STATE OF NEW YORK

PUBLIC SERVICE COMMISSION

Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electric Service	Case 05-E-1222

INITIAL BRIEF OF THE NEW YORK STATE CONSUMER PROTECTION BOARD

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I. EXECUTIVE SUMMARY

By filing dated September 30, 2005, New York State Electric and Gas Corporation ("NYSEG" or "the Company") requested permission to increase electric delivery revenue by $91.6 million and proposed to mitigate the impact of that increase by using previously collected funds and accelerating the benefits resulting from the expiration of contracts with certain non-utility generators ("NUGs") to generate an overall reduction in delivery service bills of $71.2 million annually effective October 30, 2006. Subsequently, it its rebuttal testimony filed February 21, 2006, NYSEG revised its delivery rate increase request downward to $58.3 million.

NYSEG's filing also proposed the extension of the terms of its current rate plan for an additional six years. As part of that rate plan extension, the Company would continue its Voice Your Choice program under which it offers its customers both fixed and variable price commodity options.

The New York State Consumer Protection Board ("CPB") submitted testimony on February 6, 2006 demonstrating that the Company's delivery revenue increase request

is excessive. We identified numerous necessary adjustments to the Company's projections. The CPB also showed that the Company should continue to offer a fixed price commodity option to its customers, but under modified terms that will both ensure a reasonable price for consumers and provide Energy Services Companies ("ESCOs") a fair opportunity to compete. In addition, we identified necessary changes to programs designed to ensure high quality service and to provide financial assistance to the Company's low income customers. The Company filed rebuttal testimony addressing some of our recommendations on February 21, 2006. The CPB also participated actively in evidentiary hearings held before Administrative Law Judges ("ALJs") William Bouteiller and Elizabeth H. Liebschutz form March 22 through April 5, 2006.

The CPB submits this Initial Brief regarding contested issues in this proceeding.[1] Overall, the CPB recommends that the Public Service Commission ("PSC" or "Commission") substantially adjust NYSEG's projected revenue requirement, to reflect both recommendations made by the CPB in its testimony and those advanced by other parties including Staff of the Department of Public Service. The adjustments we recommend would result in just and reasonable rates for NYSEG's customers and assure the continued provision of safe and adequate service. The Commission should also adopt our recommendation for continuation of a utility-provided fixed price option for electric commodity service which gives consumers a valuable tool to help them manage their energy bills and also provides ESCOs a reasonable opportunity to compete for those consumers' business. Our recommendations regarding measures to maintain high quality customer service and to provide financial assistance to the

[1] This Brief conforms with the "Table of Contents" agreed upon by the parties and approved by the presiding officers. In general, issues identified in that "Table of Contents," on which the CPB has not taken a position in testimony, are omitted from this Brief.

Company's low income customers should also be adopted.

III. THRESHOLD POLICY/LEGAL ISSUES

A. Multi-Year v. One-Year Case

NYSEG's filing essentially consists of three components: A traditional, major rate case that seeks to establish a revenue requirement for the rate year beginning January 1, 2007 that will result in an overall electric delivery rate increase of approximately $58 million;[2] a request to extend, with relatively minor modifications, the terms of the Company's existing rate plan established in Cases 01-E-0359 and 01-M-0404; and a proposal to utilize previously collected funds and a levelization of the NUG component of the non-bypassable wires charge to offset the delivery rate increase. As a practical matter, this case can only be considered, and must be decided by the Commission as a one-year rate case.

NYSEG's existing rate plan resulted from a Joint Proposal negotiated by the parties to its last rate case. That settlement, as subsequently approved by the Commission,[3] resolved a very wide range of issues generated by the concurrent consideration of a major rate case and a petition for the approval of the merger of NYSEG with Rochester Gas and Electric Company ("RG&E"), as well as issues related to retail access for competitive suppliers. Parties to the proposal had diverse reasons for supporting it, and none can be assumed to have concurred with all of its elements.

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[2] After adjustments included in the Company's rebuttal testimony. See Exh. 7, Exhibit ___(RRP-2), Schedule L.

[3] Case Nos. 01-E-0359, 01-M-0404, New York State Electric & Gas Corporation, Energy East Corporation, RGS Energy Group, Inc., Rochester Gas and Electric Corporation and Eagle Merger Corp., "Order Adopting Provisions of Joint Proposal with Modifications," issued February 27, 2002.

The fact that a particular term was agreed upon in 2002 is no reason to assume that it would be acceptable to the parties today.

Furthermore, the context for an extension of the current rate plan has fundamentally changed from that which existed when it was originally adopted. Then, the parties were contemplating the benefit of a major delivery rate decrease, and the merger with RG&E was about to be implemented. Today, the Company is requesting a major rate increase and the merger is largely completed.

For these reasons, the CPB advocates that every element of the existing rate plan be scrutinized anew. Unfortunately, the Company apparently takes the position that the plan is a delicately balanced package of mutually dependent elements, and that any unacceptable tinkering could result in its filing for new rates to take effect in the second year of the ostensibly multi-year plan. (SM 2057, ll. 13-21)

Given NYSEG's stance, there is really no point in litigating this proceeding as a multi-year case because one of the principal benefits of doing so, the avoidance of annual re-litigation, is absent. The Commission should treat this case as a traditional one-year rate proceeding and leave it to the parties to negotiate a longer term arrangement, if possible.

1. NUG Levelization

The CPB supports efforts to mitigate the impact of any delivery rate increases that the Commission may determine to be necessary, and has no inherent objection to accomplishing this through the so-called NUG levelization approach proposed by the Company, or the use of ratepayer funds available in the Asset Sale Gain Account

(“ASGA”). Whether either is necessary, and which would be better, cannot be determined until the Company’s revenue requirement for the rate year has been established. In general, however, if either approach would be workable, the CPB would advocate use of the ASGA in order to avoid the accrual of carrying charges associated with the regulatory asset that would be created under NUG levelization.

B. Earnings Sharing

As a threshold matter, if as the CPB recommends, this proceeding is treated as a one-year rate case, even NYSEG agrees that earnings sharing would be inappropriate. (SM 2058, ll. 13-14) If instead this case establishes rates for more than one year, then, for the reasons discussed in Section III. A. above, continuation of NYSEG’s existing earnings sharing mechanism simply because it is a part of the current rate plan is entirely inappropriate. The risks and opportunities confronted by the Company at the outset of its merger with RG&E were significantly different from those it faces now. As evidenced by NYSEG’s recent earnings, modification of the current earnings sharing mechanism is required.

If any earnings sharing mechanism is considered, however, it should not permit the Company to retain any incremental merger savings. To do otherwise would be contrary to the terms of the existing rate plan which expressly contemplated that such sharing would end after five years unless parties agreed otherwise through subsequent negotiations. (SM 1985, l. 20 to 1986, l. 8). It would also be inconsistent with proper ratemaking which seeks to replicate through regulation, the prices that would prevail under competition. As CPB witness Mr. Niazi points out, firms in a competitive market

that undertake efforts such as mergers to reduce costs cannot expect to retain the savings they achieve indefinitely because their competitors will pursue similar strategies. Ultimately, companies in competitive industries will have to reduce their prices in order to preserve market share and protect their profits. (SM 1986, ll. 19-24) While the CPB agrees that utilities should be given incentives to increase efficiency and reduce costs, such incentives should not have to be greater than those which would motivate a competitive business to act.

IV. REVENUE REQUIREMENT

A. General Matters

In its rebuttal testimony, NYSEG requested an increase in electric delivery rates that would produce an additional $58.3 million in revenue, representing approximately a 9.8% increase over existing rates. This request comes at a time when consumers are already facing record high, or near record high electricity prices, primarily as a result of rising fuel costs. Under such circumstances, it is critical that the Commission closely scrutinize every element of NYSEG's filing in an effort to minimize the ultimate impact of this proceeding on consumers' bills. Changes in programs and methodologies that result in increased costs should be rejected or postponed if they are not currently required to assure safe and reliable service.

The CPB's witnesses did not conduct a comprehensive review of every element of the Company's proposed revenue requirement. Consequently, in this section of our brief, we address only those revenue requirement issues on which we submitted testimony. Although not detailed here, we also support many revenue requirement adjustments recommended by DPS Staff and NUCOR. The record shows that the

CPB's adjustments and many of the adjustments of other parties are necessary to establish just and reasonable rates and would permit the Company to provide safe and reliable service. Our omission of any particular issue should not be construed as support for, or opposition to, the Company's position on that issue.

C. O&M Expenses

To arrive at its rate year revenue requirement, NYSEG proposes numerous upward "adjustments" to its historic test year costs. In order to prevail with respect to such increases, the Company has the burden of proving that known, or reasonably foreseeable, changes in circumstances will require it to incur the incremental costs projected in order to meet its statutory obligation to provide safe and reliable service at just and reasonable rates.[4] "Speculative or conjectural data are not acceptable and all estimates must be explained in detail."[5] It is not sufficient for NYSEG simply to state what it has determined, decided, or estimated without providing a factual basis.

Despite the clarity of its obligation, NYSEG frequently seems to get it backwards. When an opposing party points out that the Company has not provided an objective analysis of the cost savings that could be expected to flow from a proposed expenditure, and the party adjusts the Company's O&M expense projection as a result, NYSEG's primary response has often been that the party has failed to prove those benefits.[6] This is not the party's obligation. NYSEG has the burden of proving that every upward adjustment in revenue requirement it proposes reflects the incremental

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[4] 16 NYCRR § 61.1

[5] 16 NYCRR § 61.4

[6] See for example, the rebuttal testimony of NYSEG's Capital Expenditures and Reliability Panel at Tr. 527, ll. 13-20.

cost it will incur. That burden is not met by ignoring the potential benefits flowing from proposed expenditures or by attempting to shift the burden of proving them to other parties. Where this is the essence of the Company's response, its adjustments should be disallowed as a matter of law.

1. Payroll

b. Apprenticeship Program

NYSEG's Revenue Requirements Panel sponsored an adjustment to increase payroll expense by $1,175,000 for what they initially characterized as a "New Apprenticeship Program." (SM 3763, l. 17) As CPB witnesses Hugh Larkin, Jr., and Donna DeRonne ("CPB Panel") pointed out, and the Company subsequently acknowledged (SM 541, ll. 15-17) that the program is not new but rather the continuation of a program that has been in place for some time. Consequently, the costs associated with the program are not inherently incremental.

NYSEG then claimed that its proposal was actually intended to add 30 additional apprentice positions, 15 each in the categories of Line Mechanic and Utility Construction & Maintenance ("UCM") mechanics. (SM 3764, ll. 9-12) The Company asserts that the positions are necessary to fill vacancies in these employee categories that it will experience through attrition, but it has provided no study, analysis or other objective data to demonstrate that the hiring of these apprentices will actually result in an increase in payroll.

