This adjustment would remove from the Company's capital structure $1.820 million in common equity, $4 million in preferred stock and preferred securities, and $31 million in long-term debt. *Id.,* p. 8.

While Mr. Navin's reversal of these accounting adjustments has the salutary effect of lowering JCP&L's equity ratio, it is only a half-hearted measure. It does not actually recognize the debt used to finance the merger, or pass the lower costs associated with this debt along to ratepayers.

A consolidated capital structure, as proposed by the Ratepayer Advocate, includes this debt and recognizes its lower costs for the benefit of ratepayers. *R-41,* p. 5.

A further reason for adopting a consolidated capital structure is that FirstEnergy's capital structure is not easily manipulated. FirstEnergy's capital structure is an actual capital structure resulting from arms-length transactions in the capital market. JCP&L's capital structure, by contrast, is dictated by its corporate parent. The types of manipulation that can result are readily apparent from FirstEnergy's use of the $4.0 billion in low-cost debt associated with the GPU merger. Of this amount, $1.5 billion was used to pay short-term indebtedness of GPU and its subsidiaries. *R-47.* This is a common use of long-term debt, and JCP&L ratepayers should receive the benefit. *R-42,* p. 3.

Another $2.2 billion was used to finance the cash paid to the holders of GPU common stock, effectively translating equity into debt. JCP&L's proposed "stand alone" capital structure would effectively treat this amount as equity. *R-47; R-42,* p. 3. As Mr. Copeland explained in his surrebuttal testimony, this is the type of corporate "shell game" that the Public Utility Holding Company Act ("PUHCA") is supposed to prevent. *Id.* FirstEnergy has achieved technical compliance with PUHCA by assuming the risk of this debt at the parent level—but this does not change the fundamental reality that the GPU common stock has been "cashed out" and replaced with debt. If JCP&L is permitted to use its proposed "stand alone" capital structure FirstEnergy's shareholders will earn an equity return on low cost debt. *R-42,* p. 2-3.

Given FirstEnergy's control of JCP&L's financial structure, it is reasonable to assume that JCP&L's percentage of equity actually financing JCP&L's utility operations is no higher that the percentage of equity financing the consolidated companies. This is a reasonable assumption because JCP&L's utility operations presumably involve less business risk than FirstEnergy as a whole, and thus should not require a higher equity ratio than the consolidated operations. The Board relied on similar reasoning when it adopted a consolidated financial structure for Verizon New Jersey ("Verizon") in the *UNE Decision.* That proceeding also involved a regulated company whose capital structure. was subject to the control of its corporate parent. *UNE Decision R-44,* p. 36-37. The Ratepayer Advocate argued, and the Board agreed, that it was "unreasonable to assume that 'the regulated operations in New Jersey are more risky than the other businesses owned by [Verizon].'" *Id., R-44,* p. 39 (quoting Ratepayer Advocate's Initial Brief, p. 44). The same analysis applies in this proceeding. It is unreasonable to assume that JCP&L requires a higher equity ratio to finance its operations than FirstEnergy requires to finance its consolidated operations. Thus, it is reasonable for the Board to give JCP&L's ratepayers the cost benefits resulting from the lower equity ratio reflected in FirstEnergy's consolidated capital structure.

A consolidated capital structure is also consistent with the practices of credit rating agencies, which do not rely solely on "stand-alone" capital structures in evaluating the creditworthiness of regulated corporations such as JCP&L. An example of this approach is shown in the current version of Standard and Poor's *Corporate Ratings Criteria. R-43.* As explained by Mr. Copeland, Standard and Poor's rarely views regulated subsidiaries on a stand-alone basis. T116:L15 -23- T117:L25; (3/3/03) *R-43,* p. 45*;* 100-01.

Company witness Navin contends that the consolidated capital structure is not the appropriate structure because it is "transient." Mr. Navin asserts that First Energy plans "to significantly reduce the debt of the consolidated entity in the near-term." *JC-5,* p. 6. Mr. Navin further asserts in his rebuttal testimony that FirstEnergy has "advised the investment community and rating agencies of our intent to reduce leverage expeditiously." *JC-5 Rebuttal,* p. 5. However, the Company has presented no evidence to support its contention that the debt issued to finance the merger is transient. FirstEnergy issued $4.5 billion in long-term debt with maturities up to 25 years or longer. As noted by Mr. Copeland, "this hardly qualifies as 'transient'…." *R-41,* p. 6. Significant levels of debt associated with the merger may be expected to remain on FirstEnergy's balance sheet for some time. *Id.* As noted in Mr. Copeland's surrebuttal testimony, $1 billion of the $4 billion in long-term debt associated with the merger does not mature until 2006. Another $1.5 billion does not mature until 2011, and the final $1.5 billion does not mature until 2031. *R-42,* p. 3*; R-45.*

Mr. Navin's rebuttal testimony appears to be referring to plans to retire $2.2 billion of other debt from 2003 to 2005. Only a small fraction of this debt, $360 million, is specific to JCP&L. Further, the planned retirements would only reduce the consolidated debt ratio from 57.4% to 52.4%, and raise the equity ratio from 37.2% to 41.6%. *R-42,* p. 3; *R-46.* As noted in Point I. B. below, Mr. Copleand has proposed a 35 basis point adjustment to his recommended return on equity to compensate for the risks inherent in FirstEnergy's low equity ratio. This proposed adjustment is adequate to account for a difference in equity ratio of the magnitude that would result from the planned retirements. *R-42,* p. 3.

Contrary to Mr. Navin's assertions, the current consolidated capital structure is not an aberration, but is indicative of the relative levels of debt and equity that will prevail in the longer term. JCP&L's ratepayers are entitled to the benefits of this capital structure.

3. The Company's Proposed Stand Alone Capital Structure is Flawed and Should Be Rejected.

For the reasons set forth above, the Ratepayer Advocate believes that a consolidated capital structure represents the best balance of shareholder and ratepayer interests. Moreover, the Company's stand alone structure is flawed.

First, the Company improperly added $177 million to equity, equal to the after-tax effect of the $300 million deferred balance write-off agreed to by FirstEnergy in the GPU-FirstEnergy merger proceeding. As Mr. Copeland explained, this adjustment would have the effect of allowing the Company a return *on* the deferred balance. *R-41,* p. 7. This result would be contrary to the Board's merger order. As a result of settlement negotiations among the parties, $300 million was agreed to as the share of merger savings to be allocated to JCP&L ratepayers. This $300 million share was used to reduce JCP&L's deferred balance. *Merger Order* at p. 20. Mr. Navin acknowledged in his testimony that the agreed write-off "eliminated the opportunity for recovery of and on that balance." *JC*-5, p. 9. As Mr. Copeland explained in his surrebuttal testimony, Mr. Navin is attempting to construe the Board's Order as permitting the Company to escape one of the inherent impacts of a write-off, by pretending that the write-off did not occur! *R-42*, p. 4. Thus, it is clear that JCP&L's proposed adjustment represents an attempt to reclaim part of the ratepayer benefits that were specifically required under the Board's *Merger Order*. JCP&L should not be permitted to take back any part of the benefits that were promised to ratepayers as a condition of the merger.

Second JCP&L did not adjust its cost of debt to flow through to JCP&L's ratepayers the lower cost of the debt used to finance the merger. As shown in the testimony of Ratepayer Advocate witness Mr. Copeland, the weighted cost of debt reflected in the Company's proposed "stand alone" capital structure is higher than the weighted cost of debt issued to finance the merger. *R-41*, Sch. BLC-2. JCP&L's ratepayers should share in the lower cost of the debt used to finance the merger. *R-41*, p. 7.

For the forgoing reasons the Company's proposal is flawed and should be rejected by Your Honor and the Board.

B. The Appropriate ROE for the Company is 9.5% Based on Analyses of Comparable Companies, plus a 35 Basis Point Adjustment for FirstEnergy's Highly Leveraged Capital Structure.

1. Introduction

As noted above, regulated utilities capitalize their utility assets using common stock, preferred stock, and debt. The cost of common equity, unlike the costs of debt and preferred stock, cannot be determined directly from the interest rates applicable to various issues. Instead, the cost of common equity must be estimated using market-based common stock dividend and price information. *R-41*, p. 8.

Basing the allowed return on equity on the market cost of equity accomplishes two important regulatory objectives. First, this approach properly balances ratepayers' interest in receiving safe and reliable service at the lowest possible cost, with shareholders' interest in receiving the highest rate of return possible. A market-based return on equity preserves the company's financial integrity, thus allowing it to continue providing safe and reliable service for the benefit of ratepayers, while providing shareholders with a return commensurate with the returns they could earn on other investments with comparable risks. Second, an allowed rate of return equal to the market cost of equity provides management with the proper incentives to operate the company safely, reliably and efficiently. A market rate of return is neither too high, thus encouraging inefficiency, nor too low, thus tempting management to "cut corners" in order to achieve an adequate return for shareholders. *R-41*, p. 9-10.

The Company's proposed 12% return on equity is based on Dr. Morin's recommended Discounted Cash Flow ("DCF") analysis, and variations of risk premium analyses. *JC-6*, p. 14. The Ratepayer Advocate is proposing a 9.5% return on equity, with a 35 basis point adjustment for the financial risks inherent in FirstEnergy's highly leveraged capital structure. The Ratepayer Advocate's proposal is based on Mr. Copeland's use of two variations of the DCF methodology, and a risk premium analysis based on the Capital Asset Pricing Model ("CAPM"). *R-41*, p. 10. The differences between the two witnesses may be summarized as follows:

	Morin	Copeland
DCF Methods:		
Constant Growth	11.6%-13.2%	10.24-10.46%
Multiple Period (DDM)	N/A	9.77-9.80%
Risk Premium/CAPM		
CAPM	10.8%-11.5%	9.14%
"Historical Risk Premium"	11.4%-11.8%	N/A
"Allowed Risk Premium"	11.0%	N/A
Increment for Capital Structure	N/A	0.35% [3]
Overall	12.0%	9.85%

Source: *JC-6,* p. 41; *R-41,* p. 14-15, 18- 19; R-42, p. 10-11.

Mr. Copeland's results were based on the proper application of the DCF and CAPM methodologies. Dr. Morin, on the other hand, has improperly applied the DCF and CAPM methodologies, and has relied on two methodologies, "Historical Risk Premium" and "Allowed Risk Premium" which have serious conceptual and empirical flaws. The analyses presented by both witnesses, and the serious flaws in Dr. Morin's analysis, are set forth in detail below.

2. The Ratepayer Advocate's Recommended Return on Equity is Based on Proper Application of the DCF and CAPM Methodologies.

As stated earlier, Ratepayer Advocate witness Basil Copeland based his recommended return on equity on two variations of the DCF methodology (the "constant growth" model and a "multiple period" model), and a CAPM analysis.

a. Constant Growth DCF Model

The "constant growth" model is the most basic form of DCF analysis. This model assumes that the investor's required return on common equity is equal to the dividend yield plus expected rate of growth in the dividend, and assumes further that all three of these factors grow at the same rate in perpetuity. *R-41,* p. 10, 13. This relationship is expressed mathematically as:

$$k = D/P + g$$

[3] Assumes consolidated capital structure.

where k it the cost of equity capital, D/P is the dividend yield (the dividend divided by the market price of the stock), and g is the expected growth rate. *R-41*, p. 10.

The principal steps in applying the DCF methodology are (1) selection of a sample of companies with risks comparable to that of the utility; and (2) determination of dividend yields and growth factors for the comparable companies. The above equation can then be used to calculate an estimate of the cost of equity capital for the utility. *R-41*, p. 10-11.

Mr. Copeland applied his DCF model using the same sample of combination electric/gas utilities that were used in Dr. Morin's DCF analysis, with a few exceptions. Specifically Mr. Copeland excluded companies that pay no dividend or which have recently reduced dividends, as inclusion of these companies distorts the results of the DCF model. *R-41*, p. 12.

Mr. Copeland estimated the growth rates for the sample of companies using an average of published estimates of growth in earnings per share (EPS), dividends per share (DPS), and book value per share (BVPS) for the utilities contained in his sample of comparable companies. As Mr. Copeland explained, under the assumption of the "constant growth" DCF model, EPS, DPS and BVPS should all grow at approximately the same rate. Where this is the case, one of these measures can be used as a proxy for expected rate of growth in dividends. If not, then using one measure will distort the results of the constant growth DCF model. Since EPS growth rates currently are substantially higher than DPS growth rates, the best way to estimate the constant growth DCF cost of equity is to use an average of EPS, DPS and BVPS projections. *R-41*, p. 14.

Mr. Copeland's analysis of the sample of companies yielded a mean (average) estimate of 10.46% and a median of 10.24%. Of the two, the median is more reliable, as the mean reflects the impact of "outliers" in the calculation of the mean. *R-41*, p. 14-15.

b. Multiple Period DCF Model

The "constant growth" DCF produces reliable results when actual market conditions reasonably approximate the basic assumption underlying this model, *i.e.* that dividends, earnings, book value per share, and share price will grow at a uniform rate in perpetuity. However, when dividend payout rates are expected to increase or decrease over extended periods of time—as in the current market—the "constant growth" model can produce distorted and unreliable results. For this reason, Mr. Copeland also applied a "dividend discount model" ("DDM") requiring less rigid assumptions. *R-41,* p. 15.

A DDM is a form of multiple-period model, which assumes that dividends will grow at one rate for a fixed period, and thereafter at some other rate in perpetuity. *R-41, p. 16.* Mr. Copeland's model used published five-year growth rates for the 2002 through 2006, and an estimate of long-term growth thereafter. *R-41,* p. 17. Mr. Copeland's model further assumed that the retention ratios for the sample companies would change from currently projected values to a common value of 0.51 between 2006 and 2021. Using these assumptions, the model generated a series of cash flows which could then be used to solve for an expected return.

Mr. Copeland's DDM model yielded a mean estimate of the cost of equity capital of 9.80% and median estimate of 9.77% for the sample companies. These results suggest that the constant growth DCF model overstates the effect of near-term growth. *R-41,* p. 18.

c. Capital Asset Pricing Model (CAPM)

Finally, Mr. Copeland estimated JCP&L's cost of capital using the Capital Asset Pricing Model ("CAPM"). CAPM is a "risk premium" model, that is, a model based on the principle that the cost of equity capital equals the cost of a risk-free investment plus a "risk premium" to compensate for the risks of a specific equity investment. Under the CAPM methodology, the overall market risk premium is adjusted to reflect the risk of a stock or sample of stocks using a "beta coefficient," which is a measure of the risk of an individual stock relative to the market as a whole. *R-41,* p. 18.

Mr. Copeland estimated the overall market risk premium using the premium earned by common stocks over long-term U.S. treasury bonds over the past 76 years, about 5.49%. For the beta coefficient, Mr. Copeland used the published estimates of beta coefficients for the same group of comparable companies that he used in his DCF analyses. The median beta coefficient for the comparable utilities is 0.70 yielding a risk premium of 3.84% (5.49% times 0.7). Using the current treasury bond yield of 5.3% as the risk-free interest rate, Mr. Copeland estimated JCP&L's cost of capital at 9.14% (5.3% plus 3.84%). *R-41*, p. 19-20; *R-42,* p. 10-11.

d. Estimated Cost of Equity for JCP&L

Based upon the results set forth above, Mr. Copeland concluded that JCP&L's cost of equity is in the range of 9.0 percent to 10.0 percent, with the CAPM results indicating a cost of equity at the lower end of the range, and the DCF results indicating a cost of equity at the upper end of the range. Mr. Copeland therefore recommended an allowed rate of return at the midpoint, 9.5%, plus a 35 basis point adjustment in recognition of FirstEnergy's highly leveraged financial structure.

The methodology used by Mr. Copeland is consistent with that adopted by the Board in the *UNE Decision.* In that proceeding, Verizon NJ had proposed a 15.0% return on equity based solely upon a DCF analysis of "publicly traded competitor companies." *UNE Decision, R-44,* p. 31. The Ratepayer Advocate in that proceeding recommended a 10% return on equity, based on an average of the results of a DCF analysis and a CAPM analysis. As the Board noted, the Ratepayer Advocate used an average in order to reduce any upward bias in the DCF analysis. *Id.,* at 39. Intervenor AT&T had presented a similar analysis resulting in a 10.24% rate of return. *Id.* The Ratepayer Advocate's analysis was adopted by the Board as "the most reasonable one contained in the record."

Id. Mr. Copeland's analysis in this proceeding similarly relies upon consideration of both his DCF and CAPM analyses. The results of this analysis provide a reasonable return on equity.

3. JCP&L's Proposed 12% Rate of Return is Based on Flawed Applications of the DCF and CAPM Methodologies, and Invalid "Risk Premium" Methodologies, and Includes a Speculative "Flotation Cost" Adjustment.

JCP&L's proposed 12% return on equity should be rejected. This proposal is based on flawed applications of the DCF and CAPM methodologies, and invalid "risk premium" methodologies, all of which substantially overstate the Company's actual cost of equity capital. Further, the proposed rate of return includes a "flotation cost" adjustment based on hypothetical assumptions which are highly unlikely to actually occur. The end result is a proposed return on equity only 20 basis point below the 12.2% return on equity that was allowed in the Company's last base rate case, when interest rates were substantially higher than they are today. The flaws in the Company's cost of equity analyses are discussed in detail below.

a. Improper implementation of constant growth DCF model

For his DCF analysis, Dr. Morin used a simple "constant growth" DCF model. Dr. Morin's DCF analysis substantially overstates the cost of equity capital, for two reasons: (1) his estimated growth rates rely solely upon estimates of earnings growth, ignoring estimated growth rates for dividends and book value per share; and (2) he uses a functional form of the model that overstates the "dividend yield" portion of the DCF calculation.

The most significant defect in Dr. Morin's DCF analysis is his sole reliance on two sources of *earnings* growth projections for his growth rate. *R-41,* p. 20. As noted above, the "constant growth" DCF model assumes that earnings, dividends, and book value per share all grow at the same uniform rate indefinitely. Thus, it is appropriate to rely solely upon earnings projections in applying a constant growth DCF model only if payout ratios are relatively stable and earnings, dividends, and book value per share are all projected to grow at roughly the same rate. *R-41,* p. 20-21. In the current market, in which earnings per share growth rates are higher than dividends per share growth rates, the earnings per share growth rates overstate investors' long-term growth expectations. *R-41,* p. 21*;R-42,* p. 7-8.

In his rebuttal testimony, Dr. Morin argues that the dividend growth rate should be dismissed as an "outlier," because it is lower than the growth rates for retained earnings and book value per share. *JC-6 Rebuttal,* p. 14-15. This argument is without merit. As Dr. Morin acknowledges in his own testimony, projected dividend growth is lower than projected earnings growth not because of some aberration in the data, but because utilities are increasing their earnings retention ratios and thus reducing their dividend payout ratios. *JC-6 Rebuttal,* p. 15*;R-42,* p. 7. As explained by Mr. Copeland during cross-examination, by relying solely on earnings projections in a "constant growth" model, Dr. Morin has, in effect, failed to take account of the reduced value of investors' expected dividend yield in the near term. T176:L19 -T180:L23 (3/3/03). The result is a substantially overstated cost of common equity. *R-41,* p. 21-22.

Another flaw in Dr. Morin's DCF analysis is that he uses a functional form of the model which overstates the "dividend yield" (D/P) portion of the DCF calculation. Dr. Morin calculates the dividend yield by dividing the "next period" dividend by the stock price. *JC-6,* p. 33. This overstates the dividend yield, because it divides expected dividends *a year from now* by the current stock price. *R-42,* p. 6. To properly match earnings, which are an economic "flow," to market value, which is an economic "stock", the flow of dividends should be matched with the average value of the stock that produces the dividend. There are two ways to accomplish this: dividing the dividends for the forthcoming year by the average of today's price and the expected price a year from now, or averaging the current dividend and the projected "next period" dividend and dividing by the current stock price. The latter method was used in Mr. Copeland's DCF analyses. *R-42,* p.

7. Dr. Morin's analysis does nothing to address the mismatch, and thus overstates the dividend yield. *Id.*

b. Improper Implementation of CAPM

Dr. Morin has presented two different forms of the CAPM approach: a traditional CAPM analysis, and an empirical approximation to the CAPM, referred to by Dr. Morin as "ECAPM." Dr. Morin's CAPM analyses substantially overstates the cost of capital for two reasons. First, he used two incorrect methodologies to estimate the market risk premium. The result is a substantial overstatement of the risk premium–7.5% compared to Mr. Copeland's 3.84%. *JC-6, p. 23; R-42,* p. 11. Second, Dr. Morin further overstated the cost of capital in his ECAPM analysis by using the wrong kind of data. *R-41,* p. 24.

c. Overstated risk premium

Dr. Morin's first risk premium estimate is based on the Ibbotson Associate analysis of stock market returns versus long-term bonds. This estimate is based on a simple *arithmetic* mean of the annual return differences between common stocks and long-term treasury bonds. *JC-6,* p. 23;*JC-6 Rebuttal,* p. 23*; R-41,* p. 22. The correct approach for determining a "long-horizon" risk premium is based on a *geometric* mean. *R-41,* p. 22. The difference between the two approaches, and the correctness of the geometric mean, can be seen from a simple example. Suppose an investor invests $1.00, and realizes a return of –50% the first year and +50% the second year, for an ending value of $75. The arithmetic mean is zero:

$$r_a = \tfrac{1}{2}(0.50 - 0.50) = 0.0$$

The geometric mean, defined as the rate which, when compounded, will produce the ending value of $0.75, is -13.4%

$$r_g = (0.75/1.00)^{\frac{1}{2}} - 1 = -0.134$$

As Mr. Copeland explained, "[n]o investor with a portfolio originally worth a dollar and only worth $0.75 two years later would conclude that his or her average return over those two years was zero." *R-41*; p. 31-32. The geometric average correctly determines that the average return was –13.4 percent. As noted in Mr. Copeland's prefiled testimony, Ibbotson Associates' defense of this methodology is internally inconsistent and includes an example which actually proves that the geometric mean is the correct approach. *R-41*, p. 22, 32-33.

Dr. Morin states in his rebuttal testimony that he does not "know" of any textbook or journal article that advocates the use of the geometric mean for the purpose of computing the cost of capital. *JC-6*, p. 24. Mr. Copeland referred to just such an article in his prefiled direct testimony, and a copy was provided to JCP&L in response to a discovery question. *R-41*, p. 22, citing Russell J. Fuller and Kent A. Hickman, "A Note on Estimating the Historical Risk Premium," *Financial Practice and Education*, Fall/Winter 1991, Vol. 1, No. 2, p. 45-48; *R-48*. If Dr. Morin does not "know" of this article it is presumably because he has not thoroughly read Mr. Copeland's testimony or the discovery response. The article very clearly concludes that the geometric mean should be used to calculate the risk premium. *R-48*.

