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

I/M/O THE PETITION OF JERSEY CENTRAL POWER AND LIGHT COMPANY FOR APPROVAL OF AN INCREASE IN BASE TARIFF RATES, DEFERRED BALANCES FILING AND 2002 CED FILING	)))))	**DOCKET NOS. ER02080506, ER02080507, AND ER02070417** **OAL DOCKET NO. PUC 07894-02, 07984-02, AND 07983-02**

REPLY BRIEF OF
THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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POINT I. COST OF CAPITAL

JCP&L HAS FAILED TO SUPPORT ITS PROPOSED 10.05% OVERALL RETURN. YOUR HONOR AND THE BOARD SHOULD ADOPT THE RATEPAYER ADVOCATE'S PROPOSED 8.08% RATE OF RETURN

In the Initial Briefs filed in this matter, the Ratepayer Advocate presented a detailed discussion of the evidence in the record that supports the adoption of its proposed 8.08%[1] overall rate of return. As explained in the Ratepayer Advocate's Initial Brief, JCP&L's proposed 10.05%[2] overall rate of return is based on a distorted "stand-alone" capital structure and overstated 12% return on equity. *RAIB Vol. 1* at 6. The Ratepayer Advocate's proposed rate of return is based on the only actual capital structure in the record, that is, the consolidated capital structure for FirstEnergy, and a return on common equity of 9.85% based on a properly performed analysis of comparable companies plus a 35 basis point adjustment to compensate for the risks inherent in FirstEnergy's unusually low equity ratio. *RAIB Vol. 1* at 6-7.

The Board's Staff, while taking a somewhat different approach, has reached an end result very close to the Ratepayer Advocate's. Staff has not recommended the use of the FirstEnergy consolidated capital structure. However, Staff agrees that Company's proposed stand-alone capital structure reflects an exaggerated equity ratio given the operating risks facing JCP&L, and has therefore recommended an adjustment to reduce JCP&L's equity rate from 57.22% to 46%. *SIB* at 18-21. Staff also concurs that JCP&L's proposed 12% return on equity is excessive, recommending a 9.75% return on equity. *SIB* at

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[1] The recommended 8.16% overall rate of return cited in the Ratepayer Advocate's Initial Brief did not reflect the Company's 12+0 updates. The Ratepayer Advocate's updated recommendation appears in David Peterson's Schedule 1, page 3 of 3, 12+0 updates, *R-38*.

[2] The 9.89% proposed overall rate of return cited in the Ratepayer Advocate's Initial Brief did not reflect the Company's 12+0 updates, JC-5, Schedule TCN-6 (12+0 Update).

31-32. Staff is recommending an overall rate of return of 8.50%, considerably closer to the Ratepayer Advocate's recommended 8.16% than to the Company's proposed 10.05%.

The Ratepayer Advocate's Initial Brief addresses in detail the correctness of the analysis presented by the Ratepayer Advocate, and the flaws in the Company's analysis. The Ratepayer Advocate will not repeat those arguments here. However, it is necessary to address some of JCP&L's arguments characterizing the testimony of Ratepayer Advocate witness Basil L. Copeland. As explained below, these arguments are unfounded, and some of them are based on either distortion or mis-statement of the record. They should be rejected by Your Honor and the Board.

A. Capital Structure

As was explained in Mr. Copeland's prefiled direct and rebuttal testimony, and in the Ratepayer Advocates's Initial Brief, JCP&L's proposed "stand-alone" capital structure does not include any of the $4.5 billion of long-term low-cost debt issued to finance the GPU-FirstEnergy merger. R-41, p. 5.[3] Since all of this debt is reflected at the parent level, this results in an artificial inflation of the equity ratio of the subsidiary, JCP&L. *RA-41,* p. 5-5; *RA-42,* p. 2; *RAIB Vol. 1* at 9-10.

JCP&L's Initial Brief attempts to undermine Mr. Copeland's recommendations by selectively quoting his testimony on cross-examination. Mr. Copeland did acknowledge, as stated at page 19 of the Company's Initial Brief, that $2.2 billion of the debt was used to finance the cash portion of the purchase price for the merger, an amount equivalent to the "goodwill premium." However, the Company then goes on to state the following:

> In other words, Mr. Copeland admitted that the only use of the proceeds from the new FirstEnergy debt was for "the payment of the premium [which] is what resulted in the

[3] The prospectus which is in evidence as *R-47* reflects the issuance of a total of $4 billion in long term debt. However, the Company's 2001 Annual Report to shareholders, provided in response to SJREV-11, reflects, at page 35, total debt issuances of $4.55 billion, as reflected in Mr. Copeland's pre-filed direct testimony, *R-41*, p. 5.

> good will [sic] and the corresponding increase to the subsidiary' [JCP&L's] equity accounts" which was "exactly what Mr. Navin's proposal eliminates."

PIB at 19-20, quoting T150:L2-12 (3/3/03). Mr. Copeland made no such admission. While only $2.2 billion of the debt appears to have been attributable to goodwill, Mr. Copeland never stated that this was the "only use of the proceeds" of the $4 billion debt issuance. Indeed, he explained in his surrebuttal testimony and at the hearing that, based on the FirstEnergy Prospectus for the $4 billion debt issuance $1.5 billion was used to repay short-term indebtedness of GPU and its subsidiaries, and that ratepayers were entitled to the resulting benefit. *RA-42,* p. 3; *RA-47*, p. S-8; T122:L8 - T123:L123 (3/3/03). As explained in Mr. Copeland's redirect testimony, in the consolidated capital structure, the amount of the goodwill is offset by the amount of the financing used to fund the goodwill. T212:L15 - T213:L3 (3/3/03). Thus, the use of the consolidated capital structure correctly flows through to ratepayers "not the full amount of the financing, but just the amount that's in excess of whatever was used to fund the good will." T213:L5-11 (3/3/03).

By selectively quoting the transcript, JCP&L has implied, wrongly, that Mr. Copeland agreed with the Company's position that Your Honor and the Board should ignore that portion of the debt issuance that was in excess of the $2.2 billion in goodwill. To the contrary, Mr. Copeland made it clear that, in his opinion, ratepayers should receive the benefits flowing from the entire $4.0 billion in low-cost debt, not just the $2.2 billion used to finance the cash portion of the consideration for the merger.

JCP&L also has attempted to suggest that Mr. Copeland's testimony in this proceeding is contrary to his position in the current Public Service Electric and Gas Company ("PSE&G") rate case. Again, JCP&L has engaged in selective quotation of Mr. Copeland's testimony.

As JCP&L points out at page 20 of its Initial Brief, Mr. Copeland did not recommend using a consolidated capital structure in the PSE&G rate case. *PIB* at 20. During his redirect examination, Mr. Copeland explained the reason for his position in the PSE&G case:

> There wasn't anything particularly unusual about the capital structure in the PSE&G case, and I had no reason to believe that the PSE&G capital structure was affected by its corporate relationship with its parent. It was rather obvious in this case that we had these kinds of issues, because Mr. Navin had to unwind the effect in order to come up with something he thought was a more appropriate capital structure.
>
> So in a sense this case sent up some red flags and said we need to look at the capital structure issue more throughly than we might do in other cases.

T211:L4-24 (3/3/03). The above testimony, which was ignored in the JCP&L Initial Brief, provides a reasonable and logical explanation why it is necessary to use a consolidated capital structure for JCP&L but not for PSE&G.

JCP&L also asserts that Mr. Copeland used a stand-alone capital structure for PSE&G despite an equity ratio for the parent company, Public Service Enterprise Group ("PSEG") that is "approximately half" that of the utility. *PIB* 20, quoting T146:L19 (3/3/03). In fact, on the same transcript page cited by JCP&L, when Mr. Copeland was asked whether counsel's assertion that PSEG has an "equity ratio that's a little more than half of the equity ratio of the regulated utility Public Service Electric & Gas" was a "fair statement," Mr. Copeland's answer was "No." T146:L2-13. When asked to explain this "No" answer, Mr. Copeland stated as follows:

> Well, again, you're – if you lay down the capital structure numbers in these exhibits right alongside the one that was filed in the case and look on at the equity ratio then, yeah, the number is approximately half.
>
> But I pointed out the reason why that number differs is in part because there are other things that are not comparable between these two capital structures.

T146:L15-23. He then explained in response to a further question that the capital structures were not comparable because the PSEG capital structure included short-term debt, as well as securitization debt. T146:L24-25. Thus, it is clear from the full context of the testimony quoted in the JCP&L brief that, although Mr. Copeland acknowledged that "the number is approximately half," he made this very clear that he did not think that number shown for PSEG was comparable to the FirstEnergy capital structure.

The cross-examination cited in the JCP&L's Initial Brief in no way contradicts Mr. Copeland's testimony in support of using a consolidated capital structure in this proceeding. JCP&L's attempts to suggest otherwise are based on selective and misleading citation of the record, and should be rejected by Your Honor and the Board.

B. Return on Common Equity

Beginning at page 45 of the Company's Initial Brief, in a section entitled "Cross-Examination of Mr. Copeland," the Company makes a number of arguments which purport to show contradictions in Mr. Copeland's testimony. This section of the JCP&L brief includes several distortions of the record.

Mr. Copeland's prefiled direct testimony recommended that the Company's proposed flotation cost adjustment be rejected, because it is based on hypothetical assumptions which may not occur. *RA-41,* p. 27. JCP&L's Initial Brief states at page 45 that Mr. Copeland "conceded that he has recommended a flotation cost adjustment in other jurisdictions." However, JCP&L neglects to mention Mr. Copeland's testimony that he has made such recommendations in compliance with prevailing precedents in those jurisdictions:

> I've recommended an adjustment [for flotation costs] based on prevailing cases– in jurisdictions where I have opposed the precedent as well, I've gone ahead and made the calculation and made the recommendation using it.

T164:L2-6 (3/3/03). Using Maryland as an example, Mr. Copeland explained that he had opposed a flotation cost adjustment proposed by the Maryland Commission's Staff until it became clear that the Commission would continue to adopt the Staff's approach. T164:L13-25 (3/3/03). Thus, it is clear from the full context of the cross-examination that Mr. Copeland has recommended flotation adjustments in other jurisdictions not as a matter of principle, but based on controlling precedents in those jurisdictions.

At pages 45 through 46 of its Initial Brief, JCP&L has blatantly mischaracterized the methodology used by Mr. Copeland for his Discounted Cash Flow analyses. At the bottom of page 45, the Company makes the following statement:

> The essential flaw in Mr. Copeland's DCF analysis is his blind adherence to the "expected growth rate <u>in the dividend</u>".

PIB at 45, quoting *RA-41* (emphasis added in *PIB*). This is clearly a mischaracterization. As was explained repeatedly in Mr. Copeland's prefiled direct and surrebuttal testimony, and during the hearing, he did not "blindly" adhere to the expected rate of growth in the dividend. In each of his DCF analyses, dividend growth was only one part of the analysis. He also factored in estimates of growth in earnings per share ("EPS") and book value per share ("BVPS"). *R-41,* p. 13-14; *R-42,* p.7; T179:L14-21 (3/3/03). This hardly constitutes "blind adherence" to the expected rate of growth in the dividend.

In fact if any witness is guilty of "blind adherence" to something, it is the Company's witness, Dr. Roger Morin. Dr. Morin ignored dividend growth entirely, giving it <u>no weight whatsoever</u> in his DCF analyses. *R-41,* p. 20. The Company acknowledges at page 46 of its initial brief that utilities are currently lowering their payout ratios. As Mr. Copeland explained, under these market conditions, EPS projections alone will overstate the DCF cost of equity. *R-41,* p. 13, 20-21; R-42, p. 7.

Further, the Company's argument on this issue contains a blatant mis-statement of the record. Near the top of page 46 of its Initial Brief, quoting page 13, line 18-19 of Mr. Copeland's prefiled direct testimony, the Company asserts the following:

> Thus, Mr. Copeland admitted that <u>his reliance</u> solely on projected dividend growth rates "will understate the investors' long-term growth expectations" . . .

PIB at 46, quoting *RA-41,* p. 13, l. 18-19 (emphasis added). Contrary to the statement in JCP&L's brief, Mr. Copeland's testimony clearly stated that he <u>did not</u> rely solely on projected dividend growth rates.

Indeed, Mr. Copeland's prefiled testimony explained very carefully why he did not rely solely on either dividend or earnings growth rates. In the same paragraph on page 13 from which JCP&L took the quote appearing in the Company's brief, Mr. Copeland noted that there is currently a disparity between EPS and DPS growth rates. Mr. Copeland explained as follows:

> Consequently, based on current projections, relying solely upon projected EPS growth rates will overstate the investors' long-term growth expectations. Similarly, relying solely upon projected DPS growth rates will understate the investors' long-term growth expectations.

R-41, p. 13. Immediately following the testimony quoted above, Mr. Copeland's prefiled testimony contains the following question and answer:

> **Q. UNDER THESE CONDITIONS, WHAT IS THE BEST WAY TO ESTIMATE THE CONSTANT GROWTH DCF COST OF EQUITY?**
>
> A. Under these conditions, the best way to estimate the constant growth DCF cost of equity is to rely upon an average of the EPS, DPS, and book value per share ("BVPS") projections. Short-run or near-term changes in payout ratio do not impact book value per share growth as significantly as they do EPS and DPS growth, and over time EPS and DPS growth rates will always revert to the rate of growth in book value per share [footnote omitted]. For this reason, an average of these various growth rate measures is required to reasonably estimate investors' long-term growth expectations.

R-41, p. 14. It should have been clear from even a cursory reading of Mr. Copeland's testimony that he used an average of EPS, DPS and BVPS growth projections. Directly contrary to the statement at page 46 of JCP&L's Initial Brief, he did not rely "solely upon projected dividend growth."

JCP&L's Initial Brief also distorts Mr. Copeland's testimony with regard to his Capital Asset Pricing Model ("CAPM") analysis. The Company's brief, citing Mr. Copeland's prefiled direct testimony and Schedule BLC-5, states that Mr. Copeland "chose to use solely the 76-year average (1926-2001) of common stock premiums over long-term Treasury bonds" for his CAPM analysis. Then, citing Mr. Copeland's cross-examination, the Company's brief suggests that his analysis is contrary to his recommended approach of using a range of 10 to 20 years. *PIB* at 46. JCP&L has found a contradiction by misinterpreting Mr. Copeland's prefiled direct testimony. The Company's brief implies that Mr. Copeland used a single 76-year average. To the contrary, his analysis was based on geometric means calculated for five non-overlapping holding periods of 15-16 years each. This was clearly depicted in Schedule BLC-5, and explained in the cross-examination cited in the Company's brief. *R-41,* Schedule BLC-5; T183:L7-22 (3/3/03).

JCP&L also has exaggerated the record in its attempt to discredit an article by Fuller and Hickman which supports Mr. Copeland's use of geometric means in his CAPM analysis. The JCP&L brief refers to this article as having been "published in 1991 in the first (and possibly only) volume of a publication called "Financial Practice and Education" and states that "Mr. Copeland did not know whether or not this journal was peer reviewed, or even whether it is still being published." *PIB* at 47. In fact, with regard to the current status of this journal, Mr. Copeland stated that he believed that the journal "may be published under another name" though he was not certain it was still being published. T188:L19-15 (3/3/03). He also testified that he did not know whether the publication was peer reviewed, but he did know that the article had been "submitted to a workshop where it was critiqued and reviewed by some fairly eminent people in the field ...." T189:L6-14 (3/3/03). In fact, the publication is still in existence as the "Journal of Applied Finance." See http://www.fma.org/publicationsindex.htm. Further, the procedures for submission of articles make it clear that the this publication is peer reviewed. See http://www.fma.org/fpestyle.htm.

Finally, JCP&L characterizes Mr. Copeland's recommended 9.85% rate of return on equity as a "blatant attempt to deny investors their expected market return on, and to confiscate the market value of their good faith investments in utility stock ...." *PIB* at 48. During his cross-examination, Mr. Copeland acknowledged, as stated in the Company's brief, that during times when the market value of a utility's stock is higher than its book value, his recommended approach would reduce the value of the stock to its book value (*i.e.,* rate base). *PIB* at 48. The end result may well be disappointed investor expectations. However, as Mr. Copeland explained, this is because such investors "speculated on a company being able to earn more than its cost of capital." T201:L10-11. In effect, the Company's appears to be arguing that investors have the right to have the Board meet the expectations created by a period of over-earnings that have driven stock prices above their book value. As succinctly stated by Mr.

Copeland, "[s]omebody is going to lose, but that is because they were expecting to achieve ... an excess return and regulation doesn't guarantee them that." T202:L14 - T203:L3 (3/3/03).

For the reasons set forth above, and in the Ratepayer Advocate's testimony and Initial Brief, the Ratepayer Advocate's recommended rate of 9.85% would produce a fair rate of return on the JCP&L's equity capital. The arguments to the contrary in the Company's Initial Brief should be rejected as unfounded.