The CPB Panel, by contrast, has demonstrated that the level of employment of mechanics by the Company has been very stable. For the test year ended June 30,

2005, the average number of mechanics of all classifications was approximately 636. (SM 3766, ll. 3-4) Even with the addition of 38 apprentices in February 2005, the average number of mechanics for the months of July through November 2005 was just 639. (SM 3766, ll. 6, 14-15) Clearly, new hires and losses through attrition in these employee categories are in equilibrium.

Furthermore, the apprenticeship positions that formed the basis for the payroll adjustment were, according to Company workpapers, to be filled in November 2005. (SM 3765, l. 1) They were not. (SM 3765, l. 7)

The CPB does not question the fact that maintaining a well-trained force of mechanics is essential to the safety and reliability of NYSEG's distribution system, nor do we dispute the value of an apprenticeship program for succession management. The only issue presented here is whether the payroll cost associated with that program will increase in the rate year. In the face of evidence that such costs have been relatively stable, NYSEG provides nothing but unsubstantiated assertions that an increase is needed. The Company's revenue requirement adjustment of $1,175,000 should be disallowed.

c. Other – Restricted Meter Read Program

NYSEG has increased its rate year revenue requirement by $190,960 to reflect the electric business allocation of $248,000 the Company estimates will be required to cover the cost of overtime and meals for employees who must read the meters of residential customers that cannot be accessed during normal business hours. (SM 3768, l. 10). This situation arises when entry to the premises is necessary to reach the

meter and the occupant is neither present to provide access to NYSEG's employee, nor has made arrangements for access by some other means (by providing a key, for example). (SM 3767, ll. 17-27).

The CPB does not dispute NYSEG's need to read these limited access meters, nor does it take exception with the Company's policy of not entering residential premises without the presence or express permission of the occupants. What the CPB Panel suggested, however, was that it is inequitable to require all ratepayers to subsidize the expense of reading the meters of few customers who are unwilling to make the simple arrangements necessary to avoid the access problem. They recommended that those customers be charged directly for the special service received. (SM 3770, ll. 9-10) NYSEG did not respond to this recommendation.[7]

Such a charge would not be unduly burdensome. NYSEG projects that its $248,000 cost estimate will cover 12,000 meter reads made after normal working hours, making the cost of each reading approximately $20.67. (SM 3768, 15-17) Furthermore, the charge would be easily avoidable.

The CPB Panel's proposal is superior to NYSEG's in three respects. First, it avoids the subsidization issue described above. Second, it gives customers who need to make arrangements for meter reader access to their premises during normal business hours a direct financial incentive to do so. Third, as customers respond to this incentive, the problem itself begins to go away, along with the incremental costs. NYSEG's approach does none of this, but rather embeds the problem permanently in

[7] The CPB Panel suggested as an alternative that NYSEG employees' work schedules could be adjusted to cover limited access meter reads without overtime. We are satisfied from NYSEG's response that such an approach is unlikely to achieve the full savings desired and, in any event, matching cost responsibility to cost causation is more equitable for all customers.

rates for all customers. The CPB proposal should be adopted.

3. Other Post Employment Benefits ("OPEBs")[8]

The CPB Panel recommended that a discount rate of 5.75% be used in calculating rate year OPEB expense consistent with its recommendation concerning the discount rate to be utilized in calculating pension income, discussed in Point 4. below. (SM 3803, l. 19 to 3804, l. 2) This is 50 basis points higher than the 5.25% rate applied by the Company in its direct case (SM 3894, l. 7) and 25 points higher than the 5.50% rate subsequently adopted by NYSEG in its rebuttal case. (SM 3921, ll. 17-18)

Application of a 5.50% rate by the Company on rebuttal generated a decrease in OPEB expense of $328,000 compared to its original filing. (SM 3922, l. 8) For the reasons discussed in the "Pensions" section below, the use of a 5.75% discount rate for OPEB expense calculation is clearly more appropriate given the trend in benchmark bond rates. Accordingly, as recommended by the CPB Panel, a further reduction in OPEB expense of $328,000 is required. (SM 3806, l. 1-2)

The CPB Panel also recommends that a $1,179,578 allocation of costs from Energy East Corporation ("EEC") for Supplemental Executive Retirement Programs ("SERP") be removed from the rate year expenses. As noted by the Panel, these allocated costs exceed the amounts specific to NYSEG employees. They are for benefits provided to EEC management employees that are beyond the payroll, incentive compensation, stock options, and pension costs being allocated to NYSEG. (SM 3809, ll. 1-7) NYSEG's ratepayers should not be responsible for these EEC-specific costs.

[8] In this section, we address the discount rate for OPEB expense as well as the Supplemental Executive Retirement Program.

The Company responds that the executives who receive these SERP benefits provide value to NYSEG and its ratepayers; that the benefits are of a type commonly provided as a part of an overall compensation package; and that the costs of the program were allowed in rates in NYSEG's last rate case. (SM 3923-3924) That rate case was, however, resolved by a settlement involving a complex interplay of negotiated provisions and cannot be construed to serve as a precedent for future rate case decisions on specific cost items. Furthermore, as the CPB Panel noted on cross-examination, SERP costs, even where incurred by utilities, are not necessarily recovered from ratepayers. (SM 3861, ll. 12-17) They should not be included in rates in this case.

4. Pensions

The CPB Panel recommends two adjustments to revenue requirement related to pension expense. The first is a reduction of $4,625,000 resulting from the use of a 5.75% discount rate for projecting rate year pension income rather than the Company's originally filed 5.25% rate. The second is a reduction of $895,000 resulting from the elimination of an entirely speculative actuarial loss projected by NYSEG for calendar year 2006, 10% of which would have been amortized during the rate year.

There is no dispute between the CPB Panel and the Company as to the appropriate sources of information that a business should look to in attempting to estimate a discount rate for future pension income. Indeed, both the CPB Panel (SM 3796, ll. 5-19) and the Company's Retirement and Employee Benefits Panel (SM 3888, ll. 7-15) cite the same excerpt from Financial Accounting Standard 87. The differences

arise in the translation of currently available information into a projection for the rate year.

For calendar year 2004, NYSEG chose a discount rate of 6.25% based on a December 31, 2003, Moody's Aa Corporate Bond yield of 6.01%. As of December 31, 2004, it adopted a discount rate for 2005 of 5.75% based on an index of 5.66%. For its direct testimony in this case, NYSEG projected a discount rate of 5.25% based on a July 31, 2005, index of 5.21%, and utilized this rate in calculating rate year pension income. (SM 3889-3990). The Company has consistently followed the Moody's index, with discount rates set a few basis points higher than the bond rate.

NYSEG acknowledges that the most recent information available provides the best proxy for future discount rates. (SM 3889, ll. 6-7) Accordingly, in its rebuttal testimony, it proposed an increase in the rate for pension and OPEB expense calculation from 5.25% to 5.50% based on a December 31, 2005, Moody's Aa Corporate Bond yield of 5.41%. (SM 3916, ll. 6-7) As of March 10, 2006, however, the Moody's index had risen to 5.68%, as CPB Panel witness Donna DeRonne testified. (SM 3865, l. 9) Assuming the same nine point spread between index and forecast as the Company used in estimating 2005 pension expense, a discount rate in the vicinity of 5.77% would be appropriate if based on the March 10, 2006, information. Clearly, the CPB Panel's forecast discount rate of 5.75% is appropriate for calculating pension income to be included in the rate year revenue requirement. The full adjustment proposed by the Panel, which requires a further increase of $2,312,000 beyond the $2,313,000 increase conceded by the Company in its rebuttal testimony (SM 3917, l. 2), should be adopted by the Commission.

The CPB Panel also recommended that $895,000 in expense attributable to amortization of a projected actuarial loss in 2006 be removed from revenue requirement on the grounds that it is impossible to know at this time whether the Company will, in fact, incur such a loss. (SM 3802, ll. 9-10). NYSEG counters that the projected loss is attributable at least in part to the amortization of deferred gains and losses from prior years which are, in fact, known. (SM 3918-3919) The Company admits, however, that "there are gains or losses that will occur in 2006 that are not yet known." (SM 3918, ll. 18-19)

This is precisely the CPB Panel's point. The Company has projected a loss based on a single source of variation in the value of pension assets without taking into account the potential effect of other gains and losses. This is inequitable to ratepayers. The CPB Panel's adjustment should be adopted.

7. Stray Voltage

The CPB Panel recommends an adjustment of $5,501,472 to the rate year expense for stray voltage testing proposed by the Company, leaving an allowance in rates of $4,681,528. (SM 3829, ll. 14-15) It arrived at this figure by starting with the actual expenditures incurred by NYSEG in 2005, the first year of the testing program. Because the Company completed testing of only 42% of the facilities which must in the future be tested every year, the Panel increased the total expenditures to reflect what NYSEG would have spent if it had tested 100% of the system. (SM 3829, ll. 6-9) It did not further increase the calculated cost for inflation because most of the costs incurred were for outside contractors, and the Panel deemed the prices paid to those contractors

to be negotiable and not necessarily subject to inflationary pressures. (SM 3829, ll. 10-13)

The Company's principal objections to the CPB Panel's analysis are that the unit cost of inspections in the future will be higher because the 42% of facilities inspected in 2005 do not reflect a representative sample of all facilities subject to testing (SM 545, ll. 12-20); and that the "cost collection structure" established by the Company for stray voltage did not capture all of the cost incurred in 2005 or all of the types of costs that will be incurred in the rate year. (SM 546, ll. 6-10) These contentions are presented as mere assertions unsupported by any effort to quantify the net impact, if any, they would have had on actual costs for 2005 had they been taken into account. Consequently there is no objective basis for modifying the conclusion reached by the CPB Panel, and its proposed adjustment of $5.5 million should be adopted.[9]

11. Tree Trimming/Brush Cutting

NYSEG has requested an allowance of $17,696,000 for tree-trimming expenses, consisting of a base amount for ongoing work of $17 million and an additional $696,000 which the Company projects will be needed to meet the requirements of the Commission's vegetation management order. (SM 3825, l. 14 to 3826, l. 3) The CPB Panel recommends that the base amount be reduced by $481,000 to reflect the historic level of expenditures over the period 2001-2004. (SM 3826-3827)

As noted by the Panel, aside from the demands of the Commission's order, there is no reason to expect an increase in tree trimming expenses, and good reason to

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[9] It is instructive to note that DPS Staff witness Haslinger applied a methodology similar to that of the CPB Panel in calculating stray voltage expense for the rate year, and arrived at a proposed adjustment of $5,226,000, only about 5% less than CPB's.

expect the contrary as a result of the vegetation management associated with pole and equipment replacement under the Transmission, Distribution, Infrastructure and Reliability Program ("T&D IRP"). (SM 3827, l. 10-14) NYSEG's Capital Expenditures and Reliability Panel argued in rebuttal that tree trimming associated with the T&D IRP would be incremental to the Company's normal circuit-by-circuit trimming cycle. (SM 538, ll. 15-18) On cross-examination, however, the Panel acknowledged that portions of circuits trimmed during T&D IRP work would not be trimmed again during the normal maintenance cycle. (SM 615, ll. 12-15) Consequently, there clearly will be some savings to the normal maintenance program derived from the equipment replacement work, making it far more likely that the CPB Panel's historically based estimate of tree trimming costs will more closely reflect actual costs than NYSEG's projected increase. The CPB's proposed adjustment of $481,000 should be adopted.