Dr. Morin's second risk premium estimate is based on what he refers to as a "DCF analysis applied to the aggregate equity market …." *JC-6*, p. 23. This appears to be based on a simple "constant growth" DCF model and is thus subject to the same problems described above with respect to Dr. Morin's DCF analysis. *R-41*, p. 23.

d. Improper use of data in ECAPM analysis

The "ECAPM" methodology is based on empirical findings that the CAPM methodology produced downward-biased risk premiums for companies with betas less than 1.00. The ECAPM model compensates for this bias by producing a risk-return relationship that is "flatter" than that produced by the traditional CAPM methodology. *JC-6*, p. 26. Dr. Morin, however, has misused the ECAPM model. The empirical studies upon which the model was based employed "raw" or "unadjusted" betas. However, Dr. Morin has utilized published Value Line betas which are *already adjusted* to compensate for the bias found in the empirical studies. *R-41,* p. 24. In effect, he has double counted the adjustment needed to reflect the results of the empirical studies.

e. Invalid Risk Premium Methodologies

In addition to the improperly applied CAPM analyses described above, Dr. Morin has presented two additional "risk premium" analyses. Neither analysis presents a valid approach to estimating the risk premium.

Dr. Morin's Schedules RAM-2 and RAM-3 present a risk premium analysis comparing returns on electric utility stocks and gas distribution utility stocks to the yield on long-term government bonds. *JC-6,* p. 25-27. These schedules improperly base the long horizon risk premium on an arithmetic average. The result is a substantial overstatement of the risk premium. *R-41,* p. 25.

Dr. Morin's final "risk premium" analysis purports to estimate the cost of equity by comparing the historical risk premiums allowed by regulatory commissions to the contemporaneous levels of long-term Treasury bond yields. *JC-6,* p. 28. Based on this analysis, Dr. Morin concludes that there is an inverse relationship between allowed risk premiums and interest rates–in other words, that risk premiums are higher when interest rates are lower, as in the current market. *JC-6,* p. 29. This analysis should be rejected because it is wrong in concept, and because it is based on an invalid statistical analysis.

Conceptually, the "allowed risk premium" approach assumes that all electric utility companies are comparable in risk and have a constant risk premium over time. This approach also assumes that regulatory commissions do not consider any extraneous factors in determining allowed rates of return. As Mr. Copeland observed, "[n]either of these assumptions is even remotely plausible." *R-41,* p. 26.

Dr. Morin's statistical analysis is invalid, because the data he uses do not meet the conditions for a valid linear regression. One of the necessary conditions for a valid linear regression is that the data be randomly distributed about the fitted line. *R-41,* p. 27. As is clear from the time plot on page 29 of Dr. Morin's direct testimony, this is not the case with the data used for his analysis. Dr. Morin's data points are below the line in the early years shown on the time plot, and above the line in later years. *R-41,* p. 28. Dr. Morin attributes this to competition and restructuring, while Mr. Copeland believes it is due to regulatory lag—but in either event this relationship undermines the validity of Dr. Morin's statistical analysis. *Id.*

f. Improper Flotation Cost Allowance

Finally, Dr. Morin has further inflated his proposed return on equity by adding a 5 percent allowance for "flotation costs." Dr. Morin makes this adjustment to allow for the costs associated with the issuance of common stock. *JC-6,* p. 37. However, Dr. Morin's proposed adjustment is based on purely hypothetical assumptions. As Mr. Copeland explained, the market cost of capital is a forward looking concept. Thus, if the Company can finance its future capital requirements solely through retained earnings, a flotation cost adjustment will merely provide a windfall to shareholders. *R-41,* p. 29-30. Further, Dr. Morin's proposed adjustment substantially overstates any plausible estimate of actual flotation costs. Dr. Morin is proposing an allowance which equates to an annual equity return requirement of $5,937,000. Based on Dr. Morin's theory, this represents 5 percent of the equity capital raised every year through public offerings of common stock. Thus, Dr. Morin implicitly assumes $119.0 million in public stock offerings *every year.* There is no evidence that FirstEnergy has plans to issue *any* common stock on behalf of JCP&L in the foreseeable future, much less the levels implicitly assumed in Dr. Morin's analysis.

Further, the annual equity requirement of $5.937 million equates to a revenue requirement of $8.5 million. This is a substantial burden on ratepayers to reflect a cost which is hypothetical at best. The proposed flotation cost adjustment should be rejected as unfounded.

POINT II. <u>REVENUE REQUIREMENT</u>

THE APPROPRIATE *PRO FORMA* RATE BASE AMOUNTS TO $ 1,914,875,000 WHICH IS $ 138,700,000 LOWER THAN THE *PRO FORMA* 12 + 0 RATE BASE PROPOSED BY JERSEY CENTRAL POWER & LIGHT OF $2,053,575,000.

A. Overview

This section of the brief presents the Ratepayer Advocate's recommended overall position regarding the Company's revenue requirement. In determining the recommended revenue requirement for JCP&L, the Ratepayer Advocate relies upon the recommendations made by its revenue requirement expert, Mr. David Peterson, in addition to recommendations made by several other Ratepayer Advocate expert witnesses. Specifically, the Ratepayer Advocate relies upon the return on equity number recommended by Mr. Basil Copeland, the Ratepayer Advocate's return on equity expert; the recommendations made by Mr. David Nichols regarding certain demand side management ("DSM") costs associated with the Comprehensive Resource Analysis ("CRA") program; the depreciation rate and resulting depreciation expense recommendations made by Mr. Michael J. Majoros, the Ratepayer Advocate's depreciation expert; and the recommendations made by Peter Lanzalotta, regarding management audit expenses.

The Board's First Energy/GPU Merger Order required JCP&L to use the twelve month period ending December 31, 2002 as the test year in this filing.. *Merger Order* at p. 22. The Ratepayer Advocate's expert witness, David Peterson, recommended numerous rate base adjustments in his Direct Testimony in this proceeding. Mr. Peterson's recommended adjustments have been updated to reflect the Company's 12+0 filing.

The Company's proposed *pro forma* rate base is $2,053,575,000. The Ratepayer Advocate has made rate base adjustments totaling $138,700,000, resulting in a *pro forma* rate base of $1,914,875,000. Each of these recommended rate base adjustments are discussed in detail below.

B. Rate Base

1. Cash Working Capital ("CWC")

CWC 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 customers. The Company has performed a lead/lag study which indicates a positive CWC requirement of $218 million. *JC-11*, Sch. MJS-2 (12+0). The Ratepayer Advocate proposes a CWC requirement of approximately $141 million based on Mr. Peterson's recommended adjustments to certain components of the Company's lead/lag study. *R-38* (12+0 Update), p.11-12, Sch. 2, p.2.

a. Lead/Lag Study

In calculating the Company's CWC requirement, Mr Peterson made adjustments to several lead/lag components included in the Company's study. Mr. Peterson recognized, first of all, that JCP&L's inclusion of non-cash expenses in the lead-lag analysis inflated the CWC requirement. *R-38*, p. 9. The improperly included non-cash expenses in JCP&L's lead/lag study are: (1) depreciation expense, (2) amortization expenses, (3) regulatory debits and credits, (4) deferred taxes, (5) tax credits, and (6) JCP&L's common equity return. *Id*. Mr. Peterson testified that a properly conducted lead/lag st udy should *exclude* non-cash expenses and should *include* the expense leads associated with the Company's payment of dividends on preferred stock and interest on long term debt. *Id*.

Furthermore, as noted by Mr. Peterson, the Company only selectively included non-cash expenses in its CWC analysis and did not include deferred expenses in its CWC analysis. *R-38*, p.10. There is no significant difference between deferred charges that are routinely excluded from the Company's CWC calculation and the non-cash expenses that the Company decided to include in its CWC calculation. *Id*. As explained by Mr. Peterson, "[f]or both sets of costs, the cash transaction has already occurred. Neither the deferred charges nor the non-cash expenses require a current cash outlay. Because no periodic cash outlay is required, no investment in working capital is required either." *Id*. Accordingly, the same rationale used in excluding deferred charges from the lead-lag calculation should equally apply to all of the non-cash expenses currently included in JCP&L's CWC requirement. *Id.*

b. Non-Cash Expenses Should Be Excluded From The Company's Lead/Lag Study.

(i) Depreciation

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. The Company's inclusion of depreciation expense in the lead/lag analysis produces a cash basis for plant in service. *R-39*, p. 12. The expenses that relate to depreciation simply do not represent or require cash outlays by the Company during the study period used in the lead/lag analysis. As noted by Mr. Peterson, this erroneous treatment of depreciation expense ignores the fact that there is no cash outlay by the investors during the lead/lag study period. *Id*. "[N]o cash actually passes through anyone's hands when the Company records depreciation expense." *R-39*, p.12.

As noted above, CWC is all about timing. The Company argues that because depreciation reserve is credited at the same time depreciation expense is booked, net plant is thereby reduced and investors no longer earn a return on that portion of the investment. "However, the investor must wait to receive the return of capital cash payment of the depreciation expense in the form of utility revenues, thus creating a CWC requirement to the extent of the revenue lag." *JC-11, Rebuttal*, p.5-6. Mr. Swartz does not consider what happens at the beginning of the construction cycle but instead focuses his attention solely on the timing of the collection of depreciation expenses and when they are recorded and charged against the rate base. Mr. Peterson described the one-sidedness of the Company's reasoning in his surrebuttal testimony:

> For example, the Company records AFUDC and CWIP for plant expenditures made during a given month. Yet, it may take JCP&L 45 days or longer to actually pay the vendors and lenders for the materials and funds used for the construction projects. This revenue "lead" is conveniently ignored in Mr. Swartz's lead/lag analysis, yet it is just as real as his argument for including the depreciation expense.

R-39, p.12.

Mr. Peterson further clarified his analysis on cross:

> The company records AFUDC and [CWIP] on construction work before the time that he actually pays the vendor and the lenders for the funds and materials used for construction. He doesn't recognize any of that in his working capital, yet he wants to recognize the other end of the same transaction after the plant has already been placed in service. So I think his logic on this cash basis for plant and services is faulty and incomplete.

T101:L11-20 (2/26/03).

The Company objected to this testimony complaining that Mr. Peterson was introducing a new issue. After Mr. Peterson explained to the Court that this was not a new issue, that in fact he was just pointing out that the Company had made a CWC adjustment on one end of the construction life span but not the other, this testimony was allowed into evidence.

> Mr. Conway: It was never indicated in any testimony, it is a new issue as to whether AFUDC or [CWIP] does or does not have an impact on non-working (sic) capital.
>
> ALJ Jones: It is not in his direct testimony?
>
> Mr. Conway: No.
>
> ALJ Jones: It is not an adjustment made on a non-cash basis?
>
> Mr. Conway: Not for AFUDC or [CWIP]. There is nothing.
>
> ALJ Jones: Is that true?

The Witness: No. My position is there shouldn't be. They are bringing in the depreciation. I am saying the opposite end of the investment costs, when the construction of that plant took place they didn't recognize the lead –

ALJ Jones: But you didn't make an adjustment.

The Witness: No. My position is that you shouldn't recognize either one of those.

ALJ Jones: Right, because it is a non-cash item.

The Witness: Exactly. It is a non-cash item.

ALJ Jones: This is what you are saying and so – well, he is just simply saying you can't just look at depreciation. You have to look at it at the beginning, AFUDC, [CWIP] is when you are doing a construction basis, so it is not an adjustment, it is allowable.

T102:L16 -T103:L22 (2/26/03).

Because it fails to recognize the revenue lead realized from the construction of the plant, while recognizing the depreciation expense of the plant once in service, Mr. Swartz,'s defective methodology enables JCP&L to essentially have its cake and eat it too. *R-39*, p. 12; T103:L4-16 (2/26/03). This inconsistent treatment is contrary to sound rate-making policy.

Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board recognized depreciation expense for what it is and exclude this non-cash item from the Company's CWC analysis. The Ratepayer Advocate recognizes that its recommended lead/lag study treatment concerning depreciation expenses differs from current Board policy, but it believes that its recommended position is correct and must be accepted. First, the Company has provided no justification for treating non-cash expenses differently than deferred expenses. And second, the Company has recognized depreciation lag and yet has failed to consider the construction lead times. The inconsistency of allowing the Company to put only a portion of the rate base on a cash basis must not continue. The Ratepayer Advocate therefore respectfully request that Your Honor and the

Board reconsider this policy and exclude depreciation expenses from the lead/lag study for purposes of determining the Company's appropriate CWC in this case.

(ii) Deferred Taxes

The Company proposes to include deferred taxes in its CWC requirement because this is how the Company did it in the past. This proposal is contrary to BPU rate making policy. *R-39*, p.12. Deferred taxes that are collected from ratepayers can never create a CWC requirement because no investor cash has ever been paid for them. *R-38*, p.10, *R-39*, p.12. Notably, on cross examination, Mr. Swartz admitted that Board policy directed the exclusion of deferred taxes from the CWC study. T21:L14-19, 24-25; T22:L2 (2/26/03).

> A. I believe deferred taxes usually are, in fact, excluded from the cash working capital study. However, I disagree with that treatment. However, in past JCP&L studies, which my study is based on, deferred taxes were included in the study and assigned a zero lag.
>
> Q. Thank you, but you do agree that the board treatment is generally to exclude them?
>
> A. I believe so.

T21:L18-T22:L1 (2/26/03).

This policy of excluding deferred taxes from the CWC requirement was first established in a Public Service Electric & Gas base rate proceeding, BPU Docket No. ER85121163, and was reiterated in a subsequent rate case involving Elizabethtown Gas Company, Docket GR88121321. The Board in its *Elizabethtown Gas Order*[4] dated February 1, 1990, evaluated the CWC issue:

[4] *I/M/O The Petition Of Elizabethtown Gas Company For Approval Of Increased Base Tariff Rates And Charges For Gas Service And Other Tariff Revision*, Order Adopting In Part And Modifying In Part The Initial Decision BPU Docket No. GR88121321, OAL Docket No. PUC228-89 ("Elizabethtown Gas Order.")

Cash Working Capital

> With respect to deferred taxes, Petitioner recommended including deferred taxes of $1,259,000 as a component of its cash working capital requirements. Petitioner argued that there was a collection lag in recovering deferred taxes because of the deferred tax liability associated with utility plant. Rate Counsel recommended that deferred taxes be excluded from the lead-lag study since deferred taxes are a non-cash item and do not require investor supplied capital.
>
> 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 Public Service 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 Order at p. 7.

The facts considered by the Board in Elizabethtown are identical to the facts in this case. The Company has produced no evidence to the contrary. Therefore, pursuant to the Board's clear policy on this issue, deferred taxes must be excluded from lead/lag studies when determining JCP&L's CWC.

(iii) The Return On Common Equity

Return on common equity does not, and should not, result in a CWC requirement. *R-39*, p.12. The inclusion of a common equity return in the Company's lead/lag study using a zero-day expense lag implies that JCP&L compensates its shareholders on a daily basis. As Mr. Peterson testified, 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. *Id.* The fact that a shareholder receives his or her return through the quarterly payments of dividends, and any gain achieved on the sale of the Company's stock. This is the mechanism by which the common equity shareholder is compensated in the real world.

The Georgia Public Service Commission ("Georgia PSC") recognized this and has held that it is inappropriate to assume that there is a CWC requirement associated with the return on equity.

> It is error to include recognition of an alleged cash working capital requirement associated with a return on common equity. There is no such requirement. Even if one were assumed, an allowance for this has already been made by virtue of how the Commission sets the cost of equity.

Atlantic Gas Light Company, 119 *PUR* 4th 404, 408 (1991).

The Company argues that removing the revenue lag relating to the recovery of the return on equity "will certainly have a negative effect on the price of the Company's stock." *JC-1*, p.4. When asked to explain this at the hearing, Mr. Swartz appeared to be saying that he couldn't really quantify it but he believed that anything that would negatively affect JCP&L's rates would have an adverse impact on FirstEnergy's share price.

> To exclude the return on equity piece from the cash working capital would, in fact, reduce the cash working capital amount that would be in this rate proceeding and will negatively affect the rates that are established. And certainly I would think it would be reasonable to assume that shareholders would rather have rates determined on a higher cash working capital amount, and rightfully so, as opposed to a lower cash working capital amount.

T29:L6-14 (2/26/03)

The Ratepayer Advocate does not believe that vague uncertainties of under compensating FirstEnergy shareholders is adequate support for the inclusion of this non-cash expense in the JCP&L CWC lead/lag study. Mr. Swartz is not a cost of capital expert nor has he provided any support for his argument that FirstEnergy's cost of capital will increase as a result of the Ratepayer Advocate CWC recommendation.

FirstEnergy shareholders are not sent dividend checks on a daily basis and in fact, there is no contractual requirement for FirstEnergy to pay dividends to common equity shareholders even on a quarterly basis. To include this future speculative payment into CWC solely to increase shareholder compensation does a disservice to ratepayers. The Board ensures that shareholders are adequately compensated through the Company's overall rate of return. And, the Board has sufficient evidence from credible cost of capital experts in this case. Mr. Swartz's unsubstantiated testimony should be accorded no weight. As recognized by the Georgia PSC, allowed return should not be inflated through the Company's CWC requirement. Therefore, the Ratepayer Advocate respectfully requests that Your Honor and the Board remove from the lead/lag study the component for return on equity.

c. Long-Term Debt Interest and Preferred Stock Dividends Must Be Recognized in The Company's Working Capital Calculations.

(i) Long-Term Debt Interest

The Company has not recognized the actual lead in the payment of long-term debt interest in its lead/lag study in arriving at its CWC requirement. As the Company actually pays its long-term debt on a semi-annual basis, with an average payment lead of approximately 91 days, this payment lead should be considered in the lead/lag study to determine the Company's appropriate CWC requirement. *R-38*, p.11.

The rates paid by the Company's customers are set to produce, in addition to other amounts, the sums necessary to pay interest expense to bondholders. 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 these funds provided by ratepayers for interest expense payments as working capital during the interim period. 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 these funds collected earlier than needed to pay the Company's interest expense. Shareholders are not entitled to a return on capital which the shareholders have not provided. Accordingly, the actual interest lead should be reflected in the calculation of CWC. *R-38*, p. 11.

There have been several Board decisions holding that long-term debt interest should not be included in a lead/lag study. These precedents hold that a zero (0) day lag should be assigned to long-term debt payments because the return on investment is the property of investors when service is provided. *See I/M/O Atlantic City Electric Company*, BPU Docket No. 8310-883, OAL Docket No. 8543-83 (1984); *I/M/O Public Service Electric and Gas Company*, BPU Docket No. 837-620 (1984). However, this position is inconsistent with the manner in which other cash flow items are handled in a lead/lag study. For example, few would agree that the Company becomes entitled to its revenues on the day that service is provided, or that employees are entitled to their salaries on the day that service to the company is rendered. The lead/lag study examines the actual cash flows, not the incurring of an expense or liability, in determining the Company's CWC requirement. Long term debt interest expense should be treated in a similar manner.

Moreover, commissions in other states, such as the Georgia PSC, have held that it is appropriate to include interest on debt and preferred dividends with appropriate payment lags in a lead/lag study:

> As should be abundantly clear, it is error not to include elements of a lead-lag study the net payments of interest on long-term debts and dividends on preferred stock. These two elements are sources of funds utilized to reduce cash requirements.

Atlantic Gas Light Company, 119 PUR 4th at 408.

The interest payments to be made to the bondholders are fixed by contract. *R-38,* p.11, *R-39*, p.14. To refuse to consider the source of CWC from the interest payment lead penalizes the ratepayers who are providing revenues to pay all expenses, including interest expenses; and provides a "windfall" return to the common stockholders. Curiously, Mr. Swartz does not complain about long term debt pre-payment as he did with common equity. The reason for this is obviously that the Company realizes the undisclosed benefit that its receives by not recording long term debt in CWC. Therefore, the debt interest expenses should be included with the appropriate payment lead in the lead/lag study for purposes of determining the proper CWC requirement.

d. Preferred Stock Dividends

Preferred stock dividends should be afforded the same treatment as long-term debt interest. These are contractual payments, JCP&L is legally obligated to make specified payments on certain dates. In that respect, preferred dividend elements of JCP&L's return resemble other cash operating expenses for which a lead/lag calculation is required. Preferred stock dividends are paid quarterly, resulting in a 45 day expense lead, making it appropriate for inclusion in the Company's lead-lag calculation. *R-38*, p.11.

e. CWC Conclusion

In summary, based on the above described approach and based upon the cash operating expenses and taxes recommended by the Ratepayer Advocate in this case, the Ratepayer Advocate recommends a positive lead/lag study CWC requirement of $141,033,000.

2. Consolidated Income Tax Adjustment.

The revenue requirement adjustments made by JCP&L's witness, Richard F. Preiss, suggests that JCP&L files a separate federal income tax return. *JC-4*, Sch. RFP-2. This determination of revenue requirement, based upon a stand-alone federal income tax methodology, overstates the Company's tax expense. This methodology is incorrect and is inconsistent with Board precedent. *Id*.

JCP&L does not file a federal income tax return. Rather, it joins with the parent and other affiliates in filing a single consolidated tax return. *R-38*, p.12. All of the participants to this consolidated return, including JCP&L, do so in order to immediately recognize the benefit of tax losses generated by affiliated companies. That is because these tax losses can be used to offset positive taxable income of other consolidated group members, including JCP&L, resulting in a reduction in taxes payable. This tax savings must be allocated among all the companies in the consolidated group. JCP&L cannot charge New Jersey ratepayers for taxes not paid, therefore, any tax saving allocated to JCP&L must be flowed through to the benefit of New Jersey ratepayers. This "flow through" should be done to properly reflect the actual taxes paid by the Company. To do less bestows a windfall to the Company's shareholders at the expense of New Jersey ratepayers. *R-38*, p.13.

The use of a consolidated income tax adjustment is not a novel concept. The history of consolidated income tax adjustments in New Jersey has been discussed in numerous cases. The

Board has an established policy that any tax savings allocable to a utility as a result of the filing of consolidated income tax returns must be reflected as a rate base deduction in the utility's base rate filing. *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 Phase II*, BPU Docket No. ER90091090J, (October 20, 1992). For example, in the Board's Decision & Order in *I/M/O Petition Of New Jersey Natural Gas Company For Increased Base Rates And Charges For Gas Service And Other Tariff Revisions: Phase II; Consolidated Taxes*, BRC Docket Nos. GR89030335J and GR90080786J, (Nov. 26, 1991); the Board stated on page 4:

> It has been the Board's long-time policy to adjust operating income to reflect savings resulting from the filing of a consolidated income tax return by a utility's parent company. As early as 1952, the courts recognized that a utility attempting to establish its proper operating income level in a rate proceeding is "entitled to allowance for expense of actual taxes and not for higher taxes which it would have to pay if it filed on a separate basis." *In re New Jersey Power & Light Co. v. P.U.C.*, 9 N.J. 498, 528 (1952). In 1976, the Court affirmed a decision in which the Board indicated that such an adjustment was part of the Board's regular policy, which was made consistently for water and electric holding companies. *New Jersey Bell Telephone Company v. New Jersey Dept. of Public Utilities*, 162 *N.J. Super.* 60 (App. Div. 1978).

The Appellate Division has affirmed the Board's policy of requiring utility rates to reflect consolidated tax savings. *In re Lambertville Water*, 153 *N.J. Super.* 24 (App. Div 1977), *reversed in part on other grounds*, 79 *N.J.* 449 (1979).

