

**STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES**

**In the Matter of the Petition of
Public Service Electric and Gas Company
for Approval of an Increase in Electric and Gas Rates
and for Changes in the Tariff for Electric and Gas Service,
B.P.U.N.J. No. 14 Electric and B.P.U.N.J No. 14 Gas
Pursuant to N.J.S.A. 48:2-21 and 48:2-21.1
and for Approval of a Gas Weather Normalization Clause;
a Pension Expense Tracker and for other Appropriate Relief**

**BPU Docket No. GR09050422
OAL Docket No. PUCRL 07559-2009N**

REBUTTAL TESTIMONY

OF

**MARK G. KAHRER
VICE PRESIDENT – FINANCE**

EXHIBIT P-7-RB

DECEMBER 30, 2009

TABLE OF CONTENTS

	<u>PAGE</u>
I. INTRODUCTION	1
A. PERSPECTIVE AND REBUTTAL OVERVIEW	2
B. PURPOSE OF THIS TESTIMONY	6
II. REBUTTAL OF THE DIRECT TESTIMONY OF ANDREA C. CRANE	8
A. RATE BASE ISSUES	8
1. <i>Utility Plant-in-Service</i>	8
2. <i>Rate Basing of Capital Infrastructure Investment Program (CIIP) Expenditure</i>	11
3. <i>Plant Held for Future Use</i>	12
4. <i>Customer Deposits</i>	14
B. OPERATING INCOME ISSUES	16
1. <i>Pro Forma Revenue</i>	16
2. <i>Salary and Wage Expense</i>	18
3. <i>Incentive Compensation Program Expense</i>	19
4. <i>Severance Expense</i>	28
5. <i>Payroll Tax Expense</i>	28
6. <i>Supplemental Executive Retirement Program (SERP) Expense</i>	29
7. <i>Rate Case Expense</i>	30
8. <i>Injuries and Damages Expense</i>	31
9. <i>Customer Information System Amortization Expense</i>	32
10. <i>Management/Affiliate Standards Audit</i>	34
11. <i>Vegetation Management Expense</i>	36
12. <i>Energy Master Plan (“EMP”) Costs</i>	36
13. <i>Uncollectible Expenses</i>	38
14. <i>Meals and Entertainment Expenses</i>	39
15. <i>Advertising Expense</i>	40
16. <i>Dues/Lobbying Expenses</i>	41
17. <i>Gain/Losses on Sale of Property</i>	42
18. <i>Real Estate Tax Expense</i>	44
C. PROPOSED MODIFICATION TO THE CAPITAL ADJUSTMENT CHARGE	45
1. <i>Expansion of CAC to Include Capital Expenditure Other Than New Business</i>	45

III. REBUTTAL OF THE DIRECT TESTIMONY OF ROBERT J. HENKES AND MITCHELL I. SEROTA REGARDING THE PENSION EXPENSE TRACKER	47
A. SINGLE ISSUE RATEMAKING	47
B. SUBSTANTIATE THE NEED FOR A PENSION TRACKER	49
C. PENSION TRACKER AND ITS IMPACT ON THE INCENTIVE TO RUN AT THE LOWEST COST	51
D. PERFORMANCE OF THE PENSION INVESTMENT COMMITTEE	53
E. CONCLUSIONS ON THE PENSION TRACKER	59
IV. REBUTTAL OF THE DIRECT TESTIMONY OF RICHARD LELASH REGARDING THE WEATHER NORMALIZATION CLAUSE (WNC)	60
V. REBUTTAL OF THE DIRECT TESTIMONY OF MATTHEW I. KAHAL REGARDING THE COMPANY'S CAPITAL STRUCTURE	63

1 **REBUTTAL TESTIMONY**

2
3 **OF**

4
5 **MARK G. KAHRER**

6
7
8 ***I. INTRODUCTION***

9 **Q. Please state your name and title.**

10 A. My name is Mark G. Kahrer. I am the Vice President-Finance for Public
11 Service Electric and Gas Company (PSE&G, the Company).

12
13 **Q. Have you previously submitted testimony in this proceeding?**

14 A. Yes, my Direct Testimony was submitted with the Petition as Exhibit P-7. In
15 that testimony, I addressed the Company's financial policy, including the
16 overall need for regulatory relief being sought in this filing; the Company's
17 capital structure; the growth in the Company's rate base investment;
18 establishment of a gas weather normalization clause; changes to the Capital
19 Adjustment Charge (CAC) previously approved by the New Jersey Board of
20 Public Utilities (NJBPU, BPU, the Board), including the establishment of a
21 pension expense tracker and the inclusion of all non-revenue producing electric
22 and gas capital expenditures; and the Company's revenue requirements. My
23 qualifications are described in Schedule MGK-1 of my direct testimony.

1 I also submitted Supplemental Testimony on September 25, 2009,
2 reflecting six months of actual data plus six months of projected data for the test
3 year 2009.

4

5 **Q. What is the purpose of your rebuttal testimony?**

6 A. This rebuttal testimony addresses portions of the revenue requirement position
7 presented by Ms. Andrea C. Crane and also addresses portions of the
8 testimonies of Messrs. Henkes, Serota, LeLash, and Kahal prepared on behalf
9 of the New Jersey Department of the Public Advocate, Division of Rate
10 Counsel (Rate Counsel) and filed in this proceeding on November 19, 2009.

11

12 **A. PERSPECTIVE AND REBUTTAL OVERVIEW**

13 **Q. Please summarize the rationale for PSE&G's request.**

14 A. The Company's current electric and gas rates were last reset in November
15 2006. During the last three years the Company has continued to provide safe,
16 adequate, proper and reliable electric and gas distribution service to our
17 customers, as evidenced by the Company's numerous awards for reliability,
18 outstanding customer service and safe operations. The Company has received
19 the National ReliabilityOne Excellence Award recognizing the most reliable
20 electric utility in the nation four of the last five years, and has been recognized
21 by the PA Consulting Group as the most reliable electric utility in the Mid-

1 Atlantic region for the last eight years running. PSE&G has provided such
2 service while maintaining three year-old electric and gas base rate levels, and
3 at the same time absorbing increases in salaries and wages, related benefits,
4 operating costs and capital investment required to operate and maintain its
5 electric and gas distribution system, and meeting the requirements of the
6 Board. The testimonies of PSE&G witnesses in this proceeding demonstrate
7 the need for an increase in our electric and gas distribution base rates. That
8 testimony shows that the Company's request is required from a financial
9 perspective and is essential to our continued ability to meet our obligation to
10 provide safe, adequate and reliable electric and gas delivery service to our
11 customers in a manner that meets their expectations for service quality.

12
13 **Q. Has the Company updated its initial filing in this case?**

14 A. Yes. On September 25, 2009, the Company updated its initial filing for six
15 months of actual data through June 30, 2009. The update substantiates the
16 need for rate increases of \$147.02 million and \$105.94 million for electric
17 distribution and gas distribution, respectively. Rate Counsel, through the
18 testimony of various witnesses and summarized in the testimony of Ms. Crane,
19 proposes an electric distribution rate decrease of \$15.44 million, which is
20 \$162.46 million less than the Company's updated request, and a gas
21 distribution rate increase of \$13.72 million, which is \$92.23 million less than

1 the Company's updated request. Rate Counsel witnesses' recommendations in
2 this proceeding, if adopted, would clearly undermine the Company's ability to
3 fulfill its responsibility to meet its customers' expectations for safe, adequate
4 and proper as well as reliable electric and gas service, and to attract capital at a
5 fair price to support the State's economic and environmental objectives. If
6 Rate Counsel's position is adopted, it would jeopardize PSE&G's financial
7 health, and lead to higher financing costs.

8

9 **Q. Please summarize your comments on the Rate Counsel's witnesses'**
10 **testimony in this case.**

11 A. The Company's rebuttal case demonstrates that many of the positions put forth
12 by Ms. Crane and other Rate Counsel witnesses are unreasonable and are not
13 based on sound regulatory and public policy. They should be rejected by the
14 Administrative Law Judge (ALJ) and the Board.

15 Collectively, Rate Counsel's recommendations, if adopted,
16 produce a revenue requirement that is totally inadequate. The Company's
17 currently established electric and gas Returns on Equity (ROE) are 9.75% and
18 10%, respectively. Mr. Kahal has recommended an ROE of 10.1% on a capital
19 structure containing 49.73% common equity. This overall return position,
20 along with other Rate Counsel recommendations, will not provide an
21 opportunity for PSE&G to earn a reasonable return on its investment and

1 attract capital at fair price given the financial evidence provided by the
2 Company. Ms. Crane's testimony contains a large number of
3 recommendations that, if adopted, would result in an unrealistic reduction in
4 the level of rates requested. There is no recognition on her part of the impact
5 of the disallowances contained in her testimony on the continued successful
6 operation of our Company. The elimination of prudent, legitimate expenses
7 for activities that directly support safe and adequate service should not be
8 endorsed by the Administrative Law Judge (ALJ) or the Board.

9 Throughout their testimonies, Messrs. Cardenas and Daly
10 provide comprehensive overviews of how our employees have successfully
11 utilized their skills, training and assets over a period of years to provide
12 outstanding electric and gas distribution service to our customers. While
13 Messrs. Cardenas and Daly testify to the specific details of these activities, I
14 want to point out that successful management of the operations of the utility is
15 intertwined with the necessary costs and expenses that Ms. Crane recommends
16 disallowing in this proceeding.

1 **B. PURPOSE OF THIS TESTIMONY**

2 **Q. What areas will you be addressing, and what areas will other PSE&G**
3 **witnesses be addressing in their rebuttal testimonies?**

4 A. My testimony will provide rebuttal to a number of specific items addressed by
5 Ms. Crane in deriving her revenue requirements recommendations of a \$15.44
6 million decrease for electric distribution and a \$13.72 million increase for gas
7 distribution. Rebuttal testimonies submitted by:

- 8 • Mr. Krueger and Mr. Warren will address the issue of Consolidated
9 Income Taxes,
- 10 • Mr. Wreschnig will address issues surrounding weather normalization,
11 customer growth, and customer usage,
- 12 • Mr. Furlong will address the recommended adjustment to cash
13 working capital presented by Rate Counsel witness Peterson,
- 14 • Mr. McDonald of Hewitt Associates will address the recommended
15 adjustments associated with pension expense, and
- 16 • Dr. Vilbert will address the Company's cost of capital, and respond to
17 Rate Counsel witness Mr. Kahal.