16. Regulatory/Legal Expense

The CPB Panel recommends an adjustment of $1,052,611 to the Company's test year expenses for legal services of $5,160,000. The Panel arrives at this adjustment by annualizing the most recent period for which full cost information was available (January through November 2005) and adjusting it to remove legal expenses related to environmental cleanup, which is a separate expense category. No adjustment is made for inflation. (SM 3816-3817) NYSEG, by contrast, reached back five years in order to generate an average expense for legal services augmented by the inclusion of very high expenditures from 2000 and 2001. It then adjusted this already high base for inflation to arrive at its final number. (SM 3814, ll. 17-18)

Given that NYSEG's expenditures for legal services in 2000 and 2001 were nearly double the average for the four years from 2002 through 2005, the CPB Panel was clearly justified in using the most recent information available. The Company has provided no objective evidence to suggest that the rate year of 2007 will see the million dollar increase in expenses it has proposed.

The Panel is also correct in not inflating costs from the test year to the rate year. As it notes, legal fees are, to a considerable extent, within the control of the Company, both because it has the ability to negotiate the fees it pays and because it has at least some degree of discretion in limiting its use of, and dependence on, outside legal services. To the extent the allowance for legal service expenses in rates is permitted to increase with inflation, NYSEG's incentive to exercise that discretion is reduced. The CPB Panel's adjustment of $1,052,611 is appropriate and should be adopted.

17. Outside Services

The CPB Panel has proposed the elimination of a $309,000 NYSEG adjustment to expenses for outside services. The bulk of this adjustment, $300,000 relates to expenses NYSEG expects to incur for outside contractors to perform electrical, HVAC, control and plumbing tasks at Company facilities while employees hired by NYSEG are undergoing training to qualify them to perform the required work. (SM 3822, ll. 9-19) There are two good reasons why this adjustment should not be allowed.

First, NYSEG itself has asserted in defense of its apprenticeship program for line and UC & M mechanics that it needs to initiate training of new employees in advance of attrition of experienced workers in order to maintain an adequate qualified work force.

(SM 543, ll. 16-21) Had the Company done that in this case, there would be no need for the outside services expenditures proposed. As it is, ratepayers are being asked to pay both for the as yet unqualified replacement employees and the cost of outside contractors. This double cost is a result of the Company's management of its human resources and should be borne by shareholders.

Secondly, when the new employees are finally qualified, the $300,000 in outside service expense will no longer have to be incurred, but will remain in rates indefinitely. As pointed out by the CPB Panel, this is inconsistent with proper ratemaking principles. (SM 3824, ll. 10-11) NYSEG's adjustment should be removed from rate year expense.

18. Hydro Plant

NYSEG has included in its rate year revenue requirement an allowance of $2,437,202 for hydraulic power generation operating and maintenance expense. (SM 3810, table)[10] As shown by the CPB Panel, these test year expenses represent an increase of 102% over the average expenditures for the prior 4 years. (SM 3810, l. 5). Nearly all of the increase is attributable to the single account No. 535, Operation – Supervision and Engineering. In the absence of any evidence presented by the Company to suggest that the extraordinary increase in Account No. 535 in the test year was anything other than an aberration, the CPB Panel recommends that the allowance for this account be reduced by $1,027,096 to the level reported for December 31, 2004. (SM 3812, ll. 16-18)

NYSEG responds that the CPB has ignored the fact that the Company "is facing

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[10] This table was originally presented by the Company and was admitted in evidence as Exh. 5, Exhibit ____(RRP-5), Schedule D, p. 4.

a confluence of more stringent regulatory programs and more extensive maintenance programs" (SM 312, ll. 18-20), and as evidence, points to a laundry list of overhaul, repair and rehabilitation projects. (SM 312, ll. 8-10) This response completely misses the point. The CPB Panel's adjustment addresses expenditures for hydro plant <u>operations</u> which spiked abnormally in the test year. By contrast, expenses for hydro plant <u>maintenance</u> – the area in which NYSEG contends it is facing increased cost pressure – were nearly 15% <u>lower</u> for the test year than the average for the preceding four years. (SM 3810, table)

In an effort to deflect attention from its inability to support the 102% increase in supervision and engineering expenses for hydro plant operations, NYSEG criticizes the CPB for not having "proven" that these expenses are non-recurring. (SM 311, ll. 17-19) Such attempts to shift the statutory burden of proof must be rejected. It is the responsibility of the Company to provide a verifiable justification for every cost element in its rate proposal. Where none is given, it is sufficient for other parties to point out that fact. They are not obligated to prove the negative, i.e. that no justification is possible.

The CPB Panel recommends a further adjustment to hydro plant expense to remove $675,000 in costs associated with certain major hydro O&M activities enumerated by the Company in its information request response ERPE 0749 which is included in Exhibit 1. As noted by the Panel, all of the listed activities appear to be normal maintenance activities which the Company should always have been performing and which cannot be considered incremental obligations. Furthermore, the activities are clearly not annually recurring costs, but rather ones that would be incurred on a multi-year cycle.

On cross-examination, the Company's Revenue Requirements Panel acknowledged that the CPB's assessment of these projects was correct. When asked if the enumerated projects represented maintenance that NYSEG would normally perform, the Panel responded that they did. (SM 441, ll. 6-19) In commenting on the scheduling of such projects, they noted that "some of the projects would be ... on a ten-year cycle." (SM 441, ll. 22-23) Clearly, the full cost of these projects cannot appropriately be assigned to the rate year for rate setting purposes. The Commission should make the $675,000 adjustment recommended by the CPB Panel.

19. Other

i. Transportation & Distribution Infrastructure Replacement Program ("T&D IRP")

The CPB Panel recommends that the Company's proposal to include $2,360,000 in O&M expenses associated with the T&D IRP, be disallowed because NYSEG has failed to demonstrate that they are incremental to the savings that the program is certain to generate. (SM 3774, ll. 19-21 to 3775, ll. 1-4) NYSEG responds simply that the CPB recommendation is "neither realistic nor supported by any evidence." (SM 529, l. 15) In fact, however, NYSEG's own documents demonstrate the contrary.

According to a report prepared by the Company, the T&D IRP program is being undertaken in an effort to reduce the number, extent and duration of equipment-related outages. (SM 3771, ll. 6-8) As Mr. Larkin of the CPB Panel testified, "Unreliable systems cost money." (SM 3842, l. 1) Conversely, enhanced reliability saves money, and NYSEG has projected that the T&D IRP program will immediately generate "noticeable equipment-related reliability improvements." (SM 3772, ll. 6-8) As applied

to poles and related equipment, this improved reliability will reduce costs associated with investigating customer claims for losses, lower payments to customers for damages incurred, and avoid incremental maintenance and replacement costs. (SM 3772, ll. 21-28) With respect to substation equipment, in addition to capital and maintenance cost avoidance, "other cost savings may result , through improved system efficiency and lower technical losses associated with replacing components of an older design with up to date components." (SM 3772, l. 32 – 3773, l. 1).

In short, NYSEG itself foresees an immediate reduction in equipment-related failures and associated costs as well as a reduction in the long-term failure risk. The Company should not be permitted to recover the $2,360,000 in O&M expenses associated with the program without quantifying and accounting for the benefits generated.

ii. Customer Care System

The CPB Panel makes two recommendations with respect to O&M expenses associated with NYSEG's implementation of a modernized Customer Care System ("CCS"). First, it recommends that incremental labor costs of $1,732,000 for 18 new employees and certain returning employees be eliminated. (SM 3779, l. 18) Second, it calls for a further reduction in labor expense of $2,243,468, representing an imputed reduction of 10% of the current staff of Customer Representatives. The basis for these adjustments is the complete failure of the Company to quantify and credit to ratepayers the substantial benefits it will realize through the replacement of its antiquated, expensive customer care system.

NYSEG does not deny that such benefits will be realized. It simply avoids the issue by contending that the primary purpose of the CCS Project is to enhance reliability and promote other important objectives such as retail access. (SM 527, ll. 18-22) While that may well be true, the fact remains that enhanced reliability generally means lower costs, and modernized customer care systems are being put in place by many utilities in an effort to gain productivity through more effective and efficient computer systems. (SM 3776, ll. 3-5) Both DPS Staff and the CPB requested any studies or analyses performed by NYSEG to justify the CCS and to quantify the benefits provided. (SM 3780, ll. 10-17) As Mr. Larkin testified, such studies are, in his experience, always conducted by utilities prior to undertaking projects of this magnitude. (SM 3840, ll. 21-23) Nevertheless, NYSEG provided only a one page explanation which "did not in any way justify the expenditures included within the rate year for this system; nor did it detail the costs or benefits received as a result of its implementation." (SM 3780, ll. 19-21)

Although the Company acknowledges that a system such as the CCS will enhance efficiency and reliability, it has not met its burden of proving the need for an increase in its revenue requirement where it has failed to make any effort to quantify the value of potentially offsetting benefits. Under the circumstances, the adjustments proposed by the CPB Panel, totaling $3,975,468, are entirely appropriate and necessary.

D. Merger Savings

1. Integrated Back Office ("IBO") and Work Management System ("WMS")

Like the CCS project, the IBO and WMS involve substantial capital expenditures

incurred in an effort to enhance efficiency and increase productivity. NYSEG contends that the benefits of these projects were fully accounted for in its calculation of merger savings. The CPB Panel disagreed. It noted that both projects had been implemented relatively late in relation to the test year, and that their full benefits could not have been fully reflected in the test year results. (SM 3788-3789) Accordingly, it recommended adjustments to revenue requirements for each program of $1,768,320 to account for anticipated additional productivity.

