BEFORE THE
STATE OF NEW JERSEY
OFFICE OF ADMINISTRATIVE LAW

I/M/O of the Verified Petition of Rockland Electric Company for the Recovery of its Deferred Balances and the Establishment of Non-Delivery Rates Effective August 1, 2003 ("Deferral Filing")	**BPU Docket No. ER02080614** **OAL Docket No. PUCOT 07892-02N**

REPLY BRIEF ON BEHALF OF THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE

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TABLE OF CONTENTS

Page

TABLE OF AUTHORITIES

Cases and Board Orders **Page(s)**

INTRODUCTION

The Initial Briefs filed in this proceeding reflect stark differences between the public interest approach of the Division of the Ratepayer Advocate ("Ratepayer Advocate") and the self-serving approach of Rockland Electric Company ("Rockland" or "Company"). Rockland's updated filing requests recovery of a $96.4 million net deferral balance as of July 31, 2003, including interest charges of $8.9 million. In contrast, the Deferred Balance adjustments recommended by the Ratepayer Advocate result in a total disallowance of $38,775,428, plus interest. Moreover, Rockland's filing requests a four-year recovery charge for its deferred balances, including 6.25% interest, for an annual revenue requirement for the four-year period amounting to $35.4 million per year. As proposed, this annual revenue requirement would cause an increase to Rockland's rates of approximately 2.0 cents per kWh, or a 25.6% increase in rates. This is over and above the additional revenue requirements requested in the Company's pending rate case.

The reasons for all of the Ratepayer Advocate's proposed adjustments to the Company's proposal are set forth in detail in the Ratepayer Advocate's testimony and Initial Brief and will not be repeated here. This Reply Brief will highlight the differing approaches taken by the Company and the Ratepayer Advocate, and respond to selected issues raised in the Initial Briefs filed by the Company and the Board of Public Utilities' Staff ("Staff").

POINT I

YOUR HONOR AND THE BOARD SHOULD FIND THAT ROCKLAND HAS FAILED TO MEET ITS BURDEN OF PROOF UNDER HOPE CREEK AND THEREFORE MUST BE DENIED RECOVERY OF COSTS IMPRUDENTLY INCURRED.

That the proper standard of review of the prudence of the Deferred Balance is "whether or not, under the then existing circumstances, management acted reasonably", Rockland and the Ratepayer Advocate agree. REIB[1], p.20, quoting, *I/M/O the Petition of Public Service Electric and Gas Company for an Increase in Rates-Hope Creek Proceeding*, BPU Docket No. ER85121163, (Order dated April 6, 1987) ("*Hope Creek Order*"). However, in its Initial Brief, Rockland focuses on the erroneous claim that the disallowances proposed by the Ratepayer Advocate and the Auditors are "both characterized by a liberal employment of hindsight." REIB, p. 24. One must necessarily view events that occurred in the past in this proceeding thus, it becomes easy to allege that an inappropriate use of hindsight has occurred. However, the Ratepayer Advocate has shown that it was not reasonable, taking into account the attendant circumstances, for Rockland to remain inattentive to the electric grid serving New Jersey and to instead, passively remain in the NYISO, from at least August 1, 1999 until its transfer to PJM[2] in March 2002. Moreover, Rockland conveniently fails to mention one incontrovertible element of the review in this proceeding – the burden of proving the reasonableness of the expenditures included in the Deferred Balance lies with the Company alone and does not shift. *Hope Creek Order*.

In its Initial Brief, Rockland excuses its imprudence, in part, by stating that none of the parties to its electric restructuring proceedings, including the Ratepayer Advocate, proposed that it should transfer to PJM. REIB, p. 45-46. Moreover, the Company places significance on the fact

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[1] The Initial Briefs filed in this proceeding will be referred to as follows: Rockland Electric Company - "REIB"; Ratepayer Advocate - "RAIB"; and Board Staff - "SIB".