POINT II. REVENUE REQUIREMENT

A. Overview

The detailed explanations supporting each of the Ratepayer Advocate's positions on the Company's appropriate revenue requirement are contained in the record evidence and the Ratepayer Advocate's Initial Brief. The Ratepayer Advocate refers Your Honor's and the Board's attention thereto and incorporates them in their entirety herein instead of repeating those explanations at length in this section of the Ratepayer Advocate's Reply Brief. However, the Ratepayer Advocate would like to further address the following issues.

B. Rate Base

THE RATEPAYER ADVOCATE'S PROPOSED ADJUSTMENTS TO RATE BASE ARE PROPERLY BASED ON THE RECORD AND ON SOUND RATEMAKING POLICY.

1. Cash Working Capital

The Ratepayer Advocate's proposed adjustments to the Company's *pro forma* rate base were explained in detail in the Ratepayer Advocate's Initial Brief. The sections below will respond to arguments in the JCP&L Initial Brief and the Staff Initial Brief for each adjustment recommended by the Ratepayer Advocate.

a. The Ratepayer Advocate's Recommended Adjustments to The Company's Lead/Lag Cash Working Capital Recommendation Should Be Adopted by Your Honor and The Board.

JCP&L argues in its Initial Brief that the Board has long recognized "that the returns on all invested capital, including depreciation and amortization expense, interest on long term debt, dividends

on preferred stock and the return on common equity capital, are all earned and become the property of the utility's investors at the time that service is rendered." *PIB* at 52. According to JCP&L, the returns are not received by the investors until the revenue is collected from ratepayers, and therefore the Board has decided that all such returns should be included in the lead/lag study and assigned a zero payment lag. *Id*. While the Board has decided in the past that depreciation expense is properly included in a lead/lag study and that interest on long term debt and dividends on common and preferred stock should be included with zero lead days, the Ratepayer Advocate has recommended in this case that the Board re-evaluate the appropriateness of the Company's inclusion of non-cash amounts in a cash working capital analysis and acknowledge the Company's use of ratepayer funds prior to the payment of interest on long term debt or stock dividends.

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

(i) Depreciation Expense

As discussed in the Ratepayer Advocate's Initial Brief, the time has come for symmetry in the Board's Cash Working Capital policy. JCP&L's lead/lag study provides a lopsided picture of the rate base Cash Working Capital impacts. By including the non-cash depreciation expense with a lag of zero days, the Company has disregarded what happens at the beginning of the construction cycle and has focused attention solely at the end of the rate base life cycle. In support of its Cash Working Capital claim, the Company has provided Your Honor and the Board with information on the timing of the collection of depreciation expenses and when they are recorded and charged against the rate base. The Company has conveniently forgotten what happened prior to this. As noted by Ratepayer Advocate witness Dave Peterson:

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

R-39, p.12

Mr. Peterson further clarified this analysis on cross:

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

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

The Company was at the hearing and heard this testimony, over its objection, and yet has chosen not to respond to Mr. Peterson's statement. The Company merely recites prior Board Orders and states that "[t]he Advocate in this proceeding has offered no new facts or arguments to overturn this long-established line of Board precedents." *PIB* at 55.

The Company's uneven presentation is troubling and deserves careful scrutiny by Your Honor and the Board. The Board cannot continue to condone JCP&L's practice of putting only a portion of the rate base on a cash basis. This one-sided story must be recognized for what it is, unfair to JCP&L ratepayers. Accordingly, the Ratepayer Advocate urges Your Honor and the Board to reconsider this policy, and either require the Company to include all the impacts of a cash basis rate base in the lead/lag study or to exclude depreciation expenses from the lead/lag study for purposes of determining the Company's appropriate Cash Working Capital requirement.

(ii) Deferred Taxes

The Company recognizes that the Board has consistently excluded deferred taxes from the cash working capital calculation and accuses the Board of having "missed the point." *PIB* 57

The Company compares deferred taxes to depreciation expense and claims that as the ratepayer supplied funds are not immediately available for utility investment, shareholders are entitled to a return on these ratepayer supplied funds through a cash working capital adjustment. This is not a new argument and has already been addressed by the Board. As in this case, in the Elizabethtown Gas case "Petitioner argued that there was a collection lag in recovering deferred taxes . . . ." *I/M/O the Petition of Elizabethtown Gas Company For Approval of Increased Base Tariff Rates and Charges For Gas Service And Other Tariff Revisions,* BPU Docket No. GR88121321, Order Adopting in Part and Modifying in Part the Initial Decision, (February 1, 1990). The Board was not persuaded by that argument then, as it should not be now.

Indeed, the Company has missed the point. A cash working capital allowance should be included in rate base to compensate investors for investor supplied funds used to provide the day to day **cash** needs of the utility. *R-38*, p.9. In the case of deferred charges, there is no cash outlay, and therefore no investment in cash working capital is required. This is especially true with respect to deferred taxes. Deferred taxes have been collected from ratepayers without being paid to the Internal Revenue Service by the utility. It is ludicrous to argue that deferred tax expense increases the cash working capital requirement since no investor cash has been expended for the deferred taxes. As recognized by Board Staff in this proceeding:

> . . . deferred taxes should be excluded from the lead/lag study because they did not, at any point in time, require investor-supplied capital. It would be unreasonable and inappropriate to force ratepayers to pay a return on funds not supplied by investors.

SIB, pp. 69-70 citing *Initial Decision* at 35, *I/M/O Public Service Electric & Gas Company for an Increase in Rates,* Order dated, BPU Docket No. ER85121163. (April 6, 1997)

Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board exclude deferred taxes from the Cash Working Capital calculation in this proceeding.

Common Equity

The inclusion of a common equity return in JCP&L's lead/lag study using a zero-day expense lag implies that JCP&L compensates its shareholders on a daily basis. In fact, shareholders receive a return on equity through the quarterly payments of dividends and through any gain achieved on the sale of the Company's stock. This is the mechanism by which the common equity shareholder is compensated in the real world.

As noted in the Ratepayer Advocate's Initial Brief, JCP&L argues that removing the revenue lag relating to the recovery of the return will adversely affect the Company's stock price, but was unable at hearings to quantify the impact this adjustment would have on the actual share price. *RAIB Vol. I Vol. I* p. 32-33. In fact, the Company's witness appeared to say that anything that would negatively affect JCP&L's rates would have an adverse impact on FirstEnergy share price. The Board ensures that JCP&L's shareholders are amply compensated through the Company's overall rate of return and should not allow the Company to pad this return through a cash working capital adjustment. The Board should not incorporate this adjustment into the Company's Cash Working Capital allowance solely to increase shareholder wealth. To do so would be an injustice to ratepayers.

Long Term Debt and Preferred Stock Dividends

Over the years it has long been accepted Board policy that long term debt and preferred stock dividend payments should be included with a zero lag time in the cash working capital lead/lag calculation. These cases all stem from the Public Service Electric and Gas rate case of 1984 in which ALJ Joseph Rosa reasoned:

> The investors are the ones who chose management, and theoretically management could make these payments to the debt and equity holders immediately upon their receipt by the Company. Management, however, has chosen to retain them for a certain period of time, just as they can choose whether to reinvest these earnings or disburse them as dividends. If something should happen to these earnings in the period of time between the receipt by the Company and the payment to the residual, equity or debtholders, those at risk would be the residual, debt and equity holders, not the ratepayers.

I/M/O Public Service, Electric & Gas Company for an Increase in Rates, BPU Docket No. 837-620, Order dated March 23, 1984.

The glaring flaw in this logic that must finally be recognized by Your Honor and the Board is that shareholders and bond holders are amply compensated for any perceived risk in the Company's payout schedule. In fact, the price paid by equity investors is reflective of this payout schedule. Perhaps in 1984 when Judge Rosa wrote this opinion, equity investors were not as sophisticated as they are today. But today, with the amount of information readily available, equity investors know the Company's dividend payout policy when they buy their stock, common or preferred. Bond purchasers know when payments are due and value their investment accordingly. Indeed, the Company is contractually obligated to make these payments on a certain date, specified in the bond indenture.[4] Any lead time between when revenues are received from ratepayers and when interest on long term debt and preferred stock dividends are paid is recognized in the price paid for the invested capital and must be recognized in JCP&L's Cash Working Capital calculation.

Moreover, it goes against basic ratemaking policy to set rates on what theoretically could happen. These payment are not going to be made on a daily basis, in fact, it is virtually impossible for

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[4] As noted by ALJ Sukovich in the Elizabethtown Gas case, "I am persuaded by Rate Counsel's argument that there is no qualitative difference between petitioner's obligation to timely pay interest to bondholders and its obligation to timely pay bills from suppliers and that there is no reasonable rationale for using a fictitious zero days lag for interest rather than the actual 90.2 days lead calculated by [Company witness Andrew B. Herf]. *Elizabethtown Gas,* Initial Decision, p. 21, BPU Docket No. GR88121321, November 13, 1989.

the Company to do so. There is not one utility in this state that pays common equity shareholders, preferred equity shareholders or bondholders on a daily basis. To base a cash working capital allowance on the theoretical possibility of what could happen is not typical of Board policy in this state. Indeed, this Board has expressly rejected such speculative rate making policy, for example in rejecting forecasted test years in favor of an actual test year. To continually ignore year after year the Company's control of this money on the theoretical possibility that some day some manager might choose to return this money to shareholders on a daily basis is absurd. Your Honor and the Board should review this policy and discontinue this rate making policy based on an out-dated fiction.

2. JCP&L's Consolidated Income Tax Adjustment Proposal is Flawed and Unreliable

JCP&L has accused the Ratepayer Advocate of mis-applying the prior Board decisions regarding the consolidated income tax adjustment. The Company agrees that the Ratepayer Advocate's position in this case is consistent with those decisions but seems to believe that this case is different. The Company makes the same argument that it has made all along, that Mr. Peterson has ignored the fact that the unregulated business had cumulative positive income for the first nine years of the analyzed period. *PIB* 60. The Company further claims that Mr. Peterson "has also attempted to construct the highest possible amount of tax losses to create his recommended rate base deduction."

This issue was addressed at length in the Ratepayer Advocate's Initial Brief and will not be repeated here. *RAIB Vol. 1* at 36-41. The Company's proposal is unfair to ratepayers. All affiliates having positive taxable income, whether regulated or not, are entitled to a share in the benefit the whole system receives from affiliate tax losses. Staff has also rejected the Company's proposal, stating:

"Equity dictates that savings should be allocated to regulated and unregulated positive income companies by their percentage of the total positive income as proposed by Staff." *SIB* at 47.

The Ratepayer Advocate would, however, like to clarify the record regarding certain statements in the Company's Initial Brief referencing a Board Staff exhibit supporting Board policy in the consolidated tax adjustment. *S-43 Statement of Michael J. Graetz, Deputy Assistant Secretary (Tax Policy) Department of the Treasury Before the Subcommittee on Select Revenue Measures Committee on Ways and Means United States House of Representative Dated September 11, 1991, and Attached Memorandum dated September 09, 1991, from Abraham N.M. Shashy, Jr., Chief Counsel, Department of the Treasury, Internal Revenue Service to Michael J. Graetz, Deputy Assistant Secretary, Tax Policy regarding the "Internal Revenue Service Ruling Position on the Treatment of Consolidated Tax Adjustments*." The Company claims that the Mr. Graetz, in his statement, noted that "a rate base adjustment would be allowable only 'until the loss affiliate becomes profitable.'" *PIB* 59. In fact, this statement was not made by Mr. Graetz but was in the memo attached to his statement written by Mr. Shashy. The full statement of Mr. Shashy is "However, the proposed regulations would not have prohibited a commission from adjusting the utility's rate base to treat the affiliated group's tax savings from filing a consolidated return as cost-free capital until the loss affiliate becomes profitable." The Company then further cites this memo for the proposition "that the adjustment would treat the consolidated tax savings merely 'as a deferral, rather than a permanent reduction, of [the utility's] tax liability.'" The full text of cited sentence is: "This approach generally regards the taxable income generated by the utility as serving to permit current use of the offsetting losses (or credits) of unregulated affiliates and treats the benefits of filing a consolidated return as a deferral, rather than a permanent reduction, of tax liability."

The Company probably did not realize that these words were not taken from the statement of Mr. Graetz but were instead taken from the attached memorandum describing proposed regulations. The Company also probably did not notice the title of the section quoted "Issuance and Withdrawal of Proposed Regulations." *Id.* Perhaps if the Company had read to the end of that section it would have seen that "[o]n April 25, 1991, the Internal Revenue Service withdrew the proposed regulations pending congressional guidance." *Id*. at 12. So what the Company cites as a statement of the IRS's position is, in fact, selected parts of a description of proposed regulations that were subsequently withdrawn.

The Company also selectively cites certain phrases from the Conclusion section of this descriptive memorandum. Perhaps a more complete reading would be helpful.

> As I have indicated, the proposed regulations were designed to follow the general structure of normalization requirements for accelerated depreciation. In essence, this approach views consolidated tax savings resulting from the combination of losses of unregulated affiliates with the income of the regulated utility as enabling the consolidated group to use the losses sooner than if the affiliate were to file its tax return on a stand-alone basis. This measure of the utility's contribution may be captured in a rate base adjustment, which provides the utility's ratepayers with a benefit reflecting the time value of the more rapid use of the unregulated affiliates' loss or excess credits made possible by the utility's taxable income or tax liability. Under the proposed regulations, the unregulated affiliates would have been no worse off than they would be had the utility not been part of the consolidated group. **Since the utility's cost of capital reflects the activities of its unregulated affiliates, there seemed to be no reason to allocate the benefits resulting from the accelerated use of their losses or excess credits entirely to the unregulated affiliates, as would be the result if the rate base reductions were prohibited**. Thus, we concluded that we should not attempt to prohibit regulatory commissions from permitting utility customers to share in the benefit produced by consolidated tax savings through a rate base adjustment.

Id. at 13-14 (emphasis added).

Indeed, the conclusion section cited by the Company expressly contradicts the Company's contention that regulated affiliates are not entitled to a share in the consolidated group's tax loss benefits. The Company somehow twists the words "until the loss affiliate becomes profitable" to mean that if the consolidate group is able to utilize the losses of its unregulated affiliates without the regulated entity's taxable income then there is no justification to pass through any of these consolidated tax

savings to the regulated utility's ratepayers. *PIB* at 59. Thus the Company has taken a string of words, out of context, mis-cited, and mis-interpreted, from proposed IRS regulations that were subsequently withdrawn as the sole basis upon which to support an unsupportable argument, that is, if the non-regulated affiliates could absorb tax losses of the other affiliates, then the regulated affiliates are not entitled to a share of those benefits.

Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board reaffirm the Board's policy on consolidated tax savings by reducing the Company's proposed rate base by approximately $61.1 million in order to accurately reflect JCP&L's accumulated share of the consolidated tax benefit. *R-39*, p. 16, Sch. 2, p. 3.

C. Operating Income

1. Revenue Adjustments

a. Revenue Annualization

Since JCP&L's rate base and expenses have been annualized to year-end levels, consistency and the test period matching principle require that revenues also be restated to year end levels. R-38, p.17. In particular, the failure to annualize the customer growth that occurred during the test year distorts the measurement of the income producing capability of the underlying utility assets and overstates JCP&L's revenue requirement. *Id.* Based on this reasoning, Ratepayer Advocate witness David Peterson increased the Company's test year revenues by $4.684 million.

In its Initial Brief, the Company makes two equally unsustainable arguments against Ratepayer Advocate witness Mr. Peterson's upward revenue adjustment of $4.684 million to account for customer growth.

First, the Company complains that Mr. Peterson did not account for any decrease in industrial customer revenue that might occur. *PIB* at 64. However, as noted in the Ratepayer Advocate's Initial Brief, Mr. Peterson explained at the evidentiary hearings why an adjustment was not appropriate to account for any decrease in industrial customer revenue. *RAIB Vol. 1* at 44. Mr. Peterson testified that because these are generally large customers with unique load profiles he recommends a specific adjustment to reflect known changes in the industrial load rather than a revenue annualization adjustment. The Company, for its own reasons, has chosen to ignore this testimony.

Second, the Company claims that Mr. Peterson ignored the incremental expenses that are incurred as a result of customer growth. *PIB* at 64. This issue too was addressed in the Ratepayer Advocate's Initial Brief and will not be addressed at length in this document. As discussed in that document, the Ratepayer Advocate cannot consider incremental expense information that is not provided by the Company. To berate the Ratepayer Advocate for not considering what has not been provided is disingenuous at best.

