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**

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

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

Division of the Ratepayer Advocate
31 Clinton Street, 11th Floor
P.O. Box 46005
Newark, New Jersey 07101
(973) 648-2690 - Phone
(973) 624-1047 - Fax
www.rpa.state.nj.us
njratepayer@rpa.state.nj.us

Date: March 18, 2003

On the Brief:
Ami Morita, Esq., Deputy Ratepayer Advocate
Susan E. McClure, Esq., Asst. Deputy Ratepayer Advocate
Kurt S. Lewandowski, Esq., Asst. Deputy Ratepayer Advocate

TABLE OF CONTENTS

Page No.

TABLE OF AUTHORITIES

Cases **Page(s)**

Statutes

Reports

BACKGROUND AND PROCEDURAL HISTORY

With the release of the New Jersey Energy Master Plan Phase I Report ("Phase I Report) in March of 1995, the New Jersey Board of Public Utilities ("Board" or "BPU") outlined its vision for the state where a transition from traditional energy industry monopolies to a competitive market would help reduce the burden high energy prices place on the state's consumers.

In May 1995 the Federal Energy Regulatory Commission ("FERC") adopted rules that require electric utilities to provide all eligible wholesale suppliers with access to their electric transmission facilities.

On July 20, 1995, the Rate Flex and Alternative Regulation Act, P.L. 1995, c. 180 ("the Rate Flex Act") was signed into law. The Rate Flex Act instructed the Board to implement programs to promote the transition to a market-based competitive environment in the energy industries.

By Order dated June 1, 1995, the Board initiated a Phase II proceeding under Board Docket No. EX94120585 to: investigate the long-term structure of the electric power industry in the state towards developing an electric power industry policy to facilitate the emergence of a competitive marketplace; to facilitate the development of competition in areas where competitive services did not yet exist; and to continue to regulate the quality and price of energy supplies and services where effective competition did not exist, where consumers would be best served by continued regulation.

On April 30, 1997, the Board issued an Order Adopting and Releasing Final Report entitled, "Restructuring the Electric Power Industry in New Jersey: Findings and Recommendations" ("April 30, 1997 Order" and "Final Report," respectively). The Final Report cited the Legislature's stated desire to explore increased competition in energy markets as a more long term means to reduce the cost of electricity in New Jersey for all consumers, and recommended that electric consumers be given a choice of electric power suppliers beginning in October of 1998 through the unbundling of electricity services. The Board found that retail competition in New Jersey should be introduced approximately twelve months after the implementation of full wholesale competition, as provided by the FERC's Order 888. The Board's April 30, 1997 Order directed each of the state's four investor-owned electric utilities, including Rockland Electric Company ("Rockland" or "Company") to make three filings by July 15, 1997: a rate unbundling petition, a stranded costs petition, and a restructuring plan.

By Order dated June 25, 1997, the Board directed its Division of Audits and Division of Energy to initiate management audits on each of the four investor-owned electric utility companies in the State of New Jersey, pursuant to *N.J.S.A.* 48:2-16.4, by qualified consulting firms under the supervision of Board Staff, focusing on each utility's unbundling, stranded costs and restructuring filings. A Request for Proposal was issued on June 27, 1997, and the Board selected Stone & Webster Management Consultants, Inc. ("Stone & Webster") to perform the audit of Rockland's unbundling, stranded costs, and restructuring filings under BPU Docket No. EA97060398.

On July 15, 1997, Rockland made three separate filings with the Board, setting forth its rate unbundling, stranded costs, and restructuring proposals. *I/M/O Rockland Electric Company's Rate Unbundling, Stranded Costs, and Restructuring Filings,* BPU Docket Nos. EO97070464, EO97070465 and EO97070466 (collectively "Rockland Restructuring Proceeding").

In November of 1997, Rockland's corporate parent, Orange and Rockland Utilities, Inc. ("O&R") announced its intention to divest all of its fossil and hydroelectric generating facilities, and certain related assets. Rockland filed an amended and restated stranded costs petition on December 8, 1997, and amended and restated unbundled rates petition on January 30, 1998, to reflect the impact of its decision to divest.

By Order dated January 28, 1998, the Board established a procedural schedule to review certain generic restructuring issues, including the potential for exercise of market power by the state's electric utilities regarding their generation assets; functional separation plans; divestiture of generation assets; basic generation service plans, including the cost to provide service to low-income and bad-debt customers; the mechanics of the phase-in of retail competition; the customer enrollment process; load balancing and settlement system requirements for alternative supplier deliveries; and demand side management and renewable energy issues. The Board expressly retained the issue of the appropriate review and approval process for utility divestiture plans in its January 28, 1998 Order.

By Order dated March 26, 1998, the Board accepted the final Management Audit Reports of Stone & Webster as received, and released them to the parties.

On July 6, 1998, O&R and Consolidated Edison, Inc. ("CEI"), the corporate parent of Con Edison Company of New York ("ConEd"), filed a Joint Petition with the Board for approval of an Agreement and Plan of Merger and Transfer of Control, BPU Docket No. EM98070433, which the Board approved on April 1, 1999, subject to certain conditions.

On February 9, 1999, the Electric Discount and Energy Competition Act, *N.J.S.A.* 48:3-49, *et seq.* ("EDECA") was signed into law by Governor Whitman. EDECA required that by August 1, 1999, the Board order each of the state's electric utilities to: open 100% of their franchise areas to retail generation competition, *N.J.S.A.* 48:3-53.a; unbundled their rate schedules into discrete services and charges, *N.J.S.A.* 48:3-52.a; provide basic generation service ("BGS") at approved rates for customers who do not choose an alternate power supplier and provide approved "shopping credits" to be deducted from the bills of customers who choose an alternate power supplier, *N.J.S.A.* 48:3-52.b; reduce their aggregate rates for each customer class by "no less than five percent," *N.J.S.A.* 48:3-52.d(2); implement a Societal Benefits Charge ("SBC") to recover the cost of previously approved social, environmental and demand side management ("DSM") programs which were included in each utility's bundled rates, *N.J.S.A.* 48:3-60.a; and implement an approved Market Transition Charge ("MTC") to allow each utility to opportunity to recover an approved level of stranded costs as determined by the Board. *N.J.S.A.* 48:3-61.a, c, i and j.