To arrive at this adjustment, the CPB Panel compared the Company's headcount for non-union employees at the close of the test year with the number for December 31, 2005, and found a reduction of 20 employees. Of these, 16 would have been charged to electric operations. With average salaries of $75,000 per year and employee benefits and overheads of 47.36%, the elimination of these 16 positions translated into the $1,768,320 savings the Panel recommended be reflected in an adjustment to revenue requirement. The Panel attributed these savings to the IBO project which had been in effect since prior to the test year. Because there was inadequate history to evaluate the ultimate impact on productivity of the newer WMS project, it recommended that the same adjustment be used for it as for the IBO program. (SM 3790, ll. 6-8)

The critical point is that the CPB Panel's recommendation is based on actual cost reductions achieved that were <u>not</u> counted by the Company in its calculation of merger savings. On cross-examination, NYSEG's Revenue Requirements Panel acknowledged that its employee headcount was a test year average. (SM 439, l. 11-12) The CPB Panel used headcount data taken six months after the close of the test year to clearly demonstrate that benefits from the IBO and WMS projects were continuing to

accrue.

NYSEG's contention that the proposed adjustment for the WMS project constitutes double-counting of savings already calculated for the IBO program is incorrect. The Company acknowledges that WMS was not fully implemented until April 2005, with only two months remaining in the test year (SM 306, l. 15), but contends that advance knowledge of the program "at least at a general level" would have generated savings through decisions made in anticipation of its implementation. (SM 306, ll. 19-22) Even if this were true to some extent, the full impact of the program would not have been felt until after the test year. Given that the IBO program was continuing to generate savings nearly two years after its initiation, it is reasonable to assume that similar savings, resulting from specific program requirements rather than general knowledge, would be realized from WMS prior to the rate year.

Accordingly, revenue requirements should be reduced by the total of $3,536,640 recommended by the CPB Panel to reflect productivity gains from both the IBO and WMS projects.

3. Imputed Savings

As Mr. Niazi indicated in his testimony, statements made by NYSEG's parent company, EEC, cast considerable doubt on the utility's assertion that no additional merger savings are expected to be achieved in 2006. (SM 1984, ll. 17-19) In an October 2005 report on its website, EEC stated that it expected an additional $20 million in merger-related savings in 2005, as well as "final integration savings" in 2006-2008. (SM 1984, ll. 10-13) In a subsequent January 2006 report, it indicated that the expected

2005 savings had, in fact been achieved. (SM 1984, ll. 14-16)

Given that NYSEG's test year for this case ended in June 2005, it is clear that some portion of the merger savings achieved in 2005, and all of the savings that the Company's parent expects to achieve in 2006 have not been reflected in the rate year revenue requirement. The revenue requirement is inherently overstated.

To correct for the failure of the Company to account for savings it expects to achieve, Mr. Niazi recommends that revenue requirement be reduced by $6.4 million. He derives that number by comparing the $28.8 million in merger savings that NYSEG claims is reflected in the rate year revenue requirement with the $35.2 million in savings that NYSEG estimated it would achieve in 2006 at the time it entered into the Joint Proposal that concluded its merger rate case. (SM 1985, ll. 2-12)

NYSEG responds that ratepayers have had the benefit of an imputed level of savings in their rates for five years under the terms of the merger settlement; that substantial merger-related savings are reflected in the Company's cost structure; and that there was no requirement under the merger settlement that NYSEG actually achieve the $35.2 million in savings estimated for 2006. (SM 315, l. 7 to 316, l. 6) These arguments completely miss the point of Mr. Niazi's adjustment.

First, the parties agreed in the merger settlement that ratepayers would accept the reflection in rates of a defined level of merger savings for a period of five years in return for allowing the company to share in the actual savings achieved during that five year period. The agreement expressly provided that sharing would not continue beyond the term of the agreement without further negotiations and a new, or renewed, agreement among the parties. (SM 1985, ll. 19 to 1986, l. 15) There is no agreement in

place that would preclude ratepayers from realizing the benefit of a reduced revenue requirement in 2007 arising from merger-related savings.

Second, the fact that some merger savings are already reflected in the rate year revenue requirement does not justify ignoring additional savings that the Company expects to achieve, but which are not reflected because they arose, or will arise, after the end of the test year. It is the purpose of "adjustments" to account for such known, or reasonably foreseeable changes.

Finally, Mr. Niazi is not attempting to hold NYSEG to an estimate that it was not required to achieve under the terms of the settlement. Rather, in the absence of more concrete information from NYSEG and its parent, Mr. Niazi has assumed that the difference between the $28.8 million in merger savings that NYSEG says is included in the rate year revenue requirement, and the $35.2 million the Company estimated it would achieve in 2006 is a reasonable proxy for estimating the additional savings that should be reflected in the rate year revenue requirement.

In reality, the heading for this section of the brief is misleading. The term "imputation," as used in rate proceedings, connotes that establishment of a target, often a stretch, that a utility may or may not achieve. In this case, EEC acknowledges that additional merger savings on the order of $20 million will be realized in 2006. Under the circumstances, the $6.4 million adjustment to the rate year revenue requirement proposed by Mr. Niazi, far from being a stretch, is quite conservative.

E. Depreciation

The Company has proposed the adoption of a new depreciation study which,

when applied to its existing plant in service, would result in a net increase in depreciation expense of $8,070,000. (SM 1981, ll. 14-17) For the reasons discussed below, that study should not be adopted at this time, and the increased depreciation expense should be removed from revenue requirement.

First, at a time of very high and increasing energy costs, the Commission should keep consumer interests paramount in the rate setting process, particularly where, as here, it can do so without jeopardizing the ability of the utility to recover its legitimate costs. This is not, as suggested by the Company in its cross-examination, a matter of penalizing the utility for economic conditions beyond its control. It is simply the normal exercise by the Commission of its discretion to consider the overall impact on consumers of the adoption of rate modifications that are not immediately necessary to the financial well-being of a utility.

As Mr. Niazi indicated on cross-examination, adjustment of the fixed, customer charge component of rates is a common example of this exercise of discretion. Even when cost of service studies indicate that the charge should be increased, the Commission has been less likely to authorize the change when energy costs are high, and more likely to do so when prices are lower and the overall impact on the consumer is more moderate.[11] (SM 2010, ll. 10-16)

Second, the Company's new depreciation study is based on the remaining life technique instead of the whole life methodology it currently employs. NYSEG is unable to provide a citation to any PSC Order, Opinion, or Policy Statement that supports the

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[11] See for example, Lilco Gas Rates, Opinion No. 93-23 at 26, ("Although on a cost-causation basis the 20% increase appears to be justifiable, its effect on customers is excessive. Therefore, in the first rate year the minimum charge will be increased by 1.5 times the overall average increase, net of gas costs.")

use of the remaining life methodology in this state. (SM 1982, ll. 11-14) Indeed, as noted by the DPS Staff, no energy or telecommunications utility in the State of New York uses this technique.[12] Clearly, therefore, there is no compelling policy justification for making the change at this time, particularly given the significant increase in revenue requirement it will generate.

There is also no compelling economic justification. The very existence of multiple depreciation methodologies demonstrates that there is no inherently correct approach. The consistent application over time of any reasonable depreciation method will enable the Company to recover its capital costs. Failure to adopt the changes proposed will not deprive NYSEG of the opportunity to do so.

The Company argues that the proposed changes will provide a better match between the consumption of capital assets and the accounting for their use, avoiding the potential for out-of-pocket replacement expenses at the end of their useful lives. (SM 774, ll. 14-17) That theoretical convergence is illusionary. As Mr. Robinson, himself, notes, "It would be sheer coincidence if the theoretical depreciation reserve and the Company's book depreciation reserve were ever the same." (SM 779, ll. 20-21) In the real world, the decision to replace capital assets has a significant discretionary component. When funds are readily available and financing costs are low, a business may decide to accelerate the replacement of aging capital stock. Under the opposite circumstances, it is much more likely to try to squeeze every bit of additional life available from those same assets. Depreciation accounting does not drive the replacement of depreciable assets.

Given the absence of any legal or economic compulsion to adopt NYSEG's

[12] Exh. 1, Information Request NYSEG-350 (Revised)

depreciation study incorporating a methodology not currently in use by any utility in the state, the decision to accept that study is clearly a matter of discretion for the Commission. The CPB urges the PSC to exercise that discretion in the interest of consumers by rejecting the study and removing the associated net increase of $8,070,000 from revenue requirement.

G. Rate Base

3. Deferred Debits

The adjustments to pension income proposed by the CPB, as detailed above in Section IV. C. 4. require a reduction in deferred debits included in rate base of $7,110,000. (SM 3803, ll. 3-6)

d. Pensions

4. Deferred Taxes

The adjustments to pension income proposed by the CPB, as detailed above in Section IV. C. 4. require a reduction in deferred taxes included in rate base of $2,200,000. (SM 3803, ll. 3-6)

H. Cost of Capital

2. Return on Equity

CPB witness Mr. Niazi determined NYSEG's equity cost using the approach approved by the ALJs in the Generic Finance Case (91-M-0509) and consistently relied upon by the Commission. He calculated NYSEG's cost of equity by applying the two-

stage Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM") to a proxy group of electric and combination electric and gas companies rated "Aa/AA", "A/A" and "A/B" split by Moody's and Standard & Poor's. (SM 3030) The DCF approach resulted in a median equity return of 7.98% while the average of the two CAPM methods resulted in equity return of 9.47%. (SM 3035 and 3038) Applying the 2/3 DCF and 1/3 CAPM weighting adopted by the Judges in the Generic Finance Case, and since relied upon consistently by the Commission, resulted in an equity cost estimate of 8.48%. Mr. Niazi then applied a credit adjustment of 33 basis points to arrive at his final recommendation of 8.81% for NYSEG'S electric operations. (SM 3038-39) NYSEG's recommendation of a cost of equity of 11.0% is without merit.