The Ratepayer Advocate's witness, Mr. Peterson, recommended applying the rate base adjustment as the appropriate methodology to reflect consolidated income tax savings. *R-38,* p. 16, Sch. 2, p.3. This methodology has been adopted by the Board.[5]

[5] *I/M/O the Petition Of Jersey Central Power & Light Company For Approval Of Increased Base Tariff Rates And Charges For Electric Service And Other Tariff Modifications*, Final Decision and Order Accepting in Part and Modifying in Part the Initial Decision, BRC Docket No. ER91121820J, (February 25, 1993),("*I/M/O Petition of JCP&L*").

> [The Board] ADOPTS the position of Staff that the rate base adjustment is a more appropriate methodology for the reflection of consolidated tax savings. The rate base approach properly compensates ratepayers for the time value of money that is essentially lent cost-free to the holding companies in the form of tax advantages used currently and is consistent with our recent Atlantic Electric decision (Docket No. ER90091090J).

Clearly, the methodology used by Mr. Peterson is consistent with current Board policy. This methodology results in a sharing of tax benefits between the corporation's stockholders and utility ratepayers. This is so because there is a rate base deduction reflecting the cumulative tax savings which result in ratepayers being credited for the time value of money, as well as the carrying costs on these savings resulting from current use of tax losses. The rate base approach allows for future adjustments, as losses turn to positives, yet acknowledges the proper compensation to ratepayers for the time value of money essentially lent free of cost to the Company.

In *Lambertville Water, supra*, at page 28, the Court stated:

> If Lambertville is part of a conglomerate of regulated and unregulated companies which profits by consequential tax benefits from Lambertville's contributions, the utility consumers are entitled to have the computation of those benefits reflected in their utility rates.

In order to properly reflect the consolidated income tax benefits allocable to the Company, Mr. Peterson traced these benefits from to 1991 through to 2000. *R-38*, p. 16. In *I/M/O Atlantic Electric, supra*, the Board stated on page 8, "it is our judgment that the appropriate consolidated tax adjustment in this proceeding is to reflect as a rate base deduction the total of the 1991 consolidated tax savings benefits, and one-half of the tax benefits realized from AEI's 1990 consolidated tax filing." The Board further stated that, "[t]his finding reflects a balancing of the interests to reflect the unique period of uncertainty during the period 1987-1991." Additionally, the Board reaffirmed this position in its Decision & Order in *I/M/O the Petition of JCP&L, supra*, p. 8. The Board stated, "in order to maintain consistency with the methodology applied in the *Atlantic* decision, . . . a rate base adjustment which reflects consolidated tax savings from 1990 forward, including one-half of the 1990 savings, is appropriate in this case."

The Ratepayer Advocate's witness, Mr. Peterson, reviewed the taxable income of the consolidated group members from 1991 through 2000. Mr. Peterson apportioned the losses to JCP&L based on its contribution to positive taxable income over the same time period. *R-38* Sch. 2, p.3. Thus, based upon the well established Board policy regarding consolidated income tax savings, Mr. Peterson recommended a rate base deduction of $61,140,358. *Id.*

In rebuttal testimony, JCP&L witnesses Mr. Filippone and Mr. Petty argue that Mr. Peterson's consolidated income tax benefit analysis is flawed because Mr. Peterson fails to take into account that in some years, the non-regulated affiliates were profitable as a whole. *JC-3 Rebuttal*, p. 4, *JC-18*, p. 4. However, on cross examination, Mr. Filippone admitted that Mr. Peterson did in fact take into consideration the taxable gains of non-regulated companies in calculating the allocation of taxable losses which reduced tax savings for JCP&L. T14-15 (2/25/03), *R-38* Sch. 2, p.3.

Mr. Filippone and Mr. Petty further argue that for the period analyzed by Mr. Peterson (1991-2000), GPU's non-regulated businesses had a cumulative net positive taxable income in excess of $57 million and therefore were able to utilize all the tax losses of the consolidated group without the regulated companies' income. *JC-3 Rebuttal* at 4-5, *JC-18* at 2-3, Sch. LFP-1.[6] And yet, as illustrated by Mr. Petty's testimony, during the period of 1991 to 2000, the unregulated taxable income did not exceed the tax losses of the regulated company in every year. *JC-18*, Sch. LFP-1, page 2. This basically means that without JCP&L's positive taxable income, the consolidated entity would be unable to realize the tax benefits of the taxable losses in the year in which they occurred. T19:L10-17 (2/25/03).

[6] Although of the belief that JCP&L is not entitled to any tax benefits, Mr. Petty testified that the only possible benefit received by GPU's non-regulated affiliates from 1991 through 1999 was a temporary acceleration of the receipt of tax benefits. *JC-18* at 4.

There are two important reasons why Your Honor and the Board should reject all of the scenarios and conclusions regarding consolidated income taxes contained in the rebuttal testimony of Mr. Filippone and Mr. Petty. First, as Mr. Peterson accurately states in his surrebuttal testimony, the cumulative net taxable income of unregulated companies over the 1991 to 2000 period is not relevant to the issue of consolidated tax savings. *R-39*, p. 2. As previously explained by Mr. Peterson, the main reason companies file consolidated tax returns is so the consolidated entity can offset taxable income with tax losses *in the current year*, not over a nine year period. While it is entirely possible for an affiliate to have a tax loss in one year and a positive taxable income in future years, a company filing a separate tax return may have to wait several years in order to reap the tax benefits of the losses. If that company filed a consolidated return, however, the consolidated entity would realize the economic value of the tax losses in the current tax year. *Id.*

Second, the Company's witnesses incorrectly assume, without explanation, that if the unregulated affiliates have ample taxable income to absorb the tax losses of other affiliates, then the regulated affiliates are not entitled to a share in those benefits. *JC-18, p.2*. This assumption is without basis and unfair to ratepayers. As Mr. Peterson explains in his surrebuttal testimony, "[a]ll affiliates having positive taxable income, whether regulated or not, share an entitlement to the benefit the whole system receives from affiliate tax losses." *R-39, p.2*. In fact, Mr. Peterson's analysis reflects a ratable sharing of the tax savings between regulated and non-regulated companies that produced positive taxable income in each year. *Id*. Sch. 3, p. 3.

Mr. Petty's *pro forma* adjustments significantly reduced the consolidated income tax benefits attributable to JCP&L from the $61.1 million recommended by Mr. Peterson to $2.3 million. *JC-18*, Sch. LFP-2. This analysis reflects the inappropriate assumptions discussed above and is inequitable to JCP&L's ratepayers. In addition, Mr. Petty's analysis "carries forward" unused tax losses in the line labeled "Cumulative Unregulated Tax Loss." This is an incorrect treatment of tax losses which are usually absorbed in the current year by taxable income generated by other affiliates. *R-39*, p. 3. Contrary to Mr. Petty's analysis, there is no carry forward of the benefit. Therefore, Mr. Petty's calculation of the tax rate base adjustment is flawed and should not be relied upon by Your Honor and the Board. The Ratepayer Advocate's proposed rate base adjustment not only reflects a ratable allocation of tax benefits among regulated and non-regulated companies with positive taxable incomes, but is also consistent with Board policy.

Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board reduce the Company's proposed rate base by approximately $61.1 million in order to accurately reflect JCP&L's accumulated share of the consolidated tax benefit. *Id.*, p. 16, Sch. 2, p.3.

3. Summary of Rate Base

The Ratepayer Advocate recommends a total reduction in the Company's proposed rate base of $138,700,000 resulting in a *pro forma* rate base for the Company of $1,914,875. *R-38*, Sch. 2, p. 1 (12+0 Update). This amount is made up of the recommended adjustments to CWC and the adjustment for the appropriate treatment of the Company's Consolidated Tax filing. The Ratepayer Advocate's recommended Lead/Lag Study CWC adjustments to reduce the Company's CWC Requirement by $77.560 million. *R-38*, Sch. 2, p.2 (12+0 Update). And, the Ratepayer Advocate's recommended adjustment to Consolidated Tax Savings which total $61,140,358. *R-38*, Sch.2, p.3 (12+0 Update).

C. Operating Income

THE APPROPRIATE *PRO FORMA* OPERATING INCOME AMOUNTS TO $303,243,000 WHICH REPRESENTS A $72,318,000 INCREASE OVER THE COMPANY'S PROPOSED *PRO FORMA* OPERATING INCOME OF $230,925,000.

1. Revenue Adjustments

a. Revenue Annualization

(i) Weather Normalization

The Company in its initial filing used a fully forecasted revenue amount. In the Company's 12 + 0 update, test year actual revenues were adjusted for normal weather.

(ii) Company's Adjustment to Depreciation Expense

The Board has a long-standing well-established policy for using test year-end rate base.[7] With no corresponding adjustment to the income statement, there is a mismatch between the investment base (that is, rate base) and the income statement (revenues and expenses) for the test period. This is because the income statement reflects revenues and expenses incurred throughout the whole test year, while the rate base is valued on the last day of the test year. *R-39*, p. 3.

Company witness Preiss contended that his adjustment to annualize the test year depreciation expense was necessary to properly match the depreciation expense with his proposed year end rate base. Mr. Preiss acknowledges that "other than depreciation expense, JCP&L has not annualized expenses to year-end levels" and fails to explain why only this one adjustment is appropriate. *JC-4*, Rebuttal p. 1. He merely argues that the Company has attempted to "reflect the depreciation on the year end rate base" in order "to match the asset portion of the revenue requirements to the depreciation on that asset, with the asset itself, which is the rate base in terms of timing." T62:L14-23 (2/25/03).

The Company, by its actions, has failed to recognize the matching principle, a pervasive accounting principle which states that, in order to correctly assess earnings, revenues and expenses from the same period must be compared and revenues from one period and expenses from another cannot be compared. By incorporating depreciation expenses, the Company has considered only

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[7] *See In Re: Elizabethtown Water Company Rate Case*, Decision on Motion, BPU Docket No. WR8504330, May 23, 1985.

one side of the revenue/expense equation. As discussed below, Mr. Peterson's revenue adjustment incorporates the other side of the equation.

(iii) Customer Growth Must Be Annualized in Order to Properly Assess the Company Revenue Requirement

Since JCP&L's rate base and expenses have been annualized to year-end levels, consistency and the test period matching principle require that revenues also be restated to the year-end level. *R-38*, p. 17. In particular, the failure to annualize the customer growth that occurred during the test year distorts the measurement of the income producing capability of the underlying utility assets and overstates JCP&L's revenue requirement. *Id.*

Ratepayer Advocate witness David Peterson adjusted the Company test year revenues upward by $4.684 million. *R-38*, Exhibit DEP-1, Schedule 3, page 3 of 9, (12+0). This is because over the past few years, the number of residential customers has grown approximately 0.6% over the average number, and the number of commercial customers has grown approximately 0.9% over the average. *R-38*, p. 18. This revenue adjustment is necessary to properly match another element of the income statement with the Company's proposed year-end rate base. *R-39*, p. 4.

Company witness Preiss argues, first of all, that Mr. Peterson has not accounted for any increased expenses associated with customer growth. As Mr. Preiss well knows, without some support or documentation for these alleged increases, they cannot be included in the Company's revenue requirement. If revenues and expenses could be determined solely on the Company's unsubstantiated claims, there would be no need for a rate case.

Secondly, the Company complains that Mr. Peterson has not accounted for industrial customer erosion. However, as Mr. Peterson explained at the evidentiary hearings, such an adjustment is not appropriate.

> When I do year-end revenue annualizations for states or jurisdictions that have year-end rate bases, I typically don't include the industrial customers because, as you can see, there are significantly fewer of those customers, and those loads are very unique and diverse and often very large. What I prefer to do with those customers, if there is a known loss of a customer or a significant change in a customer's load or expected change in customers, either higher or lower, recognize that change explicitly rather than using the average annual approach that I did for residential and commercial. And, in fact, I would recommend doing that regardless of whether we're using an annual rate base or average rate base. If there is a significant change in your industrial load that those customers are so unique that you can't average, that you should recognize that effect, if there is one, in a separate adjustment rather than in a revenue annualization adjustment. That is why I didn't propose a separate adjustment for industrials in this case. T207-208:L21-19 (2/26/03).

Accordingly, the Ratepayer Advocate urges Your Honor and the Board to adjust the test year revenues upward by $4.684 million in order to account for the customer growth that the Company has enjoyed in the past and will continue to do so.

b. Your Honor and the Board Should Reject the Company's Proposed Adjustment to Test Year Revenues to "Annualize" Lost Revenues from New Energy Efficiency Programs.

Introduction

The Company is seeking cost recovery for its energy efficiency and renewable energy costs through two different recovery schemes. First, JCP&L requests approval for costs to be recovered through the Societal Benefits Charge. These costs include the costs of "legacy"energy efficiency programs that were established pursuant to demand side management ("DSM") regulations issued by the Board prior to the enactment of EDECA. These costs are trued up for the period from 1996-2002, and include program costs, performance incentives, and lost revenue recovery to which JCP&L is entitled in accordance with the DSM regulations. *R-69*, p. 3. "Lost revenues" refer to the revenue that is lost when energy efficiency programs reduce sales, net of corresponding reductions in the utility's variable costs. *R-69*, p. 5. In addition to "legacy" costs program, the Company's proposed SBC includes the costs of energy efficiency and renewable energy measures established as part of the Board's Clean Energy Program created pursuant to EDECA (formerly known as the Comprehensive Resource Analysis, or "CRA," program). The Clean Energy Program costs included in the SBC are limited to actual program costs, and do not include performance incentives or lost revenues. R-69, p. 4. The Ratepayer Advocate does not object to the Company recovery of these costs through the SBC.

However, the Company has also proposed a novel adjustment, by which it seeks to account for lost revenues from the new energy efficiency programs through an adjustment to test year revenues. The Board has never permitted this type of embedded recovery of lost revenues through base rates therefore Your Honor and the Board should reject this proposal. Not only is the adjustment to test year revenues an inappropriate vehicle by which to recover "lost revenues," but the Board also has yet to determine a methodology by which JCP&L and other energy utilities should estimate the amounts of the "lost revenues," if any, resulting from the new energy efficiency programs.

Background

A brief review of the history of JCP&L's energy efficiency and renewable energy programs will be helpful in placing the Company's various claims for "lost revenues" in context.

In the 1980's, the New Jersey electric and gas utilities implemented programs known as demand side management, or "DSM," programs. These programs were designed to establish and maintain cost-effective energy efficiency technologies by providing financial incentives for customers and energy efficiency contractors to install energy-saving technologies such as insulation, high-efficiency lighting, appliances, and heating and cooling equipment. The Board's DSM regulations permitted the utilities to fund these DSM programs, including lost revenue recovery, via monies collected from ratepayers through an adjustment clause mechanism. These pre-EDECA programs are often referred to as "legacy" programs.

With the enactment of EDECA, the Board was directed to undertake a comprehensive review of the utilities' existing energy efficiency programs, to determine the appropriate level of ratepayer funding for energy efficiency measures, and to establish the appropriate funding levels for new programs to promote the development of renewable energy sources such as wind, solar, and biomass. This process was the Comprehensive Resource Analysis program, known as "CRA." In its *March 9, 2001* Order[8], the Board decided the specific CRA programs and budgets to be implemented by the utilities through the end of 2003. The Board determined which energy efficiency programs should continue, and also included guidelines for the establishment of renewable energy programs for the first time.

[8] *I/M/O the Petition of the Filings of the Comprehensive Resource Analysis of Energy Programs Pursuant to Section 12 of the Electric Discount and Energy Competition Act of 1999*, BPU Docket No. EX99050347 (Generic) *et al*., (Final Decision and Order March 9, 2001) ("*March 9, 2001 Order*").

The *March 9, 2001 Order* specifically addressed the recoverability of lost revenues that JCP&L now claims resulted from its new programs. In that Order, the Board adopted the Utilities/National Resources Defense Council stipulation, which allowed lost revenue recovery for new energy efficiency programs, but not for renewable energy programs. This recovery would not be included as a new program cost, and would only be in effect through 2003. *March 9, 2001 Order* at 73. The Ratepayer Advocate was not a party to this stipulation. This office had proposed a stipulation that allowed no lost revenue recovery for new programs at all. However, the Board chose to adopt the Utilities/NRDC Stipulation, meanwhile noting that:

> Lost revenue recovery and incentives were allowed under the DSM regulations only for programs with measured and verified savings. The amount of fixed cost revenue erosion resulting from energy efficiency measures can be significant and it is therefore important for the calculation of these costs to be accurate. This need for accuracy is the reason the Board was historically unwilling to allow the recovery of lost revenues for programs that did not have verified, measured savings." *Id*.

The Board also directed that "any continued recovery beyond 2001 for legacy program lost revenues shall decline to 80% in 2002 and 70% in 2003." *Id.* at 74. No lost revenue recovery would be available for renewable energy programs. Additionally, recovery for lost revenues that were a result of new programs would be subject to the approval of the calculation methodology by the Board "prior to their eligibility for collection of lost revenues". *Id*. at 77.

The Company May Not Recover Lost Revenues Through an Adjustment to Test Year Revenues..

JCP&L's proposed "lost revenue" adjustment should be rejected as a matter of principle. As Ratepayer Advocate witness Dr. David Nichols explained in his pre-filed direct testimony, calendar year 2002 is the test year for this base rate proceeding. *RA-69*, p. 6. Electricity savings from the Company energy efficiency programs will, of course, be reflected in the final actual retail sales revenues for the year. *Id*. In effect, the Company's proposed adjustment incorporates a level of lost revenues in its proposed base rates. The Board has never allowed this type of recovery of embedded costs through base rates.

The Board Has Mandated That No "Lost Revenues" Are Recoverable Until the Board Has Issued Its Decision Regarding Energy Savings Protocols

In its *March 9, 2001 Order* , the Board was clear that it did not undertake lightly the task of allowing recovery for new energy efficiency programs, including "lost revenue" recovery. The Board was equally clear that it was going to be the sole arbiter for determining the methodology of determining energy savings (usually referred to as the protocols). Unequivocally, the Board states in its Findings that, "[t]he program evaluation plans for determining energy savings must still be approved by the Board, <u>prior to eligibility for collection of lost revenues</u> for the new energy efficiency programs." *Id*. at 77. (Emphasis added). The language is specific and clear. There can be no recovery of lost revenues without Board approval of the protocols by which lost revenues will be established.

The Board clearly states in its *March 9, 2001 Order* that it intends to carefully review the calculation of these evaluation mechanisms. The Order states, "[t]his need for accuracy is the reason the Board was historically unwilling to allow the recovery of lost revenues for programs that did not have verified, measured savings….[t]he Board wished to ensure that continued lost revenue recovery is based on accurate savings data." The Board also directed the continued decrease in collection of lost revenues for legacy programs "to protect ratepayers from paying too much." Ratepayer protection is also why the Board correctly insists that, "the basis for determining the collection of lost revenues for the new energy efficiency programs must still be approved by the Board." The Board did not state that protocols could be implemented and after the fact the Board would examine them. The Board wisely insists that the recovery methods (or protocols) must be approved before the ratepayers begin to pay for alleged lost revenues.

Company witness Siebens correctly states that the case of the approval of the protocols "is still pending before the board." T15:L8 (3/7/03). "Pending" means that the protocols have not yet been approved, and at this point neither we nor anybody else knows what or how much the Board may approve. Until this is determined, there should simply be no lost revenue recovery. Ratepayers should not be made to pay in advance for lost revenues that the Board may or may not approve for recovery. To do so would benefit the Company shareholders at the expense of ratepayers.

Moreover, the Ratepayer Advocate has presented evidence demonstrating that the Board's caution is well justified. Dr. Nichols has identified a number of JCP&L protocols which, as presently proposed, significantly over-estimate annual energy savings. Lost revenue calculations are based on estimated energy savings. To the degree that energy savings are over-estimated, so will be lost revenues. *R-69*, p. 10, Schedule DN-1. In Schedule DN-1, Ratepayer Advocate witness Dr. David Nichols provides some examples of the problems with the utilities' proposed protocols.[9]

Dr. Nichols explained his particular concerns about the protocols after initially noting that JCP&L has a long history in the area of DSM, noting that the Company was one of the first leaders in the field, promoting efficient lighting more than twenty years ago. T50:L1-4 (3/7/03). With respect to electricity savings and "lost revenues" from commercial lighting programs, Dr. Nichols notes that development in the marketplace and the spread of information indicate that there would be "some level of efficient lighting that would take place even if there were no utility program." *Id.* at L6-15. In other words, using a baseline measurement of no efficient lighting installed is simply not accurate. Yet that is exactly what the utilities' measurement protocols used by JCP&L assume for all existing facilities that participate in DSM programs. Indeed, Dr. Nichols notes that in parts

[9] Dr. Nichols addressed programs and key issues that figure explicitly in JCP&L's calculation of lost revenues as shown in Schedule MJF-6.

of the country where no utility DSM programs exist, there are still customers who purchase efficient lighting. *Id.* at L17-18.

To determine if the Company's commercial lighting programs have made a *net* impact, producing savings *above and beyond* the efficiency improvements occurring in the market anyway, a field study such as a market evaluation or market assessment must be conducted. However, Mr. Siebens stated that the Company has not yet used this tool to determine the accuracy of its "protocol" estimates of electricity savings. Accordingly, there is no way to know if the protocols have adequately estimated the energy savings from the CRA programs. T50-51, L19-2 (3/7/03). In any event it is unrealistic to assume, as do the protocols, that not even a single customer would choose efficient lighting for an existing facility were it not for the utility CRA programs.

Dr. Nichols' rebuttal testimony notes that the JCP&L CRA program of efficient lighting in new facilities contains many installation measures that happen frequently on a statewide basis. T52:L8-12 (3/7/03). Some of them are addressed in Ratepayer Advocate Exhibit R-71, which is a baseline study that was done in order to establish what was actually happening in New Jersey with regard to efficient lighting in renovation and new construction. Dr. Nichols notes that, while the JCP&L savings measurement protocol assumes that efficiency lighting in new construction is 30% more efficient than standard, "the [protocol] standard for at least half of the year seems to have been ASHRAE 90.1 1989, which is an old standard, not a state-of-the-art standard. So [Dr. Nichols] remain[s] persuaded that there is some level of free ridership, and that lost revenues are being overestimated simply by applying the protocols in their present form." T52:L13-23 (3/7/03).

The same rationale applies to the measurement protocols applied to estimate savings from efficent residential central air conditioners. The Company claims that the least efficient air conditioning unit on the market the "predominant" unit bought. But unless <u>every single customer</u> who purchases an air conditioning unit would buy the least expensive but also the least efficient unit, the baseline for the protocol should not be the least efficient unit, as it is rather, it should be something above that. Again, without a market assessment, it is impossible to determine the accuracy of the estimates upon which the protocols are based. By assuming the least efficient unit is the baseline, "we are making a generous estimate about how much is being saved." Indeed, Dr. Nichols notes that, when we are talking about lost revenues that will affect the revenue calculation, "we should be making the most cautious estimates possible, and that is not what these protocols do." T53-54: L24-7 (3/7/03).