The Ratepayer Advocate would, however, like to point out to Your Honor and the Board the strident tone and empty rhetoric of JCP&L. In its Initial Brief, the Company questions Mr. Peterson's motivation and decries his "opportunistic posturing to circumvent established Board policy." In fact, Mr. Peterson tried to explain to the Company, "my adjustment is to properly match year end rate base revenues and expenses." T138:L24-25 (2/26/2003). But, the Company has chosen to either distort or to ignore Mr. Peterson's testimony. Because the Company is unable to come up with a meritorious argument for failing to adjust revenues for increased customer growth, it resorts to questioning the motives of the Ratepayer Advocate's witness. As a further note, Board Staff has also recognized that "since Petitioner has used the year-end plant in service balance and has annualized its depreciation expenses based on year-end plant, it should annualize the revenues for customer growth through the end

of test year." *SIB* at 50. Staff then provides a comprehensive explanation of the Board precedent that supports the reflection of customer growth through the test year in its entirety. *SIB* at 50-51. Board Staff concluded that "[t]he RPA's customer annualization adjustment is the only adjustment in the record that represents a reasonable assessment of customer growth levels and more closely reflects historical Board precedent on this issue." *SIB* at 51.

Thus, Staff's position regarding revenue adjustment for customer growth dovetails with the Ratepayer Advocate's position that the Company has failed to abide by the matching principle. This pervasive accounting principle provides that in order to correctly assess earnings, revenues and expenses from the same period must be compared – revenues and expenses from different periods cannot be compared. By only recognizing depreciation expense, the Company fails to consider the other half of the equation. Mr. Peterson's revenue adjustment accounting for customer growth, supported by Staff, corrects this oversight.

b. CRA Lost Revenue Annualization

The Ratepayer Advocate reiterates its position that Your Honor and the Board not allow the inclusion of annualized "lost revenues" for new JCP&L CRA programs.

In its Initial Brief, the Company has patently ignored the fact that the *March 9, 2001 Order* specifically precludes the Company from doing what it is asking Your Honor and the Board to do, *i.e.*, approve lost revenue recovery before the Board has ruled on the protocols by which to measure these alleged lost revenues. The Board stated in its Findings in that Order that "[t]he program evaluation plans for determining energy savings must still be approved by the Board, prior to eligibility for collection of lost revenues for the new energy efficiency programs." *Id.* at 77. This office fails to comprehend why the Company argues the "Board's approval in principle of lost revenue recovery"

when the “principle” is not the issue. *PIB* at 66. The issue is that the Order clearly states that lost revenues cannot be recovered prior to Board approval of any protocol methods, principle or no principle.

The Company has also mischaracterized the testimony of Ratepayer Advocate witness Dr. David Nichols. JCP&L wrongly asserts that, in this proceeding, the Ratepayer Advocate takes no position on the “correctness” of the JCP&L protocols for estimating “lost revenues”. *PIB* at 67. In fact, Dr. Nichols identified in his testimony and schedules, as well as at the evidentiary hearing, that a number of JCP&L protocol methods, as presently proposed, significantly over-estimate annual energy savings. *RAIB Vol. 1* at 49; T47-54 (3/7/03). Indeed, even the Company attorney objected at the evidentiary hearing that “[Dr. Nichols’] surrebuttal testimony goes into great detail starting on page 3, approximately line 18, in critiquing the protocols that were used to calculate lost revenues.” T42:L17-20 (3/7/03).

The Company also chooses to quote Ratepayer Advocate witness Dr. Nichols out of context in order to make its argument. The Company asserts that “Mr. Nichols has also stated that he does not ‘object’ to the annualization of lost revenues.” *PIB* at 67 citing T55:l2 (3/07/03.) To the contrary, Dr. Nichols made it very clear that he disagreed with the Company’s proposed “annualization” adjustment:

> Q. Now, I believe that you began your testimony by saying that you object to the annualization of lost revenue by JCP&L. Is that right?
>
> A: I object to the adjustment to revenues based on a calculation of annualized lost revenue, yes.
>
> Q: My shorthand for that is annualized.
>
> A: I don’t object to annualizing. I just objected them rolling it in as an adjustment basis.
>
> Q: That is an annualization of lost revenues here, isn’t it?

> A: Annualization of lost revenues is fine, but the adjustment to revenues is not because of the matters that I have been discussing this morning.

T54-55:L21-25, 1-9 (3/7/03)

The meaning of Dr. Nichols' statement is much clearer when viewed in its proper context. The single line of testimony cited at page 67 of the Company's brief was part of an exchange in which Dr. Nichols clearly stated his objection to the Company's proposed adjustment to revenues. The Company wrongly implies that Dr. Nichols is in agreement with the proposition that "absent an adjustment to annualize lost revenues attributable to programs implemented during the test year, the *pro forma* revenues on which rates would be based would be higher than they should be." *PIB* at 67, quoting T56:L23 - T57:L7 (3/3/03). Mr. Nichols testified that this proposition would only be true "all else equal" –and then proceeded to explain as follows:

> But as I point out in my surrebuttal testimony, all else isn't equal and during all the years that JCP&L has had DSM, it has also had significant sales growth from one year to the next.

T57:L6-11 (3/7/03). Thus, contrary to the implication in the Company's brief, Dr. Nichols clearly stated his opposition to the proposition that the Company's test year revenues are overstated in the absence of an adjustment for lost revenues.

Therefore, the Ratepayer Advocate, supported by Staff, reiterates its position that until a full and complete review of the protocols is done by the Board, JCP&L cannot recover any of its alleged $722,459 in annualized lost revenues from its CRA programs. Clearly, the Company should not be permitted to include "lost revenues" as part of its base rates.

2. Expense Adjustments

a. Advertising Expenses

The Ratepayer Advocate reiterates its position, supported by Staff, that $958,000 in community affairs, public relations and image advertising be excluded from JCP&L's test year operating expenses.

The precedent and policy addressed by the Ratepayer Advocate were amplified by the Staff in its Initial Brief. Staff detailed the types of material that were and were not permitted to be recovered through ratepayer funding as decided by the Board in *I/M/O the Board's Investigation of Advertising Practices*, BPU Docket No. 712-1254 (April 11, 1980). Staff agreed with Ratepayer Advocate witness Mr. Peterson that the disallowed material falls into the categories of promotional, institutional and lobbying expenses, and therefore is not recoverable. The re-introduction of the "Jersey Central Power & Light" name in an attempt to reassure customers of a recognizable brand name to provide safe, adequate and reliable service should not impose a financial burden on the Company's ratepayers.

b. BPU/RPA Assessments

Both the Ratepayer Advocate and Board Staff concluded that the12+0 updates provided by Company witness Mr. Preiss failed to recognize the fact that, when rates are reduced at the end of this proceeding, the BPU and RPA revenue tax amounts will decline, as tax is proportional to total revenue. *RAIB Vol. 1* at 53, *SIB* at 54.

The Company agrees in principle that "any change to the Company's pro forma revenue requirements will require a further adjustment to the BPU/DRA assessment expense." *PIB* at 68.

Ratepayer Advocate witness Mr. Peterson's ($13,000) adjustment takes into account residential and commercial customer growth percentages, applys these adjustments to the gross revenue, and then adjusts that number to reflect taxes. Indeed, "Staff recommends that Your Honor and the Board support

the RPA's calculation of this adjustment for BPU/RPA assessments since it accounts for the growth in the level of customers, utilizes the most recent assessment rates and includes a tax adjustment." *SIB* at 55.

c. Charitable Contributions

Despite the fact that the Company is trying to recover for charitable contributions to the same charities with the same justification as New Jersey American Water Company, JCP&L believes that this case is different from the recently decided New Jersey American Water Company case in which the New Jersey Supreme Court held that a utility's charitable donations could not be passed on to the utility's ratepayers. *I/M/O the Petition of New Jersey American Water Company, Inc. for an Increase in Rates for Water and Sewer Service and Other Tariff Modifications*, 169 N.J. 181 (July 25, 2001). As discussed in the Ratepayer Advocate's Initial Brief, the Company's case is not different and the charitable contributions made by JCP&L cannot be passed on to New Jersey ratepayers.

Board Staff has also recognized that "[t]he mandate of the New Jersey Supreme Court with regard to whether or not the costs of charitable contributions of a utility may be passed on to ratepayers as operating expenses is clear," and that ratepayers are not to fund the charitable donations of the Company. *SIB* at 58.

The Company further thinks that because the Board, in the Company's merger proceeding, directed the Company to maintain for three years the level of JCP&L's charitable contributions, the Company is entitled to recover these amounts from ratepayers. *I/M/O the Joint Petition of FirstEnergy Corp. and Jersey Central Power and Light Co. d/b/a GPU Energy for Approval of a Change in Ownership and Acquisition of Control*, BPU Docket No. EM00110870, dated October 9, 2001. The Merger Order states at paragraph 43 of the FirstEnergy Settlement Agreement (Attachment A) that

"FirstEnergy agrees to maintain, for at least three years after the merger, and substantially at current aggregate levels, JCP&L charitable commitments to the communities served by JCP&L." The Company attempts to use this language to collect charitable donations from ratepayers. No where in the merger order is funding for these commitments discussed. Indeed, there is no need to mention it, for the New Jersey Supreme Court had several months earlier stated that the funding of charitable contributions by a utility should not come from its ratepayers, but that "they are more appropriately borne by the entity's shareholders." *New Jersey American* at 194. This is the same conclusion that Board Staff reaches as it cautions the Company that the Merger Agreement must be considered in the proper context of New Jersey case law. *SIB* at 59).

For these reasons and those enumerated in the Initial Briefs of the Ratepayer Advocate and Board Staff, Your Honor and the Board should not allow any of the Company's claimed charitable contributions to be recovered from ratepayers.

d. Depreciation Expense

As in the Initial Brief, Depreciation Expense is discussed in Point III of this Reply Brief.

e. Management Audit Expenses

This issue has been discussed at length in the Ratepayer Advocate's Initial Brief and that discussion will not be repeated here. *RAIB Vol. 1* 109 - 111. However, a few issues raised in the Company's Initial Brief will be discussed.

First, the Company repeatedly relies on the fact that the Board "did <u>not</u> find 'a prima facie' case that overall [JCP&L] provided unsafe, inadequate or improper service." *PIB* at 72. What the Board did

find however was that the Company's actions were risky and based on inaccurate information.

Specifically, the Board found:

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

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

The Company characterizes Mr. Lanzalotta's recommended adjustment as an " attack" on the Board's findings; his conclusion as "cavalier" and his testimony given "grudgingly." Once again the Company cannot make a substantive rebuttal so it resorts to unflattering characterizations. The Company relies on Mr. Sweeney's surrebuttal testimony in which he faults Mr. Lanzalotta for referring to the 1999 outages as due to transformer failure. Mr. Sweeney's lack of "expertise" is discussed at length in the Ratepayer Advocate's Initial Brief and will not be repeated here. But, in the end, the Company cannot dispute that the Board found their actions risky and based on inaccurate information, and while Stone and Webster did not concluded that the outages would not have occurred if the transformers had been replaced as scheduled they did say: "it would [have been] less likely." *S-3*, P. ES-7.

Thus as demonstrated at length in the Ratepayer Advocates Initial Brief, there is more than ample support in this record to disallow those expenses brought on by the utility's reliance on inaccurate information and risky behavior. *RAIB Vol. 1* at 109 -111. If the utility's management takes a gamble,

there should be some sharing of the loss. Ratepayers endured the physical loss through prolonged power outages, shareholders should assume at least a small portion of the financial losses through the disallowance of the cost of this audit.

f. Merger Costs

JCP&L, in its Initial Brief, attempts to mask its true intentions by stating that their main objective is not to recover merger costs but to provide customers with an additional $21.5 million of net merger savings. The Company states that the $21.5 million represents $64.2 million of gross O&M merger savings reflected in the test year, net of $42.7 million of costs incurred to achieve those savings. *PIB* at 75. Yet in fact, JCP&L is actually trying to pass on to ratepayers merger costs that were already accounted for during the Merger proceeding. JCP&L should not be allowed to recover any merger related costs in this rate proceeding because to do so would violate the express directives of the Stipulation and Merger Order. *RAIB Vol. 1* at 57. The Staff, in its Initial Brief, supported the Ratepayer Advocate's position and stated that:

> The accuracy of Mr. Peterson's assessment of the company's recovery of merger costs is evident in a review of the Board's Order in the merger proceeding. . . . The Board clearly ordered $300 million of net merger savings to be allocated to JCP&L ratepayers at the conclusion of the merger proceeding. Those *net merger savings* by definition already account for the recovery of the estimated costs of achieving the gross level of merger savings over time, a fact acknowledged by Mr. Preiss during cross examination by the RPA. (4T 79-7 to 81-20).

SIB at 63.

Moreover, JCP&L in its Initial Brief states that of the $42.7 million of cost-to-achieve that it wants to recover, $35 million was incurred in 2001 and relates to severance pay for employees who were actually terminated and received their severance payments during the 2002 year. However,

JCP&L admitted that "accounting rules required these anticipated 2002 severance payments to be recorded at the time of merger closing in *November 2001*." *PIB* at 76. (emphasis added). Therefore, absent Board authorization permitting JCP&L to defer pre-test period merger costs, JCP&L cannot justify the recovery of $35 million of merger costs that were written off in the year in which they occurred in accordance with accounting rules. The Staff echoed this sentiment in its Initial Brief when it stated that:

> The Board did not provide for the deferred recovery of merger expenses incurred prior to the test year employed in the instant proceeding. . . . the Board in fact dispensed with all prospective merger related cost recovery at the time it implemented the allocations of net merger savings at the conclusion of the merger proceeding.

SIB at 66.

JCP&L argues in its Initial Brief that it is improper to remove all costs to achieve merger savings from the test year, because retaining them in the test year results in the double counting of merger savings. *PIB* at 76. Mr. Peterson takes an opposite view in his direct testimony, stating that the recognition of any further merger related costs result in double counting of merger costs because these costs have already been used to reduce the gross savings estimate used to form the basis for the $300 million net merger savings allocated to ratepayers. *R-38,* p. 22. If JCP&L were not allowed to recover merger costs as a part of the merger proceeding, then the merger savings amount credited to ratepayers would have exceeded the $300 million figure agreed upon by the parties. The Staff also supports the view that JCP&L's proposed recovery of the subject merger costs would result in a double recovery of merger related costs. *SIB* at 62.

In conclusion, the Ratepayer Advocate respectfully request that Your Honor and the Board reject the Company's flawed proposal to pass onto ratepayers $42,696,00 in merger related costs.

g. SAP Project Evolution Amortization

The Ratepayer Advocate maintains that SAP Project Enterprise/Evolution O&M expenses are prohibited merger costs because they were incorporated in FirstEnergy's merger cost estimate that formed the basis for the $300 million net merger savings agreed upon by the parties. JCP&L's witness, Mr. Preiss confirmed on cross examination that the costs of implementing Project Evolution was included in the FirstEnergy merger related cost recovery. *RAIB Vol. 1* at 61.

Board Staff supports the Ratepayer Advocate's recommendation to remove the $1.697 million from the Company's revenue requirement request for the cost of Project Evolution and agrees that any additional recovery of costs would violate the Board's Merger Order and Settlement. Staff stated that the cost of Project Evolution has "already been accounted for in the calculation of net merger savings executed within the context of the merger proceeding." *SIB* at 64.

h. Rate Case/Regulatory Expense

The Ratepayer Advocate maintains its position that JCP&L should be required to share actual rate case expenses on a 50/50 basis collected over a five year amortization period.

In its Initial Brief, JCP&L contends that a three year amortization is a "reasonable proxy for a normal regulatory expense level in the restructured era." *PIB* at 81. JCP&L also stated that the three year amortization proposed by the Company is conservative as compared to the two-year amortization of rate case expense approved by the Board in its recent Middlesex Water[5] case. As the Ratepayer Advocate explained in its Initial Brief, a two year amortization would not be appropriate for JCP&L

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[5] *I/M/O the Petition of Middlesex Water Company for Approval of an Increase in its Rates for Water Service and Other Tariff Changes,* BPU Dkt. No. WR00060362, Order Adopting in Part/Modifying in Part/Rejecting in Part/Initial Decision, (June 6, 2001).

given its actual history of filing rate cases every ten to twelve years. *RAIB Vol. 1* at 63. Accordingly, a five year amortization is more reasonable in this instance.

