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

I/M/O THE JOINT PETITION OF PUBLIC	)	
SERVICE ELECTRIC AND GAS COMPANY	)	**BPU DKT. NO. EM05020106**
AND EXELON CORPORATION FOR	)	**OAL DKT. NO.PUC-1874-05**
APPROVAL OF A CHANGE IN CONTROL	)	
OF PUBLIC SERVICE ELECTRIC AND GAS	)	
COMPANY AND RELATED AUTHORIZATIONS	)	

TESTIMONY OF ROBERT J. HENKES ON BEHALF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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1 **I. INTRODUCTION**

2

3 **Q. PLEASE STATE YOUR NAME AND ADDRESS.**

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

6

7 **Q. WHAT IS YOUR PRESENT OCCUPATION?**

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

10

11 **Q. WHAT IS YOUR REGULATORY EXPERIENCE?**

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

18

19 **Q. WHAT OTHER PROFESSIONAL EXPERIENCE HAVE YOU HAD?**

20 A. Prior to founding Henkes Consulting in 1999, I was a Principal of The Georgetown
21 Consulting Group, Inc. for over 20 years. At Georgetown Consulting, I performed the
22 same type of consulting services that I am currently rendering through Henkes Consulting.
23 Prior to my association with Georgetown Consulting, I was employed by the American Can

1 Company as Manager of Financial Controls. Before joining the American Can Company, I
2 was employed by the management consulting division of Touche Ross & Company (now
3 Deloitte & Touche) for over six years. At Touche Ross, my experience, in addition to
4 regulatory work, included numerous projects in a wide variety of industries and financial
5 disciplines such as cash flow projections, bonding feasibility, capital and profit forecasting,
6 and the design and implementation of accounting and budgetary reporting and control
7 systems.
8
9 **Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?**
10 A. I hold a Bachelor degree in Management Science received from the Netherlands School of
11 Business, The Netherlands in 1966; a Bachelor of Arts degree received from the University
12 of Puget Sound, Tacoma, Washington in 1971; and an MBA degree in Finance received
13 from Michigan State University, East Lansing, Michigan in 1973. I have also completed
14 the CPA program of the New York University Graduate School of Business.
15
16 **Q. WHAT IS THE SCOPE AND PURPOSE OF YOUR TESTIMONY?**
17 A. I was engaged by the New Jersey Division of the Ratepayer Advocate ("Ratepayer
18 Advocate") to conduct a review and analysis and present testimony with regard to two
19 issue areas in this proceeding. The first issue area concerns the regulatory accounting
20 requirements resulting from the purchase method of accounting for the proposed merger.
21 These accounting requirements are discussed on pages 7 through 14 of the testimony of
22 Petitioners' witness J. Barry Mitchell. The second issue area concerns the allocations of
23 costs and cost savings to the electric and gas business units of Public Service Electric &

1 Gas Company ("PSE&G"or "Company") as part of the proposed merger. The Company's
2 proposed allocation process is discussed on pages 45 through 54 of the testimony of
3 Company witness William D. Arndt.
4
5 The purpose of my testimony is to present to the New Jersey Board of Public Utilities
6 ("BPU" or "Board") and the Administrative Law Judge the appropriate treatment, for book
7 and ratemaking purposes, of the regulatory accounting requirements resulting from the
8 purchase method of accounting, and the appropriate cost and cost saving allocations
9 between the Company's electric and gas business units in the proposed merger.
10
11 **Q. WHAT INFORMATION HAVE YOU RELIED UPON IN THE DEVELOPMENT**
12 **OF YOUR TESTIMONY?**
13 A. In developing this testimony, I have reviewed and analyzed pages 7 through 14 of Mr.
14 Mitchell's testimony; pages 45 through 54 of Mr. Arndt's testimony; the responses to all
15 RAR-RA and RAR-ALLOC data requests; the BPU's November 17, 2004 Order
16 concerning the merger between AGL Resources, Inc. and NUI Utilities, Inc (d/b/a
17 Elizabeth Gas Company), BPU Docket No. GM04040421; and other relevant financial
18 documents and data.
19
20 In addition, I participated in a discovery conference with Mr. Mitchell on July 19, 2005.
21 Some of the information obtained in this conference is incorporated in this testimony.
22

II. PROPOSED REGULATORY ASSET AND REGULATORY LIABILITY ACCOUNTS

Q. PLEASE PROVIDE A BRIEF SUMMARY OF THE REGULATORY ACCOUNTING REQUIREMENT ISSUE RESULTING FROM THE PROPOSED MERGER AND THE COMPANY'S PROPOSAL TO ADDRESS THIS ISSUE.