Company witness Mr. Siebens responded in his rebuttal to Dr. Nichols' criticism of the protocols by stating that, "the protocols proposed by the utilities do not exaggerate impacts in the aggregate. Of course, JCP&L welcomes the opportunity to further discuss the protocols themselves, within the context of the CRA hearing." *JC-16*, p. 3.

However, the Company has already had the opportunity to discuss the protocols, and Dr. Nichols expressed his frustration and concerns regarding the lack of cooperation on the part of all the utilities, including JCP&L, regarding the establishment of the protocols in his testimony at the March 7, 2003 hearing:

> There was a meeting of the parties in the CRA proceeding in October of 2001 where I, and the utilities were present, JCP&L, Public Service and the others, where I detailed measure by measure my concerns with these protocols. There was a consultant to the utilities from out of town, another out-of-town consultant who was present, who was responsible for the protocols. And my understanding was that he was going to take my detailed measure-by-measure criticisms and go out and do some re-working of the protocols. T48:L8-18 (3/7/03).

Dr. Nichols concluded that he continues to have the same concerns about the overstatement of lost revenues as he did in 2001, for the "the protocols in their form as submitted are being used to calculate the lost revenues." T48:L19-24 (3/7/03). Morever, the Company is willing to address the accuracy of the protocols in some future CRA proceedings and yet expects Your Honor and the Board to address the recovery lost revenues based on these protocols in this proceeding.

Conclusion

Thus, the Ratepayer Advocate urges Your Honor and the Board to disallow inclusion of "lost revenues" into base rates. This adjustment violates the Board's March 1, 2001Order which specifically requires Board approval of protocols for establishing lost revenues resulting from new energy efficiency programs before such lost revenues could be collected in rates. Further, the inclusion of lost revenues in base rates is improper as a matter of principle.

For the abovementioned reasons, the Ratepayer Advocate respectfully requests that Your Honor and the Board disallow the recovery of the Company's alleged annualized revenues for new CRA programs.

2. Expense Adjustments

a. Advertising Expenses

The Company claims that it spent $958,000 on public relations, image building, and Other advertising expenses during the test year. $605,000 of this amount was spent to reintroduce "the Jersey Central Power & Light name to customers and to underscore our renewed commitment to reliable service." *R-38*, p. 32. New Jersey ratepayers should not be held responsible for the costs of the Company re-building its reputation after several years of inadequate service reliability that has resulted in class-action litigation. By making the ratepayers accountable for this latest round of image enhancement, the ratepayers are unreasonably burdened for a second time. First, their power went out, and now they pay for the privilege of hearing the Company's "renewed commitment" to keeping the lights on – a commitment that should have never wavered in the first place.

Neither should it be the responsibility of ratepayers to pay for JCP&L's promises to its customers to meet customer service obligations. Accordingly, public relations, image rebuilding and "other" expenses should not be collected from ratepayers. The Ratepayer Advocate's position on this issue is consistent with Board precedent. *I/M/O Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Other Charges for Electric Service and Other Tariff Revisions*, BRC Docket No. ER91121820J (June 15, 1993). JCP&L's last rate case, the Board unequivocally excluded promotional, institutional and public relations advertising expenditures from being recovered from ratepayers.

Accordingly, not only should Your Honor and the Board deny JCP&L recovery for these public relations expenses because of precedent, but because the ratepayers should not be forced to pay for the healing of the Company's self-inflicted wounded reputation. As such, all public relations and image enhancement advertising costs should be excluded from JCP&L's revenue requirement.

b. BPU/RPA Assessments

Ratepayer Advocate witness David Peterson has recommended two adjustments to the Company's claimed BPU and RPA assessments. First, Mr. Peterson incorporated an assessment allowance on the additional revenue calculated for the year end revenue annualization, discussed above. He then replaces JCP&L's speculative assessment rates with the actual 2002 assessment rates.

As an additional adjustment, Mr. Peterson included the RPA and BPU assessment rates in his calculation of the revenue conversion factor. (DEP-1, Sch. 1, p.2). By failing to include the revenue tax effect of the BPU and RPA assessments into the revenue requirement calculation, the company has understated the amount by which its current revenues are excessive.

The Company failed to address this issue in its rebuttal testimony and in its updated filings did not recognize that when rates are reduced at the end of this proceeding, the BPU and RPA revenue tax amounts would also decline, because tax is proportional to total revenue. It was only at the hearing that the Company witness Mr. Preiss rejected this adjustment, explaining that the adjustment had not been made in prior years. T70:L2-10 (2/25/03). However, Mr. Preiss agreed that if JCP&L's revenues decrease as a result of the rate case, the Company would not be taxed on those revenues that were not received. T71:L19-22 (2/25/03).

Accordingly, as the RPA and BPU assessments will decline consequent to the reduction in revenue, it is necessary to reflect that reduction in the revenue requirement calculation.

c. Charitable Contributions

In July, 2001, the New Jersey Supreme Court held that "no portion of a utility's charitable contributions may be subsidized by the utility's captive ratepayers." *I/M/O Petition of New Jersey American Water Company, Inc., for an Increase in Rates for Water and Sewer Service and Other Tariff Modifications*, 169 N.J. 181, 184 (July 25, 2001). The Court reasoned that first of all, "on general fairness grounds, ratepayers should not be forced to pay additional amounts for charitable purposes at the hand of a regulated monopoly." *Id.* at 193. Secondly, because these donations are discretionary, "they are more appropriately borne by the entity's shareholders, not its captive ratepayers." *Id.* at 194. The Court concluded:

> In the last analysis, this case implicates equitable principles far more significant to ratepayers than the extra cents reflected on their water bills. Beyond those mere monetary amounts, the Court also must consider the inherent unfairness to the rate-paying public that results from treating a utility's charitable contributions as an operating expense. As recognized by other courts that have set aside such characterizations, forcing captive ratepayers to finance a utility's charitable contributions is inequitable because those costs are more appropriately borne by shareholders. Shareholders have the option of selling their shares if they are unhappy with the utility's charitable contributions or if they disapprove of the recipients of the money.
>
> In contrast, ratepayers have little recourse if they disagree with the beneficiaries of a utility's largesse. Moreover, a

> charitable contribution involves numerous personal choices, namely, whether to make it in the first instance and, if so, to whom and in what amount. Requiring ratepayers to subsidize such contributions under those circumstances is unreasonable. We also agree with those courts that have concluded that charitable giving itself is unrelated to a utility's core function.

Id. at 195.

And yet, despite this clear language, the Company has included in its revenue requirement a $752,000 allowance for charitable contributions. *JC-4,* Schedule RFP-2 (12+0), p. 4 of 29.

The Company attempts to justify the inclusion of these donations because they "are clearly consistent with the interests of our customers and the communities in which they live." *JC-4 Rebuttal*, p. 4. Mr. Preiss cites donations to United Way, youth programs, scholarship funds, American Red Cross and local police, fire and emergency services as recipients of FirstEnergy largesse. *JC-4, Rebuttal,* p. 4. What the Company does not recognize is that these are the very same types of charitable donations that New Jersey American Water attempted to justify as "an important element of its responsibility to the communities it serves." *New Jersey American Water*, 169 N.J. at 185**.** The Court noted the "number of worthy beneficiaries, i.e. fire departments, schools, churches, and medical organizations" but was not "persuaded that a contribution to those donees enables the utility to furnish safe, adequate and proper service." *Id*. Thus, the New Jersey Supreme Court has already reviewed and rejected JCP&L's argument, finding an insufficient nexus between a utility's charitable contributions and any claimed benefit to ratepayers.

Accordingly, Your Honor and the Board should not allow any of the Company's claimed $752,000[10] in charitable contributions to be recovered from ratepayers.

[10] Almost $128,000 of the charitable contributions that JCP&L is claiming are contributions made by FirstEnergy Corporation rather than through the FirstEnergy Foundation.

d. Depreciation Expense

Ratepayer Advocate witness Michael Majoros recommended certain adjustments to the Company's depreciation accrual rates which are discussed in detail in Point III. Applying Mr. Majoros's recommended accrual rates to JCP&L's year-end plant balances reduces the Company's proposed depreciation expense allowance by $37,701,000.

e. Management Audit Expense

As discussed in detail in Point IV. C., the Ratepayer Advocate recommends that Your Honor and the Board disallow all costs associated with the Phase III outage investigation conducted by Schumacher & Company and the Stone & Webster reliability audits. Had it not been for the Company's imprudent actions, these expensive remedial proceedings would not have been necessary. This adjustment reduces JCP&L's proposed management audit amortization allowance by $148,000.

f. Merger Costs

JCP&L has included merger related costs totaling $42.7 million in its revenue requirement study. This $42.7 million contains $7.677 million of merger costs incurred during the test period and an additional $32.019 million represents merger costs incurred in the pre-test years of 2000 and 2001**.** *JC-4* Sch. RFP-2 (12+0), p. 9. The recognition of **any** merger related costs in JCP&L's rate proceeding is in direct contravention with the Board's Merger Order and the Stipulation signed by the parties in that proceeding. *R-38*, p. 22.

When GPU Energy, JCP&L and FirstEnergy Corp. sought Board approval of the merger, the amount of merger savings that would be passed on to ratepayers and the amount of merger costs that would be included in rates were intensely contested issues. *See I/M/O the Joint Petition of FirstEnergy Corp. and Jersey Central Power & Light Company, d/b/a GPU Energy for Approval* *of a Change in Ownership and Acquisition of Control of a New Jersey Public Utility and Other Relief, BPU Docket No. EM00110870, Order of Approval, (Oct. 9, 2001)***.** The parties involved in the Merger proceeding arrived at a settlement and subsequently signed a Stipulation which allocated $300 million of net merger savings to JCP&L ratepayers to reduce JCP&L's deferred balance upon completion of the merger. Similarly, the Company's shareholders were allocated a portion of the net merger savings. In addition, the Board allowed JCP&L to recover certain costs associated with the merger. Those costs were recognized in the net merger savings calculation. *R-38*, p. 22.

The Board's Merger Order specifically excluded certain merger transaction related costs from any ratepayer recovery. The excluded costs include: 1) consultant fees (financial, accounting, tax etc.); (2) investment bankers fees; (3) legal; (4) shareholder meeting/proxy; (5) commission filing fees; (6) executive separation costs; and (7) facilities, transportation and employee related costs. *See* Exhibit 1 of Stipulation Agreement. All other merger costs were considered at the time of the settlement and recognized in the calculation of the settlement amount.

JCP&L should not be allowed to recover merger costs in this proceeding. To do so would violate the express directives of the Stipulation and Board Order in the Merger proceeding. The Stipulation provided that all merger-related costs were used to reduce the gross savings estimate in developing the net savings amount. In fact, JCP&L acknowledged in discovery response RAR-RR-47 that the merger related expenses for which it seeks recovery were contemplated at the time of the merger Stipulation:

> The category of costs included in Normalization Adjustment No. 8 were all contemplated at the time of the Merger Stipulation. The category of costs included Incremental IT, Equipment, Relocation, Severance, Outside Services, and Miscellaneous.

R-38 (attachment)

As Mr. Peterson correctly points out in his direct testimony, the recognition of any further merger related costs will result in double counting because these costs have already been used to reduce the gross savings estimate used as the basis for the $300 million net merger savings allocated to ratepayers. *R-38*, p. 22. Mr. Peterson further testified on this very point during the hearings:

> Merger cost treatment, the ratepayer advocate, Jersey Central,. GPU, First Energy, and all the participants in the merger proceeding signed a stipulation that JCP&L would not ask for or seek recovery of merger costs in the rates. Well, the $300 million that was agreed to by the parties in that settlement was a net of cost amount, that is, all costs were already considered when the $300 million offer was accepted.

T97:4-13 (2/26/03)

Upon cross examination, Mr. Peterson reiterated his well reasoned conclusion that all costs associated with the merger that the Company was entitled to have been fully addressed by the merger proceedings.

> Q: I mean, if in the test year all savings are flowed directly to the ratepayer, where is the company getting back the cost to achieve that it is supposed to be getting back pursuant to the merger settlement?
>
> A: You got the cost to achieve in the $300 million. That is a net of cost number.

T153:17-23 (2/26/03).

Absent Board authorization permitting JCP&L to defer pre-test period merger costs, the $35.019 million sought to be recovered by JCP&L could have been, or should have been written off in the years in which they were incurred, and cannot be included in the current test period for the purpose of rate recognition. *R-38*, p. 23, *R-39*, pp.6-7.

Furthermore, Mr. Preiss' adjustments builds into future rates a $42.696 million allowance for merger related costs, despite the fact that a large portion of the Company's merger-related costs have already been recovered. *R-38*, p. 23. As a result, if merger cost are allowed into rates JCP&L

will be able to recover $43 million each year in merger related costs from ratepayers as long as rates are in effect. Such excessive recovery is contrary to sound rate making theory and is inequitable to ratepayers.

Mr. Preiss attempts to counter Mr. Peterson's arguments by stating that JCP&L has no intention of building merger costs into future rates, but is instead "building into rates a double counting of the net merger savings reflected in the test year [because] [i]f all costs-to-achieve were not reflected, the amount of double-counted savings that would be built into rates would be even more egregious." *JC-4* Rebuttal, p. 10; T83:2-7(2/25/03). But when asked on cross examination if it was probable that the $43 million would be built into future rates and be included as a expense indefinitely, Mr. Preiss responded affirmatively. T85:12-15 (2/25/03).

Mr. Preiss further testifies that JCP&L is not seeking recovery of $43 million in merger costs from ratepayers, but is instead using the $43 million to offset test year savings to the extent the merger savings in the test year exceed the cost incurred to create those merger savings. T 82-83 (2/25/03), T158: 6-11 (2/26/03). Mr. Peterson testified that it was not evident from Mr. Preiss' testimonies and Schedules that he was simply trying to offset the merger savings instead of trying to recover merger costs. What was clear, however, was the inclusion of $43 million of costs-to-achieve in the revenue requirement which Mr. Peterson considers a "red flag." T158:20-25, T159:1-3 (2/26/03). Ultimately, the Company's argument should be rejected because "[t]he only thing that is verifiable is the actual costs spent . . . [t]here has been no verification of any savings." T157:5-6, 8-9 (2/26/03). In conclusion, the Ratepayer Advocate respectfully requests that Your Honor and the Board reject the Company's proposal to pass onto New Jersey ratepayers $42,696,000 in merger related costs.

g. SAP Project Enterprise/ Evolution Amortization

Following the merger, it was decided that the most effective and efficient way to achieve synergies between the two companies was for FirstEnergy to implement the same computer system that was already being used at JCP&L and the other GPU utilities. This decision resulted in Project Evolution. T85:18-25 (2/25/03). Project Evolution O&M expenses were incorporated in FirstEnergy's merger cost estimate that formed the basis for the $300 million net merger savings agreed upon by the parties. *R-38, p.24* JCP&L is now attempting to recover these merger related costs from ratepayers. In fact, on cross examination by the Ratepayer Advocate, Mr. Preiss admitted that the costs of implementing Project Evolution was included in the FirstEnergy merger related cost recovery:

> Q: The estimated cost of First Energy implementing its SAP system was included in the First Energy merger related cost analysis; is that correct?
>
> A: That's my understanding, yes.

T87:13-17 (2/25/03).

Consequently, JCP&L is precluded from any further recovery of Project Evolution costs.

Mr. Preiss responds to Mr. Peterson's disallowance of Project Evolution costs by asserting that Project Evolution consists of merger related and a non-merger related portions, and it is the non-merger related portion of the Project Evolution costs that should be recoverable in the test year. *JC-4 Rebuttal*, pp. 11-12. This represents a feeble attempt to justify the recovery of costs that have been strictly prohibited by the Merger Order. Furthermore, the fact that the Company failed to quantify portions of Project Evolution costs as non-merger related provides no basis on which to adjust the expense for non-merger related activities. *R-39*, p. 8.

Therefore the Ratepayer Advocate respectfully requests that Your Honor and the Board remove the $1.697 million from the Company's revenue requirement request for the cost of Project

Evolution. Any additional recovery of Project Evolution costs would violate the Board's Merger Order and Settlement Agreement. *R-39*, Sch. 3, p. 2b.

h. Rate Case/Regulatory Expense

JCP&L's estimate for the current rate case expense is $2.35 million which it claims should not be shared between ratepayers and shareholders 50/50 and should be amortized over a three year period. *JC-4*, Sch. RFP-2 (12+0 Update), *JC-4* Rebuttal, p. 13. This proposed three year amortization of the rate case expenses will provide the Company with a $783,000 annual cost allowance. *JC-4*, Sch. RFP-2 (12+0), p.15. The Ratepayer Advocate recommends that Your Honor and the Board require JCP&L to share their actual rate case expenses on a 50/50 basis and imposes a five year amortization on rate case expense recovery.

There are three basic problems with the Company's proposal. First, the exact amount of rate case costs are not yet known. This could result in actual cost to JCP&L significantly lower than the $2.35 million projected by Mr. Preiss. Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board require the Company to provide actual costs incurred toward the end of the case with revised estimates of remaining costs outstanding, if any. This procedure is fair to ratepayers without harming the Company. Moreover, allowing full rate recovery for $2.35 million in unsubstantiated cost estimates is patently unfair to ratepayers. Accordingly, Ratepayer Advocate witness Dave Peterson reduced the Company's overly aggressive $2.35 million estimate to a $2.0 million place holder until actual costs are known. *R-38,* Sch. 3, p. 7.

Secondly, Mr. Peterson recommends a five year amortization period for the rate case expense. There is no support for the Company's proposed three year amortization. JCP&L has not filed a base rate case in over ten years. Such infrequent filing of rate cases does not support a three year amortization of rate case expenses. *R-38,* p.26, Sch. 3, p.7.

JCP&L contends that a three year amortization is a “reasonable proxy for a normal regulatory expense level in the restructured era.” *JC-4* Rebuttal, p.13. Mr. Preiss provides Middlesex Water Company as an example of an instance where the Board approved a two year amortization of rate case expenses. *Id.* A water company is not a good proxy to use to judge how often a electric company will come in for a rate case post EDECA. Further, Mr. Peterson explains, a two year amortization period, while perhaps appropriate for Middlesex Water, is not equally suited to JCP&L given its actual history of filing rate cases every ten to twelve years. *R-39*, p. 9. Accordingly, a five year amortization is more reasonable in this instance.

Thirdly, in accordance with Board precedent, Mr. Peterson further reduced the $2 million rate case expense amount by 50 percent, to reflect that only half of the rate case expenses are recoverable from ratepayers. *R-38*. Mr. Preiss states in his rebuttal testimony that JCP&L should not be required to share rate case expenses because they did not initiate the filing, but instead filed at the directive of the Board. *JC-4* Rebuttal, p. 14. Mr. Preiss seems to feel that only when the Company chooses to come in for a rate increase should rate case expenses be split between shareholders and ratepayers. T90:13-25, T91:2-4 (2/25/03)

Indeed, the Company’s shareholders were well represented throughout these proceedings. There was extensive testimony on capital structure and return on equity and shareholder interests were used as a justification for case working capital rate base deductions. Consolidated tax filings, charitable contributions, incentive compensation and rate case expenses were all contested against the backdrop of shareholder interest. There were, in addition to local counsel, at least two representatives from First Energy present at the pre-hearing, at evidentiary hearings, at public hearings and on conference calls. Clearly, the outcome of this case was very important to First Energy.

Indeed, as was noted during the evidentiary hearing, the Company's shareholders have a considerable financial stake in the outcome of these proceedings.

> Q. So even though the Board ordered this rate filing would you agree that the Company is still defending the interests of the stockholders?
>
> A. In any proceeding I would expect the Company is going to defend the interests of the stockholders.
>
> Q. Mr. Preiss, the Company is proposing a 47.7 million dollar base rate deduction based on its 9+3 filing; is that correct?
>
> A. Yes.
>
> Q. And Mr. Peterson's analysis showed a two hundred forty-four million dollar revenue expense again based on the 9 + 3 filing; is that correct?
>
> A. I don't have it in front of me but I will accept the number.
>
> Q. The difference between those two positions would be $196.3 million; would that be correct?
>
> A. That sounds right.
>
> Q. That is a significant amount of money at stake for shareholders; would you agree?
>
> A. Yes.
>
> Q. Therefore, the Company's shareholders have a significant amount of money at stake in this proceeding despite the fact that the Board ordered the filing; would you agree with that statement?
>
> A. Certainly.

T 91:5 - 92:6 (2/25/03)

The theory behind the 50/50 sharing approach is that there are strong competing interests in a rate case. The Company's primary interest 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. Moreover, the 50/50 sharing of rate case expense is well established Board policy. This policy has been repeatedly reaffirmed by the Board. For example in the Pennsgrove Water Supply Company's rate case the Board said:

> Having reviewed the entire record in this matter, the Board ADOPTS the ALJ'S recommendation. In recognition of the argument that stockholders benefit from a rate proceeding, it has been the policy of the Board to utilize 50 - 50 sharing of rate case expenses for larger utilities, including water utilities. In addition, the Board notes that, in this case, since Petitioner's revenues have exceeded one million dollars in each of the last three years (companies with revenues of one million dollars or more are generally classified as Class A water companies), the Board FINDS a 50 - 50 sharing to be appropriate in this matter.

I/M/O the Petition of Pennsgrove Water Supply Company for an Increase in Rates for Water Service, Order Adopting in Part and Rejecting in Part Initial Decision, BPU Docket No. WR98030147 (6/24/99).

The Company has provided no valid reason for departing from this policy. Therefore, the Ratepayer Advocate respectfully requests that Your Honor and the Board Order a 50/50 sharing of the Company's actual rate case expenses, amortized over a five year period. *R-38*, Sch. 3, p.7.

i. Production Related Regulatory Asset Amortization

Through various Board Orders and settlements, JCP&L has been granted permission to amortize regulatory assets relating to certain production facilities. The amortization periods for the recovery of these assets were set in previous Board proceedings. *R-38*, p. 27. The following table identifies the regulatory assets and the final year of amortization set by the Board.

Regulatory Asset	**Final Year**
TMI-1 Design Basis Documentation	2014
Oyster Creek Design Basis Documentation	2009

Oyster Creek Probabilistic Risk Assessment	2009
Werner Station	2012
Merrill Creek Leasehold Improvements	2032

In this proceeding, JCP&L seeks to accelerate the amortization periods set by the Board. This acceleration will result in an increase in the Company's revenue requirements of approximately $4.8 million. *Id*. The Company claims that this accelerated amortization will "eliminate these assets from its balance sheet over a period that is consistent with the restructuring transition period." *JC-4*, p.8.

The Ratepayer Advocate disagrees with the Company's proposed modifications to Board's prior determinations regarding the proper amortization period for these assets. First, issues determined in rate proceedings are rarely decided in a vacuum. In each case where the Board established an amortization for the regulatory asset, the Board had before it a number of issues to be decided. After considering all of the issues presented in the case, the Board made decisions that balanced competing interests of ratepayers and shareholders. Accelerating the amortization for these regulatory assets now, without re-visiting all of the issues previously decided by the Board in those earlier proceedings, would upset that delicate balance.