[2] The Pennsylvania-New Jersey-Maryland Interconnection, L.L.C. ("PJM") was founded in 1927. The PJM is a limited liability company formed in the state of Delaware on March 31, 1997. The PJM began operating as an ISO on January 1, 1998.

that Mr. Cotton utilized predictions of low market prices in the NYISO in the context of the restructuring proceeding. REIB, p. 46. As stated previously, both arguments are without merit in light of the Company's irrefutable burden to prove their actions were prudent to recover the deferred balance. It is irrelevant whether or not a party to the electric restructuring failed to mention the possibility of purchasing energy through PJM. The focus of the restructuring proceeding was not to give business advice to utilities who may not have sufficient expertise to act prudently in an unregulated environment. It was the duty of the utility, the entity that runs the business on a day to day basis, and possibly the only one involved in the restructuring proceeding that was aware of the physical connection between PJM and Rockland, to suggest such purchasing. Rockland did not produce one public document filed at the Board that stated it could physically transfer[3] from the NYPP to PJM or the PJMISO during the entire period from 1997 to 1999.

As the Ratepayer Advocate has shown in its Initial Brief, Rockland has not met its burden of proof - it has not demonstrated that it was reasonable in 1997 for a New Jersey electric utility facing retail competition without generation assets, to ignore the successful, reliable, and lower priced PJM grid within its service territory and blindly remain with the inferior NYPP serving its parent. Rockland's defenses fail in the first instance, simply because there is no evidence that it even researched PJMISO pricing until June of 2001. The conduct of O&R's electric purchasing department falls far short of reasonable or prudent for its small, out-of-state "stepchild". Rockland has said nothing in its Initial Brief that would counter the Ratepayer Advocate's previous recommendation to disallow $45,379,000 of the Deferred BGS Balance, including interest, on the basis of its imprudent BGS purchasing from at least the statutory opening date for retail competition, August 1, 1999. RAIB, p.22.

Rockland inaccurately refers to December 1997 as the time that the Ratepayer Advocate contends that Rockland should have completed its transfer to PJM. REIB, p. 45. In December 1997,

[3] "Transfer" in this case refers to Rockland "transferring" its transmission facilities to the PJMISO from the NYPP, later becoming the NYISO.

Rockland knew O&R was planning to divest itself of its generating plant. RAIB, p.25. The Ratepayer Advocate does state that Rockland should have been a member[4] of PJM by December 1997, and could have transferred to PJM that early. See *RECO-35*, p. 1. However, the Ratepayer Advocate calculated its proposed disallowance based on PJM energy prices starting with the advent of retail competition and the date that Rockland would be the Provider of Last Resort ("POLR") for BGS in New Jersey – August 1, 1999.

Rockland points to the fact that this Ratepayer Advocate disallowance conflicts with the Audit Report. REIB, p. 45. This self serving distraction does not bear scrutiny when viewed in connection with Rockland's scathing argument against the Auditor's proposed disallowance for its lack of long term parting contracts. Further, the Ratepayer Advocate addresses the difference between its conclusion regarding PJM and that of the Auditors in its Initial Brief. See RAIB, pp.36-39. The fatal flaw in the Auditors' analysis is the starting date for potential transfer to the PJMISO. *Id.* Interestingly, although Staff generally concurs with the Auditor's analysis of Rockland's transfer to PJM, they believe it could have been accomplished 6 months sooner than it was and recommend a $2.2 million disallowance. SIB, pp. 16-17.

A. Nature of the PJM Transfer.

In its Initial Brief, Rockland raises the process of amending the PSA as a purportedly substantial, necessary step in transferring its Eastern Division to PJM. REIB, p 46. The PSA was an agreement between Rockland, as the purchaser of power supply, and its parent, O&R. T30:L17-20 (2/19/03). Of course, amending the PSA so that Rockland could purchase on its own behalf was a necessary step, and it was accomplished without incident, once the decision to transfer to PJM had been made. T31:L14-17; Marino, p.10. No claim was made as to any difficulty in this intercorporate transaction until now. REIB, p. 46. In fact, this amendment could have been achieved at any time it was found to be necessary or prudent for Rockland. The fact that Rockland did not make the