On March 12, 1999, Rockland filed a Verified Petition in BPU Docket No. EM99030195 ("Divestiture Petition") seeking approval of the sale of all of O&R's electric generating facilities ("Generating Assets") to affiliates of Southern Energy, Inc. ("Southern"), pursuant to *N.J.S.A.* 48:3-7, the Board's June 16, 1998 Order Adopting Auction Standards in BPU Docket Nos. EX94120585Y *et al.*, and other applicable law. Rockland also requested approval of a Transition

Power Sales Agreement ("TPSA"), dated November 24, 1998, between O&R and Southern providing for O&R's purchase of installed electric generating capacity and energy to enable O&R and Rockland to meet their BGS requirements.

On June 24, 1999, the Board issued a Summary Order Including Protective Order. *See Petition of Rockland Electric Company for Approval of the Sale of Orange and Rockland Utilities, Inc.'s Generating Assets and Related Property, A Transition Power Sales Agreement, and a Protective Order*, BPU Docket No. EM99030195 (June 24, 1999) ("Divestiture Order"). In the Divestiture Order, the Board approved O&R's sale of the Generating Assets to Southern pursuant to the terms of the asset sales agreements, but deferred any determination regarding the prudency of the terms and conditions of the TPSA to Rockland's Restructuring Proceeding. The Board further ruled that the issues regarding the allocation of sale proceeds, costs, and taxes, and the proposed sharing of gains resulting from the sale between shareholders and customers, required further review, and should be addressed in Rockland's Restructuring Proceedings. O&R completed the sale of the Generating Assets to Southern on June 30, 1999: the TPSA has since expired.

In addition to the TPSA, on July 7, 1999, Rockland filed with the Board an Incremental Energy Sales Agreement ("IESA") dated June 14, 1999 between O&R and the Southern Energy Affiliates. Commencing on the closing of the divestiture on June 30, 1999, the IESA provided incremental electric energy in excess of the TPSA commitment in order to meet the system's native load requirements until the NYISO commenced commercial operation on November 18, 1999.

On July 28, 1999, the Board issued a Summary Order in Rockland's Restructuring Proceeding that adopted with modifications a Plan for Resolution of Proceedings ("Plan"), which was incorporated in a stipulation between Rockland and New Jersey Transit. *See I/M/O Rockland Electric Company's Rate Unbundling, Stranded Costs, and Restructuring Filings*, BPU Docket Nos. EO97070464, EO97070464 and EO97070466 ("Summary Order"). In the Summary Order, the Board approved the general definition of net divestiture proceeds from the Plan, but reserved judgment on the final determination of the net divestiture proceeds. Summary Order at 4. The

Summary Order approved the Plan's use of the customers' share of the estimated net gain from the divestiture to fund part of a temporary rate refund during the period January 1, 2001 through July 31, 2003 to meet the Board's requirement for an incremental 2% rate reduction effective January 1, 2001 and EDECA's requirement of a 10% reduction from 1997 rates for the period August 1, 2002 through July 31, 2003. Summary Order, pp. 2-3. The Board required Rockland to submit, within 15 days of the date of the Summary Order, a compliance filing with a proposed determination of net divestiture proceeds based on the actual results of the closing. On August 11, 1999, Rockland filed its compliance filing with the Board and served it on all parties to the Restructuring Proceeding. The compliance filing demonstrated that the sale resulted in an after-tax gain from the sale.

In the Summary Order, the Board also established Rockland's unbundled rates to be implemented over the period from August 1, 1999 through July 31, 2003 ("Transition Period"). During the Transition Period, the Board approved rate reductions mandated by Section 4.d.of EDECA (*N.J.S.A.* 48:3-52.d), including a 5% reduction on August 1, 1999, and a 10% reduction from April 30, 1997 rates during the period from August 1, 2002 through July 31, 2003. The Board also required "a further reduction of 2% from current rates." Summary Order, p. 2. This 2% reduction is part of a permanent reduction of $1 million in Rockland's Delivery rates. *Id.*

The Summary Order established all of Rockland's unbundled average rate components for each year of the Transition Period, including Delivery service (transmission and distribution), BGS/Shopping Credit, Energy Cost Adjustment ("ECA"), MTC, SBC, and Temporary Credit mechanism. See Summary Order, p. 6. Thus, the BGS rate Rockland charged its customers was fixed for each year of the Transition Period, notwithstanding any changes that occurred in the market cost of the power Rockland purchased to serve its BGS customers.

Section 9 of EDECA (*N.J.S.A.* 48:3-57) provides that electric utilities are entitled to recover, through their BGS charges, all reasonable and prudently incurred costs incurred in the provision of BGS. To the extent that the costs Rockland incurs to provide BGS exceed the recovery afforded by its regulated rates, the Board-approved Plan authorizes Rockland to defer recovery of the net excess amount ("Deferred Balance") in a deferred account known as the Restructuring Balancing account. Plan at ¶ 28.

During the Transition Period, the Plan also provides for the Deferral of under-recovered SBC balances and the difference between actual above-market Non-Utility Generator ("NUG") contract costs and ECA recoveries. Plan at ¶¶16 and 26.