Second, the Company attempts to support its accelerated amortization plan by claiming that it is consistent with the length of the transition period. As noted by Mr. Peterson, the length of the transition period is irrelevant to the amortization of the production related regulatory assets because, by the time rates are set, the four year transition period would have ended. *R-38*, p. 28.

> Q: Okay, you see no efficiency benefit, if you will in restaggering these regulatory assets so as to amortize them over some more definitive area and get them out of rates?
>
> A. The issue isn't a definitive period. The definitive period has already been set for each one of these

> things. I don't see any efficiencies in changing it. The company has already set up the accounting for it. It is just a matter of running it out on the company's books.

T:172:2-11 (2/26/03).

Third, the decision to construct the facilities and to later dispose of the facilities through sale was for the benefit of JCP&L's customers, making it appropriate to continue amortization of those assets over the time frames previously established by the Board. *R-39*, p. 10. Mr. Peterson, on cross examination explains why these facilities, albeit no longer retained by JCP&L, are still providing indirect benefits to ratepayers:

> Q: And these facilities are not now providing any continued benefit to either Jersey Central by way of an investment or to ratepayers by way of providing capacity and energy. Isn't that true?
>
> A: There is an indirect benefit, if you will, to the ratepayers from, continuing benefit from each of these items, yes.
>
> Q: And in what way?
>
> A: Even though it is not providing service, the decision to build and later sell was based on the assessment of costs, risks and benefits over the life of those units. So if you sold it, you must have thought there would be a benefit to your customers. That benefit didn't go away when you sold it. Those benefits are continuing until the expected life has expired.

T:171:10:25; T:172:1 (2/26/03).

The Ratepayer Advocate respectfully requests that Your Honor and the Board reject the Company's proposal to speed up the recovery of certain production related assets. The acceleration of the amortization period for these assets provides no benefit to New Jersey ratepayers. The decisions have been made, the accounting set up and the annual recovery amounts decided. The only value of the $4.845 million revenue requirement is to make the Company's balance sheet look better. In these severe economic times, that is not an adequate reason. Accordingly, the Company's proposed O&M expenses should be reduced by $2,604,000 to reverse the Company's proposed amortization adjustment.

j. Restructuring Transition Costs

In 1996, when JCP&L reduced its workforce, it incurred $70.5 million in extraordinary retirement and severance costs. This $70.5 million was incurred in 1996, was recorded as an expense in 1996 and charged against 1996 earnings. In this current filing, the $70.5 million has resurfaced and JCP&L proposes to amortize this amount over an eight year period beginning August 1, 1999, resulting in an annual revenue requirement of $8.813 million. *R-38,* p. 28; *JC-4,* Sch. RFP-2 (12+0), p. 17.

Mr. Preiss, in his rebuttal testimony, testified that "[p]ursuant to the Final Report the recovery of such costs was not to be put at risk through the introduction of competition into the generation market." *JC-4* .p.17. Mr. Preiss seems to be implying that the Final Report conveyed some promise of recovery for these already incurred costs. In fact, there is no such promise. What the Final Report states is:

> We conclude that the other identified <u>potential sources</u> of stranded costs, including regulatory assets, down-sizing and restructuring costs and social program costs, are not directly put at risk through the introduction of competition into the retail power generation market, and can be addressed through more traditional ratemaking techniques.

Thus, the Final Report did not promise recovery for reduction in workforce costs incurred prior to the 1997 report. The Report spoke of "potential sources" of stranded costs, not cost already incurred prior to 1997. And, the Report envisioned that these costs would be "addressed through more traditional ratemaking techniques." Expense recovery going back seven or eight years is not a traditional ratemaking technique.[11]

Similarly, the Company mis-reads EDECA to allow the recovery of these costs. EDECA allows recovery of "restructuring related costs" and defines these costs as "costs directly related to the restructuring of the electric power industry." *N.J.S.A.* 48:3-51. The Company has made no showing that Company wide layoffs in 1996 were directly related to the restructuring of the electric power industry." Indeed, it is hard to imagine how this Company wide reduction in force could have been directly related to a restructuring process that was, in 1995-1996, still its formative years.

Notably, the Company has not identified to that section of the Board's Final Order that allowed recovery of these 1996 lay off costs. Perhaps that is because it cannot. Indeed, the Final Order does expressly allow severance related costs but not the claimed 1996 severance costs. The Final Order allows for "the recovery over a period of eleven years of $130 million in early retirement and severance-related costs that would be incurred if Oyster Creek were to shut down in 2000, subject to true up to the actual amount of such costs." *Final Order* at p. 105. If, as the Company suggests, the Board has already approved the recovery and amortization of these 1996 lay off costs in the restructuring proceeding, a cite to the Final Order is warranted. Without such a cite, the Company has provided no legal or factual basis for the inclusion into current rates of this $70.5 million in 1996 retirement and severance costs. Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board not allow further recovery for this 1996 expense.

k. Incentive Compensation

The Ratepayer Advocate recommends that Your Honor and the Board disallow $4.818 million in incentive compensation costs claimed by the Company. (Exhibit DEP-1, Schedule 3,

[11] A utility is enjoined from recovery in a current year costs that have already been recovered in prior years, a practice deemed as retroactive ratemaking. *I/M/O Elizabethtown Water Company*, 107 N.J. 440 (1987).

page 2b of 9, 12+0 update). This amount represents the amount of incentive compensation that was paid out as a result of the attainment of financial, rather than operational, incentives. Because shareholders receive the benefit from the attainment of these financial goals, shareholders should pay the costs.

(i) The Language of the Incentive Compensation Plans Unequivocally Indicates that the Financial Interest of the Shareholders is the Primary Objective.

Ratepayers do not receive a direct benefit from the Company's Incentive Compensation programs. Although the Company claims that the criteria established by the Company to reward employees under the compensation plans relate to operational goals as well as the financial performance of the Company, the plans do not give even a mention to New Jersey ratepayers in the stated objectives. FirstEnergy's 2002 "Executive Compensation Plan" had the following stated objective:

> The Executive Incentive Compensation Plan (EICP) is designed to attract, retain and reward executives; to more closely align the interests of executives and shareholders; and to promote growth in shareholder value.

FirstEnergy's "Mid-Management Incentive Compensation Plan" stated a similar objective:

> The Mid-Management Incentive Compensation Plan (MICP) isdesigned to attract, retain and reward employees to the successful operation and profitability of FirstEnergy.

R-38, pp. 30-31.

These incentive compensation plan objectives clearly indicate that the inducement for compensation in these programs is the financial success of the Company and increased shareholder wealth rather than improved customer service and reliability.

Company witness Kaplan unconvincingly disputed this position, stating that, "[c]learly, the incentive programs at JCP&L improve Company performance and benefit consumers." *JC-10*, p. 3. Ms. Kaplan states that, "[w]hile the [EICP] does specify 'increasing shareholder value,' such a goal necessarily also incorporates customer interests," (*JC-10*, p. 3.) and then stated without explanation that "it is unreasonable to believe that financial success benefits only shareholders."

Indeed, whereas Ms. Kaplan agrees that the word "ratepayers" is not specifically mentioned in the EICP objective T60:L20-21 (2/26/03), she disingenuously states that "I don't think that it's particularly necessary to focus on the actual verbiage of this when the intent and the design would suggest a broader interpretation." T60:L9-12 (2/2/03). Ms. Kaplan provided no support for her conclusion that the clear and express statement made in the plan objectives was not controlling.

(ii) The Stated Objectives of the Incentive Compensation Programs do not Place Ratepayer Interests on an Equal Level with Shareholder Interests

Regardless of the Company's assertions that the "intent" and "design" of the compensation programs are to benefit ratepayers as well as shareholders, the stated objectives are not consistent with the ratepayer goal of receiving service at the lowest possible price. Indeed, the Company has not even claimed that its incentive compensation program is either directly or indirectly necessary for the provision of safe, adequate and reliable utility service.

As noted above, the stated purpose of the plans is to advance the "growth in shareholder value" and "profitability." The criteria that determine the rewards paid out under the incentive compensation plan relate to financial performances, with shareholders as the primary beneficiaries. Customer service, reliability of service, or the rapid re-establishment of service after an outage do not factor into the incentive program. Therefore, as shareholders profit from these plans, shareholders should be responsible for the discretionary costs of these plans.

Indeed, the Company has presented no evidence that there are any benefits, much less specific benefits, that are accruing to ratepayers as a result of these incentive compensation plans. Company witness Kaplan boldly states that customer interests are "inherent" and "incorporated," and that the incentive plans are designed "to promote customer interests in the areas of service, safety and overall efficiency." Yet no specific efficiencies or benefits to ratepayers are offered in support of this assertion. *JC-10*, p. 4 .

(iii) Established Board Policy is to Disallow Incentive Compensation Expenses in Rate Base

The Board has an established policy of disallowing incentive compensation expenses in rate cases. In the Board's Final Decision and Order in *I/M/O the Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Other Changes for Electric Service and Other Tariff Revisions*, BPU Docket No. ER91121820J (February 25, 1993), the Board disallowed all of the costs associated with the utility's incentive compensation plans from its cost of service. The Board stated:

> 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. Accordingly, we HEREBY MODIFY the Initial Decision and DENY from inclusion in rates the entire test year compensation expense of $554,000.

More recently in the Middlesex Water Company base rate case, the Board reaffirmed this decision and denied the water utility's request to include incentive compensation expense in its rates. *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 (June 6, 2001). In rejecting the Administrative Law Judge's recommendation to share incentive compensation costs 50-50 between ratepayers and shareholders, the Board agreed with the reasoning in the JCP&L order, and noted that, "[t]he language in the Board's JCP&L 1993 Order is especially appropriate today when consumers are still faced with increasing energy costs, as well as other increased costs."

At the hearing, Ms. Kaplan referred to the Company's Incentive Compensation plan as a "win-win." T 54:L17 (2/26/03). Indeed the Ratepayer Advocate does not disagree that the inclusion of incentive compensation plans into base rates is a win-win for the Company's shareholders. In fact, they can't lose. The money is received from ratepayers. If financial goals are met, shareholders benefit through increased profits and management benefits through incentive compensation payments. If financial goals are not met, shareholders still benefit. The Incentive Compensation dollars collected from ratepayers but not distributed to management are still available in some form for distribution to shareholders. Undoubtedly, a win-win for shareholders.

Accordingly, as FirstEnergy shareholders are the primary beneficiaries when the Company achieves overall performance targets, the shareholders, rather than New Jersey ratepayers should pay these awards. Under this proposal, shareholders will remain protected from excessive incentive payments becoming a financial drain on shareholder wealth because the Company's plans require that a minimum earnings threshold be achieved before any payments are made. The Ratepayer Advocate respectfully requests that Your Honor and the Board disallow JCP&L's incentive compensation expenses for rate making purposes.

l. Miscellaneous Test-Year Expenses

Gross Receipts and Franchise Tax ("GR&FT") Amortization Expense

The Company included in its 12 + 0 updates $8.8 million in GR&FT expense. This Company proposed adjustment was based on a 1993 change to the tax law which required JCP&L to accelerate the payment of its GR&FT expense. The Board authorized JCP&L to amortize this expense over ten years. According to the Company, the unamortized balance as of December 31, 2002 is only $1.5 million and the amortization ended in February 2003. *CS-27*. Accordingly, Mr. Peterson deducted this $8,835,000 from the Company's claimed $65,965,000 for a total $56,152,000 Taxes Other Than Income Taxes. R-38, (12+0 update) Sch. 3, page 1.

m. Interest Synchronization Adjustment

Ratepayer Advocate witness David Peterson has provided Your Honor and the Board with the required adjustment to the Company State and Federal income taxes to synchronize the interest expense tax deduction with the debt portion of the overall return requirement that was recommended by Mr. Basil Copeland, the Ratepayer Advocate Cost of Capital expert witness. The *pro forma* tax deduction for interest expense is the product of the weighted cost of debt and the Ratepayer Advocate's rate base determination.

D. Summary

For all the foregoing reasons, as well as those set forth in the testimony of the Ratepayer Advocate's witnesses, the Ratepayer Advocate respectfully requests that the following recommendations should be adopted:

Revenues

•Customer Growth: Increases the Company's test year revenues by $4.684 million.

•CRA lost revenue: Increase the Company's test year revenues by $722,000

•Ratepayer Advocate recommended total operating revenue $893,637,000

Expenses

•Advertising expense adjustment: reduce O&M expense by $958,000

•BPU/RPA adjustment: reduce O&M expense by $22,000

•Charitable Contributions: reduce O&M expense by $752,000

•Depreciation Expense adjustment: reduce operating expense by $37,701,000.

•Management Audit Expense: reduce O&M expense by $148,000

•Merger Costs: reduce O&M expense by $42,696,000

•Project Evolution amortization: reduces operating income by $1,697,000

•Rate Case expense: reduce O&M expense by $583,000

•Production related amortization: reduce total operating expenses by $2,604,000

•Restructuring Transition Costs: reduction in O&M expense of $8,813,000

•Incentive Compensation: reduction in O&M expense of $4,818,000

•Miscellaneous Expense: GR&FT adjustment of $8,835,000.

POINT III. <u>DEPRECIATION</u>

YOUR HONOR AND THE BOARD SHOULD REJECT JCP&L'S UNREASONABLE DEPRECIATION EXPENSE AMOUNT AND ADOPT THE RATEPAYER ADVOCATE'S RECOMMENDED AMOUNT WHICH REFLECTS THE USE OF THE NET SALVAGE ALLOWANCE APPROACH.

Depreciation expense is included in JCP&L's revenue requirement and is passed on to ratepayers on virtually a dollar-for-dollar basis. Annual depreciation expense is determined by applying depreciation rates to plant investment. Depreciation rates are determined in depreciation studies. Generally, there are two components associated with the recovery of investment in plant. One is to recover invested capital, that is, money that has already been spent. Another component is the treatment of the cost of removing an asset at the end of its useful life.

The principle depreciation issue in this proceeding is the ratemaking treatment of estimated future net salvage, specifically as it pertains to the Company's annual depreciation expense. Also at issue are whether JCP&L should be required to submit a report to the Board and the Ratepayer Advocate regarding all aspects of its depreciation rate update calculations, and whether JCP&L should be required to charge the cost of removal of an asset to the cost of its replacement on going-forward basis.

As set forth below and in the testimony of Ratepayer Advocate witness Michael J. Majoros, consistent with current thinking about the ratemaking treatment of salvage costs, future net salvage should be removed from the JCP&L's depreciation rates. The Company's proposed depreciation expense should be adjusted to remove net salvage, and a net salvage allowance based on the net salvage allowance approach advocated by the Ratepayer Advocate's witness should be adopted. JCP&L should also be required to charge the cost of removal associated with an asset to its replacement. Finally, the Company should be required to submit a report to the Board and the Ratepayer Advocate regarding all aspects of its annual depreciation rate update calculations.

A. Estimated Future Net Salvage Should be Removed from The Company's Depreciation Rates.

Net salvage is the difference between gross salvage and the cost of removal of the plant. Gross salvage is the amount recorded due to the sale, reimbursement, or reuse of retired property. The cost of removal is connected to disposing of retired depreciable plant. Net salvage is positive when gross salvage exceeds cost of removal. Net salvage is negative when cost of removal exceeds gross salvage. A positive net salvage ratio reduces the depreciation rate and depreciation expense, while a negative net salvage ratio increases the depreciation rate and depreciation expense. *R-64*, p. 12.

In this proceeding, JCP&L's estimated future net salvage ratios result in an unreasonably large mismatch between what the Company proposes to collect for negative net salvage in its test year depreciation expense, and what it has actually expended for net salvage. Ratepayer Advocate witness Mr. Michael J. Majoros, Jr., found that JCP&L incorporated $43.1 million of annual negative net salvage recovery in its test year depreciation expense for transmission, distribution, and general plant. *R-64*, p. 12. However, Mr. Majoros also found that over the five-year period ending 2001, JCP&L had only experienced $3.9 million of annual negative net salvage on average. *Id.*, p.17. Furthermore, the $3.9 million figure might have been overstated, since it also includes production plant salvage and cost of removal. *Id*. Production plant was unbundled from JCP&L's rates pursuant to the Board's Order in the Company's restructuring case.[12]

Mr. Majoros testified that the mismatch between the Company's actual net salvage experience and the net salvage amount included in its test year depreciation expense for

[12] Final Decision and Order, p. 107.

transmission, distribution, and general plant results from JCP&L's inclusion of future inflation in estimating net salvage expense. *R-64* p. 13. Future inflation is included in the cost of removal estimates incorporated in the Company's depreciation rates. *Id.* Mr. Majoros found: "[t]he net salvage procedure proposed by JCP&L relates cost of removal in current dollars to retirements in very old historical dollars, thus resulting in very high cost of removal estimates." *Id.*, p. 4-6. JCP&L's approach extrapolates inflation into the future, and then charges current ratepayers for that inflation.

The approach recommended by Mr. Majoros avoids the pitfalls inherent in the Company's proposal. Mr. Majoros recommends the use of a five-year average salvage expense allowance, which he calls the "net salvage allowance approach." *R-64,* p. 17. Under this approach, net salvage ratios are not calculated or included in depreciation rates. Instead, a separate calculation of the average annual net salvage expense is done by averaging the past five years of actual net negative salvage expense. This five-year average is then added to the annual depreciation expense and included in the reserve. The use of a multi-year average is similar to a normalized expense included in a utility's revenue requirement.

The principle underlying Mr. Majoros' recommended net salvage allowance approach -- using current-period salvage expense -- was recognized by the National Association of Regulatory Utility Commissioners ("NARUC") in its publication entitled "Public Utility Depreciation Practices" ("NARUC depreciation manual"):

> Some commissions have abandoned the above procedure [gross salvage and cost of removal reflected in depreciation rates] and moved to current-period accounting for gross salvage and/or cost of removal. In some jurisdictions gross salvage and cost of removal are accounted for as income and expense, respectively, when they are realized. Other jurisdictions consider only gross salvage in depreciation rates, with the cost of removal being

> expensed in the year incurred. *R-66*, p. 158; *See also* T148:L7-T150:L1 (3/6/03).

The NARUC depreciation manual further opines on the underlying rationale for treating removal cost as a current-period expense, instead of incorporating it in depreciation rates:

> It is frequently the case that net salvage for a class of property is negative, that is, cost of removal exceeds gross salvage. This circumstance has increasingly become dominant over the past 20 to 30 years; in some cases negative net salvage even exceeds the original cost of plant. Today, few utility plant categories experience positive net salvage; this means that most depreciation rates must be designed to recover more than the original cost of plant. The predominance of this circumstance is another reason why some utility commissions have switched to current-period accounting for gross salvage and, particularly, cost of removal. *Id.*, p. 158.

Here, JCP&L falls within that group of utilities that will experience negative net salvage. JCP&L's proposed depreciation expense includes an amount for negative net salvage, where its claimed estimate of cost of removal exceeds its gross salvage. *R-64,* p. 12.

As set forth more fully below, JCP&L's proposed approach to the ratemaking treatment of net salvage is also at odds with current accounting thinking regarding net salvage. At an evidentiary hearing, Mr. Majoros was asked about 1986 New Jersey Natural Gas Company case decided by the Board as it relates to the rate treatment of net salvage.[13] T113:L8-T119:L7 (3/6/03). However, the cited New Jersey Natural Gas Company was decided in 1986, almost 17 years ago. Since that time, new developments have occurred in the treatment of obligations attendant to the removal of assets at the end of their service life.

[13] *Re New Jersey Natural Gas Company*, BPU Dkt. No. GR851097 (Order Adopting and Modifying Initial Decision dated July 30, 1986); OAL Dkt. Nos. PUC 7317-85 and PUC 4993-85 (Initial Decision dated June 23, 1986). *JC-63* (excerpt). *JC-63*.

Notably, in 2001 the Financial Accounting Standards Board ("FASB") adopted Statement of Financial Accounting Standards ("SFAS") Number 143 ("SFAS 143"or "FAS 143"), setting forth the treatment of Asset Retirement Obligations ("AROs") for financial statements issued for fiscal years beginning on or after June 15, 2002. *R-64*, p. 13-16. Both Ratepayer Advocate witness Mr. Majoros and Company witness Mr. Schad agree that SFAS constitute Generally Accepted Accounting Principles ("GAAP") at this time. *Id.*, p. 13; T53:L11-19 (3/6/03).

As Ratepayer Advocate witness Michael J. Majoros testified, the issuance of SFAS 143 supports a new look at how net salvage is treated for ratemaking purposes:

> A. SFAS No. 143 constitutes a major change which will impact both regulatory and financial books, and it deals directly with the inclusion of future net salvage ratios and depreciation rates. Thus, regardless of what the circumstances were at the time of Docket No. EO95030098, times have changed and it is irrelevant how JCP&L's negative net salvage came into the depreciation rates.

[T86:18-25 (3/6/03)]

In fact, the FERC recently issued a Notice of Proposed Rulemaking ("NOPR") contemplating changes in its Uniform System of Accounts and for ratemaking in recognition of the adoption of SFAS 143.[14] *R-64*, p. 14.

In his Surrebuttal Testimony presented at the March 6, 2003 evidentiary hearing, Mr. Majoros set forth the theory underlying SFAS 143:

> Q. Can you summarize the theory?
>
> A. Yes. This is the liability theory. If a company has a legal obligation to remove an asset at the end of its life, then the net present value of that amount is part of the cost of the asset. It is part of the original cost. What happens if the company does not have a legal obligation to remove an asset at the end of its life? Then only the original coast is depreciated. Only the $100, 000.00

[14] *Notice of Proposed Rulemaking on Accounting, Financial Reporting, and Rate Filing Requirements for Asset Retirement Obligations*, FERC Dkt. No. RM02-07-000 (11/19/02).

> is depreciated. Any removal cost will likely be expensed if and when it is incurred.

[T88:L16-T89:L3 (3/6/03)]

For long-lived assets, SFAS 143 requires companies to determine whether they have "legal obligations" to remove retired assets. *R-64*, p.13. Such obligations are referred to as "Asset Retirement Obligations," or "AROs," in SFAS 143. *Id*. As Mr. Majoros testified, if a company has AROs, the ARO is considered to be a part of the cost of the asset and recorded as such. *Id.* But only the net present value, not the inflated future value, may be treated as such. *Id.* If a company does not have any AROs associated with assets, Mr. Majoros testified that any cost of removal would likely be expensed, pursuant to the terms of a comment draft of an American Institute of Certified Public Accountants Statement of Position ("AICPA SOP") on Property, Plant and Equipment. *Id*., p. 13-14.

JCP&L has not claimed any AROs in its books for its transmission and distribution assets, pursuant to SFAS 143. RAR-DEP-53(b); *JC-59*. Although JCP&L has indeed implemented SFAS 143 effective January 1, 2003, it acknowledges that it does not have any AROs for its transmission, distribution and general plant categories. T62:L23-T63:L2 (3/6/03); *JC-59*. The absence of AROs for transmission, distribution and general plant categories means that JCP&L does not have any legal obligations to incur any negative net salvage either now or in the future for those assets. Nevertheless, JCP&L has increased its depreciation rates to collect future negative net salvage even though it does not have any legal obligation to incur such costs. Furthermore, JCP&L has further increased its depreciation rates to include future inflation in those amounts. *R-64*, p. 13.