18 In addition, my testimony will address Rate Counsel's treatment of
19 the Company's proposed changes to the Capital Adjustment Charge (CAC) to
20 incorporate an expanded Infrastructure Tracker; Rate Counsel's position,
21 described in Mr. Henkes' and Mr. Serota's testimony, on the Company's

1 proposed Pension Tracker; Rate Counsel witness Mr. LeLash's discussion of the
2 symmetrical benefit concept as it relates to PSE&G's proposed weather
3 normalization clause; and the capital structure issues raised by Mr. Kahal.

1 **II. REBUTTAL OF THE DIRECT TESTIMONY OF ANDREA C. CRANE**

2 **A. RATE BASE ISSUES**

3 **1. *Utility Plant-in-Service***

4 **Q. What is Ms. Crane’s recommendation regarding post-test year plant**
5 **additions?**

6 A. Ms. Crane is recommending that all post-test year plant additions net of post-
7 test year retirements be eliminated from the Company’s calculation of revenue
8 requirements. Her recommendation is based upon the assertion that including
9 post-test year plant “results in a mismatch among the components of the
10 regulatory triad” (Crane, page 13, line 13) and “violates the principle that all
11 components of the ratemaking equation should be matched at a point in time”
12 (Crane, page 13, lines 20-21).

13
14 **Q. Is the Rate Counsel’s testimony consistent on this point?**

15 A. No. Ms. Crane’s testimony appears to be at odds with Mr. Henkes’ belief that
16 “the ratemaking process entitles the utility no more than a reasonable
17 opportunity to recover its costs and earn a fair rate of return” (Henkes, page 7,
18 lines 17-18). The Company’s rate filing request is premised upon seeking a
19 “reasonable opportunity to recover its cost,” including the costs associated with
20 financing capital investments. To the extent possible within the constraints of
21 beginning with a historic test period, the Company’s filing also seeks to match

1 the components of the ratemaking equation at a point in time. Unless that
2 point in time is the period when the new rate levels, determined in this
3 proceeding, will be in effect, then the Company will be denied a “reasonable
4 opportunity to recover its costs.”

5

6 **Q. What is the practical effect of Ms. Crane’s position?**

7 A. Ms. Crane’s recommendation to eliminate post-test year plant additions
8 virtually guarantees that the Company will not be able to earn its allowed
9 return on equity (ROE) when new rates are in effect. Even the Company’s
10 inclusion of post-test year plant additions through February 2010 will be
11 inadequate given that new rates will not go into effect until well past February
12 2010 given the current procedural schedule. Ms. Crane fails to explain her
13 opposition to recognizing the reality of post-test year increases in rate base, but
14 does selectively adjust some (not all) expenses, and is willing to project
15 increases in revenue beyond the purely historic test year.

16

17 **Q. What is the rationale for Ms. Crane’s position regarding utility plant-in-**
18 **service?**

19 A. Ms. Crane testifies that post-test year plant additions should be eliminated
20 because “the use of plant additions that extend past the end of the test year is
21 speculative” (page 13, line 20).

1 **Q. Is Ms. Crane correct?**

2 A. No, she is not. Net plant has consistently grown over time and will continue to
3 grow. Schedule MGK-47 shows that PSE&G's net plant has grown at a
4 compound growth rate of 3.70% and 5.46% for electric and gas distribution,
5 respectively, over the period 2004 through 2009. Applying those growth rates
6 pro rata for two months to the 2009 net plant numbers produces a net plant
7 number that is only \$5 million lower than the projection in the Company's
8 filing based on a more detailed near-term planning process for electric
9 distribution, and \$19 million higher than the Company's projection for gas
10 distribution. Clearly the plant additions for two months beyond the test year in
11 the Company's filing are not speculative and are conservative and quantifiable.
12 Furthermore, the Board has recognized capital additions beyond the end of a
13 test year when the additions are known and measurable. Since the current
14 hearing schedule will not end until March, it is obvious that the net capital
15 additions will be known before the Board decides this matter. The net capital
16 additions of approximately \$67.4 million for electric and gas distribution are
17 obviously a major investment by the utility, which is being incurred to provide
18 safe and adequate service to its customers. Recovery of these costs through
19 currently-set rates is consistent with logic, equity, and Board precedent. Ms.

1 Crane's recommendation to disallow post-test year plant additions should be
2 rejected.

3

4 **2. Rate Basing of Capital Infrastructure Investment Program (CIIP)**
5 **Expenditure**

6

7 **Q. What is Ms. Crane's position regarding the inclusion of CIIP expenditures**
8 **in rate base?**

9 A. Ms. Crane recommends that only CIIP expenditures through December 31,
10 2009 be included in rate base.

11

12 **Q. Do you agree?**

13 A. No. Consistent with the Company's approach to have known and measurable
14 net plant additions in rate base, the Company is proposing to include CIIP
15 expenditures through February 2010, when new base distribution rates were
16 anticipated to go into effect. The Company's approach is consistent with the
17 BPU Order establishing the CIIP in that when the investment associated with
18 CIIP begins to be recovered through base distribution rates, the amount
19 recovered through CAC will decrease by the same amount. Ms. Crane's
20 adjustment is inconsistent with the CIIP order.

21

22

23

The Company does want to make it clear that the CIIP net investment that is rolled into rate base and therefore base distribution rates is net plant in-service. CIIP expenditures not in-service as of the date new base

1 distribution rates are set remain as investment in the CAC clause as called for
2 under the Board's April 2009 Order.

3

4 **3. *Plant Held for Future Use***

5 **Q. Why does PSE&G acquire and hold plant for future use?**

6 A. The State of New Jersey is one of the most densely populated states in the
7 country. PSE&G has an obligation to provide safe and adequate service to its
8 customers. In order to meet the growing demand of its electric customers, the
9 Company has acquired sites for future substations. By acquiring the sites in
10 advance of their need, the Company is insuring that the sites will be available
11 when they are needed. If the Company did not take this approach, these sites
12 may not be available when they are needed, which could impact the quality of
13 service to PSE&G's customers. Also, by acquiring the sites now, the
14 Company has secured the sites at a reasonable cost. In the event the Company
15 did not prudently plan for the future and acquire the sites in advance, required
16 sites (if available) would obviously be more costly.

17

18 **Q. What is Ms. Crane's position regarding these investments?**

19 A. Ms. Crane would exclude these investments from rate base, but gives no valid
20 reason to exclude these sites.

1 **Q. Has the Board recognized plant held for future use in rate base in the**
2 **past?**

3 A. Yes. For example, in Re Public Service Electric and Gas Company, BPU
4 Docket No. 812-76 (April 20, 1982), the Board rejected the ALJ's
5 recommendation to take plant held for future use out of rate base. The ALJ
6 based his decision on an assumption that the land would probably not be
7 placed in service during the life of the rates. The Board was clear that prudent
8 investment in plant acquired and held for future utility use belongs in the rate
9 base. The Board stated:

10 We...believe that certain present investments by utilities
11 for future uses must necessarily be made given current
12 logistical and economic considerations. Accordingly, we
13 *Find* that petitioner's investment in land tracts located in
14 Bayonne, Bordentown, Greenwich and Newbold Island
15 (right of way) are prudent in that sound management
16 dictates the acquisition of properties for future utility uses
17 at a time when they are readily available and cost efficient
18 to purchase. Our review of the record relative to the
19 aforementioned acquisitions reveals that they are viable
20 sites for switching and/or generating stations and that,
21 therefore, they will be necessary to meet the future
22 requirements of the company and its customers.
23 Furthermore, the record amply supports the conclusion
24 that the cost of these tracts is reasonable. Accordingly,
25 given the rapid development of an industrialized state
26 such as New Jersey, we believe that proper utility
27 planning mandates such acquisitions and that the ALJ's
28 initial decision, insofar as it excludes such properties from
29 rate base, should be modified by adding \$16,363,000 to
30 electric PHFU, the amount identifiable to said properties.
31 Id at 5.

1 The Board's rationale in this prior PSE&G rate case is just as valid today.

2

3 **4. Customer Deposits**

4 **Q. How, according to Ms. Crane, can the Board treat customer deposits in a**
5 **base rate case?**

6 A. Ms. Crane describes two methodologies for the treatment of Customer
7 Deposits in determining rate increase requirements:

8 1. Customer deposits can be treated as a component of the
9 Company's capital structure (the Company's methodology), or

10 2. Customer deposits can be treated as a reduction to rate base with
11 an "above-the-line" expense equal to the interest paid to the
12 customers on the deposits (Ms. Crane's recommended approach).

13

14 **Q. Which method does Ms. Crane advocate?**

15 A. While Ms. Crane advocates the second method, arguing that rate base is
16 limited to investment that is financed by investors, she presents no basis for
17 this concept. She reduces rate base by the entire customer deposit as if the
18 entire deposit is related to rate base.

19

20 **Q. What is wrong with that approach?**

21 A. Since customer deposits are based on the entire cost of service, including
22 commodity costs as well as O&M, Ms. Crane's assignment of the deposits as if

1 they were only related to rate base is incorrect; in fact, the majority of each
2 deposit supports non-investment elements of customer rates.

3

4 **Q. Are there other reasons that the Company's treatment of customer**
5 **deposits is superior to Ms. Crane's?**

6 A. Yes. Customer deposits as part of the capital structure are reflected in
7 PSE&G's current rates and in the revenue requirement calculations for the
8 various company EMP initiatives and CIIP. Since the Company has one
9 capital structure for its electric and gas operation, there is no need to use a
10 questionable allocation methodology for customer deposits between electric
11 and gas operations, as required if customer deposits are used as a rate base
12 deduction, as Ms. Crane advocates. It is our understanding that customer
13 deposits also appear as a component in the capital structure used to determine
14 revenue requirements in the most recently completed New Jersey Natural Gas
15 base rate case (Docket No. GR07110889), which was decided by a Board
16 Order dated October 3, 2008.

17

18 **Q. Ms. Crane believes that PSE&G's projection of customer deposits**
19 **"appears to be low based on historic levels" (page 25, line19), and she**
20 **suggests that "the BPU may decide that it is more reasonable to utilize the**
21 **March 31, 2009 balance" (page 26, lines 8-9). Is she correct?**

22 A. No, she is not. The Company continues to believe the actual balance at the end
23 of the test-year is appropriate. The March 31st balance of \$87.2 million was in

1 fact the highest in the past 24 months, and the average over the past 24 months
2 was \$76.2 million (response to RCR-A-219). To pick the balance from a date
3 other than the end of the test period or the most recent actual balance would be
4 inappropriate.