JCP&L argues in its Initial Brief that it should not be subject to50/50 sharing of rate case expenses in which only one half of the rate case expenses are recoverable from ratepayers because "JCP&L did not choose to file this case to serve its own or its stockholders' needs." *PIB* at 82. The Ratepayer Advocate submits that this argument is ill-conceived and presents no reasoned basis for the Board to deviate from its long standing policy of 50/50 sharing of rate case expenses. Furthermore, the Company acknowledged at hearings that their shareholders have a considerable financial stake in the outcome of the rate proceedings regardless of who initiated the filing of the rate case. *RAIB Vol. 1* at 63-64; T91:5-92:6(2/25/03). The Staff supported the Ratepayer Advocate's recommendation to require JCP&L to abide by the policy of 50/50 sharing of rate case expenses because "the final result produces an equal benefit to the shareholders, since the Company has a renewed opportunity to earn a fair return on equity." *SIB* at 71. Since the Company has provided no valid reason for departing from this policy, the Ratepayer Advocate respectfully requests that your Honor and the Board order a 50/50 sharing of the Company's actual rate case expenses, amortized over a five year period.

i. Production-related Regulatory Asset Amortization

JCP&L proposes to accelerate the amortization periods for select regulatory assets relating to certain production facilities because JCP&L has divested itself of its generating assets and wishes to eliminate these assets from its balance sheet. *PIB* at 82. As explained in the Ratepayer Advocate's Initial Brief, this proposal ignores the fact that when the Board established the amortization period for each regulatory asset, it was done after careful consideration of all the issues presented in the respective case, after which the Board made decisions that balanced competing interests of ratepayers and

shareholders. It would be irresponsible to accelerate the amortization for these regulatory assets at this time, without first re-visiting all the issues previously decided in those earlier proceedings. *RAIB Vol. 1* at 66. In addition, Mr. Peterson explained that the decision to construct the facilities and to later dispose of the facilities through sale was for the benefit of JCP&L's customers, which justifies continued amortization of those assets over the time frames previously established by the Board. *RAIB Vol. 1* at 67. The Staff supports the recommendations of the Ratepayer Advocate and the corresponding reduction of the proposed O&M expenses by $2,604,000. *SIB* at 73.

j. Restructuring Transition Costs

JCP&L argues that it is entitled to recover $70.5 million over an eight year period, representing certain restructuring costs for severance, early retirement and similar employee separation costs incurred in 1996. *PIB* at 84. JCP&L suggests that a request for an eight-year recovery of these costs was included as part of JCP&L's unbundling rates and restructuring case and was ultimately approved by the Board in its Final Restructuring Order, in accordance with the Board's earlier Energy Master Plan Final Report and the provisions of EDECA. *Id* at 85. This issue has been addressed in detail in the Ratepayer Advocate's Initial Brief. *RAIB Vol. 1* at 67-68. Accordingly, this section of the Reply brief will be limited to a response to the Company's Initial Brief.

First, JCP&L's reliance on EDECA to justify recovery of these costs is misplaced. As explained in our Initial Brief, EDECA allows recovery of "restructuring related costs" and defines these costs as "costs **directly** related to the restructuring of the electric power industry." *RAIB Vol. 1* at 69. The Company has not demonstrated at any time during this proceeding how the layoffs in 1996 were directly related to the restructuring of the electric power industry. *Id.* To allow recovery of such costs without such a showing is in direct violation of EDECA.

Moreover, the Company now claims because these costs were mentioned in the Company's testimony in the GPU Energy Unbundled Rates Petition, the Company is entitled to this belated recovery. In fact, the Company states that this recovery "was ultimately approved by the Board in its Final Restructuring Order." The Company provides no cite to the Final Restructuring Order to help Your Honor and the Board determine where in this Order the recovery of these amounts was approved. Clearly, if the Board had intended to include recovery of these amounts, that recovery would have been expressly authorized in the Final Order, just as the recovery for Oyster Creek was handled. The Company's claim of Board approval is without merit.

Accordingly, the Ratepayer Advocate respectfully requests that Your Honor and the Board do not authorize the utility's recovery of expenses incurred and written off more than five years ago.

k. Incentive Compensation

The Ratepayer Advocate reiterates its recommendation to disallow $4.818 million in incentive compensation costs claimed by the Company.

The Ratepayer Advocate maintains that Company witness Stacey Kaplan's opinion that the benefits to JCP&L's ratepayers are "inherent" in the Company's incentive compensation plan does not change the fact that the Company's expressly stated objectives of its incentive compensation plans are "growth in shareholder value" and "profitability."

The Company's claim of amorphous intangible ratepayer benefits discussed by a witness who claims that the "verbiage" of the incentive compensation objectives doesn't matter is not sufficient basis upon which to base inclusion of incentive compensation costs in rates. Thus, our office stands behind the recommendation to disallow $4.818 million in incentive compensation costs claimed by the

Company. The Ratepayer Advocate believes that this amount paid out was the result of the attainment of financial goals, rather than operational goals that increased company reliability and service quality.

The Ratepayer Advocate also agrees with Board Staff in its discussion of case law and policy in its Initial Brief. Staff provides a comprehensive explanation of Board precedent that disallows incentive compensation expenses to be included for ratemaking purposes. Staff, unlike the Company witness, recognizes how utility rates and reasons for those rates affect the average New Jersey consumer. In a time where livelihoods are being lost due to a weak economy, it is patently unfair to place the responsibility for payment of non-operational incentive compensation programs – such as those for highly paid executives and management personnel – on the backs of New Jersey ratepayers.

l. Miscellaneous Expenses

The Company is arguing for the recovery of $186,000 in miscellaneous expenses because there is "no factual foundation whatsoever in the record to support this recommended additional disallowance." *PIB* 93. The Company is wrong. As noted by the Company, this disallowed amount is specified in Mr. Peterson's 12 + 0 updates (R-78) and the source for this disallowance noted on the updated schedule. The Company had the chance to object to the admission of this schedule or to cross examine Mr. Peterson prior to the admission of the updated schedules. The Company declined to do so. (*See*, Letter to the Honorable Irene Jones, ALJ, from Gerald W. Conway dated April 23, 2003, "JCP&L will stipulate to the admission into evidence of each of these updated documents, without the necessity of the sponsoring witness to appear.)

Moreover, this information was provided by Company witness Richard F. Preiss. If the Company is claiming that the numbers are inaccurate, the Company should provide a corrected data response. If the Company wants to enter this data response into evidence to bolster its claim for

recovery of any of the amounts specified on this data response, the Ratepayer Advocate does not object. But for the Company to argue that it needs an explanation for Mr. Peterson's recommended disallowance is ridiculous. In opposition of the Company's position, Board Staff noted that test year operating expenses included amounts paid to the American Red Cross, the Freedom House Foundation, the New Jersey Conference of Mayors, the New Jersey Builders Association, the Northeast Sustainable Energy Association and for individual memberships. *SIB* at 83. Staff correctly recognized that these expenses must be disallowed as charitable contributions (the American Red Cross and the Freedom House Foundation) or as lobbying expenses. *Id.* Accordingly, Board Staff also recommended a $186,000 reduction to the Company's proposed test year expense. *Id.* at 84.

m. Interest Synchronization Adjustment

The Company characterizes the Ratepayer Advocate's interest synchronization adjustment as "misleading and inaccurate." *PIB* at 94. The Company's criticisms of the Ratepayer Advocate's interest synchronization adjustment are misplaced and wrong for several reasons.

JCP&L would have the proverbial tail wag the dog. The Company argues that since the interest expense shown in the Ratepayer Advocate's revenue requirement study does not match the deduction claimed on the Company's income tax return, the Ratepayer Advocate's proposed capital structure must be wrong. This is an extreme and incorrect perversion of the regulatory matching principle. The regulatory matching principle does not simply require that one expense (the long-term debt interest component of the allowed rate of return) match another expense (the interest deduction claimed on the tax return.) If that were the case, the Board would not recognize deferred taxes associated with depreciation because the ratemaking allowance for depreciation (i.e., book depreciation) does not match the income tax allowance for depreciation (which reflects accelerated depreciation.)

Moreover, even if it were the case that the ratemaking allowance for interest expense must match the deduction claimed on the Company's tax return (which it is not), it is the Company's capital structure and interest synchronization adjustment that violate this non-existent requirement. JCP&L's claimed interest deduction is calculated from the stand-alone capital structure which the Company advocates in this case. Yet, JCP&L does not file a stand-alone tax return. FirstEnergy Inc. will file a consolidated tax return on behalf of itself and all of its affiliates.

Ratepayer Advocate witness Mr. Copeland recommends using a consolidated capital structure in this case. Therefore, the interest expense deduction calculated in Mr. Peterson's interest synchronization adjustment reflects JCP&L's slice of the system's consolidated capital, which **is** reflected on FirstEnergy's consolidated tax return filing with the IRS. Therefore, while no such matching result is required, if it were required, it would be JCP&L that has violated the very standard that it advocates.

The proper matching result to consider in this instance is achieved in the ratemaking process. If Your Honor and the Board determine that it is appropriate to use a consolidated capital structure to set JCP&L's rates, as the Ratepayer Advocate contends, then the proper ratemaking allowance for income taxes should reflect the allowed interest component of the approved rate of return. This is, after all, the true meaning of the "synchronization" portion of an interest synchronization adjustment. Ratepayer Advocate witness David Peterson correctly followed this approach. The Ratepayer Advocate respectfully requests that Your Honor and the Board adopt the capital structure proposed by Basil Copeland and the related interest synchronization calculated by David Peterson.

POINT III. DEPRECIATION

JCP&L HAS PRESENTED NO EVIDENCE WHICH REFUTES THE REASONABLENESS OF THE DEPRECIATION ADJUSTMENT RECOMMEND BY THE RATEPAYER ADVOCATE BASED ON THE ADOPTION OF THE NET SALVAGE ALLOWANCE APPROACH.

The underlying depreciation issue in the instant case is the ratemaking treatment of net salvage. As set forth in the testimony of its depreciation witness, Mr. Michael J. Majoros, Jr., and in its Initial Brief, the Ratepayer Advocate's recommended adjustment, which is based on the adoption of Mr. Majoros' "net salvage allowance approach," is based on the Company's net salvage experience. *R-64*; *RAIB Vol. I*, p. 76-87.

Mr. Majoros recommended that the Company be permitted to recover an amount for net salvage equivalent to its test-year net salvage expense, $4.8 million.[6] *R-64*, p. 17. In contrast, Mr. Majoros found that the Company has incorporated $43.1 million of net salvage expense in its test year depreciation expense. *R-64*, p.12. In its testimony and Initial Brief, JCP&L has presented nothing which effectively refutes the fact that its actual net salvage experience is but a small fraction of the amount it proposes to collect for net salvage from its ratepayers. The Ratepayer Advocate respectfully submits that JCP&L's ratepayers should not be burdened with an estimated expense that is so far removed from the Company's net salvage experience. As discussed more fully below, JCP&L has not presented any convincing argument to refute that conclusion.

[6] In fact, the $4.8 million allowance is a conservative estimate, since Mr. Majoros found that the Company had only experienced $3.9 million of net salvage, on average, over the five-year period ending 2001, and that amount includes production plant salvage and cost of removal. *R-64*, p.12.

Notably, Board Staff supports the Ratepayer Advocate's position, with the exception of the time period used to establish the allowed average removal expense. *See SIB,* p. 91. Board Staff recommends that a ten-year time frame be used to compute the allowed removal expense, rather than the five-year period recommended by the Ratepayer Advocate. *Id*. However, since ten-year data is not available, for purposes of the calculation in this proceeding, Board Staff concurs with Mr. Majoros' recommended level of $4.8 million as the salvage allowance. *Id*.

JCP&L, on the other hand, opposes the Ratepayer Advocate's recommendations. *PIB* at 95-103. However, as demonstrated below and in the Ratepayer Advocates's Initial Brief, the Company's argument's against the Ratepayer Advocate's recommendation are unconvincing. *See RAIB Vol. 1* at 76-87.

The Company attempts to fault Mr. Majoros for recommending the net salvage allowance approach by citing earlier New Jersey Natural Gas Company and South Jersey Gas Company cases and conveniently dismissing new developments since those cases were decided.[7] *PIB* at 99-103. Although the Board permitted the inclusion of future negative net salvage in the calculation of depreciation rates in the cases cited by the Company, those cases were decided over 16 years ago. As Mr. Majoros testified, since that time changes have occurred in accounting thinking which warrant a new look at the treatment of net salvage. T86:L18:25 (3/6/03). As the Company noted, Mr. Majoros cited the significance of the Financial Accounting Standards Board's ("FASB") Statement of Accounting

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[7] *I/M/O New Jersey Natural Gas Company,* Docket No. GR8510974, (Order dated July 30, 1986), Initial Decision June 20, 1986; *I/M/O South Jersey Gas Company,* 65 *PUR 4th* 452 (1985).

Standards No. 143 ("SFAS 143"), which was released by the FASB in 2001.[8] *PIB* at 99; T86:L18:25 (3/6/03).

Both Mr. Majoros and the Company's witness, Mr. Schad agree that SFAS 143 constitutes Generally Accepted Accounting Practice ("GAAP"). *R-64*, p. 13; T53:L11-19 (3/6/03). Contrary to the insinuations of the Company, Mr. Majoros' conclusions do not turn on whether the recently adopted SFAS 143 is a "law." *See PIB* at 98-99. Rather, as set forth in his Initial Testimony, Mr. Majoros bases his recommendation, in part, on the theory underlying SFAS 143:

> Q. Are you recommending implementation of FASB No. 143?
>
> A. Yes. I am essentially recommending the implementing of FASB No. 143. The intellectual foundation of FASB No. 143 and the expensing provisions of the AICPA SOP make sense. If a Company proposes to charge a future expenditure to current operations, it makes sense that it must first establish the requirement to incur such a future expenditure. If such an obligation is established, it also makes sense for the obligation to be stated at its net present value to ensure that current operations are not burdened with future inflation.
>
> Alternatively, why should current costs be burdened with a future cost that the Company has no obligation to incur? If such an obligation does not exist, the costs should be capitalized as part of the replacement to which they relate, or charged to expense in the case of an abandonment. In either case, they should not be treated as part of the cost of the asset in a depreciation rate calculation because by definition, in the absence of an ARO [Asset Retirement Obligation], there is no cost.[9]

As the Company noted, Mr. Majoros did not say that including future removal cost in depreciation rates would violate SFAS 143. *PIB* at 102. However, by excluding removal costs which the Company has not identified as AROs, Mr. Majoros' net salvage allowance approach recognizes the theory behind SFAS 143. *R-64*, p. 19. Instead of including future removal costs not identified with AROs in

[8] Mr. Majoros also cited a FERC NOPR in his testimony. *R-64*, p. 14. Since that time, the FERC promulgated rules governing Accounting, Financial Reporting, and Rate Fling Requirements for Asset Retirement Obligations. FERC Dkt. No. RM02-7-000, Order No. 631 (April 9, 2003).

[9] *R-64*, p. 14, ln. 13 - p. 15, ln. 6.

depreciation rates, Mr. Majoros net salvage allowance approach would permit the Company to recover its removal costs as a separately stated current expense, based on its actual experience. In contrast, the Company proposes to include future net salvage in its depreciation rates even though it does not have an ARO associated with those assets. Notably, JCP&L has not claimed any AROs in its books for its transmission and distribution assets, pursuant to SFAS 143. *JC-59.* Furthermore, as Mr. Majoros noted, under the Company's method for accounting for future net salvage, current ratepayers are also burdened with the inclusion of future inflation in cost of removal estimates. *R-64*, pp. 13, 4 - 6.

JCP&L also erroneously presents its proposed approach to net salvage as if it were the only recognized ratemaking approach for net salvage. *See PIB* at 99-100. In fact, as set forth in detail in the Ratepayer Advocate's Initial Brief, the National Association of Regulatory Utility Commissioners' ("NARUC") 1996 Public Utility Depreciation Practices Manual ("NARUC Manual") explicitly recognizes the approach recommended by the Ratepayer Advocate. *RAIB Vol. 1* at 78-79. While JCP&L selectively quotes from one of the introductory chapters of the NARUC Manual (Chapter 2), the Company avoids the discussion of the current-period accounting approach to net salvage discussed in a later technical chapter of that manual. *PIB* at 99-100. The "current period accounting" approach recognized by NARUC in Chapter 11 (entitled "Estimating Salvage and Cost of Removal") of its 1996 depreciation practices manual sets forth the underlying basis for Mr. Majoros' net salvage allowance approach. *R-66.* There, NARUC recognized the "current period accounting" approach and provided a rationale for its use:

> Today, few utility plant categories experience positive net salvage; this means that most depreciation rates must be designed to recover more than the original cost of plant. The predominance of this circumstance is another reason why some utility commissions have switched to current-period accounting for gross salvage and, particularly, cost of removal. *R-66*, p. 158.

It is undisputed that JCP&L faces the prospect of negative net salvage. However, as set forth above and in the Ratepayer Advocate's Initial Brief and testimony of its witness, the amount that JCP&L proposes to collect in current rates for net salvage is far in excess of its net salvage experience. *RAIB Vol. 1*, pp. 85-86; *R-64*, p. 12. Mr. Majoros found that JCP&L incorporated $43.1 million of annual negative net salvage recovery in its test year depreciation expense for transmission, distribution, and general plant. *R-64*, pp. 12, 17. In contrast, Mr. Majoros found that over the five-year period ending 2001, JCP&L had only experienced $3.9 million of annual negative net salvage on average. *Id.* Additionally, as noted by Mr, Majoros, continuation of the Company's proposed method for recovery of future removal costs will cause its associated regulatory liability to grow even larger. T91:L8-T92:L2 (3/6/93). Mr. Majoros noted that JCP&L already has a regulatory liability for excess depreciation reserve for its transmission, distribution, and general plant of $147 million. *R-64*, p. 11.