The Summary Order further provides that the interest rate on any unamortized deferred balances in the Restructuring Balancing Account of up to $5 million shall be set at the cost of seven-year debt for Rockland, as adjusted periodically. Summary Order, p. 4. The interest rate on any deferred balances in excess of $5 million shall be 350 basis points higher than the cost of sever-year debt for Rockland. As discussed below, in the Final Order, the Board adjusted the interest rate on any deferred balances on a prospective basis.

By Order dated June 6, 2001, the Board directed Rockland and the other three electric distribution companies ("EDCs") to each file, by June 29, 2001, specific proposals to implement a Request for Proposal ("RFP") process for Year 4 of the Transition Period (*i.e.* August 1, 2002 through July 31, 2003). On June 29, 2001, the four EDCs filed a generic proposal, with individual company-specific addendums, recommending that the generation supply for BGS be secured by means of a simultaneous, multi-round, descending clock auction. By Order dated December 11, 2001 ("December 11 Order"), the Board approved the EDCs' proposed auction as being consistent with the requirements of EDECA. The Board also approved the deferral accounting and cost recovery process proposed in the EDCs' Company Specific Addenda.

By Joint Application ("Joint Application") to the FERC, Rockland and PJM[1] sought to effectuate a transfer from NYISO to PJM of that portion of Rockland's load which is directly

[1] 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.

connected with PJM (*i.e.*, Rockland's Eastern Division which comprises approximately 90% of Rockland's load, or about 400 MW).

The FERC approved the Joint Application by Order issued December 21, 2001 in Docket Nos. EC-02-7-000 and ER02-109-000. Although the actual transfer of Rockland's Eastern Division did not become effective until March 1, 2002, the FERC's approval of the transfer allowed Rockland to participate in the Year 4 BGS Auction as a member of PJM. Rockland's Central and Western Divisions continue to operate in the New York Control Area administered by the NYISO. Since March 1, 2002, Rockland has obtained approximately 90% of its energy from PJM and 10% from the NYISO.

On December 17, 2001, the FERC issued its order in Docket No. ER02-121-000 approving an amendment of the Power Supply Agreement between O&R and Rockland terminating Rockland's status as an all requirements customer of O&R and allowing Rockland to purchase on its own behalf some or all of its electricity requirements.

The Year 4 BGS Auction commenced on February 4, 2002 and concluded on February 13, 2002. By Order dated February 15, 2002, the Board certified the final results of the BGS auction in their entirety and approved the closing price for each EDC.

On July 22, 2002, the Board issued its Final Decision and Order in Rockland's Restructuring Proceeding. *See, I/M/O Rockland Electric Company's Rate Unbundling, Stranded Costs, and Restructuring Filings,* BPU Docket Nos. EO97070464, EO97070465, EO97070466 ("Final Order"). The Final Order modified the Summary Order by providing that upon the date of the Final Order (*i.e.*, July 22, 2002) "on a going forward basis, interest on under recovered balances should be booked at the interest rate on seven-year constant maturity treasuries, as shown in the Federal Reserve Statistical Release on or the closest to August 1st of each year, plus sixty basis points best reflecting the time period over which the balance of deferred costs will likely be financed." Final Order, p. 69. Lastly, the Final Order required interest to be accrued on a net of tax basis.

The Final Order required Rockland to submit an updated compliance filing regarding the determination of net divestiture proceeds. Final Order, p. 68. On August 13, 2002, Rockland submitted a compliance filing that updated its August 11, 1999 compliance filing.

The Final Order also required Rockland to file a petition with the Board, by no later than August 30, 2002, setting forth how it proposes to recover its deferred balances and establishing the level of its unbundled rate components other than Delivery effective August 1, 2003. Final Order, pp. 59, 65. The Board also addressed the contents of the required filing in *I/M/O Public Service Electric and Gas, et al.*, BPU Docket Nos. ER02050303, EO97070461, EO97070463, EM00040253, and ET01120830, Order Directing the Filing of Supplemental Testimony and Instituting Proceedings to Consider Audits of Utility Deferrals (July 22, 2002).

On July 29, 2002, the Board issued a Request for Proposal ("RFP") seeking an auditor/consultant to perform audits on the deferred balances of New Jersey's four electric companies, including Rockland. As a result of the RFP, Larkin & Associates ("Larkin") and Synapse Energy Economics, Inc. ("Synapse") were engaged to perform an audit of Rockland's transactions for the period of August 1, 1999 through July 31, 2003, to be conducted in two phases: (1) Phase I from August 1, 1999 through July 31, 2002; and (2) Phase II from August 1, 2002 through July 31, 2003.

On August 30, 2002, Rockland filed a petition with the Board, pursuant to the Board's July 22, 2002 Final Order, for authority to recover its deferred BGS costs, including interest ("BGS Deferral"), during the period from August 1, 1999 through July 31, 2003. ("Deferral Petition"). *RECO-1* The Deferral Petition also seeks to recover other deferred balances and to establish the level of certain components of Rockland's non-delivery rates effective August 1, 2003. In support of its deferred balance case, the Company filed the testimony of Frank P. Marino (*RECO-7*) (accounting and rate impacts), Joseph A. Holtman (*RECO-4*) (projection of future power prices; purchasing and hedging practices), and Terry L. Dittrich (*RECO-6*) (efforts to encourage customer choice and mitigate the BGS deferral). In addition to the Company, the parties to this proceeding are the Staff of the Board ("Staff") and the New Jersey Division of the Ratepayer Advocate ("Ratepayer Advocate").

By letter dated September 12, 2002, the Board transmitted this case to the Office of Administrative Law ("OAL") as a contested case. The case was assigned to the Honorable William Gural, Administrative Law Judge, t/a ("ALJ") for evidentiary hearings.

Rockland asked for a rehearing on the Final Order regarding interest rate calculations, which was granted in a Board Order decided on October 16, 2002 (the "October 16th Order"; *R-4*, Appendix B. The October 16th Order disallowed any retroactive adjustments to the interest rates found in the Summary Order, and effectively upheld the Final Order's use of the prospective interest rate comprised of the risk-free Treasury rate plus 60 basis points. In addition however, the October 16th Order upheld that interest was to be accrued on net-of-tax balances.