5

6 **B. OPERATING INCOME ISSUES**

7 ***1. Pro Forma Revenue***

8 **Q. Ms. Crane proposes an adjustment to annualize PSE&G's pro forma**
9 **revenue to reflect customer growth during the test year. Do you agree?**

10 A. No, I do not. Such an adjustment is inappropriate for the reasons set forth in
11 Mr. Wreschnig's rebuttal testimony. As Mr. Wreschnig demonstrates, Ms.
12 Crane has overstated customer growth by basing her annual growth rates on the
13 number of customers in September of each year, rather than by the preferred
14 method of calculating growth in the annual average number of customers. As
15 Mr. Wreschnig also demonstrates, Ms. Crane, by only reflecting growth in the
16 number of customers but not considering declines in customer usage, only
17 shows one half of the picture. The decline in use per customer more than
18 offsets the customer growth adjustment.

1 **Q. Are there any other problems in Ms. Crane's approach to addressing**
2 **customer growth?**

3 A. Yes, there are. On one-hand she speaks to "matching at one point in time," yet
4 in this case she chooses to annualize revenue but ignores that expenses also
5 grow over time. The Company recognizes that basing rates on a historic test-
6 year with pro forma adjustments is not perfect. In its filing, the Company has
7 pro formed certain expenses but not revenue. Not factoring in customer
8 growth is a hedge against future cost increases. If one looks at the Company's
9 projected Operation and Maintenance (O&M) expenses, excluding supply
10 expense and those expenses to which the Company has made pro forma
11 adjustments, there is still some \$496 million electric and \$193 million gas
12 O&M that is purely historic test year. If those costs grow at only 2.5% per
13 year (less than a reasonable anticipated rate of inflation), one could expect that
14 the Company will be facing O&M costs, when new rates are in effect, that are
15 \$12.4 million higher than test-year for electric and \$5.6 million for gas
16 (Schedule MGK-48). Ms. Crane contends that customer growth would
17 contribute \$3.7 million to electric revenue and \$5.5 million to gas revenue.
18 The anticipated expense growth is greater than the revenue growth from
19 increased customers. Therefore, not adjusting for customer growth acts as a
20 hedge against cost increases but is likely to be an inadequate hedge.

1 **2. *Salary and Wage Expense***

2 **Q. Do you have any comments regarding PSE&G's salary and wage expenses**
3 **in the rate-effective year?**

4 A. Yes, I do. The Company has recently announced that there will be a freeze in
5 the wages for bargaining unit and MAST employees for the year 2010. The
6 majority of bargaining unit members have agreed to the freeze. This freeze is
7 due to the economic pressures facing all of Public Service Enterprise Group
8 (PSEG). This freeze is unprecedented in the modern history of PSE&G. Ms.
9 Crane has recommended that the Company's 2011 salary and wage increase be
10 excluded from the determination of revenue requirements. Based upon the
11 current economic conditions and the Company's response to those conditions,
12 the Company in its updated filing will only include the wage increases that
13 were scheduled to occur during 2010.

14
15 **Q. Why should the Board include these scheduled wage increases in**
16 **PSE&G's rates?**

17 A. The Board should permit these increases because the freeze is an abnormal
18 event and the equivalent of the 2010 anticipated wage increases will take place
19 in 2011 (January and April for MAST employees and May for most bargaining
20 unit employees; one bargaining unit, the UWUA representing approximately
21 1,400 employees, has not agreed to the freeze, and that union's scheduled 2010
22 increase will take place). The failure to recognize this increased expense will

1 further insure that the Company will not have the opportunity to earn its
2 established return in 2011. The Company took prompt action to react to the
3 current economic conditions and should not be penalized for its prudent
4 actions. The ALJ and the Board should recognize that the partial wage freeze
5 in 2010 is abnormal, and should permit one wage increase in order to
6 normalize wages going forward.

7

8 **3. *Incentive Compensation Program Expense***

9 **Q. Ms. Crane challenges the rate recovery of the incentive compensation**
10 **component of the Company's total compensation program. Is she correct?**

11 A. No. Incentive compensation is a critical tool for aligning the performance of
12 all the individuals within the PSE&G organization with opportunities to
13 achieve performance in safety, productivity, reliability, cost control, and
14 customer satisfaction. Ms. Crane's recommendation to exclude incentive
15 compensation seems to stem from a misconception that you can separate the
16 "at-risk" portion of an employee's compensation from the base portion when
17 considering the total compensation package required to attract qualified
18 employees, as well as to provide reward and recognition to retain the services
19 of highly trained and qualified associates.

1 **Q. Why do you say Ms. Crane has a misconception about PSE&G's incentive**
2 **compensation programs?**

3 A. Ms. Crane asserts that her revenue requirement recommendation "already
4 reflects a generous allowance for officers," and that any "further reward [to]
5 officers and executives... should be borne by shareholders..."(Crane, page 56,
6 lines 1-4). She suggests that incentive compensation "[a]llow[s] a utility to
7 charge for additional return that is then distributed to employees as part of a
8 devised plan to divide extraordinary profits..." (Crane, page 56, line 21 – page
9 57, line 1). But Ms. Crane's assertion that PSE&G's incentive compensation
10 programs provide for "bonus" payments above and beyond normal
11 compensation, rather than as an incentive to achieve a broad range of goals, is
12 incorrect. The incentive programs the Company prudently implemented are
13 part of the Company's total compensation program.

14
15 **Q. Can you discuss the history of PSE&G's implementation of an incentive**
16 **compensation program?**

17 A. Yes. In the Company's litigated gas base rate case (Docket No GR01050328),
18 Rate Counsel's expert witness, Mr. Henkes, stated in cross-examination,

19 ...if there is any evidence that suggests that the incentive
20 compensation portion might be an additive to what
21 otherwise would be the overall compensation then it is my
22 position that the ratepayers shouldn't pay for that piece.

1 There simply is no basis to suggest that PSE&G's incentive compensation
2 programs are additive to what would otherwise be the total compensation. The
3 Company's total cash compensation to employees is virtually the same as it
4 would have been had we not implemented the Performance Incentive Plan
5 (PIP) program, which is not surprising given that the Company purposefully
6 took steps to ensure this result. In 1995, the Company began the phase-in of
7 the PIP from a limited number of upper level managers to all non-bargaining
8 unit employees. In 1996 and 1997, the Company continued to fund the PIP
9 program by limiting base wage increases. Thus, base wages alone were *below*
10 what they otherwise would have been, which helped fund the incentive or "pay
11 at risk" component. While Ms. Crane claims that "there is no indication that
12 the employees of PSE&G are underpaid" (page 57, lines 15-16), there is
13 clearly no evidence that our officers or employees are overcompensated, and
14 no party to this proceeding has alleged that our total compensation to officers
15 or employees is out of line with the market. Indeed, the combination of base
16 pay and incentive compensation today effectively equal what compensation
17 would have been absent the introduction of an incentive component.

1 **Q. Has Rate Counsel agreed that incentive compensation at these levels**
2 **should be recoverable through base rates?**

3 A. Yes. Again, under cross-examination in the Company's gas base rate case,
4 Rate Counsel's expert witness Mr. Henkes stated that recovery of these
5 expenses through base rates would be reasonable:

6 If those two levels [total cash compensation before PIP and
7 after PIP] were to stay the exactly the same I would agree
8 with you that is a reasonable situation...If it represents a
9 prudent expense then I -- you know, I certainly wouldn't
10 have any objection to that

11
12
13 **Q. Does PSE&G's incentive compensation program satisfy Rate Counsel's**
14 **test for reasonableness?**

15 A. Yes. Our compensation program continues to meet Rate Counsel's prior
16 expert witness own test for reasonableness and should be recognized in its
17 entirety for ratemaking purposes. The Company has prudently realigned its
18 compensation structure to provide a means of making a portion of an
19 employee's pay dependent on goal achievement. We have not indiscriminately
20 added a bonus program, but rather made changes that have been widely
21 adopted across a broad spectrum of businesses.

22
23 **Q. Is the use of incentive compensation an accepted practice?**

24 A. Yes, it is widely accepted both within this industry and in businesses
25 nationwide. In short, the benefits of incentive compensation make it a

1 necessary and indispensable part of doing business today. Public Service has
2 effectively gained the use of this beneficial tool at no incremental cost because
3 of the Company's transition methodology.

4

5 **Q. Does Ms. Crane discuss the relationship of incentive compensation to the**
6 **Company's operational goals?**

7 A. No, she essentially ignores that aspect of the program. However, the most
8 important aspect of the incentive compensation program is that it gives
9 employees a personal stake in each department's "scorecard" of key
10 operational measures that are tied to business unit goals. These measures vary
11 by department, but for almost all groups the emphasis is on safety, customer
12 satisfaction, system reliability and cost control. We share these results with
13 employees every month so that they can see if their collective efforts are
14 succeeding or slipping. Incentive compensation is an effective team builder,
15 aligning departments towards common goals that are important to our
16 customers, the Company, and investors. Some of the items included on the
17 "scorecard" for our employees last year were the number of OSHA incidents,
18 the number of motor vehicle accidents, cost control, use of overtime, customer
19 complaints, customer satisfaction survey results, and system reliability.

1 **Q. Ms. Crane acknowledges that incentives are tied to performance including**
2 **four criteria: corporate, financial, business unit scorecard, and individual.**
3 **She goes on to say that “incentive compensation awards that are based on**
4 **earnings criteria violate the principle that a utility should provide safe and**
5 **reliable utility service at the lowest possible costs” (Crane Testimony, page**
6 **56, lines 8-9). Is she correct?**

7 A. No, she is not. First, Ms. Crane’s recommendation is at odds with the findings of
8 the BPU approved Management Audit of 1992, which found that “PSE&G
9 should increase its reliance on risk-based compensation and focus on basic
10 measurements of corporate performance, such as return on equity and aggregate
11 costs.” Second, her recommendation is to exclude the entire incentive
12 component of the Company’s total compensation plan despite the fact that two
13 of the factors are not financial in nature. But even a partial disallowance would
14 be inappropriate, in that it would ignore the link, which the BPU has long
15 recognized, between financial performance and safe and reliable customer
16 service. Rates that are fairly set, with an appropriate allowed return and a
17 realistic opportunity to earn that return, provide an environment in which
18 incentive compensation goals can work to extend the life of the new rates while
19 keeping customer satisfaction, safety and other critical objectives in focus. Ms.
20 Crane also fails to recognize that a financially healthy company is able to secure
21 capital on reasonable terms, has the ability to pursue technological advances, can
22 respond to emergencies and security threats in an appropriate manner, is able to

1 attract and retain highly qualified and motivated employees, and can maintain
2 service and infrastructure quality at appropriate levels. All of these abilities
3 benefit the utility's customers.