A. Because of the purchase method of accounting used in the proposed merger, there will be a one-time adjustment to the assets and liabilities of PSE&G at the time of the merger to reflect their fair market value at that time. The result of this one-time adjustment is that PSE&G's pension and Other Post-Employment Benefit ("OPEB") expenses, third-party debt interest expenses and Basic Generation Service ("BGS") and Basic Gas Supply Service ("BGSS") contract costs on its financial books will be at different levels than the pre-merger expense levels currently allowed for ratemaking purposes This difference is due to the fact that the purchase method of accounting for the merger accelerates the timing of the financial statement recognition of previously incurred costs that have been deferred. Currently, for ratemaking purposes these deferred costs are being recognized in rates on a gradual basis through annual amortization; however, the one-time adjustment required to be made under the purchase method of accounting recognizes these deferred costs all at once on the Company's financial books at the time of the merger.

To address this issue, the Company is proposing to establish Regulatory Asset accounts (for pension/OPEB costs and third-party debt costs) and a Regulatory Liability account (for BGS/BGSS contract costs) in order to assure that the pension/OPEB costs, debt costs, and BGS/BGGS contract costs will continue to be booked at the same costs levels as existed

1 pre-merger. Thus, taking the Company's pension/OPEB costs as an example, any cost
2 difference between the annual pension/OPEB costs to be booked on the Company's
3 financial books post-merger and the annual pension/OPEB costs currently allowed for
4 ratemaking purposes is made up by an annual amortization of the pension/OPEB
5 Regulatory Asset. In this regard, Mr. Mitchell states on page 11 of his testimony:

> 6 The approval and recording of a PSE&G regulatory asset ensures that
> 7 [pension/OPEB] plan expenses in future rate-setting proceedings will be in
> 8 total identical to the amount that customers' rates would have supported had
> 9 the Merger not taken place.

10
11 Based on the fair market values as of September 30, 2004, the Company has estimated that
12 its proposed Regulatory Asset and Regulatory Liability accounts will have the following
13 approximate balances:

Line		Amount ($millions)
14–16		
17	Regulatory Assets:	
18	Pension and OPEB Liabilities	$1,100
19	Third Party Debt Obligations	$ 350
20	Regulatory Liabilities:	
21	BGS/BGSS Contracts	$ 750

22
23 **Q. DO YOU HAVE CONCERNS REGARDING PSE&G'S PROPOSAL TO ADDRESS**
24 **THE REGULATORY ACCOUNTING REQUIREMENT ISSUE RESULTING**
25 **FROM THE PROPOSED MERGER BY ESTABLISHING REGULATORY ASSET**
26 **AND REGULATORY LIABILITY ACCOUNTS?**
27 A. Yes. Taking the Company's proposed Regulatory Asset for its pension and OPEB costs as

1 an example, my concern is that a Regulatory Asset carries with it the presumption of
2 recoverability required by SFAS 71 "Accounting for the Effect of Certain Types of
3 Regulation," which could make it more difficult for the parties in future PSE&G rate
4 proceedings to take issue with the prudence and rate recovery of pension and OPEB costs
5 implicit in the Regulatory Asset balance. In other words, the establishment of a Regulatory
6 Asset pursuant to SFAS 71 may give rise to a presumption that the underlying costs are
7 automatically recoverable from ratepayers and preclude a prudence review of these costs in
8 future rate cases.
9
10 **Q. HAS THE BOARD RECENTLY RULED ON THE SAME ISSUE IN ANOTHER**
11 **MERGER PROCEEDING INVOLVING A NEW JERSEY UTILITY UNDER ITS**
12 **JURISDICTION?**
13 A. Yes. Exactly the same issue existed in the recent merger between AGL Resources, Inc. and
14 NUI Utilities, Inc. (d/b/a Elizabethtown Gas Company, or "ETG"), BPU Docket No.
15 GM04070721, with regard to NUI's pension/OPEB costs. On page 8 of the Board's Order
16 in that proceeding, the Board described the issue as follows:

17 With respect to the NUI pension plan, following the acquisition, under the
18 purchase accounting rules, the amount currently reflected by NUI as a pension
19 asset, which is being amortized as pension expense, will be eliminated.
20 Petitioners request that NUI's pension asset be treated as a regulatory asset
21 after the closing of the merger transaction. Petitioners state that this is
22 essentially a "make-whole" provision for NUI. Under this request, the
23 company would continue to amortize the asset consistent with the
24 amortization period used for the pension asset prior to the close. This will
25 ensure that the total customer obligation for the pension period cost is the
26 same pre- and post acquisition for the outstanding pension asset amount.
27
28 The Board rejected NUI's request to establish the Regulatory Asset associated with that

1 company's pension/OPEB costs. Instead, on page 14, ordering paragraph 9, of the Board's
2 Order, the Board made the following ruling with regard to this issue:

> 3 ETG shall be permitted to defer costs associated with any pension or Other
> 4 Post-Employment Benefits (OPEB) net assets or liabilities as of the date of the
> 5 [merger] closing. ETG will continue to book the amount of pension and
> 6 OPEB expenses currently authorized in ETG's rates, and will seek their
> 7 recovery through the regulatory process within the Company's next base rate
> 8 proceeding. In no event shall ETG recover from ratepayers any pension and
> 9 OPEB expenses pursuant to this provision in excess of the pension and OPEB
> 10 expenses that would have been booked in accordance with FAS 87 and FAS
> 11 106 in the absence of the merger…

12

13 In summary, rather than allowing NUI (ETG) to establish a Regulatory Asset account in
14 the amount of the pension/OPEB assets that would be eliminated at the time of the merger,
15 the Board instead allowed NUI (ETG) (1) to establish another type of deferral account[1] to
16 "defer the costs associated with any pension and OPEB liabilities as of the date of closing,"
17 (2) to continue to book the amount of pension and OPEB expenses authorized in rates at
18 the time of the merger, and (3) to seek continued recovery through the regulatory process
19 with ETG's next base rate proceeding. Thus, the Board did not approve NUI's requested
20 recovery of the Regulatory Asset through future rates, but rather directed NUI (ETG) to
21 seek rate recovery of the deferred pension/OPEB costs through the normal regulatory
22 process in ETG's next base rate proceeding.

23

24 **Q. WHAT IS YOUR RECOMMENDATION REGARDING THIS REGULATORY**
25 **ACCOUNTING REQUIREMENT ISSUE?**

26 A. Based on the concerns previously expressed in this testimony and the recent November 17,
27 2004 Board ruling regarding the same issue in the AGL/NUI merger case, I recommend

[1] For example, Account 186 – Miscellaneous Deferred Debits. The Uniform System of Accounts provides that this deferred debit account can include, among other things, "deferrals by authorization of the Commission."

1 that the Board reject the Company's proposed Regulatory Asset and Regulatory Liability
2 accounts. Instead, I recommend that the Board order the same accounting and regulatory
3 treatment to deal with the one-time merger related adjustment of the assets and liabilities
4 associated with PSE&G's pension/OPEB, third-party debt, and BGS/BGSS costs as the
5 Board ordered for the one-time merger related adjustment of NUI's (ETG's)
6 pension/OPEB assets in the recently concluded AGL/NUI merger that was completed on
7 November 17, 2004. Thus, the Board has very recently stated a regulatory policy in a New
8 Jersey merger case concerning the very same regulatory accounting requirement issue that
9 is at issue in the instant merger proceeding. I see no compelling reason why this Board
10 policy should not be extended to this merger, and no circumstances exist in the instant
11 merger case that would warrant a different treatment.
12
13 **III. PROPOSED ELECTRIC-GAS NET MERGER SAVINGS ALLOCATIONS**
14
15 **Q. IN YOUR REVIEW OF THE PROPOSED COST AND COST SAVING**
16 **ALLOCATIONS BETWEEN PSE&G'S REGULATED ELECTRIC AND GAS**
17 **BUSINESS UNITS IN THIS MERGER PROCEEDING, DID YOU FIND AN ISSUE**
18 **THAT NEEDS TO BE CORRECTED?**
19 A. Yes. The issue is that PSE&G's proposed allocation process in this merger over-allocates
20 the Company's quantified net regulated merger savings to its electric business unit and
21 under-allocates these same net regulated merger savings to the gas business unit.