In sum, JCP&L's approach is inconsistent with the underlying principles of SFAS 143. Furthermore, as Mr. Majoros testified, these excess amounts will be treated as liabilities to ratepayers on JCP&L's GAAP financial books.

A. Paragraph B73 of SFAS-143 states, 'The board', and that is the FASB, "concluded that if asset retirement costs are charged to customers of rate regulated entities but no liability is recognized, a regulatory liability should be recognized if the requirements of statement 71 are met." This means that if this board or Commission continues to allow JCP&L to recover depreciation inflated for future removal costs for which the Company has no legal obligation, those recoveries must be shown as a liability to ratepayers. In other words, that is the ratepayer's money. Has JCP&L already collected such amounts? Yes. JCP&L has collected substantial amounts, and I expect those amounts to be recorded in a regulatory liability account on its general purpose financial statements, regardless of what Mr. Schad said this morning.

[T91:L8-T92:L2 (3/6/03)]

Already, JCP&L has a regulatory liability for excess depreciation reserve for its transmission, distribution and general plant of $147 million, according to a discovery response. *R-64*, p. 11. Mr. Majoros testified as to the impact of not revising JCP&L's depreciation rates to exclude net salvage:

Q. Now, with respect to FAS-143 and other developments since 1986, you comment on that decision and the policy set forth therein?

A. Yes, I believe it is time for the Board to reconsider the concepts that underlie that, given what I have just described. Even the NARUC Manual addressed this problem that is created by the inclusion of future net salvage. It is time to reconsider that position. I can say if that position is considered and maintained, then the regulatory liability to ratepayers will continue to grow to, as I said, you know, it is over a hundred million dollars right now for this company, so.

[T152:l24-T153:l12 (3/6/03)]

In contrast, as demonstrated below and in the record, the net salvage allowance approach recommended by Mr. Majoros is consistent with the principles set forth in SFAS 143. *R-64,* p. 17.

Q. Why do you believe that JCP&L's transmission and distribution depreciation rates would violate the principles and fundamentals of SFAS-143?

> A. Because JCP&L transmission and distribution depreciation rates are designed to recover the original cost of the plant, plus an estimated future cost that the Company has no unambiguous legal liability to incur. Furthermore, even if JCP&L did have a legal obligation to incur these costs, they are overstated because they reflect the undiscounted future value of these estimates, not the net present value.

[T90:11-23 (3/6/03)]

Alternatively, under Mr. Majoros' net salvage allowance approach, consistent with the theory underlying SFAS 143, no retirement obligations would be reflected in the cost of assets, or the related depreciation rates. Instead, Mr. Majoros proposes the use of a five-year average to establish the proper expense level.

Mr. Majoros' net salvage allowance approach to measuring the net salvage allowance is also consistent with the measurement of the removal obligation found in SFAS 143. In contrast, as discussed above, JCP&L's proposed approach includes future inflation in its removal estimates. Mr. Majoros' net savage allowance approach uses a five-year average of actual removal expenses. In testimony, Mr. Majoros succinctly laid out how his use of a five-year average is consistent with the use of net present value to measure removal costs:

> The net salvage approach ensures that the Company recovers the net present value of its actual costs, but eliminates the inclusion of future inflation in depreciation rates. In my opinion, this approach is consistent in substance with the principles of SFAS No. 143. *R-64*, p. 17, L:6-9.

In sum, Mr. Majoros' net salvage allowance approach is consistent with current GAAP and regulatory accounting principles regarding the accounting and ratemaking treatment of net salvage. Other state regulators have also adopted the averaging approach advocated by Mr. Majoros. The Pennsylvania Public Utility Commission, Kentucky Public Service Commission, and Missouri Public

Service Commission have accepted the five-year average approach advocated by Mr. Majoros.[15] *R-64*, p.17.

Finally, the net salvage allowance approach advocated by Mr. Majoros would not put the Company at risk of a shortfall. It would allow the Company to recover its actual current net salvage costs, just as any other operating expanse. In his direct testimony, Mr. Majoros explained how the Company, using the remaining life technique to calculate its depreciation rates, is further protected from underrecovery, while ratepayers would be vulnerable:

> Q. Is the Company protected from underrecovery?
>
> A. Yes, the remaining life technique provides an automatic true-up because it is based on net plant, i.e., original cost minus the depreciation reserve. The remaining life technique also protects the Company from any early retirements resulting from mistakes it may have made. Again, that is because these retirements are charged to the depreciation reserve which is then reflected in the remaining life depreciation rate. The remaining life technique provides substantial protection to the Company. The remaining life technique does not, however, protect ratepayers from excessive depreciation resulting from lives which are too short or from unsupportable and unreasonable negative net salvage proposals. *R-64*, p.11, L:12-19.

For the reasons set forth above, Your Honor and the Board should reject JCP&L's proposed depreciation expense. JCP&L's proposed depreciation rates will produce excessive depreciation expense and unnecessarily increase revenue requirements. *R-64*, p. 2. Since depreciation expense flows dollar-for-dollar into the revenue requirement, excessive depreciation expense results in an excessive revenue requirement. *Id.*, p. 11. Instead, Your Honor and the Board should adopt the

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15 *See Penn Sheraton et al. v. Pennsylvania Public Utilities Commission*, 198 *Pa. Super.* 618, 184 *A. 2d.* 234 (1962)*; I/M/O Jackson Energy Cooperative Corporation for an Adjustment of Rates*, Ky. PSC Case No. 2000-373 (Order dated May 21, 2001); *I/M/O Adjustment of Rates of Fleming-Mason Cooperative*, Ky. PSC Case No. 2001-00244 (Order dated August 7, 2002); and *I/M/O Laclede Gas Company's Tariff to Revise Natural Gas Rate Schedules*, Mo. PSC Case No. GR-99-315 (Second Report and Order dated June 28, 2001). *See JC-64*.

ratemaking treatment of net salvage recommended by Ratepayer Advocate witness Michael J. Majoros for the Company's annual expense levels.

Rejecting Mr. Majoros' recommendations would impose an unjustified cost on JCP&L's ratepayers. JCP&L proposes an increase in its annual depreciation expense of $2.4 million. *JC-4*, Sch. RFP-2, p. 6 of 23. In contrast, Mr. Majoros recommends a $35.9 million decrease in the Company's depreciation expense. *RA-64*, p. 3; MJM-9.

1. JCP&L's Proposed Depreciation Expense Should Be Adjusted To Remove Net Salvage, And A Net Salvage Allowance Based On the Ratepayer Advocate's Recommended Approach Should Be Adopted.

JCP&L has incorporated $43.1 million of net salvage in its test year depreciation expense for transmission, distribution, and general plant. *R-64*, p. 12. However, over the five-years ending 2001, the Company has only experienced $3.9 million of net salvage on average. *Id*. Furthermore, as noted above and in the testimony of Mr. Majoros, the Company's five-year average includes production plant salvage and cost of removal. *Id.*, p. 17.

Mr. Majoros reduced the Company's proposed depreciation expense to remove the expense attributable to net salvage. The Company proposed a $2.4 million increase in depreciation expense. *R-64*, p. 3; *JC-4*, RFP-2, p. 6 of 23. Based on Mr. Majoros' testimony, Mr. Peterson decreased the Company's depreciation expense by $37.7 million *R-38 (*12+0 Update*)*.

Mr. Majoros also recommended that the Company be permitted to recover an amount equivalent to its test-year net salvage expense, $4.8 million. *Id*., p. 17.

2. JCP&L Should be Required to charge the Cost of Removal Associated With an Asset to Its Replacement.

As recommended by Mr. Majoros, on a going-forward basis, the cost of removal of an asset should be charged to the cost of the replacement. *R-64*, p. 19. Charging the cost of removal to the new asset will reduce the amount of cost of removal being charged to accumulated depreciation. *R-64*, p. 19. Mr. Majoros testified that this treatment is consistent with the FERC's Uniform System of Account ("USOA") definition 31, Replacing or Replacement, 18 CFR Ch. 1, para. 3.A. *Id.*

B. JCP&L Should Be Required to Submit a Report to the Board and the Ratepayer Advocate Regarding All Aspects of its Depreciation Rate Update Calculations.

JCP&L's depreciation rates for its distribution plant were established pursuant to a Board-approved stipulation in a depreciation case filed by the Company in 1995. On March 3, 1995, JCP&L filed a Petition for changes in depreciation rates applicable to certain categories of utility plant. That proceeding was resolved by a Stipulation and Addendum which were subsequently approved by the Board in a Summary Order. [16]

Paragraph 17 of the June 27, 1996 Stipulation of Final Settlement states: "In addition, the Parties further agree that, effective January 1, 2000, JCP&L shall change its method of depreciation to remaining life depreciation, <u>updated annually</u> and booked in accordance with such annual updates commencing January 1, 2000." [17] Mr. Majoros noted that the Company, in response to a discovery request, claimed that effective January 1, 2000, it began annually updating depreciation rates for account additions, retirements, transfers and adjustments. *R-64*, p. 5. At issue is the thoroughness and timeliness of the Company's updates.

[16] *I/M/O JCP&L*, BPU Docket No. EO95030098 et. al. (Summary Order, 3/24/97). *See R-64*, MJM-2.

[17] Stipulation of Final Settlement, BPU Docket No. EO95030098, June 27, 1996, para. 17. (Emphasis added.)

Mr. Majoros encountered some difficulty in verifying the Company's depreciation rates. *R-64*, pp. 6-7. Furthermore, Mr. Majoros found that there was a two-year lag in its calculation of updated rates. *Id.*, p. 7.

Given these problems, Mr. Majoros recommended that JCP&L should be required to submit a report to the Board and the Ratepayer Advocate regarding all aspects of its depreciation rate update calculations, by February 28 of each year. *Id.*, p. 19. More specifically, Mr. Majoros testified that the annual update report should "enable complete verification of the calculations to ensure that the updated depreciation rates have been calculated correctly and reconciled to the most recent FERC Form 1 or comparable state annual report." *Id.*, p. 6, ln. 8-10.

IV. SERVICE RELIABILITY

A. Measurement and Analysis of JCP&L Reliability Performance

1. Issues Concerning Reliability and Customer Service Are Relevant to the Current Proceeding

In its rebuttal testimony, the Company has questioned the "the appropriateness of introducing reliability-related issues into this proceeding." *JC 12 Rebuttal* p. 1. The Company believes, first of all, that the Board wishes "to retain any issues related to compliance with the Board's May 1, 2000 Order in Docket No. EA99070485." *Id* at 2. Secondly, the Company argues that because the December 4, 2002 Pre-hearing Order did not mention reliability or Service Quality Index, and that the Company's reliability and service quality are not issues in these proceedings because they relate solely to the separate reliability proceedings instituted by the Board. *Id*. at 3. And thirdly, the Company contends, that because there is an on-going working group formed to "deal with" the Board's proposed Electric Reliability Performance Standards, there is no need to discuss service quality or reliability in this proceeding. *Id.* at 4. The Company's arguments are simply incorrect.

First, Ms. Alexander's testimony on customer service and reliability issues does not conflict with or in any way impede the Board's prior orders with respect to JCP&L's reliability of service, including JCP&L's compliance with the Board's May 1, 2000 Outage Investigation Order. That Order adopted an auditor's report and made recommendations regarding technical issues, including how GPU should conduct inspections, file reports, and follow through with maintenance practices in the future. *I/M/O The Board's Review and Investigation of GPU Energy Electric Utility System's Reliability*, *Docket No. EA99070485* (Order 5/1/00). Rather, Ms. Alexander's testimony focused on JCP&L's <u>future</u> service quality and reliability performance in light of these prior investigations and JCP&L's promises associated with the recent merger with FirstEnergy.

The Company's second argument is equally unpersuasive. The Company asserts that because the December 4, 2002 Pre-hearing Order did not specifically mention reliability or a Service Quality Index the issue is not properly addressed in this forum. In fact, the first issue listed by Your Honor in the Pre-hearing Order is "[w]hether the proposed increase in base rates will result in just and reasonable rates." (Consolidated PreHearing Order, the Hon. Irene Jones, ALJ, dated December 2002.) Indeed, the very purpose of a base rate case, filed pursuant to *N.J.S.A.* 48:2-21, is to fix just and reasonable rates for utility service. Clearly, service reliability is within the scope of inquiry in a base rate case. *See Matter of Valley Road Sewerage Co.*, 154 *N.J.* 224 (1998); *Township Committee of Lakewood Tp. v. Lakewood Water Co*., 54 *N.J. Super*. 371 (App. Div. 1959). Any rate charged for inadequate service is unreasonable.

Moreover, issues raised in the two dockets cited by the Company are relevant to the instant proceeding. In fact, the Company's assertion to the contrary directly contradicts the testimony of its own witness. JCP&L witness Lawrence Sweeney discusses the Board's Order in one of the cited dockets (BPU Dkt. No. EA99070484) at length and, in fact, attached excerpts from documents in the cited cases to his Direct Testimony. *JC-12* p. 10-12; Schedules LES-5, -6. The Ratepayer Advocate notes that the two Orders cited by JCP&L are related. The Board's action in Docket Number EA99070484 emanated from the investigation of the July 1999 outages ordered in Docket Number EX99070483.

Furthermore, JCP&L claims that over $1.2 billion was added to its rate base since 1992. *JC-12* p. 4. The rationale for such expenditures was articulated by Mr. Sweeney in his Direct Testimony: "The overriding reason [for the investment of capital in its electric delivery system] would be to provide service that meets or exceeds the expectations of our customers while providing System security and safe working conditions for JCP&L employees." *JC-12* p. 6.

Further, in his Direct Testimony, Mr Sweeney is asked:

> Q. In your judgement, have the capital investments made by JCP&L, and the subject of this testimony, been made with the goal of providing safe, adequate and reliable service to the electric customers of JCP&L?
>
> A. Yes, the capital investments made by JCP&L in its electric delivery system have addressed the **reliability concerns** outlined by the Board and have, at the same time, enabled JCP&L to provide safe, adequate and reliable service to its electric customers. Such investments have, therefore, been reasonable and prudent.

JC-12 p. 15-16 (emphasis added).

For the Company to seek to evade review of millions of dollars of capital improvements, capital improvements whose claim to reasonableness and prudence is based on the provision of "safe, adequate and reliable service," because the Pre Hearing order did not include the word reliability is disingenuous at best.

Thirdly, the Company's allegation that Ms. Alexander's testimony somehow circumvents or interferes with the Board's existing reliability standards, is also unsupported by the evidence in this case. Nowhere in Ms. Alexander's testimony did she recommend that the existing reliability standards be ignored. On the contrary, she recommended that an Service Quality Index ("SQI") be adopted as a complement to the Board's existing regulations, not as a replacement for the existing standards. *R-26*. In fact, Ms. Alexander has adopted the BPU Customer Average Interruption Duration Index ("CAIDI") and System Average Interruption Frequency Index ("SAIFI") benchmarks as performance levels for her proposed SQI.

Moreover, unlike Ms Alexander's proposed SQI, the Board's interim standards address only reliability performance with respect to outages. Ms. Alexander's SQI address customer service performance with respect to the customer call center, field service operations relating to repairs and installation of service, credit and collection efficiency, and customer complaint handling. *R-26*. Since the Board has not addressed these performance areas in a generic manner, Ms. Alexander's proposals do not conflict in any way with the Board's regulations.

At the present time, power outages in JCP&L service territory last longer than in any other part of the state. *R-26*, p. 18**.** They also occur more frequently than in most other areas of the State. *Id.* Standards must be in place for reliability and customer service so that further deterioration is prevented. Barbara Alexander's testimony properly emphasized the importance of indices to measure service performance and to trigger customer restitution when necessary so that management will have the proper incentives to focus on the necessary programs and policies to prevent any deterioration in service.

2. JCP&L Reliability Performance

JCP&L's customers have long endured severe and prolonged power outages. Indeed, the Board has several times ordered the Company to improve its service and has recommended several steps the Company should take to achieve this end. On December 30, 1997, the Board ordered GPU "to implement certain staff recommendations designed to improve the time for restoring service and the ability of customers to obtain restoration information." *I/M/O the Investigation into Storm Related Electric Service Outages*, BPU Docket No. EX 98101130 (12/16/98). After a review of GPU's implementation of the recommended improvements, in August of 1998, the Board expressed concern that GPU Energy's restoration times had not noticeably improved and requested a further investigation in utility tree trimming practices; workforce issues; such as line crews, support staff and preparedness, and training and customer issues; such as communication of adequate restoration information. *Id*. Again, in the summer of 1999, businesses and homes throughout JCP&L territory were without electrical power for several hours to several days. And again, in response, the Board initiated an investigation and ordered the Company to "take steps to improve its ability to deliver electricity." *I/M/O Board's Review and Investigation of GPU Energy Electric Utility System's Reliability*, Order, BPU Docket No. EA99070485 (April 26, 2000). The Board noted "significant areas of concern," including "inaccurate and inadequate inspection and test records," "diminished levels of workforce," and poor "outage restoration time statistics." *Id*. In September, 2001, the Board based its approval of the acquisition of JCP&L by FirstEnergy on several conditions regarding staffing levels, reliability, and customer service performance. *See Merger Order*. And most recently, in 2002, at the Governor's request, the Company's reliability performance once again became the subject of a Board investigation after 180,000 JCP&L customers were without power, 40,000 of them without power for three days. *I/M/O the Board's Investigation Into JCP&L's Storm-Related Outages of August 2002*, BPU Docket No. EX02120950 (March 13, 2003). The Final Report to the Governor "identified concerns with JCP&L's storm response and the overall reliability of the company's electric distribution system." *Id*. No other electric utility in the State required the level of scrutiny that the Board deemed necessary for JCP&L reliability performance.

3. BPU Reliability Performance Standards

The BPU staff's Final Report on The "Interim Electric Distribution Service Reliability and Quality Standards," adopted by the Board in late 2000 and effective January 2, 2001, established a state wide standard methodology for measuring reliability of electric service. *N.J.A.C.* 14:5-7.1 The regulations provide for the calculation of each electric distribution company's ("EDC") CAIDI and SAIFI and set reliability performance levels. *N.J.A.C.*14:5-7.3, *N.J.A.C.* 14:5-7.10. The rules establish that the "minimum reliability level for the years 2001 and 2002 for each operating area is attained when its annual CAIDI and SAIFI are no higher than the 10 year benchmark standard plus two standard deviations. *Id.* The regulations do not contain performance standards for individual utilities, but establish the mechanism for the setting of performance standards for CAIDI and SAIFI. There is no provision for automatic penalties or any other enforcement action linked to failure to maintain the "minimum reliability levels." And, there are no performance standards or reporting requirements with respect to other key customer service metrics such as the timeliness of installation of service, call center performance, billing accuracy, or customer complaint performance.

B. A Reliability and Customer Service Quality Index Should Be Implemented to Ensure That JCP&L's Customers Receive Safe and Adequate Service

1. Service Quality Index

As discussed above, the very purpose of a base rate case is to fix just and reasonable rates for utility service. *N.J.S.A.* 48:2-21. Service reliability is within the scope of inquiry in a base rate case.

The Company posits that Ms. Alexander's proposals in this proceeding are based on "her generic dissatisfaction with the Board's approach to reliability standards." That is not correct. Rather, Ms. Alexander's proposals are directed to the specific service quality and reliability programs that should be adopted for JCP&L in this base rate proceeding. It is not necessary for the Board to find that its current generic regulations are in any way deficient in order to adopt Ms. Alexander's proposals. However, it is also fair to acknowledge that the Ratepayer Advocate's proposals in this regard reflect the reality that the "minimum reliability levels" set by the Board for 2001 and 2002 will allow a significant degradation of service and are accompanied by no automatic enforcement procedures or penalties. The Board's "minimum reliability levels" allow the Company to maintain CAIDI numbers that the Board itself has acknowledged are "significantly worse than the national average." *I/M/O the Board's Phase Three Review and Monitoring of the Implementation of the Recommendations From the Board Ordered Phase Two Review and Investigation of New Jersey's Four Electric Utilities,* Docket No. EX99070483 (June 6, 2001) p. 3. As the Board noted, "[t]his means that GPUE's New Jersey customers experienced, on the average, a longer time of electric service interruption in total when measured on a yearly basis than most of the electric consumers in the country and in the State of New Jersey." *Id*. While this performance may be acceptable to the Company, the Ratepayer Advocate believes that the ratepayers in this state are entitled to more.

Accordingly, Ratepayer Advocate witness Barbara Alexander recommended that the Board should hold JCP&L to a standard that has, in the past, been met by the Company and that would promise JCP&L ratepayers that some of the risk of nonperformance would be borne by the Company's shareholders, not, as currently, solely by ratepayers. To this purpose, Ms. Alexander recommended that the Board institute a regulatory mechanism, an SQI, to encourage a measurable improvement in the Company's performance. The SQI would impose a financial impact on the Company for failure to meet annual performance targets. As noted in Ms. Alexander's testimony, the purpose of this SQI is not to punish the Company but "to establish the proper financial incentives to assure future performance that Jersey Central's customers have a right to expect." *R-26* p. 25.

Generally, the proposed SQI would measure reliability of service, customer call center performance, field operations, customer complaint handling and disconnection of service ratio. Performance in each of these areas would be measured against a baseline performance standard and, when service falls below that minimum level, the Company would be required to reimburse customers for poor service in the form of a customer rebate or one time credit. Specifically, Ms. Alexander recommends that the following performance measures should be established:

Performance Area	Proposed Baseline Performance Standard	
CAIDI	Northern Region:	156
	Central Region:	110
SAIFI	Northern Region:	0.78
	Central Region:	0.78
Call Center		
Percent answered within 30 seconds		80%
Busy rate, percent of calls		<1%
Disconnection Ratio		1.3 per 1000 customers
Installation of Service		3 business days
Missed Appointments		Establish after 18 months
BPU Complaint Ratio		1.37 per 1000 customers

R-26, p. 27

a. Customer Average Interruption Duration Index ("CAIDI") and System Average Interruption Frequency Index ("SAIFI")

CAIDI is one commonly used measure for the duration of outages. CAIDI measures the minutes of interruption when an interruption occurs, that is the average length of an interruption per customer. Under the Board's rules CAIDI data excludes major storms and severe weather outages.[18]

The JCP&L North Jersey region has generally experienced higher CAIDI values than the Central operating area. This means that JCP&L customers in Northern New Jersey experience outages of longer duration than those in the Central New Jersey area. The North Jersey area has a BPU benchmark (1990-1999 ten year average) CAIDI of 156 minutes *R-26,* Exh. BA-2. In 2000, the Company's northern area CAIDI was 319 and in the year 2001 it was 161. *Id*. Similarly, the Central area CAIDI exceeded its BPU benchmark of 110 minutes in both years. In 2000, the Company's Central area CAIDI was 205 and in the year 2001 it was 126. *Id.*

[18] JCP&L's CAIDI and SAIFI data prior to 1998 included all storm outage data. Consequently, performance improvement indicated since 1997 may reflect, at least in part, the capture of different data.