4
5 **Q. Ms. Crane claims there is “Board policy” disallowing incentive**
6 **compensation costs where the program is tied to financial performance**
7 **objectives (Crane Testimony, pages 58-59). Is she correct?**

8 A. No, she has misconstrued two prior Board decisions. As this testimony
9 demonstrates, our incentive compensation program is *not* a bonus plan and
10 bears no comparison to the facts and circumstances discussed in the Jersey
11 Central Power and Light Company (JCP&L) Decision on which Ms. Crane
12 relies.¹ The program in that case was discussed in a Board Audit Report in
13 which the auditors indicated that incentive payments were in addition to the
14 base salary and merit pay that each eligible JCP&L employee received. In
15 fact, Board Staff described these payments as “bonuses” repeatedly throughout
16 their Initial Brief. As noted above, PSE&G's incentive programs do not
17 provide bonus payments.

18 Ms. Crane also refers to a Middlesex Water base rate case
19 (Docket WR00060362) and suggests that the findings of the Board in that case
20 establish ratemaking policy. While it is worth noting that the ALJ in that case
21 acknowledged that it was “...apparent from the testimony presented by the

¹ Jersey Central Power & Light Company, Docket No. ER91121820J (February 1993).

1 Company that the ratepayers are also receiving benefits from increased
2 productivity and managerial watchfulness, which has the same effect of
3 reducing costs,...” (Board Order dated June 6, 2001, page 25), the language
4 from the Staff’s Brief, quoted by Ms. Crane, makes it clear that the Middlesex
5 Water case dealt with additive “bonuses,” which is not at all analogous to the
6 situation here.

7 As I have detailed above, the Company and its employees have
8 gone to great pains to ensure that restructuring of its compensation program
9 was done properly and that the eventual component of pay that was at risk
10 would not simply be additive to base pay. An incentive component was
11 substantially carved out of base wages over a period of three years, during
12 which time base wage increases were curtailed. Proper implementation
13 strategies provide the result we have today; a compensation program that is in
14 line with the rest of the market when the incentive component is taken into
15 consideration.

16
17 **Q. What are your conclusions regarding the Company’s incentive**
18 **compensation programs?**

19 A. The Company’s compensation program is one of “total cash” compensation.
20 When the Company performs compensation comparisons within the industry, it
21 is the “total cash” compensation that is compared to other utility companies,

1 and these comparisons demonstrate that the Company's compensation levels
2 are within the norm for the industry. Thus, the compensation portion related to
3 performance is NOT additive to overall compensation, but is instead an
4 integral part of overall compensation.

5 It seems ironic that if the Company did not implement these
6 programs, but instead maintained a simple base only compensation program,
7 our total payroll would be in line with our industry peers, and would be
8 permitted recovery in base rates. The Company has taken progressive steps to
9 implement a performance based compensation plan, with "pay at risk"
10 dependent on performance items like customer satisfaction, productivity,
11 safety, and reliability of our system. Ms. Crane is proposing that the
12 performance portion be disallowed, yet it is this portion that relates to items by
13 which the consumer benefits. The Company strongly disagrees with Ms.
14 Crane and believes that the compensation program in place is fair and
15 reasonable, yields consumer benefits, and should be recovered in base rates.
16 Ms. Crane's disallowance of all of the incentive compensation costs is not
17 sound regulatory policy, is inconsistent with Board precedent, is not in the best
18 interests of our customers, and should be rejected.

1 **4. *Severance Expense***

2 **Q. Ms. Crane recommends the use of a prior three-year average of severance**
3 **expenses to determine the recoverable amount. Do you agree with her**
4 **approach?**

5 A. No. For some reason, Ms. Crane has chosen a period prior to the 2009 test
6 year despite her “matching at one point in time” concept. What is even more
7 telling is Ms. Crane’s choice of a three-year period (2006 through 2008) that
8 excludes the most recent year available (2009). If the Board uses an average as
9 opposed to accepting the test year period severance expenses, then the period
10 from 2007 through 2009 would be more appropriate, since it reflects the
11 experience for the period since base rates were last set, covers a recent period,
12 and encompasses the test year. If the recent three-year average is used, the
13 total amount of severance would be \$550,225 as opposed to the pro forma
14 costs of \$216,764 recommended by Ms. Crane.

15

16 **5. *Payroll Tax Expense***

17 **Q. Please comment on Ms. Crane’s payroll tax expense adjustment.**

18 A. Both parties agree that if salary and wages change, it follows that payroll tax
19 expense would change. However, Ms. Crane incorrectly utilizes the statutory
20 social security and Medicare tax rate of 7.65% in making this adjustment. Use
21 of the statutory rate fails to recognize that FICA wages are capped at \$106,800

1 per person for purposes of calculating the FICA portion of payroll tax. In its
2 filing the Company has estimated a more appropriate effective payroll tax rate
3 of 7.49% to account for the FICA wage cap. The 7.49% was clearly set forth
4 in the Company's workpapers, which Ms. Crane does not acknowledge. Her
5 adjustment is in error and should be rejected.

6

7 **6. Supplemental Executive Retirement Program (SERP) Expense**

8 **Q. Ms. Crane recommends the exclusion of all SERP expenses when**
9 **determining revenue requirements, based upon her belief that "the**
10 **officers of the Company are already well compensated" (page 63, line 12).**
11 **Do you agree?**

12 A. No. Ms. Crane's recommendation should be rejected because, as with the
13 issue of incentive compensation, SERP is one component of the total
14 compensation package that is necessary to attract and retain the experienced
15 and qualified employees necessary to provide customers with safe and reliable
16 service. SERP is only shown as a separate line item on the Company's pension
17 schedules due to IRS requirements; that does not make SERP fundamentally
18 different than other elements of PSE&G's pension costs. SERP is a legitimate
19 and necessary expense of doing business in today's world, and it is entirely
20 appropriate to include this expense in determining PSE&G's revenue
21 requirement.

1 7. *Rate Case Expense*

2 **Q. Crane is proposing a 50/50 sharing of the Company’s rate case expenses,**
3 **along with a three-year amortization with no return. Please comment.**

4 A. Ms. Crane’s proposal is inappropriate. An amortization of a legitimate
5 expense without a return ignores the cost associated with carrying charges on
6 the funds expended to conduct the rate case, and therefore should be rejected.
7 To recommend a 50/50 sharing under the premise that shareholders benefit
8 from rate case filings is also inappropriate. Regulatory rate making is a
9 “substitute” for the competitive market place, and conducting a periodic rate
10 case is essential to the regulatory process. If the regulatory process is an
11 essential part of what makes this industry work, then all costs associated with
12 the process are legitimate costs of business and therefore fully recoverable.

13 By advocating a 50/50 split of rate case expenses and amortizing the
14 50% split over three years without a return, Ms. Crane is further reducing the
15 Company’s recovery of its reasonable rate case expense, because PSE&G will
16 not recover this current cost for up to three years. If these costs are to be
17 amortized over three years, the full amount of the rate case expenses should be
18 allowed, with a return on the unamortized cost.

1 **Q. Ms. Crane also suggests that the BPU may conclude that the \$1.32 million**
2 **legal and consulting costs are not “justified.” Do you agree?**

3 A. No, I do not. PSE&G’s response to discovery request S-PREV-39 shows that
4 the rate case expenses for PSE&G’s 2001 gas case were \$1.183 million and for
5 the 2002 Electric case were \$1.231 million. Our position is that the \$1.32
6 million for this case, some seven years later, which is a combined electric and
7 gas distribution rate case that has more issues and witnesses than a gas only or
8 electric only rate case, is not at all unreasonable and is justified.

9

10 **8. *Injuries and Damages Expense***

11 **Q. Ms. Crane makes an adjustment to reduce the Company’s test year**
12 **expense for electric distribution by \$2.5 million based upon her opinion**
13 **that the Company’s figure appears high. Do you agree with her**
14 **adjustment?**

15 A. No. Ms. Crane makes her adjustment based on the expense for the first six
16 months of the test year. Injuries and damages expense is not normally linear
17 throughout a year, so multiplying the expense for the first six months of 2009
18 by two is overly simplistic. Interestingly, Ms. Crane chose not to fall back on
19 evaluating the reasonableness of the Company’s figure by comparing it to past
20 experience. The response to the discovery request RCR-A-47 indicates that the
21 average injuries and damages expense for electric distribution had been \$11.7
22 million for the five-year period 2004-08 and \$12.7 million for the three-year

1 period 2006-08. Both figures are in line with the Company test year figure of
2 \$12 million. The gas figure may in fact be conservative given the history of an
3 average of \$10.6 million for the period 2004-08 and \$10.4 million for the years
4 2006-08. Furthermore, when the Company updates the test year for 12 + 0
5 data, the actual injuries and damages expense will be reflected. The
6 recommended adjustment by Ms. Crane appears both unnecessary and
7 unwarranted, and should not be made.

8

9 **9. *Customer Information System Amortization Expense***

10 **Q. Please summarize the Company's request in this case for the cost**
11 **associated with the new customer information system (CIS)².**

12 A. In the Company's efforts to provide safe, adequate, proper and reliable service
13 to its customers and to enhance customer satisfaction by reducing response
14 time and facilitate customer contacts, it has invested capital in the development
15 of a new CIS. In order to make the CIS operational, the Company has been
16 incurring reasonable expenses during the course of the test year associated with
17 training customer service representatives in its use. In this filing, the Company
18 is seeking recovery of these proper and necessary costs—not over one year as a

² All CIS references are to the new Customer Case System (CCS). This change will be reflected in all future filings.

1 test year expense but to be amortized over ten years with a return on the
2 unamortized balance.