Rockland filed a Motion for *pro hac vice* Admission of John L. Carley on November 27, 2002. ALJ Gural approved the Motion by Order dated December 9, 2002.

On December 2, 2002, Jersey Central Power & Light Company ("JCP&L") filed a Motion to Participate with the Secretary of the Board. Rockland filed a letter on December 3, 2002 with ALJ Gural stating that the Company had no objection to JCP&L's request for participant status.

A prehearing conference was held at the OAL on December 3, 2002, and a prehearing order was entered on December 6, 2002. By letter dated December 12, 2002, the Ratepayer Advocate requested changes to the prehearing order. Also by letter motion dated December 12, 2002 to the Board Secretary, the Ratepayer Advocate requested, on behalf of all parties, that May 30, 2003 be reserved by the Board as a hearing date with respect to the Company's 12-month actuals, which will not be available until May 20, 2003. A revised prehearing order was entered on December 17, 2002.

On December 23, 2002, the Ratepayer Advocate filed an emergent letter motion seeking to compel Rockland to provide responses to all outstanding discovery. Rockland responded to the motion to compel by letter dated December 30, 2002. The Ratepayer Advocate filed a letter in further support of its motion on January 6, 2003. ALJ Gural granted the Ratepayer Advocate's Motion to Compel by Order dated January 14, 2003.

By letter dated January 17, 2003, the Board transmitted the redacted version of the Verification of Deferred Balances and Prudence Review Phase 1: August 1999 – July 2002 ("Audit Report"), prepared for the Board by Larkin and Synapse to the Clerk of the OAL for inclusion in the record. *S-8*. Subsequently, at the Board's open public meeting on January 23, 2003, the Board decided that the confidential Audit Report of the deferred balances of Rockland, along with Rockland's Motion for a Protective Order, should be transmitted to the OAL for consideration in the instant proceeding. The Board transmitted the confidential Audit Report to ALJ Gural on January 27, 2003.

The Ratepayer Advocate filed the Direct Testimony of James D. Cotton (*R-4*) (prudency) and James A. Rothschild (*R-14*) (securitization in connection with the deferred balance), on January 13, 2003. By letter dated February 4, 2003, the Ratepayer Advocate advised ALJ Gural and the parties to the proceeding that it would present Paul Chernick as an additional witness addressing the Audit Report. By letter dated February 10, 2003, Board Staff conditionally supported the inclusion of Mr. Chernick as a witness in this proceeding: counsel for Rockland opposed the inclusion. On February 14, 2003, ALJ Gural issued an Order denying the Ratepayer Advocate's request to introduce Mr. Chernick as a witness.

On February 17, 2003, the Ratepayer Advocate filed a motion with the Board Secretary seeking Emergent Relief, Interlocutory Review, and expedited treatment of a motion seeking reversal of the February 14, 2003 Order on Motion to Add a Witness. Rockland filed its opposition to the Ratepayer Advocate's motion with the Board Secretary on February 19, 2003. On February 27, 2003, the Board entered an Order granting the Ratepayer Advocate's Motion to Add a Witness, consistent with the Board's decision at its February 20, 2003 agenda meeting.

On January 31, 2003, Rockland filed the Rebuttal Testimony of Frank P. Marino (*RECO-8*), Joseph A. Holtman (*RECO-5*), Edward N. Krapels (*RECO-3*), and John E. Perkins (*RECO-9*).

Public hearings were held on February 10^{th} and March 19^{th}, 2003 at the Holiday Inn in Montvale. Evidentiary hearings took place on February 19^{th}, 21^{st}, 24^{th}, 27^{th} and 28^{th}, 2003 at the OAL in Newark.

STATEMENT OF THE CASE

Rockland is one of four New Jersey electric utilities. It provides retail service to approximately 70,000 customers in the Counties of Bergen and Passaic, and a small area in Northern Sussex County. Rockland's parent, O&R, is a New York utility that serves approximately 200,000 customers. Another subsidiary of O&R is Pike County Light & Power Company ("Pike"), which is in Pennsylvania and has approximately 4,000 customers. Rockland, O&R, and Pike were operated jointly as a single fully integrated electric system (the "O&R System") prior to March1, 2002, when Rockland began purchasing power from the PJM. O&R, Rockland's parent, and Con Edison Company of New York, Inc., are both subsidiaries of Consolidated Edison, Inc..

Pursuant to EDECA, retail choice for electric supply was started effective August 1, 1999, when all of Rockland's customers became eligible to select alternative generation suppliers. Currently, none of Rockland's customers take service from alternative suppliers.

Rockland traditionally received its power through FERC-approved power supply agreements ("PSA") with O&R and Pike. The PSA traditionally treated the O&R System, including O&R, as one system, and allocated a percentage of the system costs to each of the three utilities (Rockland, O&R and Pike) based upon their pro rata use of the system. However, effective March 1, 2002, the arrangement was "modified" when Rockland's Eastern Division was transferred from the New York Independent System Operator ("NYISO") to the PJMISO. Currently 90% of all of Rockland's power purchases are made from the PJMISO. 10% of Rockland did not transfer to PJM because it is not directly connected to the PJMISO.

The instant proceeding will result in Board determinations regarding: 1) Rockland's proposed recovery of its BGS Deferral and its other rate components, including levels of the ECA, the SBC, and the MTC, and 2) elimination of the Temporary Credit.

As a result of the Final Order, Rockland was permitted to defer the difference between the costs incurred to provide BGS, ECA and SBC services as well as the Restructuring Proceeding costs, and the amounts collected from ratepayers. These differences have been maintained since August

1999 by Rockland as deferred balances. 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, BPU Docket No. ER02100724.