1 **Q. BEFORE DISCUSSING THIS ISSUE IN MORE DETAIL, PLEASE DESCRIBE**
2 **THE PROCESS USED BY THE COMPANY TO ALLOCATE THE PSE&G NET**
3 **REGULATED MERGER SAVINGS TO THE REGULATED ELECTRIC AND GAS**
4 **BUSINESS UNITS.**
5 A. The Company's proposed allocation methods to allocate the net merger savings to its
6 electric and gas business units are discussed on pages 50 through 54 of Mr. Arndt's
7 testimony and quantified in detail in the response to RAR-SQ-34, workpapers 330 through
8 337 (for the allocated gross and net merger savings) and workpapers 360 through 366 (for
9 the allocated Costs to Achieve).
10
11 As described in the above-referenced material, PSE&G first took the gross merger savings
12 allocated to regulated PSE&G as a whole and then further allocated these gross merger
13 savings to its electric and gas business units. Pages 331, 336 and 337 of the response to
14 RAR-SQ-34 show that all gross merger savings other than the labor related ("Utility
15 Staffing") gross merger savings were allocated to the electric and gas business segments of
16 regulated PSE&G at historical non-fuel O&M allocation ratios of 62%/38%, respectively.
17 For the labor related ("Utility Staffing") gross merger savings, the Company used
18 electric/gas allocation factors of 72%/28%. As shown at the bottom of page 331 of the
19 response to RAR-SQ-34, the reason for the difference between the electric/gas allocation
20 factors of 72%/28% (for labor related savings) and 62%/38% (for all non-labor savings) is
21 that there were significantly more labor savings directly allocated to the electric business
22 unit than to the gas business unit. Specifically, the Company has confirmed in its response
23 to RAR-ALLOC-2 that the total electric operations support staffing savings are based on a

1 reduction of 43 full-time employees, whereas the total gas operations support staffing
2 savings are based on a reduction of 7 full-time employees. In the response to RAR-
3 ALLOC-2, the Company also states in this regard:

4 The electric operations support staffing [labor-related] savings are larger than
5 the gas operations support staffing savings for several reasons, the most
6 significant of which is the relative scale of the electric distribution operations
7 as compared to the gas distribution operations.
8

9 Next, PSE&G subtracted from the gross merger savings allocated to the electric and gas
10 business units the Company's total regulated Costs to Achieve ("CTA") allocated to the
11 electric and gas business units in order to arrive at the net regulatory merger savings
12 allocated to PSE&G's regulated electric and gas business units. Pages 361, 365 and 366 of
13 the response to RAR-SQ-34 show that all of PSE&G's regulated CTA, including the CTA
14 specifically associated with labor-related gross merger savings (severance, retention,
15 relocation) was allocated to the electric and gas business units based on the Company's
16 proposed historical non-fuel O&M allocation ratios of 62%/38%.
17

18 **Q. COULD YOU NOW DISCUSS THE ISSUE WITH REGARD TO THE OVER-**
19 **ALLOCATION OF THE COMPANY'S QUANTIFIED NET REGULATED**
20 **MERGER SAVINGS TO ITS ELECTRIC BUSINESS UNIT AND THE**
21 **CORREPONDING UNDER-ALLOCATION OF THESE NET MERGER SAVINGS**
22 **TO THE GAS BUSINESS UNIT?**

23 A. Yes. The over- and under-allocation issue consists of two parts. First, as confirmed in the
24 response to RAR-ALLOC-3, the Company's proposed historical non-fuel O&M allocation
25 ratios for electric/gas of 62%/38% are based on the ratios in existence in calendar year