While these numbers look bad enough when compared to the Company's average performance, when compared to the State's other utilities they look even worse. Based on information provided to the Board, PSE&G's CAIDI for 2001 was 84.79, Atlantic City Electric's was 77.16 and Rockland Electric's was 97. *R-26* p. 18 JCP&L's customers endure outages for a significantly longer period of time than the customers of the state's other utilities.

Moreover, the Company has not performed the root cause analysis of its CAIDI that was recommended in the March 14, 2001 Schumaker Report. *R-35*, p.7. The Schumaker Report reviewed for the BPU the implementation of certain reliability related recommendations. *Id*. The report expressed concern that the Company had not performed an analysis of the root causes of its outage duration performance and recommended that the Company should do so. The Company's failure to study the root causes of its poor CAIDI performance may have a detrimental effect on any attempts to improve the Company's CAIDI performance. *Id.* It certainly adds support for the implementation of performance targets.

SAIFI is a commonly used measure for the frequency of outages. SAIFI reflects the frequency of interruptions experienced by the utility's customers and measures the average frequency of all interruptions throughout the distribution system. The benchmark levels for SAIFI are the same for both the Northern New Jersey operating area and the Central New Jersey operating area. This suggests that historically, the customers in both regions experience the same frequency of outages.

As with the CAIDI, the Company failed to achieve BPU benchmark levels for SAIFI in 2000 and in 2001. *R-26,* Exh. BA-2 The Company's Northern region and Central regions both have a BPU Benchmark SAIFI of 0.78. *Id.* The SAIFI for the Northern region in the year 2000 was 2.74 and was 1.1 in the year 2001. In the Central Region the SAIFI for 2000 was 1.83 and in 2001 was 0.98. *Id*. Again, other New Jersey utilities performed significantly better, PSE&G had a 2001 SAIFI of .55 and

Atlantic City Electric' SAIFI was .674. Only Rockland Electric, with 70,000 New Jersey customers fared worse than JCP&L with its 2001 SAIFI level of 1.22. *R-26*, p. 18

Based on the concerns expressed by Mr. Lanzalotta and Ms. Alexander regarding the Company's poor reliability performance, the Ratepayer Advocate recommends that Your Honor and the Board established certain minimum reliability standards and establish a mechanism that will hold the Company accountable for meeting these minimum standards. As can be seen from the above discussion, the Ratepayer Advocate's recommended CAIDI and SAIFI benchmarks are the BPU benchmark levels. *R-26* p. 27; Exh. BA-2. These are not high standards and yet the Company balks at being held to even this minimum level of service. The ratepayers of JCP&L are entitled to this minimum level of service and if these performance levels are not attained in the future, a method of shifting the risk of loss from the ratepayers to the shareholders of the Company is a proper regulatory response.

b. Call Center Performance

With regard to the call center, some improvement has occurred in the last two years. In 1997 only 42% of the calls were answered within 60 seconds, in 2001 this number improved to 76% of calls answered within 30 seconds. *R-26* p. 19 While such improvement is to be congratulated, such performance is still below the industry standard to answer 80% of all calls within 30 seconds. *R-26*, p. 19.

Not surprisingly, the Company balks at the imposition of any customer call center standards. The Company argues that "no evidence has been presented indicating that current Call Center service levels . . . are inadequate" and touts its "above average" rating in the J.D. Powers 2002 Residential Study.[19] Ratepayer Advocate's recommended performance levels for the Company's Call Center performance are standards generally accepted in the industry. *R-26,* p.31-33. Surely, FirstEnergy, a Company with a "SAP Customer Care System" and call center operations that "are adequate and above the industry average"can meet such minimum standards. The cost to implement and maintain this Customer Care system is borne by the ratepayers. Surely, ratepayers are entitled to some assurances regarding the performance of this system.

Notably, in the recent Elizabethtown Water Company rate case, the utility agreed to link certain Customer Service performance measures to recovery of its SAP customer care system.[20] In that proceeding, the initial target was 70% of all calls answered within 20 seconds and within a year, 80% all calls answered within 20 seconds. It is reasonable to expect that FirstEnergy can achieve similar results with its SAP system.

c. Customer Complaint Performance

In general, over the last several years, JCP&L has had the highest complaint ratio of any New Jersey electric utility.[21] *R-26,* p. 20. As noted by Ms. Alexander, a significant percentage of all complaints received by the Company were service interruption complaints. *R-26* at p.20-21.

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[19] According to the Company, the National Industry average score for customer satisfaction with Call Centers was 100. The FirstEnergy Reading Call Center scored 101. (*JC 12 Rebuttal*, p. 28) The Company has not provided this document in the record in this case, nor was it supported by expert testimony or analysis. Presumably, the Company's actual performance data as reported in Ms. Alexander's testimony in a more reliable indicator of ratepayer satisfaction.

[20] *I/M/O the Petition of Elizabethtown Water Company for Approval of an Increase in Rates for Service,* BPU Docket Number WR01040205, OAL Docket No. PUC 347-01, (January 23, 2002)

[21] In 1999 and 2000 due to massive billing errors Conectiv's complaint ratio was higher.

Ms. Alexander has recommended that the customer complain level not be allowed to rise above the five year historical average of 1.37 complaints per 1000 customers for the 1996-2000 period. JCP&L claims that the Company treats customer complaints seriously and "analyzes and seeks to understand the nature of the complaints filed against it so that it can effectively address the causes of those complaints." *JC-12 Rebuttal*, p. 28. And yet, the Company offers no proposal to address a complaint ratio that, in 2001, was the highest in the state. The Ratepayer Advocate is not attempting to impose new higher standards on the Company, we are merely trying to prevent further degradation.

d. Collection Efficiency / Disconnection Ratio

Beginning in 1999, JCP&L's collection efficiency dropped and the Company has incurred a significant increase in uncollectible expense. The net write off in dollars doubled between 1998 and 1999, going from $4.7 million in 1998 to $9.5 million in 1999. The accumulated provision for uncollectible accounts rose from $6 million in 1999 to $21.5 million in 2000 and then dropped to $13.4 million 2001.

Like the call center standards, the Company balks at the imposition of an "arbitrary disconnection ratio standard" because "no evidence has been presented indicating that JCP&L's disconnection ratio is excessive when compared to other similarly situated EDCs." *R-12 Rebuttal, p.34* Indeed, the Ratepayer Advocate is not asking the Company to reach the level of the other EDCs, only that the Company maintain historically achieved levels. Ms. Alexander's recommended disconnection ratio of 1.3 per 1000 customers is only slightly lower than the Company's year 2000 high disconnection ratio of 1.42. *R-26*, p. 22.

Ms. Alexander also suggested some simple alternatives to increase collections that have reportedly worked with other utilities. For example, the Company could investigate more customer friendly bill collection methods such as enclosing a postage paid envelop with every bill. *R-26* at p. 22. The Company did not comment on this suggestion. And, not noticing that Ms. Alexander's focus was to ease payment options to reduce overdue accounts, not merely to react to a customer once an account falls overdue, the Company merely stated that the Company's strategy "is to make every reasonable attempt to contact delinquent customers through the use of letters and phone calls prior to issuing disconnection notices." *JC-12 Rebuttal* p. 29.

Accordingly, the Ratepayer Advocate witness Barbara Alexander recommended that the BPU closely monitor the Company's disconnection ratio to ensure that the Company does not rely too heavily on this collection tool. The Company's disconnection ratio has been trending upward since 1999. In fact, JCP&L's rate of disconnection has significantly increased in 2001 and 2002, from .46 in 1999 to .57 in 2000, 1.42 in 2001 and 1.38 for the first six months of 2002. Ms. Alexander has recommended that the Company be held to a disconnection rate of 1.3 per 1000 customers.

e. Field Operations

At this time, the Company seeks to provide new service to customers within 5 business days. *R-26*, p. 23 Prior to the merger with FirstEnergy, this target was 3 business days. *Id*. In 2000, the average installation waiting period was 10 days, in 2001 the average was 6 business days and in the first half of 2002, 5 business days. *Id*. The Company apparently does not track whether its repair and installation appointments are met on time. Ms Alexander recommended that the Company return to the pre-FirstEnergy standard and provide service to customers within 3 business days. *R-26*, p. 28. She also recommended that the Company begin to collect missed appointment data and that a baseline standard should be adopted. *Id*. Ms. Alexander recommended that this standard should reflect not only the historical performance of JCP&L, but the typical performance in this regard at other utilities. *Id*. The Company did not address these issues.

2. Customer Service Guarantee

The Ratepayer Advocate further asks that Your Honor and the Board impose a Customer Service Guarantee for certain service quality failures. Such a mechanism would reimburse an individual customer for the aggravation associated with utility service quality failures. Customers who suffer through extended power outages and missed appointments, or who are forced to wait more than 3 days for service installation, deserve some restitution. The utility should not be allowed to miss appointments with impunity. A person who has taken time off from work to meet a utility worker is entitled to some consideration if that appointment is missed. A person who suffers without air conditioning through an extended heat wave should receive some compensation.

In response Mr. Sweeney merely noted that the Company does not support Customer Service Guarantees and that the Board has not yet determined that financial penalties are necessary at this time. *JC-12 Rebuttal*, p. 36 Due to the service quality issues highlighted in this proceeding, service guarantees are indeed appropriate and, in fact necessary. Futhermore, to have standards without penalties is meaning less.

Accordingly, the Ratepayer Advocate respectfully request that Your Honor and the Board implement a Customer Service Guarantee similar to the guarantee provided by Conectiv to its New Jersey customers who suffer an outage in excess of 24 hours, that is, a guaranteed amount of $50 per 24-hour period. *See Merger Order* Other service quality failures should be accompanied by a guarantee amount of $25 to $30. *R-26*, p. 31

3. Additional Reliability Concerns

a. Substation Transformers and Facilities

The Ratepayer Advocate's witness Peter Lanzalotta reviewed the in-service age of the Company's substation transformers and the levels of peak loading to which they have been exposed. Age and peak loading levels are factors in evaluating remaining transformer life. According to Mr. Lanzalotta, if a transformer is not loaded beyond its capacity, it may, on average, expect 40 years or more of useful service life. *R-35*, p. 15 If, however, a transformer is loaded up beyond its rated capacity, its service life can be shortened to a small fraction of this time span.

The Company was able to provide in-service dates for 94% of the 234 transformers in the Northern area. Seventeen or about 8% of these transformers have been in service for 40 years or more and six of the northern area transformers have experienced loads moderately beyond their loading limit. None of these six were among the transformers that have been in service for 40 years or more.

Mr. Lanzalotta found the information regarding the Central area transformers much more alarming. The Company was able to provide in-service dates for 229 of 248 transformers, or 92%, of the substation transformers in the Central area. Thirty, or 13%, of the substation transformers for which in-service ages have been provided have been in service for 40 years or more. *JC-12 Rebuttal*, p.17. None of these transformers have been in service for 50 years or more. T103:L6-8 (2/20/03). That almost none of the Company's substation transformers in both operating areas are reported to have been in service for more than 50 years indicates that, despite Mr. Sweeney's assertions to the contrary, age is a significant factor in transformer life.

Mr. Lanzalotta explained that the apparent lack of data for the Company's central area substation transformers increases concerns that originate with the relatively high percentage of older transformers and the relatively high percentage that have been exposed to overloads in the past three years. As noted in the record, thirteen percent of the Central area's substation transformers have 40 years or more of service. Another eight percent of the area's substation transformers have in-service dates that are not available and therefore may be just as old.

Mr. Lanzalotta concluded that because of the advanced age of many of the Central district substation transformers, the level of load to which they have been exposed, the unavailability of data for in service dates for many of the transformers and the unavailability of historical peak loadings beyond the last three years there is a concern regarding the potential reliability impacts of these transformers over the next ten years. JCP&L is facing the prospect of having to replace a sizable percentage of the central area's substation transformers without complete data. This indicates that further declines in reliability are possible, or even probable.

In his rebuttal testimony, Mr. Sweeney, explained that the data for the Central area was not missing but had been "inadvertently provided as part of the Company's response to RAR-RE-44, instead of RAR-RE-43[22]." *JC-12 Rebuttal*, p.16. Mr. Sweeney then cited a portion of the Stone and Webster report to support the Company's contention that age of the Company's transformers is not a concern. Indeed, on the stand, Mr. Sweeney repeatedly testified that in his opinion "age in and of itself does not necessarily contribute to equipment failure." T49:L21-25; 50:L21-23. (2/20/03) In fact, even when asked if age **might** be a factor he merely parroted "I think age in and of itself does not necessarily contribute to equipment failures."

Experts, however, agree with Mr. Lanzalotta that age and loading are factors to be considered when evaluating equipment. In fact, the Stone and Webster report, relied by Mr. Sweeney as support for his "age is not a factor" argument in fact supports the Ratepayer Advocate's premise that age and loading are important reliability factors. For example, when discussing the failure of the Red Bank

[22] The corrected Central area figures provided by the Company are reflected in the preceding paragraphs.

Transformer #2, the report notes that "we believe that the failure is the result of long-term insulation degradation, exacerbated by elevated temperatures and/or overvoltages experienced during its service life." *S-3* Stone & Webster 1999 Outage Report, p.ES-1 Similarly, in discussing the failure of the Red Bank transformer #1, the report finds "the failure was the outcome of long-term insulation degradation, as opposed to sudden failure. Elevated temperatures and overvoltages can contribute to the degradation process." *Id.* at ES-5. Likewise the report noted, "[t]here is no accurate mechanism to predict if the new transformers would have experienced bushing failures had they been installed and in service during the July 3-8 event, but it would be less likely since dielectric degradation generally takes time to occur." So, apparently, age and loading were factors in the failure of both of the Red Bank transformers that were the cause of the prolonged 1999 outages.

Mr. Sweeney was also unable to testify what percentage of transformers had been in service for more than forty years, he was not familiar with the Hartford Steam Boiler Company and he didn't know how the Company derived its definition of "bulk transmission." T50:L8; T52:L18;63:L12 (2/20/03). He did not know whether JCP&L used primarily radial or loop distribution claiming he was not a planning engineer. T67:L21-25 (2/20/03). And he was unable to offer an opinion whether radial or loop distribution feeds were more reliable, again claiming he was "not an engineer." T68:L21-25 (2/20/03). Notably, in response to a transcript request, sponsored by Mr. Sweeney, the Company admits to 559 distribution circuits in the JCP&L's Central region, all of which are radial circuits. Similarly, all of the Company's Northern region circuits are radial circuits. *TR-2*. Perhaps Mr. Sweeney, who appears to have a financial rather than an engineering background, was the wrong person to for the Company to sponsor as the sole witness testifying regarding the Company's reliability performance.

b. Tree trimming

Ratepayer Advocate expert witness Peter Lanzalotta looked at the Company's tree trimming practices, noting, first of all, that increases in SAIFI are frequently accompanied by cutbacks in a utility's tree trimming program. *R-35*, p. 9. And, secondly, that JCP&L was directed by the Board, in 1997, to increase its frequency of comprehensive tree-trimming. *Id*. Mr. Lanzalotta found that after four years of implementation of a four year tree trimming cycle, some feeders are still facing intervals of six to ten years between comprehensive trims. *Id*. These long intervals are cause for concern for reliability related reasons, especially in light of the Company's deteriorating SAIFI performance.

In his rebuttal testimony, Mr. Sweeney testified to the Company's tree trimming policies. He acknowledged in his rebuttal testimony that information provided in discovery to the Ratepayer Advocate was not "the actual work plan." He testified that "[t]he actual tree-trimming work plan provides for a levelized work load each year that meets the four-year criteria, as previously discussed." *JC-12 Rebuttal* p. 12. Notably, Mr Sweeney did not testify that the Company trimmed or inspected all trees in both the North and Central regions every four years. Perhaps that was because he could not.

What Mr. Sweeney did testify to was that JCP&L has adopted the Ohio parent's philosophy of "more is better" when it comes to tree trimming.

> Q. JCP&L adopted the First Energy policy on tree trimming?
>
> A. Yes, Jersey Central is the first one of the operating company that has adopted First Energy vegetation management standard.
>
> Q. As a result of that is JCP&L doing more tree trimming per year than it was doing under the original tree trimming policy?
>
> A. Could you define "more"?
>
> Q. More, a larger number of circuits that you tree trim in the past?

> A. The Company is still on the Board's required four year tree trimming cycle. First Energy standards do trim closer, they trim further from the wire, closer to the base of the tree, that's why I asked what "more" was.

Tr 69:6-22 (2/20/03).

Thus, it seems the Company is attempting to circumvent the Board ordered four year tree trimming cycle by lopping off a larger portion of the tree at one time. Apparently, the FirstEnergy "vegetation management standard" is not tree friendly.

Furthermore, as noted by Mr. Lanzalotta, the Company has repeatedly updated its response to RAR-RE-62.

> I was originally supplied with data in response to discovery that asked for the last feeder trimming for each distribution feeder, the next scheduled comprehensive feeder trimming, and I believe I also asked for information on what they call hot spot trimming.
>
> Now in response to that data I filed some direct testimony and then in the surrebuttal I find out that these were just suggested schedules by I believe a forestry group and that these didn't really actually reflect in effect what I had asked for in discovery.
>
> I also might point out that subsequent to our getting this corrected data, RE-62, the Company modified its response to this question apparently a third time. I got these responses yesterday afternoon after 4:00 P.M. in which apparently the data for the Central area that I had been given before was not correct.

The Company's first response to RAR-RE-62 merely noted that information regarding the 2nd comprehensive tree trimming for each feeder was not available, explaining "[t]he information is not available because, during the 2000-2001 re-organization process whereby JCP&L returned to a regional approach, certain tree-trimming data from the centralized management period does not appear to have been preserved." *R-37*; (response to RAR-RE-62.) Subsequently, the supplement to this data response claims that some un-named "individual," who was not available when the first response to RAR-RE-62 was provided but now is available to respond, is the "most knowledgeable." This un-named individual has determined that information previously provided was outdated. *R-37,* (response to RAR-RE-62, suppl.) The third response to RAR-RE-62 corrected information provided in the second.

At this point, it appears Mr. Lanzalotta's assessment of the Company's tree trimming practices is effectively uncontested. Clearly, Mr. Sweeney is not qualified to testify in this area and the Company has declined to provide even the name of the person who is "most knowledgable". Data is missing and then found, information is provided and then disclaimed. After his review of the Company's most recently provided response to RAR-RE-62, Mr. Lanzalotta concluded:

> In going through the new Central area data we find that there were sixty-two feeders on a schedule of five years or longer with no hot-spot trims in the last four years out of a total of five hundred and eighty-nine feeders, which means that approximately eleven percent of the area's total do not appear to be on a four year tree trimming schedule.

Tr 101:L18-25 (2/20/03).

Accordingly, because the Company was unable to establish that they have complied with the Board's recommended tree trimming practices the Board should hold the Company financially accountable to its ratepayers for at least the minimum SAIFI levels recommended by Ms. Alexander. Furthermore, the Board should warn the Company that tree trimming must be done in a responsible fashion and that over-trimming to lengthen the time periods between trimming cycles is not an acceptable solution. The Board has determined that a four year tree trimming cycle is a responsible balance between practicality and esthetics. FirstEnergy should not be allowed to disregard that standard.

c. Stray Voltage

"Stray Voltage" refers to the situation where there is a difference in voltage between the grounded surfaces at customer locations and the earth. In suburban areas, stray voltage may manifest itself in the form of shocks received by people touching supposedly grounded surfaces such as swimming pools or water pipes. During this past summer, the Company received a number of complaints from ratepayers in Ocean County about "stray voltage." *R-35*, p. 18. Apparently, the distribution system in this area was converted from 4.8 kV delta to 12.5 kV grounded wye, but that the neutral wire was never replaced and was, perhaps, inadequate for the area's needs. In response, the Company took actions that reduced the level of stray voltage but did not eliminate the problem. These actions included the upgrading of some 7,000 feet of neutral wires on the distribution system. *Id*. at 19. A subsequent BPU investigation resulted in the Company's being directed, among other things, to upgrade more than seven miles, more that 37,000 additional feet, of neutral wires on the distribution system prior to the coming summer. *I/M/O the Board's Investigation into Allegations of Stray Voltage Occurances Within the Service Territory of Jersey Central Power & Light Company*, BPU Dkt. No. EO02120923, Order Adopting Report (March 6, 2003).

It is apparent that the Company's practices regarding the sizing of distribution system neutral conductors are not adequate for all of its service area under all conditions. The BPU has directed the Company, among other things, to upgrade its distribution system, calling this upgrade, "important to the health and safety of the residents of the state."[23] While no specific remedy was proposed in Mr. Lanzalotta's testimony regarding an approach to addressing the Company's stray voltage related problems, these apparent safety related shortcomings provide additional support for carefully monitoring customer complaints, which alerted the Company to its stray voltage problems in Ocean County, and to address problems that are reflected in both the content and the volume of such complaints.

[23] See BPU Website http://www.bpu.state.nj.us/, BPU Release 39-02

C. The Company's Ratepayers Should Not be Forced to Pay For Reliability Audits Necessitated by Management's Failure to Heed Prior Ratepayer Funded Reports.

Mr. Lanzalotta further recommended that Your Honor and the Board disallow costs of reliability related consultant studies that were performed after the 1999 GPU outages. This conclusion was based on the fact that the Red Bank substation transformer failures, and the resultant BPU investigations and studies, could have been avoided if the Company had followed the practices and procedures it had in place at the time of the failures.

The Company claims that Mr. Lanzalotta misunderstood "the findings and conclusions of the consultants' report with respect to these matters." *JC-12 Rebuttal*, p.20. The Company notes that Mr. Lanzalotta refers to "transformer failures" and takes comfort from the fact that it was the bushings that failed, not the transformers. *Id.*

What the Company neglects to mention is that "[d]ue to the explosion and fire damage that was sustained by the bushing at the time of failure, the transformer could not be returned to service." S-3 Stone & Webster 1999 Outage Report; ES-1. Moreover, Stone and Webster also characterized the failure as a "failed transformer." The Report notes that "[b]y 1300 hours on July 8, 1999, following the replacement of **failed transformer** #2, all customers were returned to service. Work to replace **failed transformer** #1 was completed on July 13, 1999, bringing the Red Bank substation back to normal operations. *Id.* (emphasis added).

The Company further contends that Mr. Lanzalotta is also mistaken in his assertion that the 1999 outages "would have been avoided if the Company had followed the practices and procedures it had in place at the time." The Company notes that Mr. Lanzalotta is not specific about what practices and procedures he is referring to. Perhaps Mr. Lanzalotta is referring to the fact that the Company had earlier determined that these substation transformers needed to be upgraded and, as was specifically noted in the Stone and Webster report, had already been purchased and placed on site. If these upgraded transformers had been installed when delivered in the Spring of 1998, the 1999 outages could have been avoided.

The Company then cites to the Board Order adopting the Stone and Webster report in which the Board found that "there is not a prima facie case demonstrating that overall GPU provided unsafe, inadequate or improper service to its customers."