3
4 **Q. Ms. Crane recommends that the Company's request for recovery of these**
5 **costs be denied. Is she correct?**

6 A. No, Ms. Crane is in error on a number of points. First, she characterizes our
7 request as "retroactive ratemaking" under the misconception that a "deferred
8 accounting order from the regulatory authority" is required. The Company has
9 deferred the CIS expenses for financial accounting purposes. It had begun, and
10 continues, to defer those costs in anticipation of receiving the BPU's
11 permission to recover those costs over the amortization period requested. Ms.
12 Crane indicates that a prior BPU acknowledgment of our deferral of the cost
13 would come with no guarantee of recovery through rates and would require the
14 issue to be decided in this proceeding. The situation presented here is therefore
15 no different than if the Company had previously notified the Board.

16
17 **Q. But isn't Ms. Crane correct that "a company cannot unilaterally decide to**
18 **defer costs and expect recovery in a future rate case?"**

19 A. I take no issue with her statement, as far as it goes. However, since these
20 expenses occurred during the test year, what the Company is doing is currently
21 deferring costs and *seeking recovery in a current rate case*. Second, Ms.
22 Crane suggests that there is a second criterion for recovery of deferred costs.

1 Specifically, she claims that the CIS expenses should have a “material impact
2 on [PSE&G’s] financial integrity.” There is no support for her position. Ms.
3 Crane in essence takes the prohibition against “single issue ratemaking” to an
4 extreme whereby no expense would be recoverable through rates, since any
5 one cost in and of itself would not likely have a material impact on the
6 Company’s financial integrity. The fact is that by year end, PSE&G will have
7 expended approximately \$38 million, which is in excess of the amount of
8 certain deferrals that the Board has approved in the past. For these reasons,
9 Ms. Crane’s adjustment to the Company’s request for recovery should be
10 dismissed.

11

12 ***10. Management/Affiliate Standards Audit***

13 **Q. Ms. Crane recommends an adjustment to the Company’s**
14 **Management/Affiliated Standards BPU Audit expense claim. Do you**
15 **agree with her approach?**

16 **A.** No, I do not. Ms. Crane’s makes an arbitrary adjustment to the Company’s
17 Management/Affiliated Standards BPU Audit (“BPU Audit”) which takes into
18 account only half of the picture of the Company’s claim. Basing her
19 adjustment on an amount shown in the Company’s workpapers for the 2009
20 plan year alone and excluding 2010 amounts does not account for the entire

1 duration and expected total expenses of this type of undertaking which is
2 expected to be complete in mid-late 2010.

3
4 **Q. What would be an appropriate amount to be included in this proceeding?**

5 **A.** Prior to the initiation of this BPU Audit and continuing through the release of
6 the final BPU Audit report, the Company retained various expert outside
7 consultants to assist in this matter. These consultants are anticipated to cost
8 well in excess of the \$900,000 suggested by Ms. Crane.

9 Due to the fact that the start date for this audit was delayed until
10 September 2009, the Company has only expended approximately \$600,000
11 through November 2009 for outside consultants audit support. As these types
12 of expenditures will continue through the completion of the audit in mid-2010,
13 the Company anticipates spending an additional \$1.5 million through
14 completion of the audit. Based on the Company's experience, PSE&G expects
15 to expend approximately \$2.16 million over the \$1.2 million authorized for the
16 Board's consultant, Overland Consulting. These costs are incremental to the
17 costs for the Company's personnel. Therefore, the Company's proposed
18 adjustment should be accepted.

1 ***11. Vegetation Management Expense***

2 **Q. Ms. Crane has made an adjustment to reduce the test year expense for**
3 **vegetation management by \$3.2 million to “mitigate the impact of annual**
4 **fluctuations” and to arrive at a number she believes “appears more**
5 **reasonable.” Is she correct?**

6 A. No, she is not. Ms. Crane arrives at her “more reasonable” figure by averaging
7 the expense for the period 2006 through 2008. Ms. Crane’s approach (1)
8 ignores that it is inappropriate to not include the test year in the average for the
9 same reasons discussed earlier in my testimony, (2) does not recognize that the
10 Company operates on a four-year tree trimming cycle, and (3) ignores that the
11 use of four year old nominal expense numbers (which do not reflect the
12 impacts of inflation on estimating a future expense) would understate the cost
13 the Company will be incurring when new rates go into effect. The Company
14 will be updating its test year expense in its 12 + 0 filing, which is the figure
15 that should be used. Ms. Crane’s adjustment should be rejected.

16

17 ***12. Energy Master Plan (“EMP”) Costs***

18 **Q. Does the Rate Counsel understand how EMP costs are handled in the**
19 **Company’s filing for an increase in base distribution rates?**

20 A. There appears to be some confusion on this point. On page 78 of her
21 testimony, Ms. Crane states that “to the extent that revenue and costs
22 associated with these programs are included in the Company’s filing, they can

1 distort the test year financial results.” She provides an example that implies
2 that including EMP costs would lead to an overstatement of distribution
3 revenue requirements. But to the contrary, absent the Company’s adjustment
4 for EMP on Schedule MGK-42, EMP costs would lead to an understatement of
5 distribution revenue requirements, since the BPU-approved regulatory
6 treatment of our EMP investment provides a return on that investment which
7 should be eliminated from our test period numbers prior to calculating
8 distribution revenue requirements. This is what PSE&G has done in its filing.
9 The adjustment put forward by Ms. Crane essentially gives back to rate payers
10 the return that the Company has been authorized to earn on its EMP
11 investments, and therefore is inappropriate.

12
13 **Q. Are any EMP clause recovered costs also being recovered under PSE&G’s**
14 **base case filing?**

15 A. There appears to be some confusion on this point as well. As demonstrated in
16 PSE&G’s discovery responses, the fact is that these costs are definitively not
17 being recovered through the Company’s base rate filing. The response to
18 RCR-A-20 clearly lists the specific positions recovered through RGGI clause
19 mechanisms. The response to S-PSEG-LABOR-4 provides the dollars of
20 expense associated with the positions listed in RCR-A-20. The response to
21 RCR-A-6 clearly states that any expenses recovered in base distribution rates

1 are not also being recovered through RGGI clause mechanisms. If one reads
2 these three responses together, the “uncertainty with regard to the costs
3 included in base rates versus the costs to be recovered through surcharge
4 mechanisms” (Crane, page 80) is dispelled, making Ms. Crane’s adjustment
5 unnecessary.

6
7 **Q. Ms. Crane also makes an adjustment to eliminate 50 percent of the**
8 **administrative costs associated with PSE&G’s Solar Loan I program; is**
9 **she correct?**

10 A. Absolutely not. Ms. Crane makes this adjustment with no basis and no
11 support. The Company did not waive recovery of these costs in the settlement
12 supporting the program. The settlement simply limited administrative costs
13 included in the Solar Loan I Program rates to 50 percent of the total
14 administrative costs incurred. The fact is that these are reasonable and
15 necessary expenses for a beneficial program, and these expenses should be
16 recognized in PSE&G’s base rates.

17

18 ***13. Uncollectible Expenses***

19 **Q. How does Ms. Crane handle uncollectible expenses?**

20 A. Ms. Crane does not make a specific adjustment to expenses, but she
21 recommends an uncollectible factor of 1.2% versus the Company’s proposed
22 1.42%. Her recommendation is based on a three-year average of actual net

1 write-offs. When adjusting injuries and damages, where costs were lower
2 during the first half of the year, Ms. Crane chose to annualize the first six
3 months of the test period. If she had proposed the same method for the write-
4 offs, the 0.83% for the first six months of the test period would equate to
5 1.66%, which exceeds the Company's proposed 1.42%. Ms. Crane's arbitrary
6 adjustment should be rejected.

7

8 ***14. Meals and Entertainment Expenses***

9 **Q. Ms. Crane has recommended the disallowance of \$1.37 million of meals**
10 **and entertainment expenses that are not deductible on the Company's**
11 **income tax return. Do you agree?**

12 A. No, I do not. Ms. Crane's logic in making this adjustment is that if the
13 expenses are not deductible for tax purposes then they are not reasonable
14 business expenses. Ms. Crane provides no support for her conclusion. She
15 does not consider that sometimes IRS rules are established for public policy
16 reasons and do not reflect true business considerations. (For example,
17 accelerated tax depreciation is in place to spur capital investments, yet for book
18 accounting purposes the norm is that depreciation expense is straight line over
19 the life of the asset.) The basic rule is that you are allowed to deduct, for book
20 and regulatory purposes, the cost of meals or entertainment that have a bona
21 fide business purpose. For IRS purposes, a company can deduct for tax

1 purposes 50% of those bona fide meals and entertainment expenses. Why can
2 the Company deduct only 50% of the cost? Because when the Company
3 reimburses an employee for a business meal that employee recognizes no
4 income subject to tax, yet the IRS assumes the employee would eat even if he
5 or she did not have a business purpose for the meal. The IRS extracts its tax
6 therefore from the Company, which had reimbursed the employee. Ms.
7 Crane's arbitrary position is that expenses for which the Company is denied an
8 IRS deduction are not legitimate business expenses. This disallowance
9 suggested by Ms. Crane should be rejected.

10
11 *15. Advertising Expense*

12 **Q. Ms. Crane has taken the position that expenses labeled corporate**
13 **sponsorship or branding are not directly linked to "the provision of safe**
14 **and adequate utility service" and should be disallowed. Please comment.**

15 **A.** I disagree with Ms. Crane's conclusion. Corporate sponsorship and branding
16 satisfies the needs of our customers, the general public, and the financial
17 community for information, education and awareness. Expenditures in these
18 areas provide the foundation of confidence for the acceptance of beneficial
19 changes put forward by the Company. That confidence results from
20 maintaining and building upon a basic trust that industry changes will not
21 compromise the safety and reliability of the utility delivery system or weaken

1 the Company's financial ability to support the delivery activities. Such
2 expenditure upholds public and investor confidence and supports the
3 Company's efforts to work with the State in furthering its public policy goals.
4 Of course, a loss of investor and market confidence leads to increases in the
5 Company's cost of capital, which increases the required returns and inhibits
6 support of the State's public policy goals. The Company submits that the value
7 of such advertising expenses needs to be recognized, and Ms. Crane's
8 adjustment should be rejected.