The BGS component of the deferral is $100.5 million, or more than 100% of the total deferral, as there is an over-collection of the ECA. The purpose of the ECA is to recover Rockland's share of above-market NUG contract costs. Rockland has received over-collections of the ECA in the amount of $8.9 million. Rockland claims that this situation will turn around in Years 4 and 5 since the ECA rate was reduced effective August 1, 2002. Rockland proposes to use its over-recovered ECA of $8.9 million[2] to:

1) offset NUG costs through 12/31/08 of $3.7 million,
2) offset excess refunds of $1.6 million provided under the Temporary Credit, which will expire August 1, 2003,
3) offset unamortized Restructuring Proceeding costs of $1.9 million (see *RECO-2,* FPM-1, Page 3 of 6), and
4) partially offset by $1.6 million the Societal Benefits Charge ("SBC") under-collection of $2.9 million. *RECO-2*, FPM-1, Page 4 of 6

After applying the ECA credit, Rockland proposes to reset its SBC rate to recover in one year its deferral balance at July 31, 2003, plus its projected SBC costs through July 31, 2004. It proposes to maintain its ECA rate in effect for Year 4 without change, and use those revenues as an ongoing offset to future NUG costs.

There is also a Temporary Credit of $3,935,000 that is due to expire on August 1, 2003. This credit was designed to make rate reductions to customers, including: 1) Rockland's allocated portion of the divestiture gain of $1,420,000; and 2) a depreciation charge refund amounting to $851,000 to fund the credit. As noted in the Final Order, the difference between the Temporary Credit and the two sources of refunding are subject to deferred accounting and recovery or refund

[2] See *RECO-2*, FPM-1, p. 3 of 6.

in the future.[3] The total amount of refunds for the transition period is $3.935 million and therefore, the excess refunds amount to $1,664,000.

Rockland's updated filing claims a $96.4 million deferral as of July 31, 2003, including interest charges of $8.9 million, which is comprised of the following four components:

Basic Generation Service ("BGS")	$100.5 Million
Energy Cost Adjustment ("ECA")	(8.9)
Societal Benefits Charge ("SBC")	2.9
Restructuring Proceeding Costs	<u>1.9</u>
Total Net Deferral Balance	$96.4 Million
	=====

There are several operational, financial, and post transition period adjustments that result from the Ratepayer Advocate's analysis of the Company's position.

Rockland could have transferred its Eastern Division from the NYISO to the PJM years before it actually was transferred in March 2002. In fact, by August 1999 the PJMISO was fully operational, and had 130 members by then. During the transition period, Rockland incurred millions of dollars worth of charges it seeks to collect from its ratepayers as a result of not transferring its Eastern Division to the PJMISO by August 1999. A transfer to PJM by August 1999 results in a Gross Deferred Balance with Interest of $62,921,000. *R-6,* JDC-2, p. 1.

Had Rockland transferred to PJM by August 1999, the TPSA and IESA contracts would not have applied to the Eastern Division. The Gross Deferred Balance with Interest reduced by the costs for these contracts, amounts to $61,808,000. *R-6,* JDC-3, p. 1.

The Ratepayer Advocate has made adjustments to reflect the savings had Rockland joined PJM at the beginning of the transition period, discontinued the TPSA and IESA contracts for Rockland's Eastern Division, and discontinued to incur hedging costs for the Eastern Division, as shown by the Ratepayer Advocate to be the prudent approach that should have been taken by Rockland.

[3] Final Order, BPU Docket Nos. EO97070464, *et. al*., July 22, 2002, para. 1(c), p.64.

As a result of the above Ratepayer Advocate adjustments, the total Net Deferred Balance with Interest amounts to $32,406,000. *R-6*, JDC-4, p. 1 and T79 (2/19/03). The total Gross Deferred Balance with Interest amounts $52,477,000. *R-6*, JDC-4, p. 1 and *RECO-2*, FPM-1, p. 6 of 6.

The Company has included amounts for the BGS Auction/PJM Transfer Costs amounting to $1,143,000 for the twelve months ending 7/31/02. However, the Ratepayer Advocate reduced this amount by $325,428, because this amount, which was charged to BGS Auction/PJM Transfer Costs, should already be included in rates and was not an incremental expense to Rockland. *R-6*, JDC-1 through JDC-4.

The Ratepayer Advocate recommends the following adjustments:

- reduce the deferred balance associated with the Restructuring Proceeding costs by $1,747,000, plus interest, *RECO-2*, FPM-9;
- reduce the deferred balance associated with the PJM Transfer by $325,428, plus interest, *R-6*, JDC-1, p. 1 of 5;
- reduce the deferred balance to reflect the earlier transfer of the Eastern Division to the PJM in the amount of $28,345,000, plus interest, *R-6*, JDC-2, p. 5 of 5, line 2;
- reduce the deferred balance to reflect removal of TSPA and IESA for the Eastern Division, amounting to $949,000, plus interest, *R-6*, JDC-3, p. 5 of 5, Line 2, less JDC-2, p. 5 of 5, Line 2;
- reduce the deferred balance to reflect removal of costs for Hedging for the Eastern Division, in the amount of $10,354,000, plus interest. *R-6*, JDC-4, p. 5 of 5, line 3; and
- reduce the deferred balance to reflect removal of Consumer Education Program ("CEP") costs of $446,000, plus interest. *RECO-2*, FPM-4, p. 1.

In conclusion, based upon the Ratepayer Advocate's analysis, Your Honor and the Board should disallow $38,775,428 of the deferred balance, plus interest. See *RECO-2*, FPM-1, Page 6 of 6, less *R-6*, JDC-4, Page 1; T79:L24.