CPB's Presentation

DCF Analysis**.** Mr. Niazi applied the two-stage growth model developed in the Generic Finance Case to a proxy group of "Aa/AA", "A/A" and "A/B" split companies (Exh.112, Sch. 1). As explained by Mr. Niazi in his testimony, he initially selected electric and combination electric and gas companies that were rated "A/A" by Moody's and Standard & Poor's. Eight companies satisfied these criteria. He discarded three companies from this group, as two have significant unregulated operations and one is involved in a merger. This left a proxy group comprised of only five companies, which he considered too small to obtain reliable results. To enlarge the proxy group, Mr. Niazi included companies rated above "A/A" and those rated "A/B" split by Moody's and Standard & Poor's. Based on the slightly relaxed criteria, Mr. Niazi added four companies to arrive at a total of nine companies as his proxy group. (SM 3031-32)

Mr. Niazi applied a two-stage DCF growth model to the proxy group to arrive at a median return of 7.98% as shown in Exhibit 112, Schedule 1, page 4. The DCF model he used is the same that was approved by the ALJs in the Generic Finance case. For the six-month average prices in the proxy group, Mr. Niazi used the average of monthly high and low closing price of each stock for the period July to December 2005. All other data, including dividends per share, earnings per share, book value per share and shares of common stock, were taken from the Value Line Investment Survey as agreed upon in the Generic Finance case. (SM 3035)

Capital Asset Pricing Model. In developing a CAPM estimate of NYSEG's equity return, Mr. Niazi once again relied on the Generic Finance case. He used the average of the two CAPM methods recommended by the Judges in that proceeding. The traditional CAPM produced an equity return of 9.25% while the zero-beta CAPM approach produced an equity return of 9.68%. The average of the two CAPM methods result an equity return of 9.47%. (SM 3036)

As shown in Exhibit 112, Schedule 2, Mr. Niazi determined the risk-free rate by using the six-month average ending December 2005 of 20-year and 10-Year Treasury Bond Yields as reported by the Federal Reserve Board (Federal Reserve Statistical Release, January 17, 2006). The beta of 0.73 used to adjust the market risk-premium was derived from the same electric and combination electric and gas proxy group companies used for the DCF analysis. It is the average of the individual company betas as reported by Value Line. The market return of 11.0% used in the CAPM method is based on the January 2006 issue of Merrill Lynch Quantitative Profiles – Monthly

Insights for Equity Management. The estimate is the implied return for a portfolio of 1,101 companies. Finally, the risk premium of 6.45% is derived by subtracting the 4.5% risk-free rate from the 11.0% market return. (SM 3037-38)

Incorporating all the variables discussed above in the respective formulas, indicates a required return of 9.25% for the traditional CAPM approach and 9.68% for the zero-beta CAPM method as shown in Exhibit 112, Schedule 2, pages 1 and 2 respectively. The average of the two approaches results in a CAPM equity estimate of 9.47%.

Overall Recommendation. Mr. Niazi used the 2/3 DCF and 1/3 CAPM weighting recommended by the ALJ's in the Recommended Decision in the Generic Finance case and consistently applied by the Commission in many proceedings.[13] Applying a 2/3 weighting to the DCF estimate (7.98%) and a 1/3 weighting to the CAPM estimate (9.47%) results in an overall base equity return estimate of 8.48%. (SM 3038-39)

Credit Quality Adjustment. Mr. Niazi used a proxy group rated "Aa/AA", "A/A", and "A/B" split, while NYSEG is rated Baa1 by Moody's and BBB+ by Standard & Poor's respectively. Since NYSEG is rated somewhat lower than Mr. Niazi's proxy group he adjusted his equity return to reflect this difference. He based his adjustment on the difference in A-rated and Baa-rated utility bond yields over a two-month period from November and December 2005. Over that two-month period, A-rated utility bond yields averaged 5.84% while Baa-rated utility bond yields averaged 6.17%. Based on this data, Mr. Niazi increased his base equity estimate of 8.48% by 33 basis points (6.17%-

[13] See for example., Opinion No. 95-16, National Fuel Gas Distribution Corporation.

5.84%) to arrive at a final recommendation of 8.81% as NYSEG's equity return. (SM 3039)

DPS Staff Presentation

Staff recommended an equity return of 8.7%, just 11 basis points less than CPB's recommendation of 8.81%. Although both the CPB and Staff used a similar analysis, in that both followed the recommendations of the Generic Finance case, their proxy groups are quite different. As mentioned above CPB used a proxy group of 9 companies that are rated "Aa/AA", "A/A" and "A/B" split, while Staff used a proxy group of 23 companies that are rated both "A/A" and "B" by Moody's and Standard & Poor's. The fact that these very different proxy groups produced very similar results tends to confirm the robustness of the models used by the CPB and the DPS Staff.

NYSEG's Presentation

As explained by Mr. Niazi, the Company attempted to justify its requested equity return of 11.0% by relying on four different methods: DCF, CAPM, Risk Premium and Comparable Earnings. Based of these four different methods, Company witness Rosenberg estimates equity returns for NYSEG ranging from a low of 8.9% to a high of 18.0%. (SM 3041-42)

Mr. Rosenberg's estimates should not be relied upon. First, the use of Risk Premium and the Comparable Earnings methods were expressly rejected in the Generic Finance Case and have been repeatedly rejected since by the Commission.[14] Second, Mr. Rosenberg's DCF analysis is not consistent with the approach approved in the

[14] See for example, Opinion No. 96-16, National Fuel Gas Distribution Corporation.

Generic Finance Case. Third, for the CAPM, Mr. Rosenberg uses inputs that are clearly excessive, and then makes his results even less realistic by adding a premium. All of this results in equity estimates that are overstated.

Mr. Rosenberg develops three separate DCF estimates based on different measures of long-term projected growth. First, he uses retention growth that results in a DCF estimate of 8.9%. This method is the closest to the method approved in the Generic Finance case and results in the lowest return calculated by Mr. Rosenberg. However, he then arbitrarily excludes the results of four companies from his total proxy group of eight companies, thereby increasing his estimate to 9.9%. (Exh. 116, page 2)

Next, Mr. Rosenberg substitutes the growth in Growth Domestic Product ("GDP") as his measure of long-term projected growth. This results in a DCF estimate of 10.2%, approximately 130 basis points higher than his estimate based on retention growth. If projections for electric industry growth were unavailable, there might be some justification for using broader measures of growth. That is not the case here, however, as Mr. Rosenberg himself has used specific utility industry growth projections in developing other estimates. Moreover, to the best of our knowledge, the Commission has never relied upon GDP growth as a measure of growth of utility dividends. Consequently, there is no basis for using GDP growth as a proxy for long-term growth of the utility industry, and the results derived should be discarded.

For his third DCF estimate, Mr. Rosenberg used long-term industry projected growth. Once again, this is a broad measure of growth and estimates based on it should be ignored since growth projections for the proxy group companies are readily available and have been used by Mr. Rosenberg. Overall, all of Mr. Rosenberg's DCF

estimates are overstated and should not be relied upon. (SM 3042-43)

Mr. Rosenberg also generated two sets of equity returns based on the traditional and the zero-beta CAPM approaches. His first set of CAPM estimates was based on a market return of 11.8% derived from risk premium data reported in Ibbotson Associates publication Risk Premia Over Time Report: 2005. His 11.8% market return is 80 basis points above the market return of 11.0% reported by Merrill Lynch for 1,101 firms as shown in its the January 2006 issue of Quantitative Profiles – Monthly Insight for Equity Management.

For the second set of CAPM estimates, Mr. Rosenberg calculated a required market return of 13.3% for the S&P 500. By comparison, the January 2006 issue of Quantitative Profiles – Monthly Insight for Equity Management, reports a required return for the S&P 500 of 11.0%. Mr. Rosenberg's estimate of the S&P 500 is 230 basis points higher than the estimate provided by Merrill Lynch. The inputs to Mr. Rosenberg's CAPM formula are clearly excessive, hence resulting in equity return estimates that are also excessive and unrealistic. (SM 3044-45)

Mr. Rosenberg makes his CAPM estimates ranging from 9.7% to 11.4% even more unrealistic by adding a 50 basis points size premium to account for mid and small market capitalization. The Commission has never adopted such an adjustment and we recommend that it reject both Mr. Rosenberg's overstated CAPM estimates and his size premium adjustment. (SM 3045)

Company Rebuttal

Mr. Rosenberg claims that Mr. Niazi's 8.81% cost of equity recommendation

does not pass his test of reasonableness. He cites reports that show average allowed returns for energy utilities in the range 10.5% to 11.0%. Further, he contends that based on Value Line projections, the proxy group used by DPS Staff and CPB will earn a median return 160 basis points above their equity return recommendation. He also points out that the DPS Staff and CPB DCF recommendation is below the 250 basis points risk premium level employed for low-end sensitivity in the Financial Integrity agreement that was part of the Generic Finance case. (SM 3143-46) Mr. Rosenberg also expresses concern about the selection of the CPB's proxy group and the consistency of the CPB's estimate with investor expectations. (SM 3146 – 8)

None of Mr. Rosenberg's contentions has merit. First, there is no evidence to show whether the allowed returns cited by Mr. Rosenberg were based on settlement agreements or decisions in litigated cases. (SM 3143-44) There is also no indication whether they are one year allowed returns or multi-year returns. Further, other circumstances, such as issuance allowances, can lead to differences in allowed returns. Finally, the Commission to the best of our knowledge has never relied on allowed returns in other jurisdiction to determine equity returns for New York state utilities as suggested by Mr. Rosenberg. In fact, the Commission has indicated the opposite. In Case 90-G-0673, involving Central Hudson Gas and Electric Corporation, the Commission said:

> To the extent comparisons between equity allowances provide any guidance as to an appropriate allowance for Central Hudson, our awards provide the most relevant information.[15]

Second, Mr. Rosenberg's contention that CPB and Staff's equity return

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[15] Case 90-G-0673, Central Hudson Gas and Electric Corporation, Opinion No. 91-14, issued July 1, 1991, at 7.

recommendation is unrealistic because based on Value Line projection, their proxy group companies will earn higher returns, is absurd. (SM 3145) Mr. Rosenberg's argument implies that the Commission should award equity returns based on projections of earned returns rather than a determination of a fair and adequate allowed return. One cannot compare the determination of a fair and adequate return with projected returns. This is another attempt by Mr. Rosenberg to confuse the issue. His own DCF estimates of 8.9% and 9.2% based on long-term projected and industry growth, respectively, are well below the 10.3% Value Line projection of what he claims Staff's proxy group will earn.