1 2003. This same response also indicates that the actual net non-fuel O&M electric/gas
2 ratios for 2003, on a rounded basis, were not 62%/38% but, rather, 61%/39%. So even if
3 one accepts the use of the year 2003 for the determination of the historical non-fuel O&M
4 allocation ratios for electric/gas, these ratios should be 61% for the electric business unit
5 and 39% for the gas business unit. The response to RAR-ALLOC-3 further shows that (1)
6 the non-fuel O&M allocation ratios for electric/gas for the year 2004 amount to
7 58.5%/41.5%; and (2) the historic non-fuel O&M allocators for the Company's gas
8 operations during the last 4 years, 2001 through 2004, have continously increased each
9 year from approximately 19% to 41.5%. Based on this information, I recommend that the
10 historic non-fuel O&M allocator to be used to allocate the regulated PSE&G's net merger
11 savings to the electric and gas business units be set at 58.5%/41.5% rather than the
12 Company's proposed ratios of 62%/38%. I believe this recommendation is appropriate
13 because the 2004 non-fuel O&M allocation ratios are the most recent ratios available at this
14 time and should be considered the most representative of the Company's future non-fuel
15 O&M allocators given the recent discernable trend of increasing gas and decreasing electric
16 allocation ratios.
17
18 Second, there is an issue with regard to the Company's proposal to allocate the labor-
19 related gross merger savings to its electric and gas business units based on allocation
20 factors of 72%/28% while using electric/gas allocation factors of 62%/38% for the CTA
21 specifically related to changes in labor-related costs (severance, retention, relocation). This
22 proposed allocation approach is internally inconsistent and is not reflective of the statement
23 made by Mr. Arndt on page 51 of his testimony that the CTA allocations should be

1 determined in a manner consistent with the associated gross merger savings allocations,
2 i.e., the CTA allocations, wherever possible, should follow the associated gross merger
3 savings allocations. I therefore recommend that PSE&G's total regulated labor-related
4 CTA (severance, retention and relocation costs) be allocated to the Company's electric and
5 gas business units at the same electric/gas allocation ratios used for the allocation of the
6 labor-related gross merger savings.
7
8 **Q. HAVE YOU CALCULATED THE IMPACT OF YOUR RECOMMENDATIONS**
9 **ON THE COMPANY'S PROPOSED FOUR-YEAR NET MERGER SAVINGS**
10 **ALLOCATIONS TO THE REGULATED ELECTRIC AND GAS BUSINESS**
11 **UNITS?**
12 A. Yes. As summarized in the table[2] on page 54 of Mr. Arndt's testimony, the four-year total
13 regulated PSE&G net merger savings amount to approximately $66 million, of which
14 approximately $47 million has been allocated by Mr. Arndt to the electric business unit and
15 approximately $19 million to the gas business unit. By contrast, under my recommended
16 allocation methodology, the four-year total regulated PSE&G net merger savings amount
17 of approximately $66 million should be allocated to the electric business unit at an amount
18 equal to approximately $42 million and to the gas business unit at an amount equal to
19 approximately $24 million. The calculations underlying the Company's proposed and my
20 recommended electric/gas allocations of the total regulated PSE&G net merger savings of
21 $66 million are shown on Schedule RJH-1 attached to this testimony.
22

[2] Under the caption "Tier III."

1 **Q. HAVE YOU ALSO QUANTIFIED THE ALLOCATIONS TO PSE&G'S**
2 **ELECTRIC AND GAS BUSINESS UNITS OF THE 10-YEAR NET MERGER**
3 **SAVINGS RECOMMENDED BY RATEPAYER ADVOCATE WITNESS DAVID**
4 **PETERSON BASED ON YOUR RECOMMENDED ALLOCATION FACTORS?**
5 A. Yes. As shown on Schedule RJH-2, based on my recommended allocation factors,
6 approximately $394 million of Mr. Peterson's recommended total 10-year net merger
7 savings amount of approximately $635 million is allocable to PSE&G's electric business
8 unit and approximately $242 million is allocable to PSE&G's gas business unit.
9
10 **Q. MR. HENKES, DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**
11 A. Yes, it does.