9

10 ***16. Dues/Lobbying Expenses***

11 **Q. Ms. Crane recommends the disallowance of 15% of the Company's**
12 **membership dues on the basis that such costs constitute lobbying activities**
13 **(with two specific exceptions noted). Is this disallowance supported?**

14 **A.** No it is not. The arbitrary 15% figure is based upon recommendations Ms.
15 Crane has made in other utility rate proceedings, but she has provided no
16 evidence to support that figure in this proceeding. She further applies a 15%
17 disallowance to all the dues, including AGA dues of \$459,248, which
18 constitute 88% of the total dues paid by the gas distribution business in the first
19 six months of the test year. Yet the Company's response to S-PREV-46
20 indicates that AGA lobbying expenses are anticipated to be only 4.38%, not

1 15%. Thus, Ms. Crane has again applied a “pick and choose” method of
2 ratemaking and made an arbitrary adjustment.

3
4 **Q. Does the Company believe that these memberships are a legitimate**
5 **expense in the course of utility business?**

6 A. Yes, and all of these expenses should be permitted recovery. Corporate
7 memberships in associations, such as Edison Electric Institute and American
8 Gas Association, serve to create a viable business environment in which to
9 operate effectively. Memberships assist organizations in their mission as a
10 public resource for lifelong interactive exploration of science, technology,
11 environmental and other public policy issues. Ms. Crane’s proposed
12 disallowance of this expense should be denied.

13

14 ***17. Gain/Losses on Sale of Property***

15 **Q. How has the Company treated gains on the sales of property in this base**
16 **rate case?**

17 A. The Company has allocated 50% of the gain on the sale of property to rate
18 payers based upon the average of sales over the last five years, consistent with
19 the last base rate cases filed by the Company with the BPU.

1 **Q. What is Ms. Crane's recommendation on this issue?**

2 A. Ms. Crane recommends that 100% of the gain on the sale of property go to rate
3 payers and asserts, illogically, that "by using a five-year average, there is
4 already an implicit sharing of gains/losses between ratepayers and
5 shareholders, since only 20% of the gains/losses in any one-year flow through
6 the ratemaking equation."

7
8 **Q. Do you agree?**

9 A. Not at all. Under Ms. Crane's five-year average approach, one hundred
10 percent of the average number would flow to ratepayers every year, and there
11 is no support for that result under Board precedent or as a matter of fairness.

12
13 **Q. Do you have any other comments on Ms. Crane's proposal?**

14 A. Yes. Ms. Crane's approach implies that some of Ms. Crane's test year
15 adjustments based upon three-year averages implicitly already disallow 33% of
16 the expense, and then her adjustment takes 100% of the average adjustment
17 again. That clearly was not her intent. The purpose of the Company's
18 averaging its gains on property sales over the past five years is to create a
19 representative number—note that the gains/losses for the Company in the test
20 year is zero (Schedule MGK-26 R-1). Ms. Crane's adjustment is inconsistent
21 with past Board policy, past treatment of PSE&G and is based upon flawed
22 logic. The proposed adjustment should be denied.

1 **Q. Ms. Crane makes a further adjustment with respect to sales of utility**
2 **property to eliminate what she incorrectly believes to be double taxation.**
3 **Please comment on that adjustment.**

4 A. Ms. Crane's adjustment is incorrect. The income taxes reflected on Schedule
5 MGK-26 R-1 are as Ms. Crane describes on page 92 (lines 1 through 5). She
6 seems to believe that the difference between the line labeled "Net
7 Income/(Loss)" and the line labeled "Operating Income Increase (Decrease)
8 After Taxes" on Schedule MGK-26 R-1 is the "double taxation." Ms. Crane
9 appears to misunderstand the Company's adjustment. That difference is the
10 50/50 sharing of gains/losses in the Company's petition. Therefore, this tax
11 adjustment by Ms. Crane is not warranted and should be rejected.

12

13 **18. *Real Estate Tax Expense***

14 **Q. Ms. Crane recommends the elimination of real estate tax expenses**
15 **associated with certain capital expenditures which she would have**
16 **excluded from the calculation of base rates—chief of which are costs**
17 **associated with the CIIP expenditures. Please comment on this**
18 **adjustment.**

19 A. Ms. Crane's adjustment is based upon a composite real estate tax rate she
20 calculates using total electric and gas distribution information. Ms. Crane has
21 acknowledged that she assumed that all plant would be subject to real estate
22 taxes. This adjustment is inappropriate in that the plant excluded by Ms.

1 Crane's plant adjustments does not constitute real property and is therefore not
2 subject to real estate tax.

3

4 **C. PROPOSED MODIFICATION TO THE CAPITAL ADJUSTMENT**
5 **CHARGE**

6

7 ***1. Expansion of CAC to Include Capital Expenditure Other Than New Business***

8 **Q. Ms. Crane characterizes the Company's proposal to include capital**
9 **expenditures other than those directly related to new business in the**
10 **investments recoverable through CAC as "nothing more than another**
11 **attempt to shift risk from shareholders to ratepayers and to relieve**
12 **management of its responsibility to manage the Company appropriately."**
13 **She also claims that "implementation of a CAC-like mechanism would**
14 **remove a powerful incentive for utility cost control between rate cases"**
15 **(Crane testimony at page 104, lines 18-21). Do you agree?**

16 **A.** No, I do not. In fact, the motivation for the Company's proposal is to provide
17 the financial stability and reduced regulatory lag that is essential to pursuing
18 capital investments at levels well in excess of cash generated from depreciation
19 in these financially volatile times (see my direct testimony at pages 15 through
20 17). The Company's proposal serves to reduce regulatory lag but does not
21 shift risk nor remove incentives to control costs, since the Company would still
22 face "a review of expenditures at the time of the next base rate case" (Kahrer
23 Direct, page 17, lines 10 and 11).

1 **Q. Please comment on Ms. Crane’s characterization of the \$260 million and**
2 **\$77 million increases associated with this proposed change to CAC as**
3 **“costing ratepayers millions of dollars in higher utility bills” (Crane, page**
4 **107, lines 2-3).**

5 A. Ms. Crane obfuscates the issue by blurring the line between these revenues,
6 which would support distribution plant necessary for safe and reliable service,
7 and, in the same passage, potential revenue required to meet BPU mandated
8 societal benefit charges, to support state endorsed RGGI investments, and
9 increases in the price of the commodity (for which PSE&G is a collection
10 agent for producers). She also ignores that the CAC revenue figures she cites
11 represent increases through 2013, which implies annual increases of only 1.2%
12 and 1.0% for electricity and gas respectively. Ms. Crane’s recommendation to
13 deny the Company’s requested modification to CAC is unfounded and should
14 be rejected.

1 **III. REBUTTAL OF THE DIRECT TESTIMONY OF ROBERT J. HENKES**
2 **AND MITCHELL I. SEROTA REGARDING THE**
3 **PENSION EXPENSE TRACKER**

4 **Q. What issues do you address in this section of your rebuttal testimony?**

5 **A.** In this section, I will address the testimony of Rate Counsel witness Robert J.
6 Henkes, who provides a number of reasons for his recommendation that the
7 Company’s request for a Pension Expense Tracker (Pension Tracker, PET) be
8 rejected. I will also address Rate Counsel witness Serota’s criticisms of
9 PSE&G’s Pension Investment Committee’s investment policies.

10

11 **A. SINGLE ISSUE RATEMAKING**

12 **Q. Please summarize Mr. Henkes’ claim that a Pension Tracker constitutes**
13 **“single issue ratemaking.”**

14 **A.** Mr. Henkes’ single issue ratemaking argument seems to center on two points:

15 (1) ”the proposed PET would inappropriately change rates without
16 regulatory scrutiny of all of PSE&G’s revenue requirement
17 components and could result in an achieved return higher than
18 justified if all components of the ratemaking formula were
19 considered” (Henkes testimony at page 7, lines 2-5), and

20 (2) “utilities are not guaranteed cost recovery; rather, the ratemaking
21 process entitles the utility no more than a reasonable opportunity
22 to recover its costs and earn a fair rate of return” (Henkes
23 testimony at page 7, lines 16-18).

1 **Q. Is he correct?**

2 A. No. What Mr. Henkes fails to mention is that with regard to Point 1 above,
3 even if the Pension Tracker were implemented, PSE&G could still achieve a
4 return lower than justified if all components of the ratemaking formula were
5 considered. In other words, the Pension Tracker does not guaranty a fair rate
6 of return, and the creation of a Pension Tracker is not inconsistent with Mr.
7 Henkes' Point 2 above.

8 Further, Mr. Henkes' position on single issue ratemaking in the
9 context of a pension tracker appears to be inconsistent with the Division of
10 Rate Counsel's position on a weather normalization clause as expressed by Mr.
11 LeLash. It does not appear that Rate Counsel considers a weather
12 normalization clause to be single issue ratemaking as long as it is one-sided—
13 the Company would always refund the money dictated by the normalization
14 even if it were earning below its allowed return, but the Company would not
15 recover those funds if its overall return exceeds the allowed return on equity
16 (ROE). Clearly it is Mr. LeLash's feeling that Mr. Henkes' "tenet of
17 ratemaking" – that the Company be provided "a reasonable opportunity to
18 recover its costs and earn a fair rate of return" – means that the Company may
19 always earn below its allowed ROE, but never in excess of that figure.

1 **B. SUBSTANTIATE THE NEED FOR A PENSION TRACKER**

2 **Q. Are pension costs the type of costs that are traditionally recovered**
3 **through clauses like the pension expense tracker?**

4 A. Yes, they can be. Mr. Henkes contends that given the type of costs at issue, the
5 Company has not substantiated the need for pension expense tracker. He is
6 incorrect. Clauses traditionally exist to address those costs of business that are
7 subject to a high degree of variability (e.g., weather and commodity costs) and
8 that are largely out of the control of the Company (e.g., societal benefit costs
9 and commodity costs). Pension costs are both highly variable and are largely
10 out of the Company's control. These costs have recently fluctuated
11 dramatically. The costs also are subject to the vagaries of the financial
12 markets, significantly more-so than other expenses referenced by Mr. Henkes
13 such as wages and salaries, medical expenses, and insurance expenses.

14
15 **Q. Doesn't a pension expense tracker favor the utility at the expense of**
16 **ratepayers?**

17 A. Absolutely not. Without a mechanism by which cost recovery is adjusted for
18 actual expenses, the pension cost included in rate base is as likely to materially
19 exceed actual costs as it is to fall short. Thus, use of the proposed PET is
20 sound regulatory policy that serves to protect ratepayers, as well as PSE&G,
21 from significant shifts in cost (up and down) without corresponding changes in
22 recovery. A pension tracker of a cost that is beyond the Company's control

1 could also help reduce the need for base rate cases. Furthermore, the pension
2 tracker is symmetrical. To the extent pension costs are reduced in the future,
3 ratepayers will get the benefit through reduced rates in a timely manner.