POINT I

OVERVIEW

The full recovery of the proposed deferred balance will have an unprecedented impact on the rates paid by the customers of the Company. The intent of EDECA was to lower rates and to provide better quality of service to energy consumers in New Jersey through competition. Just four years after the start of restructuring, the ratepayers of New Jersey are faced with little choice in competitive suppliers of electricity, a deferred balance of the four electric utilities over 1 billion dollars, and a rate impact that may be as high as a 25.6 % increase for Rockland's customers for four years, in addition to the rate case increases proposed. *RECO-2*, Schedule FPM-1, p.1. In sum, if the proposed deferred balance costs are fully recovered by the electric utilities, such corresponding rate increases will have a significant negative impact on New Jersey's economy and to New Jersey's utility customers.

It is always the duty of any utility to deliver safe, adequate and proper service at the lowest possible cost. Rockland actively ignored this obligation, and thus did not meet its burden to prove the prudence of certain decisions that led to a significant amount of its deferred balance. *R-4*. The Company has historically served a high concentration of residential customers and has encountered a very low customer switch rate to alternative TPS suppliers. *RECO-1*, p. 19. In fact, based upon the Board's most recent statistics, as of January 15, 2003, out of 3,187,879 residential electric customers throughout the state, only 1,836 have switched to third party energy suppliers. Out of the 1,836 customers served by third party suppliers, none are Rockland's customers. It will be shown in this brief that the Company knew that they would have to serve BGS customers and they knew that electric deregulation was pending, yet surprisingly the Company failed to adequately prepare itself for its obligation to serve its customers at fair and reasonable rates. As early as 1997, the Company had the opportunity to do the prudent thing -- to switch to the lower priced, more reliable PJMISO, but Rockland stubbornly clung to the NYISO to the detriment of its customers. Evidence obtained through discovery and cross examination of the Company's witnesses indicates that the issue of whether to join the PJMISO and leave the NYISO was not even thoroughly explored by the Company. Rockland's own internal document obtained through discovery shows that the PJMISO would have amounted to substantial savings. *R-4*, Appendix F.

POINT II

THE PROPER STANDARD FOR REVIEW OF THE PROPOSED RECOVERY OF THE DEFERRED BALANCE IS WHETHER THE COMPANY MET ITS BURDEN OF PROOF THAT THE COSTS WERE "REASONABLY AND PRUDENTLY" INCURRED.

The Board has broad and sweeping powers over all aspects of public utilities subject to its jurisdiction. *See N.J.S.A.* 48:2-13; *Township of Deptford v. Woodbury Town Sewerage Corporation*, 54 *N.J.* 418 (1969); *In re Public Service Electric and Gas Company*, 35 *N.J.* 358, 371 (1961). The Board is the regulatory agency with jurisdiction and control over electric public utilities, including jurisdiction to set rates. *N.J.S.A.* 48:2-21. It is established law in New Jersey that a public utility is required by statute to show that an increase in rates is just and reasonable. *Id.* The statute is clear that, "the burden of proof to show the increase, change or alteration is just and reasonable shall be upon the public utility making the same." *N.J.S.A.* 48:2-21(d). A long line of cases in New Jersey supports the premise that the burden of proving reasonableness of costs lies with the Company. In reviewing the prudency of costs to build the Hope Creek nuclear plant, the Board held that "[i]t is uncontroverted that Public Service had the burden of proving the reasonableness of its expenditures for Hope Creek as only reasonable costs can be included in rate base and permitted to earn a return." *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*"). See also, *Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 222 (1950).

EDECA and the Final Order specifically state that only "reasonable and prudently incurred costs" claimed by an electric public utility to provide BGS may be recovered. *N.J.S.A.* 48:3-57(e) and Final Order, p. 61-62. The burden of proof that the deferred balance claimed by the Company is just and reasonable lies with the Company, as supported by precedent in the State.

In evaluating whether the Company met its burden that it acted reasonably and prudently during the transition period, the Board must evaluate the managerial conduct in light of the circumstances, information and options in existence at the time when management decisions were made. Quoting the New York Public Service Commission ruling, the Board stated that:

> The Company's conduct should be judged by asking whether the conduct was reasonable at the time, under the circumstances considered that the company had to solve its problem prospectively rather than in reliance on hindsight. *In effect, our responsibility is to determine how reasonable people could have performed the tasks that confronted the Company. Hope Creek Order*, pp. 65-66 (emphasis added)

The *Hope Creek Order* further clarifies the Board's standard of review when determining prudency:

> [t]he Company, as discussed earlier in this Order, had the burden of proof with respect to the reasonableness of the costs that were expended in building the plant. In order to meet that burden with respect to the various enhancements, the Company had to show the reasons why each of the enhancements were installed and the benefits to be derived from their installation. An integral part of the benefits associated with the enhancement is a justification of the costs. *Id.* at. 89.

Thus, it is clear that the present deferred balance prudency review must apply the standards set forth in the *Hope Creek Order* and determine whether: 1) the Company's actions during the transition period met the reasonable person standard given the specific circumstances at the time decisions were made; and 2) the Company has sufficiently shown the reasons why each BGS cost was incurred and the benefits derived by the Company's actions. The following discussions will show that the Company failed to fully document its BGS procurement decisions and made imprudent decisions for a large portion of the Deferred Balance. Ultimately, the Board must determine whether the proposed recovery of the deferred balance is in the public interest.

POINT III

YOUR HONOR AND THE BOARD SHOULD FIND THAT ROCKLAND'S FAILURE TO MOVE TO THE PJMISO FROM THE NEW YORK POWER POOL WAS IMPRUDENT, THEREFORE, $45,379,000[4] OF THE DEFERRED BGS BALANCE SHOULD BE DENIED.