JCP&L also attempts to use the FERC Uniform System of Accounts ("USOA") to bolster its argument. *PIB* at 100-101. However, while the USOA recognizes salvage value and cost of removal, it does not in itself govern ratemaking policy. Rather, the USOA is a system by which regulatory policy may be systematically translated into accounting entries and financial data.

As set forth in its Initial Brief, the Ratepayer Advocate also recommends that JCP&L should be required to submit a detailed report to the Board and the Ratepayer Advocate regarding all aspects of its depreciation rate update calculations by February 28 of each year, in conjunction with its annual depreciation update required by Paragraph 17 of the June 27, 1996 depreciation Stipulation.[10] *RAIB Vol. I* at 86-87. Board Staff supports this reporting requirement. *SIB*, p. 91.

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[10] *I/M/O JCP&L*, BPU Docket Nos. EO95030098, *et al* (Summary Order dated 3/24/97), Stipulation of Final Settlement, p. 25, para. 17. (Emphasis added.)

Finally, a number of preliminary items raised in JCP&L's Initial Brief must be addressed. JCP&L attempts to use precedent to bolster its position, citing the Ratepayer Advocate's "role" in the setting of its current depreciation rates. *PIB* at 96-98. The Company's depreciation rates were last set pursuant to a Board-approved stipulation of settlement ("Stipulation").[11] However, in addition to setting forth the agreed-upon substantive material, the Stipulation also embodied provisions limiting the effect of the Stipulation. Under a section entitled "No Precedential Effect," the Stipulation sets clear limits on its applicability:

> Except as expressly provided for herein, no Party shall be deemed to have approved, agreed to or consented to any principle or methodology underlying or supposed to underlie any agreement or stipulation included herein, and no such agreement or stipulation included herein shall be deemed to have any further binding or precedential effect for purposes of any other pending or future proceeding among the parties or involving any other persons or entities which are not parties hereto, except as specifically so provided herein. Stipulation, p. 38 [emphasis added].

The terms of the Stipulation of Settlement of Depreciation Rates appended to the Stipulation bolster the prohibition set forth in the Stipulation:

> [T]his Stipulation of Settlement, fixing proper and adequate current rates of depreciation on the affected classifications of JCP&L's utility property, shall be without prejudice to the rights and positions of any of the parties hereto with respect to the ratemaking treatment to be afforded to the resulting depreciation expenses in connection with any future base rate proceeding involving JCP&L.[12]

Thus, in accordance with the terms of the Board-approved stipulation, JCP&L should not be permitted to use the terms of the Stipulation as a basis for its arguments here.[13]

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[11] *I/M/O JCP&L*, BPU Dkt.Nos.EO95030098, *et al* (Summary Order dated 3/24/97).

[12] *Id*., Attachment A, Stipulation of Settlement of Depreciation Rates, pp. 6-7, para. 9.

[13] The precedential effect of the depreciation Stipulation was also addressed in a letter motion filed by the Ratepayer Advocate on March 11, 2003 in the instant proceeding.

JCP&L also argues that it did not seek to change its depreciation rates in the instant proceeding and remarkably likens an inquiry into its current claimed depreciation expense in a base rate case as single-issue ratemaking. *PIB* at. 97-98, 102-103. Whether or not JCP&L proposed a change in its depreciation rates does not exempt its current depreciation expense from scrutiny in a base rate case. The purpose of a base rate case, filed pursuant to *N.J.S.A.* 48:2-21, is to fix just and reasonable rates for utility service. Depreciation is a proper focus of inquiry in a base rate case. *See Central R. Co. of N.J. v. Department of Public Utilities*, 10 *N.J.* 255 (1952), appeal dismissed 345 *U.S.* 931. Here, JCP&L proposes an $846 million revenue requirement, and depreciation expense represents 17% ($147 million) of this total. *JC-4*, pp. 1, 2 (12+0). Depreciation is one of the largest expense items on the Company's books, it is a non-cash expense, and it is based almost entirely on the judgement of the Company's management. Depreciation rates have a direct impact on a utility's level of expenses, its accumulated depreciation reserve and, ultimately, the rates for utility service. Hence, an inquiry into the basis of the Company's depreciation expense is properly within the scope of a base rate case.

In summary, for the reasons set forth above and in the Ratepayer Advocate's Initial Brief and testimony of its witness, the Ratepayer Advocate respectfully requests that Your Honor and the Board adopt the following recommendations:

- JCP&L's proposed depreciation expense should be adjusted to remove net salvage from the depreciation rates and replaced with a net salvage allowance based on the Ratepayer Advocate's recommended approach. The Company proposed a $1.515 million increase in depreciation expense. *R-64*, p. 3; *JC-4*, RFP-2 (12+0), p. 6 of 29. Based on Mr. Majoros' testimony, Mr. Peterson decreased the Company's depreciation expense by $37.7 million *R-38 (*12+0 Update*),* p. 2a of 9.

- JCP&L should be required to charge the cost of removal associated with a retired asset -that is replaced - to its replacement on a going forward basis.
- JCP&L should be required to submit a report to the Board and the Ratepayer Advocate regarding all aspects of its annual depreciation rate update calculations.

IV. SERVICE RELIABILITY

A. Measurement and Analysis of JCP&L Reliability Performance

1. Introduction

The Company begins its Initial Brief in the area of Service Reliability by accusing the Ratepayer Advocate of "attempt[ing] to paint a picture of JCP&L as a company with poor reliability and declining customer service performance." *PIB* at 103. Notably, the Company does not deny that it is a company with poor reliability and declining customer service performance, it merely objects to the Ratepayer Advocate's recognition of it as such. The Company then states: "The Advocate's sole objective in its broad brush strokes is an attempt to depict the need in this proceeding for the imposition of a new performance index – the so-called Service Quality Index – with which to measure and address JCP&L's future reliability and customer service performance." The Company does not then bother to explain why measuring and addressing JCP&L's reliability and customer service performance is inappropriate, it merely goes on to object to Mr. Lanzalotta's testimony as "an attempt to support Ms. Alexander's proposal for the SQI." Perhaps the Company would have preferred that Ms. Alexander's testimony not be supported by Mr. Lanzalotta. The Company then berates Ms. Alexander for her critique of "the Company's past reliability performance, . . . call center performance, the rate of customer service complaints, the Company's collection history and approach, and the Company's use of customer surveys." *PIB* at 104. The Company objects to Ms. Alexander's recommended SQI, "an index seemingly of her own design," because it contains automatic penalties for failure to meet, but no rewards for meeting, baseline targets." *PIB* at 105. The Company then relies on the testimony of Mr. Sweeney who, as discussed at length in the Ratepayer Advocate's Initial Brief, was not qualified to testify to these issues. Notwithstanding this lack of expertise, according to the Company, Mr. Sweeney

corrected Ratepayer Advocate errors or misunderstandings "with respect to certain of their conclusions about customer service issues, tree trimming cycles, maintenance practices, transformer aging and a stray voltage complaint."[14] *PIB* at 105. The lack of credibility of Mr. Sweeney's testimony regarding these issues was discussed at length in the Ratepayer Advocate's Initial Brief and will not be repeated in this Reply Brief. The Ratepayer Advocate would like to remind Your Honor and the Board however, that Mr. Sweeney has, more than once, demonstrated his lack of knowledge in these areas. *RAIB Vol. 1* at 104, 106.

2. Service Reliability is Germane to This Proceeding

The Company argues that service reliability is not germane to this proceeding. The Company contends, first of all, that this proceeding is already "sufficiently complex." The Company cites to no Board Order, regulation or policy that would allow an issue to be discarded from a rate case because the proceeding is "already sufficiently complex." To say that an issue raised in a rate case should not be addressed by Your Honor and the Board because it adds complexity to the proceeding is a novel, if unpersuasive, argument.

The Company next argues that its objection to the "injection" of these issues into this proceeding "is fundamentally based upon the Board's generic rulemaking approach to service reliability standards and its more specific proceedings arising out of the July 1999 outages and **other experiences** associated with particular storms or extreme weather conditions." *PIB* at 106 (emphasis added). Apparently, the

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[14] The event characterized by the Company as "a stray voltage complaint" included several communities in Ocean Township, involved ground voltage in a neighborhood playground that was four or five volts and triggered a lengthy Board investigation. The Board eventually ordered the Company to replace more than seven miles of neutral wires to fix the problem. *I/M/O the Board's Investigation into Allegations of Stray Voltage Occurances Within the Service Territory of Jersey Central Power & Light Company*, BPU Docket No. EO02120923, Order Adopting Report (March 6, 2003.)

Company feels that service quality is properly an issue only when (1) the Company has had a negative "experience" and the Board is forced to order an investigation, or (2) service quality has fallen to the level experienced by the ratepayers of Valley Road Sewerage Company. *PIB* at 106 fn36. Valley Road is not a proper benchmark and no Company should be allowed to fall to the level of the Valley Road Sewerage Company before the Board can take action. Furthermore, as explained fully in the Ratepayer Advocate's Initial Brief (*RAIB Vol. 1* at 88-91), Ms. Alexander's testimony focused on JCP&L's <u>future</u> service quality and reliability performance in light of the Board's prior investigations. Thus, the Ratepayer Advocate's recommendations are not a "not-so-cleverly-disguised" attempt to "trump" the Board but rather are simply an attempt to provide the Your Honor and the Board with additional resources to deal with an on-going situation.

The Company next argues that service quality is not germane to this proceeding because "the Advocate has seized upon this proceeding to further its own agenda for promoting a new set of reliability and customer service standards, a methodology for measuring them and penalties for enforcing them." First, to clarify the record and as noted above, these are not "<u>new</u>" standards but are based on historical performance, industry standards or the Interim Reliability Standard approved by the Board. Second, while improved service quality and reliability may be on the Ratepayer Advocate's "agenda" it does not necessarily follow that these issues are then not germane to the instant proceeding. The Company's logic is flawed.

The Ratepayer Advocate has explained at length the relevance of service quality to this proceeding and will not re-cover the same ground in this Reply Brief (*RAIB Vol. 1* at 88-91) but would like to remind Your Honor and the Board of the Company's obligation to provide safe, adequate and proper service. Based on the evidence in this proceeding, the Company has not always met that obligation. It is important to recognize that the Ratepayer Advocate's proposed Service Quality Index

with attendant performance standards and penalties, is not offered to punish the Company for past performance but rather to assure that the Company actually delivers adequate service quality and reliability to its customers in the future.

3. Specific Reliability Issues

CAIDI and SAIFI

The Company notes that the Ratepayer Advocate's testimony "suggests that JCP&L's CAIDI performance is poor, that it has not met established benchmarks, or even, at times, the minimum reliability levels contained in the Interim Reliability Standards." *PIB* at 112. The Company does not deny this "suggestion" nor does it say that this "suggestion" is wrong or inaccurate. It merely complains that the Ratepayer Advocate brought up the issue. In fact, these statements are accurate as described and documented in the testimonies of Ms. Alexander and Mr. Lanzalotta on behalf of the Ratepayer Advocate. The Company then goes on to complain that the Ratepayer Advocate "made much ado about the reported change in the performance results included in JCP&L's 2000 Annual Performance Report," "challenged the credibility of the Company's reports of its performance" and "dismissed the Company's explanation that the installation of an automated OMS has adversely affected the accuracy of the reporting of the number of customers affected by specific power outages." *PIB* at 112. Apparently the Company would have preferred that we accept their statements without question.

With respect to the impact of OMS on the Company's reliability performance and its impact on Ms. Alexander's proposed performance standards for CAIDI and SAIFI, the Company's proposal is that Your Honor and the Board do nothing to assure service reliability for several years. JCP&L's reasoning appears to be that the impact of OMS is not known and will not be known until several more years have passed and we cannot use historical data to predict future performance or establish standards. If

accepted, this proposal will paralyze the public's ability to demand reasonable service quality. The Ratepayer Advocate recommends an approach that is more protective of the public's right to adequate service quality. It is JCP&L's obligation to demonstrate that the service quality actually delivered to its customers is not below the level reported and in effect under the Board's Reliability Rules. The Company's failure to demonstrate the actual impact of OMS on its reported CAIDI and SAIFI performance should not be used as an excuse to prevent customers from demanding adequate service quality during the period that these rates are in effect.

Furthermore, the Company's reliance on the "OMS excuse" runs only one way, to the advantage of the Company. For example, in JCP&L's 2000 Reliability Report, the Company excluded data from five storm affected periods from its calculation of performance even though the OMS data did not report that enough customers were affected by these five weather events to catagorize them as major events. However, when the annual data demonstrates that CAIDI and SAIFI outage events have increased, the Company blames it on OMS over-reporting. T94-95 (2/20/03). Clearly, the effect of OMS can have the effect of both undercounting and over counting events and event length, which is precisely why Ms. Alexander has recommended that the future performance of JCP&L be measured against an historical average and the Board's previously established Benchmark Reliability Standard for JCP&L. If, in fact, the installation of OMS will result in better performance by the Company, an assumption that must be made in order to justify the expense associated with the installation of OMS, then the Company runs little risk in the use of historical performance data to establish standards that it must meet in the future. The approach recommended by the Ratepayer Advocate shifts that risk to the Company and not the customers, a result that is both proper and fair.

The Company hopes that the issues of tree trimming cycles, maintenance practices and results, transformer aging, and the stray voltage complaint have been "put to rest." *PIB* at 115. The Ratepayer

Advocate has addressed these issues at length in its Initial Brief and refers Your Honor and the Board to that document. *RAIB Vol. 1* at 102-112.

B. Service Quality Index

As noted above, the Ratepayer Advocates proposed SQI does not attempt to "trump" the Board. Rather Ms. Alexander's proposed SQI program was designed to complement the Board's reliability rules. It is not unusual for states to adopt generic service quality standards and individual electric utility standards at the same time. (*See* e.g., *R-26*, Exh. BA-3 which summarizes state activities with respect to the development of a service quality index for electric and gas utilities). These two approaches are complimentary and serve different purposes. Furthermore, it is important to understand that the Board's Reliability Standards do not establish a single generic statewide reliability standard. Rather, the Board has established individual utility standards for each electric utility based on that utility's historical performance, which is exactly the approach recommended by Ms. Alexander. Ms. Alexander's recommended standards for CAIDI and SAIFI are the Benchmark standards established for JCP&L by the Board in its Reliability Rule. As a result, the only "conflict" between Ms. Alexander's proposal and the Board' Reliability Rules is that Ms. Alexander and the Ratepayer Advocate propose to link JCP&L's earnings to compliance with those standards. The Ratepayer Advocate's recommended approach can hardly be described as "trumping" the Board. Rather, it builds on the Board's Reliability Rules and applies a utility-specific remedy that complements the Board's approach.

The Company also finds fault with Ms. Alexander's testifying "at length" about the Company's performance and claims that this analysis was undertaken "in order to leverage support for her agenda to impose her proposed SQI." Note, once again, the Company does not refute the completeness or accuracy of Ms. Alexander's testimony. The reason for Ms. Alexander's "lengthy" testimony is that,

unlike the Company's testimony and argument in this matter, her testimony includes substantial factual background and justification for her recommended performance standards. Not once has the Company claimed that this evidence was not accurate. This evidence provides the "objective criteria" that the Company claims is lacking in Ms. Alexander's proposals. These performance standards are based on JCP&L's historical performance and take into account the variables associated with year-to-year variation. In addition, where recommended standards are not based on JCP&L's historical performance they are based on industry or other accepted standards. For example, as noted in the Ratepayer Advocate's Initial Brief, the call center performance standard proposed in this proceeding, 80% of all calls answered within 30 seconds, was accepted by the Board in the Elizabethtown Water Case.[15] *RAIB Vol. 1* at 98.

Furthermore, the Company's statement that "Mr. Sweeney fully explained the Company's philosophy or business rationale with respect to its pertinent business practices or the particular facts and circumstances that may have led to transitional changes in practices or in results with respect to some or all of these areas" is meaningless. This vague statement of Company policy and practice was notably lacking any evidence that would challenge Ms. Alexander's fact-based presentation of actual service quality performance data.