4

5 **Q. Mr. Henkes concedes that the pension expense PSE&G faces reflects a**
6 **large increase, but emphasizes that this is only a small percent of total**
7 **O&M expenses, and testifies that to substantiate the need for a pension**
8 **tracker, conditions must exist that could jeopardize the financial well-**
9 **being of the utility (Henkes testimony, page 10, line 24). Is he correct?**

10 A. No. There is no basis for Mr. Henkes' position. Using Mr. Henkes' "one
11 expense item at a time" analysis, no O&M expense on its own would be
12 considered significant. The fact that pension expense may account for a
13 relatively small portion of O&M expenses does not mean that an effort should
14 not be undertaken to manage the impact of market volatility on pension
15 expense and pension funding through the use of the tracker.

16 Further, in concluding that pension expense averages "only"
17 0.57% of O&M expenses, Mr. Henkes errs by comparing the pension cost to
18 total distribution O&M including the cost of the commodity, which generates
19 no margin for the Company. Eliminating commodity cost from the
20 denominator and only focusing on controllable costs, pension expense
21 represents over 5.75% of PSE&G's total O&M — ten times Mr. Henkes'
22 estimated figure, and a significant portion of the Company's distribution costs.

1 **C. PENSION TRACKER AND ITS IMPACT ON THE INCENTIVE TO RUN AT**
2 **THE LOWEST COST**
3

4 **Q. How do you respond to Mr. Henkes' claim that "guaranteed pension cost**
5 **recovery . . . removes or reduces the incentive for the Company to manage**
6 **its pension obligations in the most efficient manner and at the lowest**
7 **possible cost" (Henkes Testimony, page 11, lines 18-20)?**

8 **A.** We would expect the opposite to be the case. Costs associated with pension
9 expense are unique in that the approach that serves to reduce costs over the
10 long-term results in significant volatility in cost over the short-term, as
11 evidenced by PSE&G's level of pension expense over the recent past.
12 Moreover, PSE&G participates in pension plans that cover all employees of
13 Public Service Enterprise Group. As such, matching recovery of costs with
14 revenues for PSE&G employees does not reduce or eliminate the burden to
15 manage the program in an efficient, low cost manner since other employee
16 groups, for whom matching does not exist, participate in the plans. Finally, the
17 fiduciary standards of ERISA require the pension plan sponsor to manage the
18 cost of the plan effectively and to apply prudent standards to all fiduciary
19 decisions. The use of a Pension Tracker does not change or lower the fiduciary
20 standard by which the Company must manage the pension plan.

1 **Q. Mr. Henkes seems to view the establishment of a PET as a “back-door”**
2 **way to get rate relief. He states that “[t]ypically, the use of reconcilable**
3 **surcharges or adjustment clauses... provide a utility with extraordinary**
4 **rate relief...” and should be “limited to costs of service that have a**
5 **significant impact on the utility’s financial condition.” (Henkes Direct,**
6 **page 9 lines 17-20). Do you agree?**

7 **A.** No, I do not. The Company’s motivation for proposing the PET was clearly
8 stated in my Direct Testimony:

9 A significant driver of future pension cost is asset
10 performance, which is subject to the uncertainty of the
11 financial markets. I believe it is important to maintain
12 financial stability for the Company by providing revenues
13 for full collection of pension costs. At the same time, I
14 believe it is equally important not to over collect these
15 revenues if pension costs fall.” (Kahrer Direct Testimony,
16 page 18, line 19 through page 19, line 3).
17

18 Our PET is designed to protect both the Company and the rate payers from the
19 variability of the markets. By example, the 6 + 6 update indicated a rate year
20 pension expense of \$81.6 million thereby establishing base rates and setting the
21 pension expense figure by which the PET would be measured. The response to
22 discovery request S-PREV-71 UPDATE reflects the current lower estimated
23 pension expense. These lower estimates were used to calculate the revised rate
24 year pension figure of \$73.2 million. Schedule MGK-49 illustrates this
25 calculation. The expectation would be that rate payers would be better off to
26 the tune of \$8.4 million with the existence of the PET since the difference

1 between the \$81.6 million in base rates and the “actual” lower expense of
2 \$73.2 million would be returned to ratepayers through the operation of the
3 PET.

4
5 **D. PERFORMANCE OF THE PENSION INVESTMENT COMMITTEE**

6 **Q. What is the basis for the Pension Investment Strategy?**

7 A. The Pension Investment Committee (Committee) considers multiple approaches
8 to best carrying out its fiduciary responsibilities under ERISA. The Committee,
9 consistent with prudent best practices, adopted a risk/return-based asset
10 diversification strategy. Over time, it has worked with different investment
11 consultants, who have vetted and agreed with this approach. In fact, virtually all
12 investors and investment publications believe that a long-term investment
13 strategy based on prudent asset allocation will yield the best results.

14 The Committee believes that two broad investment classifications
15 best describe the majority of investable asset classes for the Trust: (1) Equity,
16 and (2) Fixed Income Investments. The Committee also believes that the prudent
17 allocation and management of assets between these asset classes over time will
18 satisfy the Trust's Investment Objectives.

19 Mr. Serota suggests that the Committee should have immunized
20 the portfolio at a time, when the funding level approached 96.8%. However, Mr.

1 Serota fails to acknowledge the complexity in immunizing the portfolio. Over
2 time, the Pension Benefit Obligation (PBO) changes for additional service costs,
3 growth due to the interest cost component and differences in actuarial
4 assumptions versus expectations. So, in order for a firm to properly immunize
5 the pension liability, it must be significantly over funded. A reasonable level to
6 assume for this would be approximately 115-125%.

7

8 **Q. Please comment on Rate Counsel witness Mr. Serota's suggestion (Serota**
9 **testimony at 12-13) that PSE&G's pension investment committee should**
10 **have implemented investment recommendations in the August 2007**
11 **asset/liability study.**

12 A. Mr. Serota states that after the completion of an August 2007 Asset/Liability
13 Study the Company had achieved 96.8% of its PBO, yet the Committee chose
14 to not change its investment strategy. Mr. Serota suggests that at that time the
15 Committee "might well have considered locking in the funding level of 2008
16 and converting the asset mix to possibly immunize both the assets and
17 liabilities against stock market and interest rate fluctuations." (Serota
18 Testimony at pages 12-13). Contrary to Mr. Serota's suggestions, the PIC
19 investment strategies were in accord with accepted industry practices.

1 **Q. Please explain.**

2 A. The growth rate in PSEG liabilities is significantly higher than that which
3 could be earned on an invested bond fund. If PSEG were to immunize assets
4 and liabilities as Mr. Serota suggests, PSEG would be “locking in” the annual
5 cost associated with the provision of ongoing benefit accruals. Instead,
6 PSEG’s strategy contemplated the long-term nature of its pension obligations
7 and the generally accepted notion that over longer time periods a diversified
8 portfolio of stocks and bonds is expected to achieve higher rates of return and
9 will therefore reduce the long-term cost of the plan to both PSEG and to
10 ratepayers.

11
12 **Q. Mr. Serota claims that following the August 2007 Asset/Liability Study,**
13 **the Committee “chose not to change investment strategies” (Serota, page**
14 **12, lines 18-19). Was this a flaw in the Committee’s decision making?**

15 A. Not at all. Mr. Serota’s reference to the August 2007 Asset/Liability Study and
16 the changes that could have been made, when closely examined, are not valid.
17 The change that was referred to in the August 2007 Asset/Liability Study as
18 potentially improving the financial efficiency of the fund was a recommended
19 shift from the then-current bond allocation into a long-duration bond fund.
20 Serota Testimony at page 12, lines 16-18. Had that change been implemented,
21 it would not have resulted in improved investment performance. Set forth
22 below is an analysis of the performance of the then-current bond investments

1 to what a long-duration bond fund would have earned during the relevant
2 period, had the changes referenced been made. The return of the long duration
3 bond fund has been proxied by the Barclays Capital Long Government/Credit
4 Index, the standard index for investments of this type.

	Periods Ending 11/30/2009		
	Annualized		
	YTD	1 Year	2 Years
BarCap Long Govt/Credit Index	5.39%	17.22%	6.87%
PSEG Actual Fixed Income Return	14.85%	21.21%	6.98%

5
6 Based on the data above, I contend that it is not appropriate to criticize PSEG
7 for not making this change, as the change would have resulted in lower
8 investment returns over the period.

9
10 **Q. Is Mr. Serota's criticism of PSE&G's Pension Investment Committee**
11 **Pension Trust Fund investment policy valid?**

12 A. No. Ignoring the fact that the Committee's investment policies were in line
13 with industry standards and the Pension Trust Fund value had greatly
14 benefitted from the Committee's investment policy, Mr. Serota suggests that
15 the Committee decided to take on more investment risk than it should have,
16 and that the long-term benefit obligations fell back by \$800 million. Mr.
17 Serota estimates that this fund value reduction equates to \$100 million in

1 additional pension expense each year for a decade. Serota Testimony at page
2 14, lines 1-5.

3 Mr. Serota's discussion of investment choices is narrow and one-
4 sided. His discussion fails to recognize the substantial benefits that have
5 resulted and are expected to result from this investment strategy over the long
6 term time horizon applicable to pension obligations. The PSEG trust fund has
7 earned an average annual rate of 3.7% over the last ten years. Indeed, Mr.
8 Serota's claimed pension expense is lower than at the time the Company filed
9 its base rate case. That is attributable to improved asset performance flowing
10 from the Committee's investment policy.