[4] Membership in the PJMISO does not mean that a utility had to transfer its transmission lines to the PJMISO. However, a PJM membership did allow members to perform transactions on the PJMISO.

decision to amend the PSA until it became a necessary to participate in the Year 4 BGS Auction, has no effect on evaluating the timing of the transfer. *RECO -1*, p. 22. As stated by Mr. Marino, "there's really no point to modifying the power supply agreement prior to the time that the transfer was going to be approved and implemented." T67:L9-13 (2/19/03). Had Rockland made the prudent decision to transfer to PJM with the onset of competition or before, the PSA could and arguably would have been amended to accommodate Rockland's corporate decision.

Rockland also points out the obvious fact that until the transfer of the Eastern Division to PJM was pursued and completed, Rockland was economically limited to purchasing through New York due to "transmission constraints and other fees". REIB, p. 47. It was established that Rockland could not readily switch back and forth, purchasing energy for its Eastern Division simultaneously through PJM and the NYPP.[5] The Ratepayer Advocate has not suggested that Rockland could or should have been quickly switching between or simultaneously purchasing energy through PJM and the NYPP. Any statement regarding the fact that it was necessary for Rockland to first transfer to PJM prior to purchasing energy through the PJMISO for its Eastern Division has no bearing on when that decision was made and certainly cannot form the basis of an argument in support of Rockland's position. The fact is, Rockland (O&R) ultimately achieved all of the necessary steps to become a member of the PJMISO when it finally desired this membership for Rockland. Participation in the Year 4 BGS Auction evidently piqued O&R's corporate interest more than years of a mounting BGS deferral that was "recoverable"under EDECA.

B. PJM Pricing.

In its Initial Brief, Rockland repeatedly attempts to avert attention from the real issue at hand regarding PJM – was it reasonable for Rockland to wait until June 2001 to consider PJM and its pricing? In its prudence review, the Ratepayer Advocate investigated whether it is reasonable to expect the management of a New Jersey electric utility like Rockland, facing generation asset

[5] O&R purchased energy for Rockland in the New York Control Area through the New York Power Pool (NYPP) until November 1999, and then through its successor, the New York System Operator (NYISO).

divestiture and the onset of retail competition for its mostly residential customers, to study (or even notice) the potential pricing and reliability of the Independent System Operator commencing operation in its service territory. Rockland cannot and does not deny that PJM energy prices were, with few exceptions, substantially lower than energy prices through the NYISO from November 1999 through July 2002. This irrefutable information was calculated and provided by the Company to the Ratepayer Advocate. T184:L11-T185:L1 (2/28/03). There is also no disagreement as to when the NYISO commenced operation - November 1999. REIB, p. 48. Beginning in December of 1997, Rockland should have evaluated the potential utilization of the only existing ISO in its service territory, PJM. As discussed in the Ratepayer Advocate's Initial Brief, Rockland knew the goal of competition in New Jersey was to lower energy prices and it knew it was going to have to provide BGS service with no generation of its own, but did not consider the apparent options for its customers. Rockland ignores this sad testimonial to its (O&R's) management and instead discusses the price forecasting testimony submitted by other parties in its electric restructuring cases. REIB p.49.

It is true that Mr. Cotton testified in Rockland's stranded cost proceeding on behalf of the Ratepayer Advocate. It is also true that he utilized the market price estimates of another Ratepayer Advocate witness, Doug Smith, in his examination of divestiture as a means to minimize stranded costs. *Id.* The prices forecasted by Mr. Smith and adopted by Mr. Cotton turned out to be lower than the actual PJM prices, but since that is true, they also would have been that much lower than actual NYISO prices. Thus, the pricing forecasts that were provided do not bear on Rockland's lack of effective management decisions to evaluate price savings possibilities with PJM. The testimonies of Mr. Cotton and Mr. Smith are irrelevant to the management decisions that Rockland should have been making. Had Rockland presented the fact that it was directly connected to the PJMISO, and therefore, the PJMISO was an option to consider in the context of restructuring, testimony on that issue would be relevant.