Moreover, contrary to JCP&L's assertions, the approach recommended by Ms. Alexander is not "seemingly of her own design." Not only is her approach used by many states, as outlined in her Exhibit BA-3 attached to her Direct Testimony, but several states have combined a statewide set of reliability rules and an individual utility Service Quality Index. Indeed, her proposals are entirely in the

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[15] Similarly, in a recent news article in the Courier Post, the President of Comcast's Eastern Division cites as an example of the company's customer focus "90 percent of customer calls are handled within 30 seconds or less." (Attached hereto as exhibit A).

tradition of recent merger cases approved by the Board that contain a number of service quality and reliability provisions that complement the Board's Reliability Rules. For example, the GPU Energy merger decision involving JCP&L, the Board identified certain measures "to reduce the decline in JCP&L's service quality and reliability." *I/M/O The Joint Petition of FirstEnergy Corp. and Jersey Central Power & Light Company, D/B/A GPU Energy, For Approval of a Change in Ownership And Acquisition of Control of a New Jersey Public Utility And Other Relief*, Order of Approval, p. 25 BPU Docket No. EM00110870 (October 9, 2001) The Board ordered JCP&L to:

1. inspect every transmission and distribution substation and related equipment on the GPU system in New Jersey and assure that the transmission and distribution maintenance programs are adequately funded,
2. develop a targeted Customer Average Interruption Duration Index ("CAIDI") performance improvement program;
3. expedite the deployment of the Outage Management System ("OMS"); and
4. re-evaluate capital projects.

Id.

The Board noted that "[i]t is crucial that the specific measures identified to reverse the declining quality of JCP&L's service and reliability be complied with fully and permanently to ensure that New Jersey customers served by JCP&L receive reliable service. *Id.* In addition, as a condition of the merger, the Company agreed to honor all pre-merger employee contracts, agreements and collective bargaining agreements; to protect employee pension benefits, to maintain two New Jersey regional headquarters, and, prior to any reduction in the distribution system operation and maintenance group, the Company would provide a study demonstrating that "further workforce reductions will not adversely impact overall reliability performance, including SAIFI, CAIDI, inspection and maintenance schedules and power quality. *Id.* at 27-28. The Company also agreed to retain the existing six New Jersey customer payment centers for at least five years and to implement a circuit reliability index program, to directly and quickly address storm restoration problem areas. *Id*. at 29. The Company promised to keep the

Board informed of any changes to JCP&L collection policies and to provide Board Staff with the location of JCP&L call centers, "staffed by representatives trained and capable to provide customers with at least the same quality of customer service as they do today." *Id* at 29-30. More recently, the Board approved a merger settlement in which Atlantic City Electric agreed to provide individual customer rebates for service quality failures, similar to one of Ms. Alexander's proposals in this proceeding. *I/M/O Atlantic City Electric Company, Conectiv Communications Inc and New RC, Inc. for Approval Under N.J.S.A. 48:2-5.11 and N.J.S.A. 48:3-10 of a Change in Ownership and Control,* BPU Dkt. No. EM01050308, Order of Approval dated July 3, 2002. As a condition of the merger:

> Petitioners proposed five service guarantees, pertaining to (1) appointments, (2) new connections, (3) residential billing accuracy, (4) call service center levels and (5) call abandonment. Petitioners also proposed two guarantees to further improve reliability, pertaining to (1) restoration of customer service after an outage and (2) individual circuit performance.
>
> The proposed reliability guarantee regarding restoration of service provided that if a metered customer lost electric service, power would be restored as soon as possible, but no later than 24 hours after it was lost. If such were not accomplished, the customer's account would be credited $50.00. The outage restoration guarantee would not apply to unmetered electric services, during major events or during periods of labor disruption or their events beyond a company's conrol, where a restoration could not be completed for safety reasons, for scheduled interruptions, of if a customer refuses access to his/her property.

Id. at 29.

Clearly, the Board is not opposed to approving service quality programs that build upon and complement its Reliability Rules for individual utilities. Perhaps the Company felt because it had neither the facts nor the law to support its poor performance, it needed to clutter the record with baseless accusations against the witness.

And finally, the penalty recommended by Ms. Alexander is based on a reasonable portion of JCP&L's revenues and is not "arbitrary." Rather, it is "arbitrary" in the extreme for JCP&L to argue

that it should be allowed to continue to earn revenues and profits from New Jersey ratepayers that carry no risk of failure to maintain historical levels of service quality and standards that are widely accepted by other utilities.

Conclusion

As discussed above and in more detail in the Ratepayer Advocate's Initial Brief, the Ratepayer Advocate recommends that Your Honor and the Board institute a Service Quality Index program for JCP&L.

V. COST OF SERVICE/RATE DESIGN

The Company in its Initial Brief finds fault with three specific areas of the Ratepayer Advocate's cost of service/rate design testimony: (1) the Company faults the Ratepayer Advocate's use of the Board approved average and excess method, (2) the Company disagrees with the Ratepayer Advocate's recommendation that the Company continue to allocate the MTC as it was designed by the Board in the restructuring order, and (3) the Company disparages the Ratepayer Advocate's rejection of the Company's suggested massive rate increase on individual customers unfortunate enough to have had their service disconnected or on customers who are unable to accommodate the utility's normal working hours for final bill readings. As will be explained below, the Company's arguments are without merit.

A. Your Honor and the Board Should Adopt the Ratepayer Advocate's Proposed Cost of Service Methodology and Reject the Company's "Refinements" to Long Standing Board Approved Cost of Service Methodology.

The Company first complains about the Ratepayer Advocate's use of the Board approved average and excess method. *PIB* p.120. The Company characterizes Mr. Hayden's deviations from the Board approved method as "refinements," and notes that the "refinement" that the Ratepayer Advocate disagrees with is Mr. Hayden's use of a single non-coincident peak rather than the Board approved use of the four summer months non-coincident peaks. *PIB* p.121. The Company notes that Mr. Hayden has explained that the use of the four data points "skews the whole formula toward day-to-day energy usage" and argues that there is no Board articulated policy recommending the use of four non-coincident peaks. The Company then relies on the NARUC manual for support of a single non-coincident peak.

The use of four non-coincident peaks is well known and long established Board policy. The Company claims that the Board's Final Order from JCP&L's last base rate case is silent on this point. In fact, in that Order, the Board clearly states that "the average and excess approach advocated by Rate Counsel and supported by Staff" in the Company's prior case was "the appropriate basis for the classification and allocation of T&D costs." *I/M/O the Petition of Jersey Central Power & Light Company For Approval of Increased Base Tariff Rates and Charges For Electric and Charges for Electric Service And Other Tariff Revisions*, Final Decision and Order, p. 16, Docket No. ER91121820J (June 15, 1993). Presumably all the participants in that case, including the Company, understood the details of Rate Counsel's proposal. For the Company to now claim, without any support, that the "underlying record from that case" is unclear and to imply that it did not know the Board approved average and excess method utilized four non- coincident peaks is incredible.

This assertion is even more incredible when seen in the light of the Company's discovery responses to this case. In fact, in discovery, the Company's witness acknowledged that the Board approved average and excess method utilized four non-coincident peaks and that this information had been obtained through a review of prior JCP&L rate cases. For example, the Company explained:

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

CS-21, Response to RAR-RD-18.

The Company again recognizes the Board approved use of four coincident peaks in its response to RAR-RD-54. The Company replies:

> Mr. Hayden's cost of service study uses a single non-coincident peak for each class in the average and excess method. At the time the cost study was filed with his direct testimony, Mr.

> Hayden was under the impression that he had followed the Board-approved method, basing the demand allocation portion of the average and excess method on a single non-coincident peak rather than the average of four.
>
> Through review of Exhibit JC-308 (Docket No 89110912J) and in preparation of the response to RAR-RD-18, Mr. Hayden learned that he had not used the Board approved method. However, Mr. Hayden believes the departure to be appropriate for reasons given in his rebuttal testimony at page 2, line 17 through page 4, line 8.

CS-25, Response to RAR-RD-54.

Thus, for the Company to now argue in its Initial Brief that there is "no articulated Board policy on whether to use the single non-coincident class peaks, as Mr. Hayden recommends, or the average of four summer monthly non-coincident peaks, as Dr. Stutz recommends" is disingenuous.

Furthermore, rate stability is fostered by avoiding changes in the cost of service methodology. As noted both by the Ratepayer Advocate and Board Staff, the Company's proposed "refinement" to the Board approved average and excess method significantly changes the unitized rates of return for the various rate classes. The unitized class rates of return produced by Mr. Hayden's average and excess method are very different than the unitized class rates of return produced when using the Board=s approved methodology. For example, the unitized rate of return for the class RS, residential service, is .76 under Mr. Hayden=s methodology and .83 under the Board=s approved methodology. *R-76*, Sch. JS-8. For the rate class RT, Mr. Hayden=s methodology produces a .72 unitized rate of return; under the Board's approved methodology, the unitized rate of return for the class RT is .97. *Id.* For the rate classes GS, GP, and GT, the unitized rate of return goes from 1.23 using Mr. Hayden=s method to 1.13 using to Board's approved method for GS, from 1.62 to 1.44 for GP and from 3.76 to 3.49 for GT. In fact, the only class unitized rate of return that did not change significantly using Mr. Hayden=s methodology was Lighting.

The Company's departure from the Board=s approved average and excess method "distorts the results of the COS study and leads to the derivation of unjust and unfair distribution rates." *SIB* at 104. Accordingly, Your Honor and the Board should reject Mr. Hayden=s proposed change to the Board's approved cost of service method.

B. Your Honor and the Board Should Maintain the Allocation of MTC Responsibility Carefully Crafted During the Restructuring Process and Reject the Company's Proposal to Resurrect the LEAC for the Recovery of Stranded Costs.

The Company disagrees with the Ratepayer Advocate's recommendation that the Company continue to allocate the MTC as it was designed by the Board in the Restructuring Order. In so disagreeing, the Company does not explain why a "fuel clause" method is the proper rate design for the collection of stranded costs through the MTC, there is no reasoned explanation why this shift in MTC responsibility is warranted, and the Company has produced no evidence indicating that any rate class caused a greater share of the stranded costs to be recovered through the MTC after August 1, 2003. It merely notes that "[n]othing has been cited to discredit this method" and argues that "this method is as suitable for the MTC as it was for the LEAC." *PIB* p. 126. The Company is wrong. The energy related LEAC mechanism is not suitable for the recovery of stranded costs and should not be approved by Your Honor and the Board.

First, as noted by Ratepayer Advocate witness Dr. John Stutz, the Company is resurrecting a recovery mechanism that the Board eliminated with the arrival of restructuring. In the JCP&L Final

Order, the Board eliminated the LEAC.[16] It was not, as the Company would argue, the Board's policy to suspend the LEAC temporarily only to be revived after the transition period.

Secondly, the LEAC is an energy related mechanism. Company witness Sally Cheong claims that her proposed "MTC rate design is consistent with the Board's long standing policy regarding the recovery of energy-related deferred costs in the levelized energy adjustment clause prior to restructuring." *JC-8*, 21. Thus, the Company has recognized that the LEAC was designed for the purpose of recovering costs associated with electric energy sold by the Company. What the Company has failed to acknowledge is that when the Company=s new rates go into effect, the MTC will no longer be recovering energy-related costs. Rather, as of August 1, 2003, the MTC will recover only stranded costs. As noted by Board Staff, "[t]he end of the transition period necessitates the separation of the various components of the current MTC charge whereby the energy components would be reflected in the BGS, leaving the MTC to only recover stranded costs." *SIB* at 111.

Thirdly, as noted by Ratepayer Advocate witness Dr. Stutz and Board Staff, the Company's proposed allocation of MTC responsibility would be an unexpected change, seriously adverse to the majority of the Company's customers who are served on rates RS and GS. R-76 p. 16, *SIB* at *111*. The Company=s proposal would shift MTC revenue responsibility dramatically. For example, JCP&L=s proposal will increase MTC responsibility for residential customers from 38.3% to 41.7%, an increase of almost 9% . *R-77,* Sch.JS-11. At the same time, the Company=s proposal will **decrease** MTC responsibility for GP customers more than 30%. *Id.* There is no evidence that any rate class caused a greater share of the stranded costs to be recovered by the MTC after August 1,2003. In the absence of

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

such evidence, the Company=s proposal constitutes undue discrimination (*R-76*, Sch. JS-3, Criterion 5 of Bonbright's *Criteria of a Sound Rate Structure*.)

The Ratepayer Advocate=s proposed rate design, a flat, per-kWh charge for each rate class, preserves the status quo in MTC responsibility and furthers sound rate design policy and principles. Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board maintain the current distribution of MTC responsibility, preserving the carefully crafted burden sharing established when rates were unbundled.

C. Considering the Huge Impact the Proposal Will Have on Low Income Ratepayers, Your Honor and the Board Should Reject the Company's Proposed Increase in Reconnection Charges.

JCP&L disparages the Ratepayer Advocate's rejection of the Company's suggested massive rate increase on individual customers unfortunate enough to have had their service disconnected or on customers who are unable to accommodate the utility's normal working hours for final bill readings. The Company claims that "these services cost money to render, and Ms. Cheong's proposals are entirely cost based." *PIB* at 127. The Company argues that there is "no factual support" for the assertion that these services are used by low income customers and as these charges "are not part of the package of programs and measures that JCP&L offers for the benefit of low-income customers, one need not even address the question of whether it is sound utility regulatory policy to intentionally set these charges on a subsidized basis." *Id.*

The Company's claimed increase in costs for these services is $338,518. *R-78* Surrebuttal Testimony of John Stutz, p 6. Recovery of this amount from all customers would have a bill impact of about 0.02 %. T176:L4-5 (3/17/03). On the other hand, customers subject to these charges would see

an increase of as much as 56%. And, as specified in the Ratepayer Advocate's Initial Brief, as recognized by Board Staff, and despite the Company=s claim to the contrary, it is reasonable to assume that most of the Company's proposed re-connection increase will fall most heavily on those customers who are least able to afford it, that is, customers who are already struggling to pay their bills. Thus, those customers most particularly unable to withstand any increase are hit the hardest. Given this reality, the Ratepayer Advocate believes that an increase at this time is particularly inappropriate.

Accordingly, the Ratepayer Advocate recommends that Your Honor and the Board reject the Company=s proposed increases in Reconnection Charges and keep these charges at their current level.

VI. BASIC GENERATION SERVICE PRUDENCE REVIEW

A. Standard of Prudence Review

In its Initial Brief, JCP&L supported the Auditors's broad-based definition of the standard for a prudence review. Specifically, this standard asks:

> Did management make the decisions and take the actions that a reasonable individual would have, given the alternatives and information available at the time such decisions and actions were taken, consistent with legislative and other regulatory requirements?

While this "reasonable man" is an important general frame of reference, specific guidance toward how this standard is applied to public utilities is helpful. As noted in the Ratepayer Advocate's Initial brief,

> [t]he benchmark for determining whether utility management has acted prudently is similar to the standard of care analysis in common-law negligence, but with the caveat that the standard of care required of utility management is greater than that of other private sector management. *See, e.g., Virginia Electric Power Co.,* 11 F.E.R.C. para. 63,028 at p.65,189 (Initial Decision), *aff'd in relevant part,* 15 FERC para. 61,052 (1981). The fact-intensive prudence inquiry focuses on whether the utility management acted in a manner consistent with the performance of other similarly situated utilities. *Arizona Public Service Comm.*, 21 F.E.R.C. para. 63,007 (1982) (Initial Decision), *aff'd in relevant part*, 23 F.E.R.C. para. 61,419 (1983). *RAIB Vol. 2* at p.5 fn. 5.

The Company's adoption without reservation of the Auditors' broad and unspecific standard offers little guidance in determining whether the Company acted prudently as it incurred BGS costs. Rather, a more reasonable standard is the "reasonable utility" standard. Just as the "reasonable investor" would compare his or her results to other similar investors or to overall market performance, the "reasonable utility" standard can be based on procurement results of similarly situated utilities, as suggested by Ratepayer Advocate witness Paul Chernick, or, as suggested by Board Staff, to the PJM spot market price. Against either of these two measures, JCP&L's procurement performance has failed.

B. Development and Implementation of the Supply Process

The Company supports its claim that its BGS costs were incurred prudently by citing the "unequivocal endorse[ment]" of the Auditors. *PIB* at 130. This accolade is hardly surprising as the Audit Report quoted freely and liberally from the Company's testimony and discovery responses, often adopting the Company's words as the Auditor's own *RIB Vol. 2* at 39-44. This practice also casts doubt on the allegedly independent nature of the Audit Report. Therefore, the Auditors' "unequivocal endorse[ment]" must be taken with a grain of salt.

The Company's claim that it "does not earn any profit" through reimbursement of BGS costs, *JCPL Brief* at 134, is a similarly deceptive semantic. The Company profits by shielding shareholders from cost of poor management, a cost the shareholders should, by right, absorb. The Company profits by shifting the burden of imprudent BGS procurement onto captive ratepayers, rather than accepting responsibility for its failure to contain costs adequately. The Company claims that "there was nothing [it] could have done to have avoided these under-recoveries," but that assertion, too, is an inappropriate attempt to shift the focus from the inquiry in this proceeding. The issue is whether the Company could have *minimized* or otherwise *reduced* the under-recoveries through prudent power acquisition. As the Ratepayer Advocate demonstrated in its initial brief, the Company's own records of its processes do not evidence prudent behavior on the part of the Company mostly because, the Company never provided adequate documentation of its processes. Moreover, the Ratepayer Advocate did not argue in its brief that the Company should be denied recovery of *all* of the BGS deferrals. Rather, the Ratepayer Advocate used as a benchmark the price paid by FirstEnergy affiliates in Pennsylvania, and recommended that Your Honor and the Board hold the New Jersey affiliate to a similar performance. *See RAIB Vol. 2* at 26, 46.