In fact, what Stone and Webster did find was that:

> Although GPU's electric system generally withstood the exceptional peak demand, there were areas that experienced significant service interruptions. These interruptions were primarily due to two transformer bushing failures at the Red Bank Substation. Other outage causes involved pole top transformers, low voltage conditions attributable to unprecedented high load demands, and Company implemented load shedding efforts. Over 105,000 customers were affected, primarily in Monmouth and Ocean counties. This represents approximately 10.6% of the GPU's 988,000 customers.

S-3 Stone & Webster 1999 Outage Report, p.ES-1

Thus, within a five day period, over 10% of the Company's customers were without electricity for some period of time. Surely that is indication of inadequate service.

Moreover, the Board, in that same Order stated:

> While our consultant found that GPU's transmission planning criteria is consistent with regional electric planning authorities, the consultant also found that GPU's own engineering planners recommended replacement of the transformers as outlined above, and that decision was then re-evaluated by management and the replacement was deferred to the year 2000. The investigation disclosed that the decision to defer was based in part on inaccurate cost estimates and manpower and budgetary constraints. We find that the decision to defer the installation was risky, as the decision to defer does not appear to have been based on a careful, deliberate process taking into consideration important elements, such as maintenance and test records of equipment scheduled to be replaced.

I/M/O The Board's Review and Investigation of GPU Energy Electric Utility System's Reliability, Docket No. EA99070485 (May 1, 2000)

The Company's position is unfair and is an uncessary burden on its ratepayers. The Company undertakes a study, at ratepayers' expense. The study makes a very specific recommendation regarding replacement of transformers at the Red Bank substation. The Company's management takes the risk and chooses to ignore that study. Ratepayers lose and prolonged power outages are endured even though JCP&L's customers have continue to pay JCP&L to provide them with safe, adequate and proper service. Now, the Company wants ratepayers to pay for that mistake, to pay for yet another study, occasioned by management's disregard of the first study. Perhaps it is time that management assumed some of the risk. Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board disallow all costs of reliability related consultant studies that were performed after the 1999 GPU outages.

Conclusion

To date, the risk of the Company's performance failures has been borne solely by the Company's ratepayers.

Morever, recently, the Board has recognized that shareholders should shoulder some the responsibility for poor performance and ordered JCP&L to reimburse County Offices of Emergency Management for expenses incurred during the 2002 power outages that affected 180,000 JCP&L customers in the Central Region and left about 40,000 of those customers without power for three days. *I/M/O the Board's Investigation in JCP&L's Storm-Related Outages of August 2002,* BPU Docket No. EX02120950 (March 13, 2003). Total restoration was not completed until five days after the storm.

The Ratepayer Advocate recommends that Your Honor and the Board institute a Service Quality Index program for JCP&L. The SQI should compel the utility to maintain historic levels of service quality and reliability and impose financial penalties for failure to maintain these performance levels. In addition, the Company should be held accountable to individual customers in the form of rebates for failure to meet certain service quality performance levels. This program would encourage JCP&L to focus on service quality and reliability and will shift some of the burden for non-performance on to the Company's shareholders.

POINT V. **<u>COST OF SERVICE/RATE DESIGN</u>**

YOUR HONOR AND THE BOARD SHOULD ADOPT THE RATEPAYER ADVOCATE'S PROPOSED CLASS REVENUE DISTRIBUTION AND RATE DESIGN

A. Cost of Service

1. Overview

Ratemaking begins with the required revenues to be collected. The process involves two steps: the setting of class revenue requirements and the development of the charges applicable to each class.

Ratepayer Advocate witness John Stutz noted that Bonbright's Criteria of a Sound Rate Structure provides an appropriate general framework for ratemaking. The three criteria identified by Bonbright as primary are:

- Effectiveness in yielding total revenue requirements under the fair-return standard, (#3)
- Efficiency of the rate classes and rate blocks in discouraging wasteful use of service, and (#8)
- Fairness of the specific rates in the apportionment of total costs of service among the different customers. (#6)

R-76, p. 6

Dr. Stutz noted that Bonbright's criteria 6, equity, is the primary consideration when responsibility for a utility's required revenues is apportioned among the rate classes. *Id.* Once an equitable division has been made, efficiency and equity in intra-class apportionment have to be balanced in the design of customer, demand, and energy charges applicable to each rate class. Rates are designed to recover the share of required revenues allocated to each rate class, thus addressing revenue sufficiency.

As noted by Dr. Stutz, in addition to Bonbright's Criteria Number 6, three other of Bonbright's criteria are closely linked to the issue of equity in ratemaking and will need to be addressed in order to produce equitable rates:

- The related "practical" attributes of simplicity, understandability, public acceptability, and feasibility of application, (#1)
- Stability of the rates themselves, with minimum of unexpected changes seriously adverse to the existing customers, and (#5)
- Avoidance of "undue discrimination" in rate relationships. (#7)

The Company's ratemaking goals emphasize adequacy of revenues and proper price signals. However, rather than pursue equity, JCP&L seeks only to avoid "undue inequity." *JC 8*, p.13. The Company also emphasizes the goal of gradualism. Gradualism is not a substitute for equity. Gradual implementation of an inequitable apportionment of revenue responsibility simply hides the inequity from the ratepayers. This is neither appropriate nor desirable.

2. Your Honor And The Board Should Reject The Company's Modifications To Board Approved Cost of Service Methodology.

JCP&L=s Petition in this matter included a class cost of service study, the results of which were presented by JCP&L witness, Mark A. Hayden. *JC-7*. In preparing his cost of service study, Mr. Hayden generally complied with Board approved methods. *JC-7*, p.8 Mr. Hayden did identify four modifications that he felt were necessary to "more appropriately allocate costs." In a few instances, Mr. Hayden departed from Board approved methods without knowing that he was doing so. T27:L11-14 (3/17/03).

Mr Hayden claimed that his "testimony embodies four modifications to the methods that were used in prior cases." *JC-7*, p. 4. Mr. Hayden's first "modification" was subsequently recognized by Mr. Hayden as not a modification at all. *CS-21*. In his prefiled testimony Mr. Hayden claimed that modification 2 is necessary to accommodate restructuring related changes and that modifications 3 and 4 more accurately reflect cost causation.

However, Mr. Hayden, made a "fifth" modification that was a significant departure from previously approved cost of service methodology. As noted by Mr. Hayden in his response to Ratepayer Advocate discovery request RAR-RD-18,

> Mr. Hayden would also like to take this opportunity to explain that after further review of the embedded cost study ordered in BPU Docket No. ER89110912J dated 4/9/93 (Exhibit JC-308) he has determined that he has made an additional substantive departure that was not noted in his original testimony. *JC-7*. His study (Schedule MAH-1) uses a single non-coincident demand for each class rather than the average of four summer monthly non-coincident demands when applying the average and excess method to allocate costs. *CS-21*.

Mr. Hayden then states that he "believes this modification is appropriate since the distribution system must be sized sufficiently to meet the single maximum peak and not the average of the four summer monthly peaks." *Id*.

Thus, Mr. Hayden has allocated costs using a single non-coincident demand for each class rather than the Board approved use of the average of four summer months non-coincident demands. Mr. Hayden has justified his deviation from the Board's approved methodology on the assumption that sizing provides the basis for cost allocation. And, undeniably, all load bearing equipment must be properly sized to meet maximum demand. However, if sizing provided the basis for allocation, the costs associated with all load-bearing equipment would be allocated solely on the basis of demand. The Board has rejected this concept noting, "there is a dual demand and energy dimension to transmission and distribution system planning and operation which should henceforth be reflected in cost allocation." *I/M/O Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions*, BPU Docket No. ER91121820J (June 15, 1993)

Indeed, the Board has been very clear about what methodology it prefers. In Order after Order the Board has established the use of the average of four summer peaks rather than the Company proposed single peak. *Id.* Mr. Hayden departed from this method and has subsequently attempted to justify his departure from the Board approved methodology by claiming that the Board's approved method "places insufficient weight on the annual peak" and so "waters down the usefulness of the formula." *JC-7 Rebuttal,* p.4. Ratepayer Advocate witness John Stutz disagreed with this assessment of the Board approved methodology noting that "[s]ound ratemaking considerations support the Board's decision." *R-77*, p. 2.

Moreover, this is not an insignificant departure from precedent. The unitized class rates of return produced by Mr. Hayden's average and excess method are very different than the unitized class rates of return produced when using the Board=s methodology. For example, the unitized rate of return for the class RS, residential service, is .76 under Mr. Hayden=s methodology and .83 under the Board=s methodology. *R-76*, Sch. JS-8. For the rate class RT, Mr. Hayden=s methodology produces a .72 unitized rate of return; under the Board=s methodology, the unitized rate of return for the class RT is .97. *Id.* For the rate classes GS, GP, and GT, the unitized rate of return goes from 1.23 using Mr. Hayden=s method to 1.13 using to the Board=s method for GS, from 1.62 to 1.44 for GP and from 3.76 to 3.49 for GT. In fact, the only class unitized rate of return that did not change significantly using Mr. Hayden=s methodology was Lighting.

Your Honor and the Board should reject Mr. Hayden=s proposed change to the Board's approved cost of service method. The choice of methods can affect cost of service study results and so impact class revenue requirements and rate design. *R-76*, Sch. JS-8. The Board=s approved cost of service methods were used in the carefully crafted unbundling of rates which provides the basis for JCP&L=s transition to competition. Rate stability is fostered by avoiding changes in the cost of service methods. Accordingly, these methods should not be changed without good reason.

B. Rate Design

1. Overview - The Company's Proposed Class Revenue Distribution Disproportionately Affects Residential and Small Commercial Customers.

The Company has not made any proposals that shift class revenue responsibility due to the expiring customer credit or the SBC decrease. However, for the MTC and the Delivery Charges, the situation is quite different. JCP&L has proposed changing the basis for MTC responsibility and has proposed allocating the decrease in Delivery Charges quite selectively. These two proposals raise serious issues of reasonableness and equity as well as public understanding and acceptance.

Preliminarily, it is important to note that the harshest impact of the Company=s proposed rate design falls on customers served on rates Residential Service (ARS@) and General Service Secondary (AGS@) serving small commercial customers. These customer provide about 76% of JCP&L=s current revenues. About 77% of the net increase due to the expiration of the customer credit and the SBC decrease falls on these rate classes. However, for the MTC and the delivery charges, where the Company has proposed changes to the current rate allocation, the residential and small commercial users assume responsibility for about 110% of the net increase. *R-76,* Sch. JS-6. As Dr. Stutz noted, this disproportionate impact is the result of the Company=s proposed rate design and violates the equity and gradualism aspects of Bonbright=s *Criteria of a Sound Rate Structure*.

Applying the principles of equity and gradualism in this proceeding is particularly important in light of the other rate changes proposed by the Company. In addition to the 2.1% decrease in the delivery rate and the 0.8% decrease in the SBC charge, the Company expects that JCP&L=s ratepayers will see increases of 5.6% due to the credit elimination and up to a 9.7% increase in the MTC rate. *JC-3*, MJF-3 (12+0) In addition, ratepayers will see an increase in the cost of BGS service starting in August 1, 2003. *Id*. Accordingly, the Company's ratepayers are facing significant increases in electric rates with the greatest impact felt by the Company's residential and small commercial customers.

2. Delivery Charges

Delivery charges recover distribution, transmission, customer service and information, administrative and general costs, along with federal and state taxes, the transitional energy facilities assessment (TEFA) and SUT. *R-76,* p. 22. The Company has proposed no changes in transmission or TEFA revenues. The remaining costs, exclusive of SUT, are referred to by JCP&L as Adistribution.@ In prefiled direct testimony, the Company proposed a net decrease of about $11.9 million in distribution revenues. With SUT, the impact of the Company=s proposal is a $12.6 million revenue reduction.

JCP&L initially proposed to share this substantial net decrease in Delivery Charges through a mix of increases and decreases. The Company proposed rate increases totaling about $6.4 million for rate classes RS, RT and GST and for Lighting. The remaining customer classes, GS, GP, and GT, were then given a $19 million revenue requirement decrease to split, with a $9.1 million decrease being allocated to the rate class GT.

The first problem with this proposed allocation is that this result reflects Mr. Hayden=s version of the average and excess methodology rather than the Board approved average and excess method.

As discussed above, the use of the proper methodology produces unitized rates of return closer to 1.0 for the above favored classes. Thus, all else being equal, it would be appropriate to provide these classes with a lesser share of the benefits from a decrease in distribution costs than JCP&L originally proposed. Such a result would certainly be more publicly acceptable, one of the practical attributes of a Sound Rate Structure identified in Bonbright=s Criterion No. 1 .

Moreover, Ratepayer Advocate witness Dr. John Stutz recommended that at least some of the beneficial impact of the rate decrease be shared among all rate classes. *J-76*, p. 24. Dr. Stutz recommended that 80 percent of the decrease be allocated directly to the three rate classes that were allocated decreases under the Company=s original proposal. Dr. Stutz then allocated the remaining 20% among all rate classes. This distribution of the revenue decrease still provides the bulk of the beneficial impact of the rate decrease to the same three rate classes as the JCP&L proposal. The difference is that under this proposal they receive about 90 percent of the benefit, not the 151 percent proposed by JCP&L. The remaining 10 percent is spread so that all rate classes see some benefit from the decrease. *J-76*, Sch. JS-9.

With the 12+0 updates, the Company's witness Sally Cheong was given $47 million to distribute among the various rate classes. Without a word of explanation, Ms. Cheong changed her analysis and granted a $11.7 million decrease to the RS class, the same class she allocated a $1.9 million **increase** to a couple of months earlier. (*JC-8*, SJC-2 (12+0). When asked about this at the hearing she stated: " I made a judgment to provide revenue reduction to the RS." T131:L14 (3/17/03).

Accordingly, Ratepayer Advocate witness John Stutz updated his schedule JS-9 to reflect the additional classes allocated a rate decrease by the Company. As noted above, Dr. Stutz recommended that at least some of the beneficial impact of the rate decrease be shared among all rate classes. *J-76*, p. 24. Accordingly, based on Ms. Cheong's revised allocation, Dr. Stutz allocated 80 percent of the

Company's proposed decrease to among all rate classes granted a rate decrease by Ms. Cheong. The remaining 20 percent was allocated among all rate classes on a KWh basis. This distribution of the revenue decrease still provides the bulk of the beneficial impact of the rate decrease to the same rate classes as the JCP&L updated proposal. The difference is that under the Ratepayer Advocate's proposal, all rate classes see some benefit from the decrease. *J-76*, Sch. JS-9.

Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board adopt this proposal and provide an at least minimal decreases to all rate classes. This distribution is supported by the cost of service study results produced using the Board=s approved methods and it meets Bonbright=s criteria of public understanding and acceptance better than the Company=s proposal.

3. MTC Responsibility

The Company has proposed to remove the residual effects of the transition-period MTC and to use the levelized energy adjustment clause (LEAC) as a basis for the MTC. The Company suggests that the proposed MTC rate design "is consistent with the Board's long-standing policy regarding the recovery of energy-related deferred costs." *JC-8*, p.21. Thus, the Company has proposed for recovery of the MTC by deriving an MTC Factor (in mills per kWh) and then making voltage level adjustments for customer billing purposes. The Company's proposal to recover MTC revenues through a method the Board has historically used to recover LEAC under recoveries is misplaced. First, the Company is resurrecting a recovery mechanism that the Board eliminated with the arrival of restructuring. In the JCP&L Final Order, the Board eliminated the LEAC.[24] Moreover, the LEAC was designed for the purpose of recovering costs associated with electric energy sold by the Company. When the Company=s new rates go into effect, the MTC will no longer be recovering the energy-related costs.

[24] *I/M/O Jersey Central Power and Light Company, d/b/a GPU Energy - Rate Unbundling, Stranded Cost and Restructuring Filings, Final Decision and Order*, BPU Docket Nos. EO97070458, EO97070459, and EO9707460, (March 07, 2001), p. 106.

Rather, as of August 1, 2003, the MTC will recover only stranded costs. While stranded costs have been recovered through the LEAC in the past, this use does not reflect the basic purpose for which the LEAC was designed and does not provide a sufficient basis upon which to reintroduce the LEAC recovery mechanism.

Furthermore, in the Final Decision and Order, the Board changed the terms of the settlement in that case, raising the retail adder applicable to rates RS and RT. In doing so, the Board carefully balanced its treatment of residential service and residential time of day service rates. As the Board acknowledged, such an adjustment would require a downward adjustment in the residually determined component of unbundling - the MTC - in order to meet other constraints. In light of this, a shift in MTC responsibility which increases the net burden on most residential customers and alters the balance between rates RS and RT is particularly inappropriate.

Finally, the Company=s proposal would shift MTC revenue responsibility dramatically. For example, JCP&L=s proposal will increase MTC responsibility for residential customers from 38.3% to 41.7%, an increase of almost 9%. *R-77,* Sch.JS-11 At the same time, the Company=s proposal will **decrease** MTC responsibility for GP customers more than 30%. *Id.* The Company fails to recognize that the MTC is an existing charge. While the MTC may have been set residually, the Ratepayer Advocate believes that in setting this charge, the Board carefully considered the impact this rate would have on JCP&L customers and made its restructuring decision so that MTC responsibility was shared in a just and reasonable fashion. In ratemaking there is a presumption in favor of existing rates. *R-76,* Sch. JS-3; Criterion 5 of Bonbright's *Criteria of a Sound Rate Structure*. The Company has not shown a need nor provided a basis for changing the existing shares of MTC responsibility.

Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board maintain the current distribution of MTC responsibility, preserving the carefully crafted burden sharing established when rates were unbundled. First, the Ratepayer Advocate=s proposal maintains the current pattern of MTC responsibility which neither advantages nor disadvantages any class. Thus, this proposal is publically acceptable. Secondly, this proposal eliminates the seriously adverse impact, implicit in the Company=s proposal, to the majority of the Company=s customers who are served on rates RS and GS and is thereby compatible with Bonbright=s Criterion No. 5 for a sound Rate Structure. Thirdly, the current allocation of MTC responsibility derives from a rate unbundling which the Board carefully crafted to afford all classes of customers some opportunity to benefit from competition, in compliance with the fair allocation requirement in Bonbright=s Criterion No. 6. Finally, the Company=s proposal substantially increases MTC responsibility for certain rate classes. There is no evidence that any rate class caused a greater share of the stranded costs to be recovered by the MTC after August 1,2003. In the absence of such evidence, the Company=s proposal constitutes undue discrimination. Thus, the Ratepayer Advocate=s proposed rate design, a flat, per-kWh charge for each rate class, preserves the status quo in MTC responsibility and furthers sound rate design policy and principles.

C. Reconnection Charges

JCP&L is proposing to increase its reconnection charge for customers whose service has been disconnected from $22 to $27 for customers whose service is reconnected during normal business hours, Monday through Friday, 9:00 A.M to 4:30 P.M., a 22.7% increase. This is an 80% increase above the current average of $15 for all New Jersey electric utilities. T147:L10-16 (3/17/03). JCP&L also proposes to increase the reconnection charge for all other hours from the current $54 to $70. The Ratepayer Advocate believes that this charge is excessive, unduly burdensome to low-income customers and counterproductive.

The Company=s reconnection charge falls most heavily on those customers who are least able to afford it, that is, customers who have difficulty paying their utility bills. Given this reality, the Ratepayer Advocate believes that an increase at this time is particularly inappropriate. The proposed increase is also likely to be counterproductive. If a high fee is imposed on a customer with a limited ability to pay, that customer is less likely to return to the system, resulting in lost revenue and other customers having to bear more than their share of embedded costs.

Moreover, the Company=s proposal should be viewed in light of the Board=s Universal Service proceeding, which has already been decided, awaiting for a written Board Order. I/M/O Establishment of a Universal Service Fund Pursuant to Section 12 of the Electric Discount and Energy Competition Act, BPU Docket No. EX00020091. As is addressed at length in the testimony, comments and other submissions by the Ratepayer Advocate in that proceeding,the Universal Service programs under consideration by the Board may be expected to reduce the number of customer shut-offs for non-payment. The Ratepayer Advocate believes that this is a better approach than increasing the amount the Company may collect from a customer whose service is restored.

Accordingly, taking the preceding considerations into account, and giving weight to Bonbright=s criterion of rate stability, the Ratepayer Advocate recommends that Your Honor and the Board reject the Company=s proposed increases in Reconnection Charges and keep these charges at their current level.

D. Overall Rate Impact

The Ratepayer Advocate's initially filed position was based on principles rather than numbers and was illustrated using the Company's initially filed numbers. Those principles still hold now that actual numbers and updated schedules have been provided by the Company. To clarify the impact of the Ratepayer Advocate's recommended revenue adjustments will have on rates, the chart attached hereto as Schedule 1 applies the cost of service/rate design principles advocated by the Ratepayer Advocate to the Ratepayer Advocate's updated numbers.

E. Motion for Summary Disposition

On April 23, 2003, Intervenor New Jersey Commercial Users ("NJCU") filed a Notice of Motion for Partial Summary Disposition of The Issue of The Proper Methodology For JCP&L's Cost of Service Study and For Related Discovery Relief. NJCU is seeking summary judgment on the appropriate methodology to be used in JCP&L's Cost of Service Study in support of its base rate case. NJCU is also asking Your Honor to order JCP&L to provide a Cost of Service Study "that eliminates the energy related component from distribution plant costs and related expense." NJCU relies on its Brief and the Briefs filed on behalf of NJCU in the Public Service Electric and Gas rate case (BPU Docket No. ER022050303, OAL Docket PUC-5744-02.)

JCP&L filed its rate case on August 1, 2002 and more than three months later, NJCU filed its Motion to Intervene on November 21, 2002. On November 27, 2002, the Company sent a letter to Your Honor setting forth its non-opposition to the NJCU Motion to Intervene. Since that time, presumably, NJCU has received copies of the Company's Petition, all discovery responses and all testimonies that have been filed in this case. NJCU should have known the Cost of Service Study used by JCP&L since the inception of this case. If NJCU thought that a modified Cost of Service Study would contribute to the record in this matter, such information should have been requested during the discovery process. The Company's refusal to provide such information could have then been addressed in the proper manner. By waiting until this late point in the proceeding to file this Motion, NJCU is doing what it promised not to do, adding "confusion and undue delay" to this proceeding.

Moreover, the issue raised by NJCU is not appropriate for summary disposition. As evidenced by the testimony in these proceedings, the proper Cost of Service allocation methodology is clearly a "disputed issue of material fact." Because the Company did not follow "guidelines" set forth in the National Association of Regulatory Utility Commissioners Electric Utility Cost Allocation Manual is not a sufficient basis upon which to grant Summary Judgement. In fact, the Preface of the NARUC manual states as an objective for the manual: "The writing style should be non-judgmental; not advocating any one particular method but trying to include all currently used methods with pros and cons." Thus, the manual is descriptive, not prescriptive. Furthermore, although NJCU may characterize it as "unreasonable and improperly named," the average and excess method has been the Board approved method in this state for many years.

Accordingly, the Ratepayer Advocate respectfully request that Your Honor deny NJCU's Motion for Partial Summary Judgment.

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