As mentioned previously, Rockland did not provide any evidence to refute the fact that only the Company had knowledge of the long existing direct physical connection between Rockland and PJM during the relevant years when switching to PJM should have been thoroughly discussed and explored as a possibility. The only offering on this point is Rockland's gratuitous statement that it is interconnected with and has historically purchased capacity from PSE&G. REIB, p. 51. On the basis of this statement, one could not necessarily conclude that Rockland is directly connected to the PJMISO. Rockland jumps to the inference of a direct physical connection to PJM from its statement regarding a PSE&G interconnection, and provides no basis or explanation. In fact, Rockland could have no direct physical connection to the PJMISO and still have purchased power from PJMISO companies.

C. Rockland's Move to PJM.

Rockland boasts that it was an unprecedented move to transfer to PJM once it decided to do so in 2002. REIB, pp. 52-53. However, on further examination, it becomes clear that no other NJ EDC would try to transfer out of PJM when they were already a member of the best ISO in the country. Moreover, why would any of the New Jersey EDCs look into transferring outside of their service territory to a different ISO? It was Rockland who was not looking within its own New Jersey service territory and to the only viable ISO (PJM) at the time.

Rockland also claims that it studied the PJM transfer in a timely manner but the evidence in this proceeding does not support its conclusion. REIB, p.53. Rockland points to the fact that the NYISO did not commence operation until November 18, 1999 as somehow supporting its delay. It is precisely because the NYISO commenced operation so much later than the PJMISO that Rockland should have transferred to the PJMISO by no later than August 1, 1999. PJM launched its energy market April 1, 1997; by December 31, 1997, PJM membership increased from 8 to 100. *R-4*, Appendix E. Rockland offers no acceptable support for its *laissez faire* schedule, finally analyzing PJMISO prices in June 2001.

D. PJM Volatility in Summer 2000.

Had Rockland's management utilized the reasonable option - PJM - for divestiture and retail competition in New Jersey in August of 1999, the prices in PJM's market during the summer of 2000 would have been a slight and fleeting hardship in the context of overall savings of approximately $28 million dollars plus interest. There was price volatility in the PJM Capacity Market in the summer of 2000, however this is irrelevant to the prudence review of a BGS deferral that started August 1, 1999. REIB, p. 54. Moreover, the Ratepayer Advocate presented evidence that the NYISO had concerns for the actual and potential exercise of "market power" within its own market which underscored the need to look at alternatives. T188:L14-T189:L13 (2/28/03).

E. NYISO Reserve Margin.

The Ratepayer Advocate presented evidence that the NYPP's relatively smaller reserve margin presented yet another reason Rockland should have been pursuing a transfer to the PJMISO. *R-21*. In response, Rockland asserts that there "was no capacity shortage in the NYISO". REIB, p. 56. Not only is this response not on point, the evidence showed that the prevailing opinion during the 1997 time period was that the PJMISO was forecasted to have superior reserve margins, which would keep wholesale prices down when compared to the NYPP. The Ratepayer Advocate presented a publication from the North American Electric Reliability Council (NERC) that demonstrated relatively small reserves in the NYISO, especially when compared to PJM. *R-4*, 32. Rockland does not dispute the existence of the report or the facts stated therein. REIB, p. 56. The Ratepayer Advocate noted this as yet another unfavorable comparison of the NYPP(NYISO) to PJM and hence, another impetus to transfer. Rockland weakly countered with a later report on potential new "in-state capacity" for New York, much of which was never built. T171:L14-T172:L4 (2/28/03).

F. The TPSA/IESA and Hedging Costs Are Properly Disallowed.

The Company contends that the Ratepayer Advocate's disallowances for the TPSA/IESA and Rockland's hedging activities should be ignored because Mr. Cotton did not dissect them as to

exact terms or details. REIB, p.45. The Ratepayer Advocate's disallowance of these costs is not predicated on the terms of the TPSA/IESA, or the details of the hedging activities at issue. The Ratepayer Advocate has demonstrated above and throughout this proceeding that Rockland was imprudent in ignoring the PJM ISO, literally in its own backyard, as an option for significant savings in BGS expenses for its Eastern Division. Because of this imprudence, Rockland overspent on its costs for BGS from August 1, 1999 through March 2002.