It is always the duty of any utility to deliver safe, adequate and proper service at the lowest possible cost. Rockland actively ignored this obligation and thus did not meet its burden to show it acted prudently when accruing a significant amount of its deferred balance. *R-4.* By virtue of its actions, Rockland failed the reasonably prudent utility test for several reasons: 1) the Company should have known that the pending competitive energy marketplace and its parent company's 1997 plans to divest its generation, the source of Rockland's electric supply, made the switch to the PJMISO the only prudent act under the circumstances; 2) the PJMISO was widely known to offer lower prices than the NYPP and the NYISO. In fact, from August 1999 until March 1, 2002, when Rockland finally transferred its load to the PJMISO, Rockland missed BGS savings of approximately $28,345,000, plus interest; 3) the PJMISO was not only the lower cost alternative, it has proven to be more reliable than NYISO; 4) the Company had ample opportunity and was physically connected to PJM, making a switch from NYPP relatively inexpensive; 5) if the Company switched to the PJMISO in a timely manner, the high cost TPSA and IESA contracts would have been unnecessary, saving the Company $949,000, plus interest. The hedging costs in the NYPP and NYISO of approximately $10,354,000, plus interest would not have occurred. The aggregate savings for hedging in the NYPP /NYISO and the TPSA and IESA contracts total $11,303,000, plus interest. *R-6*, JDC-3.

It is always the duty of any utility to deliver safe and adequate service at the lowest possible cost. It was up to Rockland to look after New Jersey ratepayers' interests and to make the transfer

---

[4] $45,379,000 is calculated by using the number for the total projected BGS balance as of July 31,2003 with allocated interest provided by Rockland, of $100,536,000. See *RECO-2,* FPM-1, page 6 of 6. The Ratepayer Advocate total BGS disallowance, including interest, of $ 55,157,000, is then subtracted. See *R-6*.

to the PJMISO very early after the establishment of the PJMISO. Rockland, on behalf of its New Jersey ratepayers, should have been testing the PJM market well before divesting its assets and prior to its parent, O&R, joining the NYISO. This should have been a warning signal to Rockland that, by the end of the transition period, Rockland would be applying for a huge rate increase unless some sort of mitigation efforts were used to reduce BGS costs. Rockland did not transfer its Eastern Division (90% of its load) to the lower priced PJMISO until March 1, 2002. *RECO-4,* p. 4.

A. O&R's Plans to Divest its Generation and the Pending Competitive Energy Marketplace Should Have Been Sufficient Impetus to Look Seriously into the PJMISO.

Rockland should have made all preparations to join the PJMISO well in advance of electricity wholesale competition in New Jersey. One of the first indications that the competitive electric market would arrive in New Jersey was the 1995 Flex Rate Act. This statute directed the Board to implement programs that promote a transition to a market-based, competitive environment in the energy industries. *N.J.S.A.* 48:2-21.28. Around the same time period, the genesis of this very proceeding started to take shape by the release of the New Jersey Energy Master Plan Phase I Report in March of 1995. In the summer of 1995, the Board commenced an investigation to consider opening up the electric retail market in the State to competition. In addition, the FERC adopted rules that require electric utilities to provide all eligible wholesale suppliers with access to their electric transmission facilities in May of 1995. *R-4*.

The April 1997 Final Report cites the Legislature's stated desire that increased competition in energy markets be explored as a long term means to reduce the cost of electricity in New Jersey for all customers. *R-4*. The Final Report envisioned that a power exchange would emerge as a result of the restructuring of the PJM power pool. Final Report, p. 66. The Final Report also envisioned a wholesale power market by October 1997 (see Page 69) and the commencement of retail competition in New Jersey by October 1998. Also in the Final Report was the Board's conclusion that the costs for those electricity services would be unbundled beginning in October 1998, approximately twelve months after the implementation of full wholesale competition, as provided by the FERC's Order 888.

Rockland knew in 1997 that O&R was going to divest itself of its generating plant, in part, in response to the restructuring in New York and New Jersey, shutting the Company off from its main source of electricity until the creation of the NYISO. The Company prepared and filed a Preliminary Divestiture Plan in 1997. *RECO-1*, p. 5. Therefore, the Company must have known that it would have to replace the source of its power supply in the near future. It certainly knew enough to think through the idea of entering a power supply agreement (the TPSA and IESA contracts) with Southern Energy. *Id*. Therefore, by virtue of knowing that the Company was divesting its generating assets, Rockland clearly understood years in advance that it would either have to buy power supply at the market or enter into a bilateral contract to purchase power.

These new laws and proceedings before the Board coupled with the loss of its parent's generation plants should have been a wake up call to any prudently run utility to investigate switching to the PJMISO. *R-4*. However, rather than participating fully in New Jersey's goal of electric competition, Rockland's progress was dilatory in New Jersey's Electric Restructuring. The Company initially wasted nearly two years, from January 1, 1998, when the PJMISO first became operational, to November 18, 1999, when the NYISO became operational, not taking advantage of the far superior market. *R-4*, Appendix E. The Company's decision making, under the circumstances and the information available at the time, falls far short of prudent.

B. PJM Electric Generation Prices Were Widely Known to Be Lower than Prices Available Through the NYPP and its Successor, the NYISO.

The reasonable and prudent New Jersey utility would have or should have been aware as early as 1997 that PJM would likely produce cheaper power than the NYPP. *R-21*. The Board noted, in its April 30, 1997 Final Report, that the 1994 rates in New York, particularly for residential customers, were 17% higher in New York than in New Jersey, 42% higher than in Pennsylvania, 52% higher than in Delaware, and 61% higher than in Maryland, indicating that New York had much higher costs of generation than in PJM states. Final Report, pp. 21-24. Despite the clear price differential between the PJMISO and NYISO, witnesses for the Company admitted that there were no inquiries into PJM pricing as compared to those in the NYPP prior to its preparations to participate in the Year 4 statewide BGS auction. *RECO-8*, p. 9; T180:L6 (2/28/03).