11
12 **Q. Mr. Serota suggests that the Committee's investment policy "was driven**
13 **strictly by the reward side of the relationship" and generally ignored risk.**
14 **Is he correct?**

15 A. No, Mr. Serota's claim is unfounded. The decisions made by the PIC were
16 based on a balanced review of the risks and rewards associated with each
17 investment alternative. Indeed, the following data from the Watson Wyatt's
18 Asset/Liability Model substantiates the reasonableness of the conclusions
19 reached by the PIC:

1

	Prior Target	New Target	Better/ (Worse)
Expected Return	7.3%	7.7%	0.4%
Volatility	17.1%	11.3%	5.8%
Expected Case (50th %ile) Contributions over 10 Years	\$1,586	\$ 1,549	\$ 37
Worst Case (95th %ile) Contributions Over 10 Years	\$2,941	\$ 2,734	\$ 207
Expected Case (50th %ile) Pension Expense Over 10 Years	\$1,368	\$ 1,355	\$ 13
Worst Case (95th %ile) Pension Expense Over 10 Years	\$2,537	\$ 2,353	\$ 184
Expected Case (50th %ile) Funded Ratio at end of 10 Years	122%	117%	(5.0)%
Worst Case (95th %ile) Funded Ratio at end of 10 Years	79%	78%	(1.0)%
Source: Watson Wyatt's Asset/Liability Modeling Study dated June 2009			

2

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As illustrated by the table above, the new target portfolio adopted by PSEG optimized the risk and return equation that drives pension funding. The new target has a higher rate of return and a lower cash contribution and book expense over a ten-year period in the expected case. However, the new target portfolio has a significantly lower measure of volatility and has lower cash contribution and book expense over a ten-year period in the “worst case” 95th percentile outcome. This demonstrates that PSEG selected a portfolio that improved both the risk and return profile of the plan, seeking to minimize costs to PSEG and to ratepayers over the ten-year period in both the expected case and under “worst case” economic scenarios

1 **E. CONCLUSIONS ON THE PENSION TRACKER**

2 **Q. What are your conclusion regarding Mr. Henkes' and Mr. Serota's**
3 **testimony on the pension expense?**

4 A. Mr. Henkes has failed to make a convincing case for recommending the
5 rejection of the concept of a pension tracker. His single issue ratemaking
6 argument is one-sided and inconsistent with the position put forward by Rate
7 Counsel witness Mr. Lelash. The Company has substantiated the need for a
8 tracker, and Mr. Henkes' view that a tracker takes away the Company's
9 incentive to operate at the lowest cost is without merit. Finally, Mr. Serota's
10 comments regarding the PIC's investment policies are also incorrect, and are
11 not supportable when viewed in the context of actual results. Rejecting
12 PSE&G's proposal for a Pension Tracker would not be in the best interest of its
13 customers.

1 **IV. REBUTTAL OF THE DIRECT TESTIMONY OF RICHARD LELASH**
2 **REGARDING THE WEATHER NORMALIZATION CLAUSE (WNC)**
3

4 **Q. Rate Counsel witness Mr. LeLash discusses the symmetrical benefit**
5 **concept upon which the use of a WNC is commonly justified. Would you**
6 **care to comment?**

7 A. Mr. LeLash is absolutely correct that the clause is commonly justified on the
8 symmetrical benefit concept, and that concept, properly implemented for a
9 WNC, would only calculate the margin variance derived from abnormal
10 weather and either charge it, or reimburse it, to customers. No dead-band test
11 would be included, no rate impact test would occur, no refund of “excess”
12 earnings and no limitation on refunding for an earnings test would occur. This
13 would be a truly symmetrical clause.

14
15 **Q. Would the Company’s proposal result in a symmetrical clause?**

16 A. Yes.

17
18 **Q. Please explain.**

19 A. With respect to the weather and a test as to whether the Company is earning its
20 allowed rate of return prior application of a WNC for any year, there are four
21 possible states:

- 22 1. Weather is colder than normal and the Company is over earning.
23 2. Weather is colder than normal and the Company is under earning.
24 3. Weather is warmer than normal and the Company is over earning.

1 4. Weather is warmer than normal and the Company is under earning.

2 Under the Company's proposal, the following are the actions
3 with respect to the WNC under the four states:

4 1. WNC refund to customers

5 2. No WNC refund to customers

6 3. No WNC charge to customers

7 4. WNC charge to customers

8 One can assume that weather is equally likely to be either
9 warmer or colder than normal in any year. If one assumes that the Company is
10 equally likely to under earn or over earn, then each of the above states has an
11 equal, one in four, chance of occurring in any year. One can then readily see
12 that there is balance and symmetry in that there is a WNC refund, no refund,
13 no charge and a charge.

14
15 **Q. Does the modification proposed by Mr. LeLash result in a symmetrical**
16 **clause?**

17 A. No.

18
19 **Q. Why not?**

20 A. Mr. LeLash would change the rules proposed by the Company such that under
21 the second state the WNC would provide a refund to customers even though
22 the Company is under earning. This would remove the symmetry from the

1 WNC, and, given the probabilities of the various states assumed above, assure
2 that over time the Company's stockholders would be net losers under the
3 WNC.

1 **V. REBUTTAL OF THE DIRECT TESTIMONY OF MATTHEW I. KAHAL**
2 **REGARDING THE COMPANY'S CAPITAL STRUCTURE**

3
4 **Q. Why is the Company's capital structure a significant issue in this case?**

5 A. The Company is seeking an increase in revenue to recover its costs, including
6 the cost to finance its invested capital. How the Company finances its capital
7 investment, as I explained in detail in my direct testimony on pages 8 through
8 11 and reiterated in my supplemental testimony on page 5, is driven by "what
9 the financial community is expecting in order for the Company to be able to
10 raise funds at the best possible rates and whenever the need arises." Rate
11 Counsel witness Mr. Kahal in fact does "not object to [my] discussion
12 concerning the need for maintaining reasonable financial strength in order to
13 access capital on reasonable terms" (Kahal, page 17).

14
15 **Q. Mr. Kahal implies that your argument is out of date since it relies on a**
16 **February 2009 article, and he states that "while certain weakness in**
17 **markets remains, it is a dramatically-improved situation from a year**
18 **ago..." As such he concludes that if you merely move half way from the**
19 **common equity ratio last authorized (47.4% in 2006) to the Company's**
20 **requested 51.2% today, you will have sufficiently strengthened the balance**
21 **sheet to meet the financial community's expectations. Do you agree with**
22 **Mr. Kahal's analysis?**

23 A. No. Mr. Kahal apparently believes that since this Spring when my direct
24 testimony was prepared, the financial community has moderated its

1 expectations regarding the appropriate amount of common equity in the
2 Company's capital structure. This view, however, is not supported by the
3 opinions of the rating agencies. In response to discovery request RCR-A-70
4 Update, the Company provided the most recent credit agency reports for
5 PSE&G. Moody's Credit Opinion: Public Service Electric and Gas Company,
6 dated September 10, 2009, states:

7 Moody's views PSE&G's May 2009 filing for electricity
8 and gas base rates positively. The filing proposes to
9 increase PSE&G's allowed ROE to 11.5% from the 10%
10 last approved for gas base rates and the 9.75% last
11 approved for electric base rates. The base rate filing also
12 seeks to raise the deemed equity for rate-making purposes
13 to 51.2%, a level consistent with recent BPU decisions
14 and higher than those approved in PSE&G's last base rate
15 decision...Moody's assumes that PSE&G will receive
16 reasonable treatment on its requests and that the
17 incremental cash flows associated with the ultimate
18 decision should partially mitigate some of the financial
19 pressure stemming from the company's substantial
20 planned capital spending over the next several years.

21
22 Similarly S&P pointed out on September 21, 2009 that "[r]atings could come
23 under pressure if the company's financial measures decline..." S&P Ratings
24 Direct Summary: PSE&G (also produced in response to RCR-A-70 Update).

25
26 **Q. What are your conclusions regarding the Company's capital structure**
27 **request?**

28 A. It is important to note that the Company, at the date of its filing, was seeking a
29 capital structure reflecting 51.2% common equity. In September 2009, the

1 rating agencies still believed that there should be no reduction in the current
2 credit metrics, and at that point in time the Company's actual capital structure
3 reflected 52.85% common equity as of June 30 (see response to discovery
4 request RCR-ROR-33). The Company's actual capital structure was 53.4%
5 common equity as of September 30, and is anticipated to be approximately
6 53% common equity at test year end. Nevertheless, the Company continues to
7 request a 51.2% equity ratio in this case, consistent with its long-term goals.
8 Moody's expects reasonable treatment on the Company's request for a 51.2%
9 common equity to partially mitigate the financial pressure from the Company's
10 capital spending requirements. The Company firmly believes, and has
11 substantiated, that the capital structure reflected in its filing is consistent with
12 the expectation of the financial community. Mr. Kahal's half way approach
13 from an equity ratio of 47.2 to 49.7, rather than the Company's actual capital
14 structure of 51.2%, is completely arbitrary.

15
16 **Q. Does this conclude your rebuttal testimony?**

17 **A.** Yes, although I reserve my right to submit additional testimony and evidence
18 in response to any additional materials placed in the record or as otherwise
19 permitted by the Board.

Public Service Electric and Gas Company
Growth in Net Plant
(millions of dollars)

<u>Year</u>	<u>Electric</u>		<u>Gas</u>	
	<u>Net Plant</u>	<u>Percent Change</u>	<u>Net Plant</u>	<u>Percent Change</u>
2004	3,401		2,113	
2005	3,471	2.06%	2,208	4.50%
2006	3,586	3.31%	2,383	7.93%
2007	3,715	3.60%	2,491	4.53%
2008	3,903	5.06%	2,633	5.70%
2009	4,079	4.51%	2,757	4.71%
Compound Growth:		3.70%		5.46%
Plant at 2009:		4,079		2,757
% Incr over 2-months:		0.62%		0.91%
Plant at 2/28/10 based				
5-year CAGR:		4,104		2,782
Plant at 2/28/10 per filing:		4,109		2,763
Difference:		(5)		19

Schedule MGK-48

Public Service Electric and Gas Company
Test Year O&M Without Pro-Forma Adjustments
(millions of dollars)

	<u>Electric</u>	<u>Gas</u>	<u>Total</u>
Operation Expense	4,348	2,414	6,762
Maintenance Expense	101	29	130
Total O&M	<u>4,449</u>	<u>2,443</u>	<u>6,892</u>
Power Supply Expense	3,684	-	3,684
Total Gas Supply	<u>-</u>	<u>1,938</u>	<u>1,938</u>
Total O&M excl Commodity	765	505	1,270
O&M Items Pro-Formed:			
Wages	174	192	366
Payroll Tax	13	14	27
Pension & Fringe Benefits	140	97	238
Postage	6	5	10
Mgmt/Affil Stds Audit	2	2	3
Insurance	4	3	7
Sub-total	<u>339</u>	<u>312</u>	<u>651</u>
Test Year O&M Without Pro-Forma Adjustments	427	193	619
Annual Inflation Rate	2.5%	2.5%	2.5%
Inflated Test Year O&M Without Pro-Forma Adjustments	12.4	5.6	18.1