Moreover, the uneconomical hedging expenses incurred by the Eastern Division during this period must also be disallowed because they would have been unnecessary within the prudent corporate action of a transfer to PJM. RAIB, p. 32. Additionally, if Rockland had made economic financial hedges after August 1, 1999 in the PJMISO, it may have further reduced its BGS costs. The costs associated with the TPSA and IESA contracts also would not have been necessary had the PJM transfer been effectuated by August 1, 1999. RAIB, p. 33. Rockland has presented no evidence that either the hedging or TPSA/IESA costs would have occurred absent Rockland's association with the NYPP during the time in question, thus they must be disallowed.

POINT II

THE COMPANY HAS NOT PROVIDED ANY COMPELLING REASON TO REJECT THE RATEPAYER ADVOCATE'S RECOMMENDED TEN-YEAR AMORTIZATION PROPOSAL.

In an oral ruling at its agenda meeting of March 20, 2002, the Board further clarified the issues to be decided in the instant case. Among the issues identified for determination in the instant proceeding was the proper rate treatment of the deferred balance.[6] For the reasons set forth in more detail below, and in its Initial Brief and witnesses testimony, the Ratepayer Advocate recommends that the 10-year amortization proposal set forth by Mr. Rothschild, and the resulting rates, should be adopted by Your Honor and the Board as the proper going-forward ratemaking treatment of the Company's deferred balance. *See* RAIB, pp. 56-64; *R-14*. As discussed more fully below, Rockland has not presented any convincing arguments to refute the Ratepayer Advocate's recommendation.

Board Staff largely agreed with the Ratepayer Advocate's position. SIB, pp. 34-38. Noting that the Company's four-year amortization proposal would "yield a near 25% rate increase," Board Staff shared the Ratepayer Advocate's concern about the impact of the large rate increase that would result if the Company's amortization proposal were adopted. SIB, p. 38. Board Staff agreed with the Ratepayer Advocate's recommendation to use a 10-year amortization period rather than the Company's proposed 4-year amortization period. *Id*., p. 38.

With respect to carrying charges, Board Staff rejected the Company's argument of using its overall rate of return. Both the Ratepayer Advocate and Board Staff agree that the Company's overall rate of return should not be used. As to carrying charges, Board Staff recommended using a one-year treasury bond rate, plus 30 basis points, rather than the 7-year treasury rate plus 60 basis

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[6] *See I/M/O PSE&G*, BPU Docket No. ER02050303; *I/M/O Atlantic City Electric Company, d/b/a Conectiv, JCP&L, PSE&G, and Rockland Electric Company* , BPU Docket Nos. ER02080510, ER02080507, ER02080604, and ER0208614 (Oral ruling, March 20, 2003). T2-3 (Item 1A-Audits, 3/20/03).

points recommended by the Ratepayer Advocate. Both rates are significantly lower than the Company's proposed overall rate of return.[7]

The Company's contention that the interest rate recommended by Ratepayer Advocate witness Mr. Rothschild is unsupported is without merit. REIB, p. 58-59. The interest rate recommended by Mr. Rothschild is consistent with what the Board allowed in the past. Mr. Rothschild recommended a rate based on a seven-year treasury rate, plus 60 basis points. *R-14*, p. 5. A seven-year fixed-rate of interest approximates the time that money is outstanding if the money is gradually recovered over 10 years. RAIB, p. 62; T181-182. The rate recommended by Mr. Rothschild is consistent with that established by the Board in its Order on Motion for Reconsideration, dated October 16, 2002.[8]

Contrary to the Company's argument, the interest rate recommended by Mr. Rothschild is not "artificially low." REIB, pp. 58-59. If the amortization proposal recommended by Mr. Rothschild is superceded by securitization before the expiration of the recommended 10-year amortization period (not unlike a bridge loan in concept), the rate recommended by Mr. Rothschild might, in fact, be set too high. Board Staff recommends a rate based on an even shorter period, a one-year treasury rate plus 30 basis points. SIB, p. 38.