In fact, the Company openly acknowledges its inability to adhere to a defined strategy. *RAIB Vol. 2* at 15, 16.

> As Mr. Mascari discussed, the Company then sought to fill these supply targets over time in a manner that avoided large purchases on the broker market that could have had the effect of driving the prices even higher. Notwithstanding this general guiding principle, when the Company became aware of opportunities to effect significant purchases at attractive prices in transactions that would not drive prices higher, it took advantage of those opportunities. *PIB* at 135 (internal citations omitted).

Further, the Company's initial brief highlights JCP&L's constantly changing story. As noted above, the Company's Initial Brief cites to Mr. Mascari's testimony referring to "discuss[ion]" that the Company had when it sought to fill targets in a manner that would "avoid large purchases on the broker market." *PIB* at 135 *citing JC-14* at 11-12. Yet, an examination of Mr. Mascari's original direct testimony reveals that his discussion there referred to purchases on the *"wholesale"* and not the broker market. *JC-14 Direct* at 12:3. In fact, Mr. Mascari did not distinguish between broker and bilateral purchases until his rebuttal testimony, see *JC-14 Rebuttal* at 6-9.

The Company's shifting story is a distraction throughout these proceedings. As described by Mr. Chernick,

> The Company has repeatedly changed its story on which risk mitigation or hedging models it used for selecting the amount of forwards to purchase prior to the start of the delivery month.
>
> In the first version, in direct testimony submitted by the Company, only the X-model was discussed. This left the impression that the X-model was the only target-setting model used, and that the only strategy that varied over time was the fill rate. This was the version of the Company's story that I relied upon in my direct testimony.
>
> The second version emerged haphazardly in discovery on direct, as the Company revealed use of the HOST model from February 2001 to July 2002. (e.g. RAR-BGS-48, 51, 52, and 53). Mr. Graves's rebuttal testimony reviewed and supported the HOST model, and found that the Company was prudent because it had used the HOST model.

> The third version appeared in the rebuttal of Mr. Stathis, and subsequent discovery. Mr. Stathis criticizes my direct testimony for relying on the HOST targets that the Company provided, and testifies that JCP&L did not trust the HOST model and rejected it sometime in 2001 in favor of different targets, determined under the Lock and Load policy. That policy arbitrarily set targets at average on-peak energy load, ignoring all the risk considerations of the X-method and the HOST model. . . .
>
> In sum, the Company has repeatedly produced different and inconsistent descriptions of how it picked those very important targets. The Company should have told the full story in its direct [testimony], and allowed for full discovery on all its decisions. *R-60* at 4, 5.

The inconsistency and secrecy in the Company's account of its processes frustrates reasonable analysis. The Company should have discussed all its procurement strategies clearly and in a straightforward manner in its initial testimony. Instead, the Company carefully doled out information about its procurement policy throughout these proceedings, withholding information until specifically asked. Indeed, basic procurement strategies were not mentioned until discovery or even rebuttal testimony.

Similarly, the Company's description of "private, direct purchases from a creditworthy counter-party," *PIB* at 136, is another example of the shroud behind which certain of the Company's procurement occurred. The Company highlighted this same point in its testimony when it stated that such transactions "could effectively mask" the Company's participation in the market. *JC-14 Rebuttal* at 21:16. But, as noted in the Ratepayer Advocate initial brief, "[a]lthough the Company cites discretion as a method by which to avoid affecting the market, the anonymity of these sales similarly shields the Company and its purchasing partners from scrutiny." *RAIB Vol. 2* at 16.

The Company's pattern of distraction again surfaces in its attempt to discredit Mr. Chernick. The Company notes that Mr. Chernick was assisted by "only two other professionals." *PIB* at 139. This is a red herring whose irrelevance is amplified by the Company's typical failure to offer evidence as to

why (1) more professionals would have been ultimately better, or (2) any indication that the man-hours input into the project were insufficient. The Company makes much noise about the fact that Mr. Chernick "acknowledge[d] that he was not retained to conduct a full audit of the Company's MTC/BGS Deferred Balance," *PIB* at 139, but then, nobody ever claimed that was Mr. Chernick's goal. Rather, Mr. Chernick's objective as described in his testimony is to review the Company's request for approval of that portion of the deferred balance accumulated as the result of the difference between BGS costs and revenues from August 1, 1999 through July 31, 2002. *R-59* at 4. The Company's attempt to discredit the witness can be interpreted only as a feeble effort to direct Your Honor and Board's attention away from the Company's poor procurement practices.

Similarly, the Company's acknowledgment of "cost recovery-related risk" in its SEC filings, *PIB* at 140, is without substance: mere acknowledgment of risk does not equal a statement as to the Company's quantification of that risk, and the statement certainly does not reveal that the Company perceived New Jersey risk to be as high or equal to that contemplated in other jurisdictions.

C. Differences Between New Jersey and Pennsylvania, and Other Indicators of the Company's Failure to Demonstrate Prudence

1. New Jersey and Pennsylvania Differential

The Ratepayer Advocate addressed the faults with the Company's claims regarding New Jersey and Pennsylvania differences in its brief. *RAIB Vol. 2* at 24-26. It bears mention, however, that even the Company's price differential argument in its initial brief begins with a misstatement. Specifically, the Company argues, "Mr. Graves describes the higher annual spot prices *in the Jersey zone, where the Company purchases its power.*" *PIB* at 142 (emphasis added). Yet, when a specific location where the

Company purchased its power was identified, the Company identified the PJM Western Hub traditionally not thought of as the "Jersey Zone". *See JC-14* at CAM-6.

This "misstatement" is simply another example of the Company's use of baseless excuses to explain the vast disparity in prices between procurement in New Jersey, where recovery was assured, and procurement in Pennsylvania, where it was not. Like the Company's other excuses to explain their poor performance, this does not hold water. Your Honor and the Board must hold the Company to some reasonable performance standard. Accordingly, the Ratepayer Advocate has recommended that the Company's performance in New Jersey should be measured against the performance of its Pennsylvania affiliates. The Company has provided no basis to do otherwise.

2. Other Evidence that the Company Failed to Demonstrate Prudence

a. The Company Failed to Demonstrate that it Employed Appropriate Standards

As described in the Ratepayer Advocate brief, JCP&L did not maintain a clear record of its strategies and guidelines, how it actually made its purchase decisions, and whether or how it used its models. There is no evidence that JCP&L ever conducted any internal evaluations of its performance. *See RAIB Vol. 2* at 6-12. Any attempt to judge the Company's procurement process by an analysis of its models is functionally impossible, since it is not clear what role the models actually played in the procurement decisions. *RAIB Vol. 2* at 15-20. Further, as described in the Ratepayer Advocate's Initial Brief, the Company did not heed the advice of its own consultants on such important aspects as the usefulness of after-the-fact evaluations of performance, *see RAIB Vol. 2* at 35-39, and the importance of considering ratepayer interests in the tradeoff between risk and cost, *see RAIB Vol. 2* at 16-18.

The Company's reliance on the Audit Report must be taken in context. *PIB* at 130. As evidenced by the Ratepayer Advocate brief, the Auditors quoted extensively, and often without sufficient citation, from Company testimony and discovery responses. *RAIB Vol. 2* at 40-44. As concluded in the Ratepayer Advocate brief, it is often difficult to discern where the Company left off, and the Auditors began. *See, i.e., RAIB Vol. 2* at 40. All that is clear is only that the Company appears to have spent a lot of time and money, hired consultants, and run models. Those actions, however, do not bespeak prudent procurement decisions.

b. The Company Shows a Misunderstanding of Benchmarking, and Indeed Ignored its Own Consultants' Advice to Implement Such Measures

JCP&L argues that "acknowledged (and uncontrollable) influences on spot prices undermine any rationale for Mr. Chernick's after-the-fact analyses. *PIB* at 146. Although it is true that no one can predict the future with 100% accuracy, prudent businesses study their past experiences to better forecast possible outcomes in the future and to minimize risk. In fact, when Mr. Chernick criticized the Company for not having done any after-the-fact comparisons, Mr. Chernick did not insist that the Company use *spot prices* as its benchmark. Mr. Chernick's point is the importance of the utility to look back and to evaluate the Company's performance to better prepare for the future, and, especially in a volatile market, to minimize risks.

The Company has talked itself into a corner. As described in the Ratepayer Advocate brief, the Company contends, especially through Mr. Graves, that the only way to judge prudence is to evaluate the models used by the Company. *See RAIB Vol. 2* at 35-39. But, as also described in the Ratepayer Advocate brief, the Company did not apply those models consistently. *RAIB Vol. 2* at 15-20. Claiming prudence where models have been implemented inconsistently could be acceptable only if the deviations

from the plan were documented, and that documentation proved acceptable. Yet, as described at length in the Ratepayer Advocate brief, *RAIB Vol. 2* at 10-12, the Company never provided adequate documentation of its actions, nor has Company has provided any demonstration that its departures from the model results improved performance. Nor has the Company performed any *post hoc* comparisons. The Company attempts to support its claim of prudence by parading a series of models that it never actually followed.

c. The Company Failed to Provide Sufficient Data

The Company declaims Ratepayer Advocate criticism of the Company's record-keeping. The Company claims that it "fully responded" to all of the Ratepayer Advocate's discovery requests, *see PIB* at 147, but seemingly ignores the fact that many of those responses were far from sufficient. Mr. Chernick noted this fact in his initial testimony, in which he recounted a laundry list of Company responses to discovery requests that fell short of full disclosure:

> In RAR-BGS-132, JCP&L refuses to compare the costs of its congestion hedges to the actual costs of congestion, on the grounds that "an after the fact comparison such as is requested has no relevance in determining whether or not the acquisition of a hedge was an appropriate action at the time such acquisition decision was made."
>
> In RAR-BGS-127, JCP&L similarly asserts that it did not analyze whether the post-merger acceleration of procurement had "reduced the cost of BGS supply as compared to the pre-merger procurement strategy" because "JCP&L does not believe such after-the-fact analyses are relevant because the prudence of the actions must be judged in light of the facts and circumstances as they existed at the time the decision was made and cannot be reassessed with 20/20 hindsight."
>
> In RAR-BGS-12(a), JCP&L states that it did not retain the market-price data that JCP&L received from brokers at the time it was making purchases, because those data served no further "operational" purpose. Of course, the data describing the pricing options that JCP&L staff faced at

> the time they made their decisions would be essential in any review of staff performance or of the guidelines under which the staff was operating.
>
> In RAR-BGS-14(a), the Company similarly states that it did not retain the broker price quotes contemporaneous with its sales into the market.
>
> In RAR-BGS-66, JCP&L states that it cannot provide published data in its possession due to copyright concerns, and that it had disposed of all contemporaneous data due to lack of an "operational reason" for retaining the data.
>
> In RAR-BGS-124, JCP&L states that it did not retain information on the capacity offers, "market intelligence," notes of discussions with counter-parties, or the Company's resultant views"—that is, its conclusions and decisions. *R-59* at 31:1-32:2.

It is apparent from these responses and others that the Company's definition of "fully responded" does not necessarily contemplate that the responses actually contained relevant or useful information. The Company claims that the data that it retained was sufficient, *PIB* at 147. JCP&L also argues that the auditors did not complain about the lack of data. *PIB* at 147. However, the auditors relied on Company's claims rather than independent review of Company analyses. As described at length in the Ratepayer Advocate brief, a substantial portion of the Audit Report consists of direct and quotes from Company testimony and discovery requests, frustrating any attempt to "discern the value-added analyses of the auditors." *See RAIB Vol. 2* at 40-44.

d. Compliance with Procurement Strategy

Notwithstanding certain flaws of the X-method, as discussed in the Ratepayer Advocate brief at pages 13-15, the Company's *implementation* of the strategies undermined any appropriateness that may have been ascribed to them. The Company characterizes its out-of-model purchases as "discretion," *id.*, but the Ratepayer Advocate submits that the cumulative effect of the Company's practice boasts the appearance of adoption, and then disregard, for its selected strategies. The Company explained in detail

its "Dollar Cost Averaging" approach, but then explained subsequently that this mattered only on the broker market. A more rational approach (from which a degree of prudence might have been inferred) would have the Company set forth at the outset the objectives of its strategy, the market(s) in which it would be utilized, and guidelines for when the model could be superseded.

The Company misstates Mr. Chernick's testimony. *PIB* at 148. Mr. Chernick is not demanding that Company follow a "cookbook" approach, but rather that the Company offer an accurate account to the Board of exactly how it made its decisions. The only support that the Company has offered for its claim of prudence is that it ran its models and used the DCA. Yet, as described above, the models were frequently disregarded; there are no indicators as to whether ratepayer actually benefitted from the Company's deviations from its models.

The Company's citation to Mr. Chernick's statement, *PIB* at 148, that the Company's courses "all sound very appropriate" tells only half the story – a complete reading of Mr. Chernick's statement reveals his point. In the sentence *immediately* following, Mr. Chernick continues,

> Unfortunately, when asked for "full and complete copies of all documents including workpapers, studies, analyses, meeting minutes, PJM local forecasts, and PJM price forecasts from mathematical models used at each morning meeting for short term supply planning," all that JCP&L could provide was a pile of 10-day graphs of load and weather forecasts, some with JCP&L's hourly energy supply on the same graph, and a smaller number of 10-day forecasts for the day-ahead energy price at the Western Hub. There were no analyses of energy market conditions, generation outages, transmission outages, real-time PJM pricing, congestion within PJM, volume targets, types of products, or price ranges. *R-59* at 20:19-21:4.

The Company's misplaced quote is entirely consistent with the conduct of the Company in this proceeding – lots of explanation supported by no quantitative data.

e. The Company's Stated Objective Reveals Faults in the Strategy

In the Initial Brief the Ratepayer Advocate described in depth the difference between minimizing cost and risk. *RAIB Vol. 2* at 13-15

3. The Company's Discussion of the Audit Report "Concerns" Continues the Company's Habit of Providing New and Different Information.

The Audit Report raised a number of concerns regarding JCP&L's procurement strategy. The Company addresses three of these concerns, the excess purchase of supply for the summer of 2001 resulting in an estimated incremental cost of $11.7 million; the failure to secure an energy TPPA for the Company's divested fossil generation and the absence of weather hedges from the Company's BGS portfolio. *PIB* at 154.

<u>Excess Purchases for Summer of 2001</u>

The Auditor's determined that:

> JCP&L has not provided any reasonable justification for having bought over its target commitment levels for the months of June, July, and August 2001. These supply procurements resulted in excess and unnecessary costs being incurred.

S-38, VII-36.

The Auditors estimated the "incremental cost impact of JCP&L's deviations from its Summer 2001 (June, July, and August) BGS fill strategy to be approximately $11.7 million." *Id.* at VII-57.

The Company's response to these "Alleged Purchases for Summer of 2001" is another example of the constantly shifting JCP&L story. The Company has claimed that the HOST model was designed in the fall of 2000 and implemented in February 2001, and, according to the Auditors "was a major advancement over the X-Method." *S-38*, VII-16. And yet, apparently the Company never really used the HOST model. In supplemental rebuttal filed on April 21, 2003, Mr. Mascari testifies that it was not

possible to implement the HOST model in February 2001 for the summer months, because "JCP&L had already reached its higher X-method procurement goals." *JC-14*, Supplemental Rebuttal at 5. And then, in November, the Company switched to the Lock and Load Procurement Strategy. Thus, JCP&L's claim that its procurement practices were prudent rests in large part on its reliance on the sophisticated HOST model, but JCP&L's brief now seems to indicate that the Company never actually used the HOST model to guide its hedging decisions.

The Company admits that it over-purchased forwards for the summer of 2001, explaining that it "would have been required to sell off significant quantities of power in order to reduce its contracted-for supply to lower HOST model targets." *PIB* at 155. The Company claims however that it could not sell these excess forwards, even if it had wanted to, because "such a sell off would have required the Company to rely to a much larger degree on the PJM spot market." The Company claims that "it may have had difficulty in meeting these new [PJM] credit policies" if it had increased future reliance on PJM spot market.

The Company makes this argument as if it had no alternative. The Company seems to believe that it could either hold on to the excess energy or, if it sold some of this excess energy, it would be forced into the PJM spot market. The Company is wrong. Selling forwards to meet the HOST target would not require that the Company buy more spot in the PJM markets. In fact, the Company had other options. For example, the Company could buy forwards a week or two weeks in advance of the delivery month, from the broker market or from PJM. The Company has completely disregarded available options and chose, for no good reason, to hold on to excess energy.