Mr. Rosenberg's reference to the 250 basis points risk premium level from the Financial Integrity Agreement is completely irrelevant. (SM 3145) Those indicators were developed for entirely different purposes, not to serve as measuring rods to determine the adequacy of DCF equity returns. The Commission has repeatedly rejected risk spread analyses and has often given equity allowances slightly above, and sometimes below, the debt cost of the utilities. In a Brooklyn Union proceeding the Commission said the following:

> Staff responds, first, that the Commission has uniformly refused to determine equity allowances upon the basis of risk premium analyses; second, that the Commission has often provided equity allowances only slightly above (and, occasionally, below) the debt cost of the utility being examined, including recent decisions as to Rochester Gas & Electric and National Fuel gas Distribution, and, third, that the true measures of equity cost is found in a company's stock price, not in its bond yield.
>
> The staff arguments correctly reflect our position. A risk spread analysis is an inadequate method of measuring what investors currently perceive as the cost of equity, particularly when there is nothing suspect about the result achieved by

> application of a company-specific DCF analysis to a subject company other than the result differs from the result of a risk spread analysis.[16]

Mr. Rosenberg seems to try to make much ado about nothing when it comes to the selection of the proxy group. (SM 3146-47) While that process is important, in this case it does not matter whether the CPB, DPS Staff or the Company's proxy group is used. The CPB used a proxy group of 9 companies and estimated an equity return of 8.81%. DPS Staff used a proxy group of 23 companies and estimated an equity return of 8.7%. If the CPB or the Staff approaches were applied to the Company's proxy group, the estimated equity return would change little. The problem is not with the selection of the proxy group, but with the inputs used by the Company. As pointed out earlier, the Company used vastly overstated inputs in its DCF and CAPM calculations, which resulted in equity estimates that are overstated and completely unreasonable.

Mr. Rosenberg also contends that the CPB and DPS Staff's use of Value Line projections of near-term growth in dividends in their DCF analysis reflects a pessimistic view of investor growth expectations. (SM 3148) He cites projected growth in earnings and book value from the same Value Line source as evidence of higher short-term growth. This is pure obfuscation. One set of Value Line projections obviously cannot be used to undermine other projections from the same source, because in estimating future dividends Value Line had to take into account its own projections of earnings and book value growth. The dividend projections cannot be any more pessimistic than the other projections.

[16] Case 89-G-1050, Brooklyn Union Gas Company, Opinion No. 90-29, at 20-21.

V. COMMODITY OPTIONS

A. Policy Issues

To fully evaluate the policy issues presented by NYSEG's proposal to continue its Voice Your Choice program, it is essential to examine the experience of the Company, ESCOs and consumers over the past 3-plus years to determine which elements of the program have worked, and which have not. When that is done, five important conclusions become abundantly clear: (1) consumers, particularly smaller customers, have benefited greatly from the availability of NYSEG's fixed price option; (2) consumers who have an opportunity to choose overwhelmingly prefer the fixed price option offered by the utility; (3) consumers have been educated in the market through a well-publicized program that fosters both the short-term and long-term strategies suggested by the Commission for promoting migration of residential customers; (4) ESCOs have increased their share of the market in NYSEG's service territory, but at a slower than desirable pace; and (5) the level of earnings realized by NYSEG as a result of the program have far exceeded the expectations of the parties who agreed to its inception, are far beyond what can be considered just and reasonable, and should be brought under control.

First, during a period of extremely high volatility in the price of electricity, NYSEG's fixed price option has provided consumers true price stability at a reasonable cost. During the first commodity rate period under the Voice Your Choice program, fixed price customers paid very nearly the same price as the average paid by variable price customers, but without the price swings. While NYSEG acknowledges that the extremely close congruence between the fixed and average variable prices may be

coincidental, (SM 1661, ll. 17-21) it nevertheless demonstrates that the methodology for setting the fixed price under the Voice Your Choice program effectively provides a reasonable forecast of the forward market price of energy.

Second, consumers, particularly residential and small commercial customers, have demonstrated a strong preference for having a fixed price option available from the utility. Of those customers who affirmatively chose an option during the enrollment period for the current commodity rate period, 75.2% chose the fixed price option.[17] In addition, a fair percentage of those customers who made no choice undoubtedly did so with the knowledge that they would receive the fixed price option by default. Clearly, if consumers were told that NYSEG could only offer a single commodity option, as Staff and Direct Energy propose, they would overwhelmingly urge the Commission to make it the fixed price option.

Third, consumers in NYSEG's territory (along with that of its sister utility, RG&E) have been in the unique position of being exposed to the decision-making process involved in choosing between variable and fixed electric prices under a program in which both options are priced at market-based rates. Arguably, therefore, the Voice Your Choice program promotes both the short and long-term strategies recommended by the Commission for the transition of residential customers to competitive suppliers.

In its "Statement of Policy on Further Steps Toward Competition in Retail Energy Markets," the Commission expressed a preference for greater exposure of small customers to price fluctuations,[18] but recognized that, in the shorter run, residential

[17] Exh. 1, Information Request Response NYSEG ERPE0428.

[18] Case 00-M-0504, Retail Competition Policy Statement, August 25, 2004, p. 40.

customers need protection from price volatility in utility commodity rates even if such hedged pricing may inhibit competition.[19] The Voice Your Choice program provides the protection without the inhibition. Residential customers can choose a fixed price while, at the same time, as pointed out by Energetix in its testimony, ESCOs have realistic pricing targets against which they can compete for the customers' business. (SM 1962, ll. 10-19)

Fourth, the expansion of retail access, as measured by the market penetration of ESCOs in NYSEG's service territory, has increased, but the pace of growth has been slower than would be desired. According to the statistics posted for February 2006 on the PSC website,[20] NYSEG's 4.4 percent increase in number of residential customer accounts migrated to ESCOs over the past year would put it near the middle among the state's utilities, ahead of National Grid and Orange & Rockland, but behind its sister utility RG&E, Central Hudson and Consolidated Edison. Between September 2002, immediately prior to the first Voice Your Choice enrollment period, and February 2006, residential migration increased by 31,772 customer accounts, or slightly over 1% of total residential customers per year.[21]

Finally, it is indisputably clear that the earnings of the Company attributable to the Voice Your Choice program have far exceeded the expectations of the parties to the Merger Rate Plan joint proposal, generating overall equity returns on electric operations

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[19] Case 05-M-0504, Proceedings on Motion of the commission Regarding Provider of last Resort Responsibilities, the Role of Utilities in Competitive Energy markets and Fostering Development of Retail, "Statement of Policy on Further Steps Toward Competition in Retail Energy Markets," issued August 25, 2004, p. 33-34 ("Retail Competition Policy Statement").

[20] http://www.dps.state.ny.us/Electric_RA_Migration.htm.

[21] 20,199 accounts as of September 2002 (SM 1995, l. 19) vs. 51,971 for February 2006, per the PSC website cited above.

in excess of 15% in every year that the plan has been in effect.[22] In 2005, NYSEG's earnings from commodity operations alone, after taxes and sharing, were over $58 million (SM 1603, ll. 5-6), nearly commensurate with earnings from the delivery business.[23]

It should be noted that there is nothing whatsoever in the record to suggest that NYSEG did anything more than follow the rules they were given under the Merger Rate Plan settlement. Their success appears to have been a combination of good management of their energy portfolio, and considerable good luck, as rising commodity prices combined with a fixed percentage retail conversion factor significantly increased margins in dollar terms (SM 1654, ll. 9-14), and there were no serious outages or weather-related price spikes that could have drained profits. (SM 1655, 1-6) Nevertheless, earnings at the level NYSEG has realized clearly should not be considered just and reasonable at a time when prevalent authorized returns on equity, by the Company's own evidence, averaged around 10.8%,[24] and this is particularly true at a time when the utility's customers were experiencing increasingly high energy costs.

While such earnings levels are clearly unacceptable from a ratepayer standpoint, this is not a problem that is inherent in the offering of a fixed price commodity option by the utility. The problem can be corrected with adjustments to the earnings sharing mechanism, as both CPB and NUCOR recommend.

Given the factors discussed above**,** the fundamental policy question presented by

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[22] Exh. 1, Information Request Response NYSEG ERPE0203.

[23] Delivery earnings were $70.8 million per Exh. 1, Information Request Response NYSEG ERPE1048.

[24] Exh. 117, Exhibit ___(RGR-1).

NYSEG's Voice Your Choice proposal is whether continuation of a utility-provided commodity option that residential and small commercial customers demonstrably desire and that has given those customers protection from price volatility at reasonable rates, can be compatible with the Commission's objective of promoting robust competition for commodity sales. The CPB maintains that, with the program modifications described in our proposal below, the answer to this question is clearly "yes."

We recognize that the Commission has expressed a clear preference that utilities not offer commodity programs under which they have the potential to earn a profit.[25] It has also recognized, however, that protecting smaller customers from the effects of market volatility is an important utility function, at least until competitive retail markets are more fully developed.[26] NYSEG's program clearly promotes the latter objective.

The Commission has justifiably praised the benefits of "the flexible administrative course to restructuring the market that New York alone has taken."[27] This approach has permitted state utilities to pursue a variety of efforts to expand retail access, some of which have worked, and some of which have not. Neither the PSC nor the CPB has learned all there is to know about how to expand competition for energy commodity sales, and we should not now eliminate experimentation in favor of the type of mandated statewide uniformity that the administrative approach to restructuring the energy industry has thus far avoided.

Consider, for example, O&R's Switch and Save program. This marketing effort began as the idea of a single utility, and it proved successful. The CPB has, in fact,

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[25] Retail Competition Policy Statement, p. 40.

[26] Id., p. 34.

[27] Id., p. 1.

consistently supported the adoption of similar programs, with appropriate consumer protections, at other utilities. Despite this, the PSC's electric migration website reports that residential electric migration on O&R declined over the last year.[28] This does not mean the Switch and Save program should be curtailed, or that the NYSEG Voice Your Choice program, where migration increased over the same period, is necessarily a superior alternative. It simply demonstrates that no single approach is the ultimate solution and that experimentation and innovation should continue to be encouraged.

The Commission notes that its flexible approach allows it to benefit from the experience of other states.[29] The fixed price option incorporated in NYSEG's Voice Your Choice program is simply a form of the "price to beat" approach used in many states, and which has been successful where the price used provides sufficient "headroom" for ESCOs to operate. In this regard, the 35% markup applied by NYSEG is very generous. It is uncontroverted that only a little over half of this markup was required by NYSEG to cover retail supply costs.[30] The rest was available for margin. This should be more than adequate headroom for any competent, creditworthy ESCO to compete. As discussed below, the deficiencies in the Voice Your Choice program, from the standpoint of promoting competition, involved elements other than price.

The Commission should not throw out the manifest consumer benefits provided by the Voice Your Choice program in order to deal with the problems of excess earnings and slow growth in ESCO market penetration. The better approach is to modify the elements of the program that have not worked as anticipated and keep those that have.

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28 http://www.dps.state.ny.us/Electric_RA_Migration.htm.

29 Retail Competition Policy Statement, p. 1.

30 SM 1483, ll. 20-21.

The CPB proposal does this.