In sum, the Ratepayer Advocate's recommended ten-year amortization proposal effectively addresses rate shock. In contrast, the four-year amortization proposal advocated by the Company would subject its ratepayers a rate increase of nearly 25%, as noted by Board Staff. SIB, p. 38. For all of the above reasons, and for the reasons set forth in the Ratepayer Advocate's Initial Brief and its witnesses testimony, the Ratepayer Advocate respectfully submits that Your Honor and the Board should adopt the ten-year amortization proposal recommended by the Ratepayer Advocate.

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[7] Board Staff conditioned its recommendations to apply only until the Board presumptively approves securitzation of the deferred balance. SIB, p. 38.

[8] *See I/M/O Rockland Electric Company*, BPU Docket Nos. EO97070464, EO97070465, and EO97070466 (Order on Motion for Reconsideration and/or Clarification dated October 16, 2002), pp. 4-5.

CONCLUSION

For all of the foregoing reasons, and the reasons stated in its Initial Brief, the Ratepayer Advocate respectfully requests that an Initial Decision be rendered recommending that the Board find and conclude that:

- A composite Federal/New Jersey tax rate of 40.85% is the appropriate tax rate for purposes of this proceeding;
- The Ratepayer's recommended adjustment (disallowance) of $325,428, plus interest of the BGS Auction/PJM Transfer Costs, should be adopted. R-6, JDC-1 through JDC-4;
- The Ratepayer Advocate's conclusion that RECO acted imprudently and should have transferred its Eastern Division from the NYISO to the PJMISO by August 1, 1999 should be adopted. See R-6, JDC-2, Pages 1 through 5 (shows monthly savings);
- The Ratepayer Advocate's recommended adjustment (disallowance) for the issue reducing the deferred balance reflecting the earlier transfer of the Eastern Division to PJM, in the amount of the adjustment is $28,345,000, plus interest. (See Exhibit R-6, JDC-2, Page 5 of 5, line 2);
- The Ratepayer Advocate's recommended adjustment (disallowance) for removal of Hedging for the Eastern Division, in the amount of$10,354,000, plus interest, should be adopted. (See Exhibit R-6, JDC-4, Page 5 of 5, line 3);
- The Ratepayer Advocate's recommended adjustment (disallowance) for CEP costs of $446,000, plus interest, should be adopted;
- The Ratepayer Advocate's recommendation to direct Rockland to use its $3.7 million in over-recovered NUG costs, collected through the ECA, to offset the BGS deferral, should be adopted;
- The Ratepayer Advocate's recommendation to prohibit Rockland from offsetting its over-recovered NUG costs with $1.6 million Temporary Excess Refund, and instead direct Rockland to add the $1.6 million to the Deferred Balance, should be adopted;
- The Ratepayer Advocate's recommendation to prohibit Rockland from offsetting its SBC under-collection with its over collected Deferred ECA Balance, should be adopted;
- The Ratepayer Advocate's recommended adjustment (disallowance) to eliminate the costs for the TPSA/IESA in the amount of $949,000, plus interest, should be adopted;
- Thus, the Deferred Balance adjustments recommended by the Ratepayer Advocate, resulting in a total disallowance of $38,775,428, plus interest, should be adopted;

In addition, as recommended by the Ratepayer Advocate:

- The deferred balance recovery period should be extended to ten years;

- The interest rate for the term of the recovery period should be set at the beginning of the recovery period using the seven-year treasury rate (set closest to August 1), plus sixty basis points, and remain constant for the entire amortization period;
- The amount upon which the interest accrual is based should be reduced to reflect the tax benefit associated with the underlying expenses; and
- The interest expense recovery revenue should not be grossed-up for taxes.

Respectfully submitted,

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