Furthermore, the Company blames PJM "stringent new credit policies" and yet has provided no analyses or calculations to indicate that increased reliance on the spot market would have placed JCP&L anywhere near the PJM "credit limit" specified in the PJM Credit Policy. *JC-14*, CAM-21. The

only support for this contention, provided very late in the proceeding, is (1) a copy of the new PJM credit policy that required that utilities maintain a BBB rating; and (2) testimony that if the Company increased its spot purchases to some unspecified level, it could possibly exceed PJM credit limits. *JC-14*, Supplemental Rebuttal Testimony, p. 6-7. The Company's position in this regard is a lot of implication and supposition, with no supporting data. Indeed, without some review of the communication from PJM there is no way for Your Honor and the Board to determine that JCP&L was, in fact, precluded from selling excess forwards by the PJM credit policy.

<u>The Company's Failure to Enter Into TPPA for Fossil Plants</u>

The Company next addresses the Auditors finding regarding the Company's failure to enter into Energy TPPA for Fossil Plants. *PIB* at 155.

The Auditors found that:

> As a result of its objective to maximize asset sales price, the TPPAs negotiated by JCP&L exposed JCP&L and its BGS customers to market price volatility. With regard to the sale of the fossil units to Sithe in 1998, the lack of an option for access to energy appears naive in light of JCP&L's understanding of the unproven nature of the competitive market; however, these TPPAs were reviewed by the BPU and found to be prudent. Neither BWG today, nor JCP&L then will ever know how much providing some optionality would have cost, because it does not appear to have been asked for at the time of the fossil unit auction.

S-38, VII-28.

The Company "believed" that "'significant encumbrances' on the plants, such as a full output TPPA, could reduce bidding interest and the ultimate purchase price to be paid for the plants." The Company provides no support for this belief, merely stating that it "was advised by its consultants." *PIB* at 156.

The Company also relies upon "the lesson learned from the Homer City sale." According to the Company, Homer City was a coal fired plant in Pennsylvania jointly owned by Penelec and New York

State Electric and Gas Company. The Company claims that "[b]ased on the indicative bids received, the decision was made to include only options for capacity in the TPPA, a decision that was explicitly acknowledged by the New York Public Service Commission as having been based on 'negotiations with potential purchasers.'" *PIB* 157. The Company does not provide a cite for this Commission statement and it does not appear to be in the New York Commission decision pages attached to RAR-BGS-194, cited by Mr. Mascari in his supplemental rebuttal. The "indicative bids" were not provided, in fact, there is not even a statement regarding the number of bids and conditions. The Company does not explain why this one experience with one plant in Pennsylvania was sufficient to deter the Company from attempting to negotiate any other TPPAs. Once again, the Company has attempted to justify a failure to act in a prudent manner with unsubstantiated assertions of Company beliefs.

Weather Hedges

The Company also takes issue with the Auditor's finding that the Company failed to fully utilize available hedging options. *PIB* 159. The Auditors found that:

> The Company was aware of the potential benefits, but did not avail itself of weather hedges that might have provided some additional volume protection during the summer of 2001. The use of weather hedges may have also provided some nominal cost savings during the summer of 2002; however, it was not unreasonable for the Company to focus its efforts on more traditional risk management products at this point in time.

S-38, VII-54.

The Auditors did not quantify this finding.

The Ratepayer Advocate discussed the Company's failure to utilize financial and weather hedging in the Initial Brief and will not repeat that discussion here. *RAIB Vol. 2* at 21-22. The Ratepayer Advocate would like to point out that this is just another instance of the Company's failure to

take advantage of the many available tools that could have reduced the BGS deferral for the Company's ratepayers.

D. The Company Failed to Demonstrate That It Took All Reasonable Measures To Mitigate Its Stranded Costs Associated With Its NUG PPAs

In its brief, the Company addressed the three small NUG contracts that had been singled out by the Audit Report. *See PIB* at 161. Disputing the Auditors' opinion that there had not been adequate attempts to mitigate these contracts, the Company set forth various reasons why these contracts have not been addressed. *Id.* The Company concludes that the "unique factors" presented by the NUGs, the "relatively small savings potential, and the significant impediments to successful completion of contract restructurings" all contributed to the Company's decision to "prioritize its NUG mitigation efforts on facilities that had the potential to produce more significant savings for its customers."

But, JCP&L's customers have yet to realize any savings, either from the small, ignored contracts, or from the larger ones on which the Company claims to have focused its attention. As described in the Ratepayer Advocate's Initial Brief, *RAIB* at 27, 28, the Company has made little progress in reducing costs associated with NUG contracts since 1997. With exception of a March 2001 "interim operating agreement" with Parlin and Newark Box that resulted in approximately $6.3 million in savings through the third quarter of 2002, there has been no mitigation of NUG costs since 1997.[17] *See S-38*,VIII-5.

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[17] / This "interim operating agreement" allowed JCP&L to resell natural gas rather than use it to make electricity.

E. *Post Hoc* Review is Appropriate in the Evaluation of the Company's Imprudence

The Company argues that the possibility of variable inputs – *i.e.,* different natural gas prices, weather, demand, etc. – preempts the validity of any *post hoc* analyses. *PIB* at 146. The Company cites Mr. Chernick's recognition of the fact that market conditions can vary at any time. *Id.* Yet, the possibility of variability does not address the issue of whether a *post hoc* analyses is justified. Rather, the incidence of variability warrants recognition of additional factors that must be included in model design, whether those factors be hedging or some other management action necessary to blunt the risk of price spikes and shortages. *The general success of a strategy can be discerned even in an environment that has multiple variables.* There is no market or endeavor that does not contemplate variable conditions; even constant-demand markets must contemplate some amount of risk or instability. Therefore, the acknowledgment that markets have different multiple reactions to various conditions is an assumption that must be built into any strategy, but it is *not* an assumption that justifies the pre-proclaimed ineffectiveness of a *post hoc* review.

F. Staff Recommendation Supports a Finding of Imprudence

Board Staff also recommends a disallowance of certain of the BGS deferrals. Staff agreed with Mr. Chernick's "criticism of the models employed by the Company, as well as his contention that they were inconsistently applied in securing BGS supply during the first three years of the transition period." *SIB* at 146. Further, Staff concurs with the Ratepayer Advocate that "the objective that drove both the X-Method and the HOST models, minimizing the difference between BGS costs and revenues, *i.e.,* the effect on the Company's earnings, to have been misguided and inappropriate." *SIB* at 147. Staff further characterized the Company's actions as "outright speculation in [the] choice of the models' objective." *Id.* Staff also reported that, despite the Company's claim that *post hoc* analyses are not appropriate, "the

Brattle Group [the Company's consultants] did, in fact, perform a retrospective analysis of how JCP&L's actual BGS procurement results compared to both the DCA approach and 100% reliance on the PJM spot market from December 1999 through July 2000." *SIB* at 148. In that calculation alone Staff found an $84 million dollar difference, and remarks that it is "incredibl[e] (at least to Staff)" that this difference was not analyzed. *SIB* at 148, 149. Staff, in fact, finds this failure to question the procurement method at that time to be "patently imprudent." *SIB* at 149.

Staff's finding in this regard is consistent with the Ratepayer Advocate position. As explained by Mr. Chernick in his direct testimony,

> The Company should have been conducting after-the-fact comparisons through the BGS-procurement period because information on the performance of a strategy is vital to determination of whether the strategy should be continued. If every transaction of a particular type that JCP&L made turned out to be uneconomic, prudent management would require that the use of the type of transaction be re-examined, restricted, or stopped entirely. I do not believe the JCP&L could prudently acquire BGS supply without such information. *R-59* at 32:2-16.

Staff's finding reinforces the position of the Ratepayer Advocate that the Company did not incur BGS costs prudently. Accordingly, Your Honor and the Board should disallow imprudently incurred BGS costs, in accordance with the position of the Ratepayer Advocate.

Staff's determination of a different disallowance amount (Staff recommends a disallowance of $152.5 million) reflects the different route that Staff took in its calculations and findings.

The Ratepayer Advocate disagrees with certain of Staff's findings with regard to the Pennsylvania/New Jersey differences, and for those reasons stands by its initial position that the Pennsylvania/New Jersey differences are the appropriate benchmark for calculating the BGS disallowance. As described in the Ratepayer Advocate brief, the Company attempted to justify the difference with several insufficient explanations. The Ratepayer Advocate addressed all of these claims,

point-by-point, and demonstrated that they did not provide reasoned justification. *RAIB Vol. 2* at 24-26. Staff agreed that, with the exception of differing LMPs, “the effect of the other factors cited in the Company’s testimony was not quantified” (as described elsewhere in this brief, the inability of the Company to provide quantitative data is one of the fatal flaws in its attempt to claim that it acted prudently). Rather than provide a point-by-point analysis as the Ratepayer Advocate did, Staff “[i]ntuitively . . . concede[d]” that the factors claimed by the Company “could plausibly account” for the difference between New Jersey and Pennsylvania costs. *SIB* at 155. The Ratepayer Advocate submits that an “intuitive” concession that factors “could plausibly account” for differences is not as strong as the Ratepayer Advocate’s reasoned analysis that was elucidated in both testimony and the brief, and which was available for cross-examination at evidentiary hearings. The position of the Ratepayer Advocate is based upon the reasoned understanding and analysis of a subject matter expert, and provides a solid basis upon which Your Honor and the Board can stand its decision to disallow BGS deferral amounts.

In the end, both Board Staff and the Ratepayer Advocate determined, after review of the Company’s processes and actions, that the Company did not act prudently. Accordingly, the Ratepayer Advocate respectfully requests that the Your Honor and the Board find that the Company acted imprudently, and disallow $239 million in BGS deferrals.

Summary

As explained at length in the Ratepayer Advocate’s Initial Brief, the Company bears the burden of proof in this proceeding. The Company has not demonstrated that it incurred its BGS costs prudently. Therefore, the Ratepayer Advocate recommends that the Court deny recovery of $239 million of the deferred balances as well as the $ 59,463,586 in interest collected on the Company’s NUG

above market costs. Finally, Your Honor and the Board should disallow the Company's self-authorized collection of a 14.64% return on its generation assets through BGS revenues.

POINT VI. DEMAND SIDE MANAGEMENT

The Ratepayer Advocate has responded to the Company's claim for "lost revenues" in the Revenue section of this Reply Brief.

POINT VIII. CONSUMER EDUCATION

The Ratepayer Advocate reiterates its position that Consumer Education Program ("CEP") costs should not be collected from ratepayers without proof from the Company that the costs for this program were reasonably and prudently incurred.

Neither attainment of the Measures of Success, nor the recommendations of the auditor's report, offer any evidence that costs were incurred in a way that justifies their recovery. The Board itself in its *June 23, 2000 Order* stated that "[t]he reasonableness and prudence of the cost levels incurred to achieve the Board approved measures of success will need to be assessed in reviewing the SBC filings." The Order clearly states that the Measures of Success themselves are not the benchmark to ensure cost recovery. Rather, it states that upon attainment of the Measures of Success, the Board will determine if the CEP costs were reasonable and prudent, and therefore recoverable in a manner consistent with EDECA.

The Company has failed to provide any evidence that the CEP costs that it seeks to recover were incurred in accordance with the prudence standards that were clearly set out in the Board in the *Hope Creek Order*. This Order set forth a two-prong test for a prudence review that mandated that regulators determine whether the company performed its task in a manner that was reasonable at the time and

ordered the company to prove to the regulators that each cost was incurred with good reason for the benefit of the ratepayers. With no evidence from JCP&L, Your Honor and the Board are unable to determine if the Company's expenditures were reasonable, prudent, and therefore eligible for recovery from ratepayers.

Additionally, as the statewide CEP did not attain all of the Measures of Success benchmarks in Years 2 and 3, recovery is automatically precluded. The Center for Research and Public Policy ("Center"), hired to advise the Board and research the level of consumer awareness of energy issues, noted in its Sixth Report to the Board that switching activities of residential consumers did not meet the Year 2 target. In Year 3, the Center noted in its Seventh Report to the Board that consumer awareness of conservation efficiency and financial assistance was below target. Therefore, the initial benchmark that must be hurdled before the prudence review was not even met, and, therefore, ratepayers should not be made to pay for a program from which they received little or no benefit.

POINT IX. REMEDIATION ADJUSTMENT CLAUSE ("RAC")

The Ratepayer Advocate refers Your Honor and the Board to the Initial Brief for discussion of this issue. *RAIB Vol.2* at 57-73

POINT X. OTHER SBC DEFERRED BALANCES

The Ratepayer Advocate refers Your Honor and the Board to the Initial Brief for discussion of this issue. *RAIB Vol.2* at 57-73

TABLE OF CONTENTS

POINT I. COST OF CAPITAL 1
A. Capital Structure 2
B. Return on Common Equity 5

POINT II. REVENUE REQUIREMENT 11
A. Overview 11
B. Rate Base 11
1. Cash Working Capital 11
a. The Ratepayer Advocate's Recommended Adjustments to The Company's Lead/Lag Cash Working Capital Recommendation Should Be Adopted by Your Honor and The Board. 11
b. Non-Cash Expenses Should Be Excluded From The Company's Lead/Lag Study. 12
(i) Depreciation Expense 12
(ii) Deferred Taxes 14
2. JCP&L's Consolidated Income Tax Adjustment Proposal is Flawed and Unreliable 17
C. Operating Income 20
1. Revenue Adjustments 20
a. Revenue Annualization 20
b. CRA Lost Revenue Annualization 22
2. Expense Adjustments 25
a. Advertising Expenses 25
b. BPU/RPA Assessments 25
c. Charitable Contributions 26
d. Depreciation Expense 27
e. Management Audit Expenses 27
f. Merger Costs 29
g. SAP Project Evolution Amortization 31
h. Rate Case/Regulatory Expense 31
i. Production-related Regulatory Asset Amortization 32
j. Restructuring Transition Costs 33
k. Incentive Compensation 34
l. Miscellaneous Expenses 35
m. Interest Synchronization Adjustment 36

POINT III. DEPRECIATION 38

JCP&L HAS PRESENTED NO EVIDENCE WHICH REFUTES THE REASONABLENESS OF THE DEPRECIATION ADJUSTMENT RECOMMEND BY THE RATEPAYER ADVOCATE BASED ON THE ADOPTION OF THE NET SALVAGE ALLOWANCE APPROACH. 38

IV. SERVICE RELIABILITY 46
A. Measurement and Analysis of JCP&L Reliability Performance 46
1. Introduction 46
2. Service Reliability is Germane to This Proceeding 47
3. Specific Reliability Issues 49
B. Service Quality Index 51
Conclusion 55

V. COST OF SERVICE/RATE DESIGN 56
A. Your Honor and the Board Should Adopt the Ratepayer Advocate's Proposed Cost of Service Methodology and Reject the Company's "Refinements" to Long Standing Board Approved Cost of Service Methodology. 56
B. Your Honor and the Board Should Maintain the Allocation of MTC Responsibility Carefully Crafted During the Restructuring Process and Reject the Company's Proposal to Resurrect the LEAC for the Recovery of Stranded Costs. 59
C. Considering the Huge Impact the Proposal Will Have on Low Income Ratepayers, Your Honor and the Board Should Reject the Company's Proposed Increase in Reconnection Charges 61

VI. BASIC GENERATION SERVICE PRUDENCE REVIEW 63
A. Standard of Prudence Review 63
B. Development and Implementation of the Supply Process 64
C. Differences Between New Jersey and Pennsylvania, and Other Indicators of the Company's Failure to Demonstrate Prudence 67
1. New Jersey and Pennsylvania Differential 67
2. Other Evidence that the Company Failed to Demonstrate Prudence 68
a. The Company Failed to Demonstrate that it Employed Appropriate Standards 68
b. The Company Shows a Misunderstanding of Benchmarking, and Indeed Ignored its Own Consultants' Advice to Implement Such Measures 69
c. The Company Failed to Provide Sufficient Data 70
d. Compliance with Procurement Strategy 71
e. The Company's Stated Objective Reveals Faults in the Strategy 73
3. The Company's Discussion of the Audit Report "Concerns" Continues the Company's Habit of Providing New and Different Information. 73

D. The Company Failed to Demonstrate That It Took All Reasonable Measures To Mitigate Its Stranded Costs Associated With Its NUG PPAs 77
E. *Post Hoc* Review is Appropriate in the Evaluation of the Company's Imprudence 78
F. Staff Recommendation Supports a Finding of Imprudence 78
Summary 80

POINT VI. DEMAND SIDE MANAGEMENT 81

POINT VIII. CONSUMER EDUCATION 81

POINT IX. REMEDIATION ADJUSTMENT CLAUSE ("RAC") 82

POINT X. OTHER SBC DEFERRED BALANCES 82

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Statutes

N.J.S.A. 48:2-21 44

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