B. NYSEG Proposal

NYSEG proposes a continuation of its existing Voice Your Choice commodity options program, with minor, non-substantive modifications As is the case with the current program, customers in NYSEG's service territory will have four basic options for commodity service. Under two of these, the Fixed Price Option ("FPO") and the Variable Price Option ("VPO"), the customer's energy supply is provided by the utility. Under the other two, the ESCO Price Option ("EPO") and the ESCO Option with Supply Adjustment ("EOSA"), the energy commodity is provided by an ESCO.

All options are not available to customers at all times. The program utilizes two-year "commodity rate periods" starting on January 1, preceded by three-month enrollment periods that commence on October 1 of the prior year. Under the current program, enrollment periods were conducted from October 1 through December 31, 2002, for the commodity rate period covering calendar years 2003 and 2004, and from October 1 through December 31, 2004, for the 2005-2006 commodity rate period.

During an enrollment period, any NYSEG customer who is not otherwise contractually bound for service,[31] is free to choose either the FPO, the VPO or the EPO (the EOSA, as discussed below, is not relevant during the enrollment period). Customers may also freely change their energy services provider prior to the end of the enrollment period.

After the enrollment period, customer options become more limited. Customers

[31] This discussion concerns only customers' rights and obligations with respect to NYSEG. The ability to switch from ESCO service to utility service during or after an enrollment period may be limited by contract.

who elect the VPO from the Company, can switch to service from an ESCO under the EPO at any time, but are no longer eligible for the FPO. Those who chose the FPO may switch to the EPO only during the first four months of the commodity rate period. Thereafter, they may switch to ESCO service only under the EOSA.

Customers who elect ESCO commodity service under the EPO during the enrollment period may switch at any time to utility service. Small customers may choose either the VPO or the FPO, although the enrollment period price for the FPO may no longer be available as the Company has the right to update it periodically. Large customers switching from ESCO service to utility service may only take the VPO.

The price charged by NYSEG under both utility supply options comprises two components, an energy supply price and a non-bypassable wires charge ("NBC"). Under the FPO, each component remains fixed for the duration of the commodity rate period, giving customers an overall fixed price for two years. Under the VPO, the price changes daily.

Calculation of the FPO supply price component begins with an estimate of the wholesale price of energy for the commodity rate period based on market price information available during the last 20 trading days prior to the enrollment period. This estimate is then subjected to certain locational and load shape adjustments to arrive at a price for NYSEG's service territory. (SM 1482, ll. 1-17)

Next, using similar market price information, NYSEG estimates the cost of unforced capacity for the commodity rate period. The wholesale energy supply and capacity prices are then added together and multiplied by a "retail conversion factor" of 135% to arrive at a system average FPO price. Finally, the average price is

differentiated among service classes on a cost causation basis using class load shapes, class contributions to system peak demand, and class loss factors. (SM 1482-83)

The supply price under the VPO is essentially a daily pass-through of market prices. The cost of energy is based on the NYISO day-ahead price. The cost of capacity is derived from the monthly NYISO capacity auction price. As with the FPO, prices are adjusted by service class based on class load shape, contribution to peak and losses. Any difference between the day ahead prices used and the real time prices experienced is trued-up and credited or charged to VPO customers in a subsequent billing cycle. (SM 1485-86)

The second component of the FPO and VPO rates, the NBC, is intended to recover purchase power related costs, net of credits, for the market value of power purchased by NYSEG under certain legacy contracts, primarily with NUGs and the New York Power Authority ("NYPA"). It also recovers the cost of ancillary services and the NYPA Transmission Adjustment Charge associated with energy supply, provides customers the benefit of wholesale transmission revenues accruing to the Company, and recovers the cost of serving customers in the higher cost eastern part of NYSEG's territory at the same rate as customers in the west. (SM 1488, l. 17 to 1489, l. 2) For the FPO, the NBC is calculated in advance and fixed employing the same market data used to set the energy supply component of the price. For the VPO, the NBC is calculated monthly and subsequently trued-up to actual costs. (SM 1490, ll. 13-17)

Under the EPO, the energy supply price is determined by agreement between the customer and an ESCO, and may be fixed, variable or provided in any other manner that the ESCO chooses to market. All EPO customers, however, are charged the

variable NBC applicable to the VPO. (SM 1486)

Finally, the EOSA is essentially a mechanism to allow customers who initially choose the FPO to later switch to ESCO service without subjecting NYSEG to the risk associated with changing volume commitments that it would face if switching were freely available. With the EOSA, customers remain liable for the FPO price, including the fixed NBC, but they are given a credit equal to the VPO energy supply rate plus one mil per kilowatt hour. Their net cost thus becomes the sum of the ESCO supply price, plus the fixed NBC, plus the difference between the FPO supply rate and the VPO supply rate, minus one mil. (SM 1486-87)

Overall, NYSEG's commodity proposal would maintain the status quo, under which the Company's commodity earnings have been excessive and ESCOs have increased their share of the market at a slower than desirable pace.

C. Staff Proposal

The DPS Staff recommends that NYSEG be required to eliminate FPO service and offer only the variable price and ESCO price options. As of January 1, 2007, all FPO customers would be switched to the VPO unless they find an acceptable ESCO alternative. All EPO customers would remain with their suppliers. EOSA customers will either stay with their ESCOs or move to the VPO. (SM 1844, l. 18 to 1845, l. 6)

The Staff proposal is a mass of contradictions. Staff contends that having the utility provide two distinctly different services is too confusing for consumers to handle (SM 1843, ll. 18-19), but apparently sees no problem with them sorting through multiple, similar ESCO offerings. Staff also says that the FPO both enriches shareholders and

harms competition (SM 1843, ll. 15-17), but fails to explain why an overpriced utility commodity program should not be a dream come true for competitive suppliers.

Staff says that the VPO is good because it provides a just and reasonable price (SM 1845-46), while the FPO is bad because it does not. (SM 1846, ll. 6-10) The only problem with this argument is that the price of the two services, over time, has been the same. (SM 1661) From the standpoint of the rates paid by consumers, either both options were just and reasonable, or neither was. The real objection of the Staff, and of the CPB, to the current program is not to the level of the FPO price, but rather to the structure of the earnings sharing mechanism included in NYSEG's current rate plan which has allowed the Company to retain far too great a share of net commodity income. Had the earnings cap proposed by the CPB in this case been in place for the past three years, the excess revenues returned to ratepayers would have made the FPO a vastly better deal for customers than the VPO.

Next, Staff assures us that eliminating the utility option under which the great majority of small customers currently take service would not be disruptive to consumers because it "expects" ESCOs to continue offering fixed prices in NYSEG's territory. (SM 1844, ll. 3-4) Apparently, these ESCO prices would be the same fixed prices that few if any customers have heretofore been interested in paying. After all, only about 7% of residential customers in NYSEG's service territory are currently being served by ESCOs under any type of service, fixed or variable.

Finally, Staff argues simultaneously that the VPO sends better price signals to consumers (SM 1856, ll. 3-5) and that those signals must be muted by requiring NYSEG to hedge its supply portfolio to limit price volatility. (SM 1846, l. 15 to 1847, l. 2)

Staff calls this a "happy medium," (SM 1847, l. 3), perhaps because it sees the unhappiness of consumers and ESCOs canceling each other out.

Simply put, Staff's proposal deprives consumers of a stable price they manifestly desire, deprives ESCOs of a target price they should easily be able to compete against, and does nothing to promote the cause of expanded competition for energy commodity services. The CPB proposal, by contrast, aims at retaining the consumer-friendly aspects of the Voice Your Choice program while eliminating or restructuring those features that inhibit ESCO activity.

D. CPB Proposal

The CPB's proposal to modify and continue the Voice Your Choice program would simplify the utility's commodity offerings, enhance the ability of ESCOs to compete for customers, and assure that any earnings realized by NYSEG from the program will be reasonably commensurate with its risks. The key elements of that proposal are as follows:

1) Open enrollment at all times;

2) Customers will be bound for one year, rather than two, when they choose the FPO;

3) Default service will be the service affirmatively chosen by a customer during the previous commodity rate period, or the VPO if the customer made no choice;

4) A fixed NBC will be offered for the customers of ESCOs that choose to provide an "all-in" fixed price;

5) NYSEG's earnings under the program will be capped at a 100 basis points

return on equity equivalent, with all excess earnings accumulated in the asset sale gain account ("ASGA") for the benefit of customers.

Open Enrollment. The current process, tied to a biennial "open season," inherently inhibits ESCOs from making a substantial long-term commitment of resources and personnel to the development of market share in NYSEG's territory because of the long periods of inactivity between the short windows of opportunity represented by the enrollment periods. Customers who have made a decision during the enrollment period are unlikely to be good candidates for any subsequent marketing effort. (SM 1995, ll. 5-16) As Mr. Niazi testified, the effect of this schedule is clear from migration statistics which jump during enrollment periods but then stagnate or even decline until the next open season. (SM 1995, l. 17 to 1996, l. 7)

Keeping enrollment open will, of course, mean that a customer who has not made an affirmative choice of service may do so at any time and may choose NYSEG's FPO option. It clearly would not be reasonable to expect the Company to hold its FPO rate open indefinitely. Therefore, the CPB recommends that NYSEG be permitted to update its FPO rate periodically after the start of the commodity rate year, as it does currently for small customers who return to the Company from ESCO service. (SM 1487, l. 22 to 1488, l. 3)

One-year FPO Term. Limiting the term for which customers choosing the FPO will be bound to NYSEG for fixed price service to a period of one year will provide several benefits for competitive suppliers. First, it assures that customers will be shopping for supply at least annually. Second, it creates an opportunity for ESCOs to offer products to customers who are looking for longer-term price stability; and finally, it

may obviate the need for the EOSA. The EOSA never provided anything more than a very limited “escape hatch” for customers in any event, because their continued responsibility for the difference between the fluctuating VPO price and the FPO price effectively precluded ESCOs from offering them a fixed price alternative. With the shorter commitment period we propose, the mechanism is unnecessary.

Default Service. Any commodity program adopted by the Commission in this case that provides for a choice of services will require an enrollment period during the fall of this year in order to permit customers to make a decision prior to the start of the 2007 rate year. Those who make no decision will have to be assigned to an option. The CPB position is that those customers who have affirmatively demonstrated a preference by choosing an option, should be permitted to continue with their choice until they themselves make a change. All other customers who express no preference would be assigned to the VPO.

There are two good reasons for making the variable rate option the default. First, it will expose customers to price volatility as desired by the Commission, creating a marketing opportunity for ESCOs. More importantly, however, it will help assure that NYSEG’s rate for fixed price service more closely reflects the full market risk inherent in such offerings when made by ESCOs. This is critical if, as we recommend, NYSEG is permitted flexibility in setting the price for FPO service.

Currently, with the FPO as the default, NYSEG can be quite comfortable in its supply planning because it knows it will have a very substantial portion of the load on its system. About 60% of all customers end up on fixed price service by default (SM 1997, ll. 13-14) and, as noted above, three-quarters of those who make a choice also pick the

FPO. NYSEG needs to make very little allowance for the risk or over or under-matching supply acquisition with load.

ESCOs do not have the same luxury. Their loads will depend on how many customers they can sign in the time available to market to them. They must either line up supply and hope that they can sell it, or sign up customers and hope they can get sufficient supply at a price that preserves their margins. Either way, the risk of a mismatch is a cost that must be recovered in their prices. In order to level the playing field for fixed price offers, NYSEG must also be required to face this risk and internalize its cost. (SM 1997, l. 18 to 1998, l. 5)

Our recommendation that the VPO be the default for customers who have not made an affirmative selection is inexorably linked to our recommendation that the enrollment period remain open. With open enrollment, no VPO customer would ever be more than one month away from FPO or EPO service. This is an acceptable tradeoff for what we believe will be significant improvements to NYSEG's commodity program. If, however, the Voice Your Choice program were to continue with a limited enrollment period and a two-year commodity rate period, we very definitely would insist on an FPO default.

Fixed NBC. Our recommendation that the NBC be fixed for customers of ESCOs that choose to offer an "all-in" fixed price, is also intended to help level the playing field for fixed price offers. Currently, any customer who takes service from an ESCO (other than under the EOSA) is assessed the same variable NBC that is charged to VPO customers. With such a constantly shifting charge, it is almost impossible for ESCOs to offer a fully fixed price comparable to the Company's FPO. Even knowing the inputs to

the pricing model, they are still dealing with contracts and purchasing decisions that are outside their control and difficult to hedge. NYSEG, itself, acknowledges that there are substantial risks associated with trying to project a fixed NBC, even with the Company's long experience with the components of the charge. (SM 1999, l. 17 to 2000, l.7) In order for ESCOs to offer a fixed price that, like the FPO, includes both the supply charge and the NBC, NYSEG should allow each ESCO to designate which of its customers are to be charged the fixed NBC, and NYSEG should provide that fixed NBC.

Earnings Cap. Based on the results that NYSEG has achieved during the first three years of the Voice Your Choice program, the CPB recommends, as Mr. Niazi testified, that earnings from the commodity program be capped at the equivalent of 100 basis points of ROE, or $14.55 million per year.[32] Any excess earnings should be accumulated in the asset sale gain account, or some other mechanism, for the benefit of ratepayers.

Setting the FPO Price. Mr. Niazi's testimony also included the recommendation that NYSEG be given flexibility in pricing the FPO. (SM 2001, ll. 1-5) Based on testimony elicited at the hearings in this case, we are withdrawing that proposal as unnecessary and instead support continuation of the current pricing methodology as described in our discussion of the NYSEG proposal above.

NYSEG realized net income after taxes from commodity sales of approximately $64 million in 2005. Company witness Mr. David Segal testified that virtually all of those earnings were attributable to the FPO. (SM 1653, l. 24) Clearly, the FPO price is not too low. There should be ample "headroom" in the 135% retail conversion factor to permit ESCOs to compete for fixed price business. Consumers will be protected by the

[32] Exh. 1, Information Request Response NYSEG ERPE0202.

earnings cap we propose and also, we would hope, by competitive ESCO offers.

E. NUCOR Proposal

NUCOR agrees with the CPB that NYSEG should be permitted to continue its Voice Your Choice programs "as long as their is substantial consumer interest in subscribing to those offerings." (SM 2732, ll. 11-12) It recognizes the overearnings problem and recommends that this be dealt with by imposing a cap equivalent to a 50 basis point return on equity and returning any excess earnings to customers through a reduction in the NBC.

As noted above, the CPB believes that the excess earnings realized by NYSEG to date are not an inherent feature of the Voice Your Choice program. Despite the good fortune the Company has realized to date, there remains considerable risk in holding a fixed price offer for electricity open for seven months (enrollment period plus four-month switching period for VPO customers), and then absorbing all volume risk associated with its fixed price commitment for a full two years. Therefore, we believe that the 100 basis point cap we recommend is more equitable.

F. Direct Energy Proposal

Direct Energy makes three recommendations related to NYSEG's commodity service. First, it recommends that all customers pay the same NBC in order to facilitate the comparison of prices across competitors. (SM 1337, ll. 7-13) The CPB agrees that the NBC paid by customers of ESCOs should be the same as that paid by customers of the utility for similar services. However, because we advocate the continued offering of

both fixed and variable options by NYSEG, we do not agree that there must be a single NBC. It is sufficient for price comparability that ESCOs have the ability to assure that their variable price customers pay the same NBC as NYSEG's variable price customers, and that the same be true for fixed price customers.

Second, Direct Energy argues that customer enrollment in ESCO or utility commodity offerings should be continuously open. (SM 1343, ll. 12-13) The CPB agrees and makes the same recommendation.

Finally, Direct Energy recommends that NYSEG be required to offer only a single commodity service with the price determined monthly based upon the cost of monthly forward contracts actually purchased by the utility to provide the service. Here, the CPB strongly disagrees. Not only would this proposal deprive consumers of the fixed price option they manifestly prefer, but it would expose them to the full, unhedged volatility of the electric market in direct contradiction to the recommendations of the Commission.[33] Given that ESCOs are already active in NYSEG's service territory and are increasing their penetration of the small customer market despite the current limitations of the Voice Your Choice program which the CPB's proposals would eliminate, there is absolutely no evidence that the draconian restructuring proposed by Direct Energy is necessary for competition to flourish.

IX. SERVICE QUALITY PERFORMANCE MEASURES

The CPB recommends continuation of NYSEG's current Service Quality Performance Mechanism ("SQPM") for electric operations, with NYSEG's proposed modification of the PSC Complaint Rate threshold targets and several changes

[33] Retail Competition Policy Statement, p. 41.

proposed by CPB witness Ms. Donna DeVito. Ms. DeVito recommended an upward adjustment to the Overall Customer Satisfaction Index (SM 2745, l. 12) to establish a performance threshold that represents a realistic minimum level of performance. (SM 3744 – 5) She also recommended several changes to program reporting requirements and evaluation procedures.

As Ms. DeVito explained, Company's historical performance on the Overall Customer Satisfaction Index for the years 2003 - 2005 was 79.5%, 82.0% and 79.6%, respectively. Establishing the initial threshold of performance based on the three-year average of 80.4%, with a safety margin of 5% of the average performance for that period, will provide an appropriate quality service measurement that will also reflect potential random variations in the service quality data. Under the Company's current SQPM, a score of "less than 73%" will incur a revenue adjustment of at least $100,000. A new target of "less than 76%" before imposition of the initial $100,000 penalty would help maintain an incentive to deter performance slippage and encourage maintenance of high customer service, while providing the Company with appropriate performance safety margins. The proposed increase in the SQPM threshold to 76% will heighten awareness and allow any performance slippage to be addressed more promptly, but only if necessary. This recommendation would not result in the assessment of a penalty if NYSEG's current service quality is maintained. The current revenue adjustment allocation of $1 million for the Overall Customer Satisfaction Index measure and the use of a sliding scale to assess penalties, are appropriate and should be maintained.

NYSEG believes that any change in the target levels is inappropriate in a one-year rate case. Further, the Company contends that when considered in the context of

the entire proceeding, such a change would be punitive and would require the Company to take on additional risk. In addition, the Company contends that the CPB and DPS Staff positions assume that customer service satisfaction will continue to improve above existing levels and would result in acceptable performance being rewarded with more stringent measures. (SM 1135)

As Ms. DeVito demonstrated, however, changes in the target level are being recommended not to reflect increased performance, but to establish a reasonable measure of a performance threshold. Adjusting performance standards to reflect actual historical averages, with allowance for variation, is a reasonable and balanced approach. Since historical data include the effect of economic changes, energy supply price fluctuations, regulatory changes and changes in demographics, it is reasonable to establish and adjust future performance targets based on recent actual data.

The CPB's recommendation of specific reporting requirements and an annual meeting with interested parties to assess the SQPM, is intended to help ensure that the program is operating as intended and that any necessary modifications are identified promptly. (SM 3746) Similar reporting requirements and evaluation meetings are currently applicable to other utilities, including National Grid USA. As part of its ten-year rate plan in Case 01-M-0075 (filed October 11, 2001), National Grid USA meets with DPS Staff and interested parties in the third, sixth and tenth year of the plan to evaluate that utility's SQPM and discuss proposed modifications. Similarly, annual evaluation of customer service quality programs are under consideration currently in Cases 05-E-0934 and 05-G-0935, involving Central Hudson Gas and Electric.

Overall, the CPB's proposed modifications of NYSEG's SQPM establish realistic

goals, include reasonable financial consequences for under-performance, and provide an opportunity to correct any deficiencies in a timely manner. The CPB's recommendations should be adopted.

X. LOW-INCOME (POWER PARTNER) PROGRAM

The CPB supports and recommends continuation and expansion of NYSEG's current Power Partner Program for electric operations as currently administered. The Program includes a monthly discount on the basic service charge, arrearage reduction with suspension of late payment charges, and dollar-for-dollar matching up to a maximum of $100 per 12-month period. In addition, NYSEG offers individualized assistance to each customer to identify eligibility for other community-based programs and services.

Currently, the program is limited to 22,500 participants. CPB witness Ms. DeVito explained that its funding should be increased to ensure that all eligible customers can obtain the program benefits. (SM 3749) In addition, CPB also recommends more specific reporting and evaluation based on NYSEG's request for a six-year program. (SM 3749 – 50) The establishment of the specific form and data to be included in reports and evaluations, such as the number of customers enrolled by month with additions and departures shown separately and specific categories to identify the reasons why customers depart the program, will provide the information needed to evaluate the program and to identify areas of possible improvement.

NYSEG has proposed to maintain the current discount level and number of program participants. (SM 2458, ll. 15-22) While the CPB is in agreement with the level of discount, the number of participants should increase to all those eligible under

existing criteria. DPS Staff also recommended that the same discount should be maintained, but participation should be extended to all HEAP recipients. (SM 3667, ll. 9-14)

XII. CONCLUSION

For the reasons set forth in its testimony in this proceeding and in this Initial Brief, the recommendations of the Consumer Protection Board with respect to the rate plan filed by New York State Electric and Gas Corporation should be adopted by the Commission.

Respectfully submitted,

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