During the 1990's, PJM sold more energy to the NYPP than it purchased. *R-23*, *R-24*. A reasonable utility would have concluded at that time that fuel prices would tend to be lower in PJM than in the NYPP, since PJM is closer to the coal mines. *R-21*. The traditionally cheaper prices from coal fired plants in western Pennsylvania made PJM a much cheaper operation than the NYISO to any reasonably and prudently run New Jersey utility. There is more coal and nuclear capacity in PJM (33% and 23%, respectively) than in New York (14% of each). *R-21*. All New Jersey utility companies within the service area of the PJMISO, other than Rockland, were members of the PJMISO in 1997. The North American Electric Reliability Council ("NERC") issued a report in October 1997 showing that by 2006, capacity resources would be tight in New York's Region, particularly compared with PJM's Region. *R-4*.

In comparison to the PMJISO, the NYISO was much slower in developing. The NYISO did not launch its operations until November 1999. *R-4*. In addition, by December 31, 1999, the NYISO membership was only a little more than one-half of the PJMISO. *R-4*, Appendix E. And, most importantly, the prices at the NYISO were substantially greater than those at the PJMISO. PJM, on the other hand, was ordered by FERC to become an ISO in November 1996, and had received FERC approval by November 1997. *R-4*. The PJMISO also had as many members at year-end 1997 (100) as NYISO had at year-end 1999 (90). And finally, the PJMISO had lower average prices per kWh. See *RECO-4*, JAH-1, Page 1 of 4, compared with JAH-4, Page 3 of 4.

The slow developing NYISO did not fare well in the area of wholesale and retail prices either. The New York State Public Service Commission voiced its concern about NYISO's prices on December 14, 2000, when it released a special report, entitled, <u>Interim Pricing Report on New York State's Independent System Operator</u>. *R-4*. The following excerpt highlights the problems of the NYISO:

> The first year of operations of the competitive wholesale market has been marked by tight supply conditions. Very little new generation has been built in New York in the past decade. Furthermore, New York's economy is strong and demand for electricity is rising at a rate much higher than predicted in the most optimistic forecasts of a few years ago. Even with a well-established properly functioning marketplace, such an environment would be expected to yield high prices during peak load periods. Adding new generation, using energy more efficiently, and enhancing customers' ability to respond to price increases are the keys to lowering wholesale electric prices in the long run.

Until significant amounts of new generation can be built, current conditions could have large cost consequences if proper care is not taken. The potential exists for serious run-ups in prices caused by scarcity of resources, NYISO systems that do not yet work as intended, a marketplace that is not yet fully competitive, and market participants taking advantage of problems that have been identified but not yet fixed.

Moreover, the failure of Rockland's parent company, O&R, to hedge against NYISO's high prices started to be noticed by industry insiders such as the Public Utility Project of New York, Inc.:

> These prices became of major concern to all New York consumers during 2000. Instead of lower energy prices anticipated by the PSC (New York Public Service Commission) when it effectuated the NYISO, the NYISO established energy prices far in excess of those that would have existed under traditional ratemaking standards and procedures. While electric rates of most upstate utilities and the Long Island Power Authority (LIPA) remained stable, *utilities with automatic rate adjustment clauses (Consolidated Edison and Orange and Rockland Utilities) made large purchases of NYISO priced energy, and failed sufficiently to hedge against high prices in off-market transactions. This combination – automatic rate adjustment clauses and an uncritical reliance on the NYISO market – proved disastrous producing the "outrageous double-digit increases (for consumers) in New York City last summer" recently recognized by State policy makers.*[5] *R-4* (emphasis added).

The overwhelming publicly available information on price comparisons between PJM and the NYPP evince the fact that Rockland failed the *Hope Creek Order* standard at the time decisions were made. Under the *Hope Creek* standard, once it was realized that PJM became an ISO,

[5] *Comments of the Public Utility Law Project on the DPS Staff Interim Pricing Report on New York State's Independent System Operator*, Public Utility Law Project of New York, Inc., Jan. 5, 2001.

Rockland should have moved expeditiously to transfer to PJM. Rockland is a New Jersey utility and has therefore always served its customers within PJM service territory. Rockland should have been concerned regarding impending electric competition because of the high percentage of residential customers in its service territory. It was obvious to Rockland that competition in the Company's service territory was not thriving, and that Rockland would need to provide BGS service for most of its customers for some time going forward. A reasonable and prudent utility would have been actively searching for the lowest BGS prices, especially when those low prices were available to all other electric utility customers in New Jersey as early as January 1998, when the PJMISO commenced.

C. In Addition to Pricing Issues, the PJMISO Was Superior to NYISO in Reliability.

Following the implementation of the PJM Energy Market on April 1, 1997, which was established by the FERC in February of 1997 as the nation's first bid-based Energy Market, "PJM became one of the most liquid and active cash electric energy markets in the U.S."[6] During 1997, participants in PJM's power pool grew from just eight investor-owned public utilities at the outset to 100 members by year-end. The PJMISO members represented "virtually every segment of the modern electric power industry – investor-owned and municipal utilities, electric cooperatives, independent power producers, power marketers, and load aggregators."[7]

One of the most publicized of the PJMISO's accomplishments in 1999 was its handling of the heat wave that occurred in the eastern United States that summer, which culminated in an all-time peak demand for electricity on July 6, 1999. As a result of record-breaking temperatures, actual demand soared to "51,600 MW hours in the PJM control area, breaking the previous record of 49,406 MW hours set in July 1997."[8] By putting into play its Emergency Procedures, "the extraordinary demands for electricity were met without any rolling blackouts in the PJM

---

[6] *R-4*, p. 28.

[7] *Id*.

[8] *Id*.

transmission system..."[9] Also, "market response to PJM's transparent energy price signal contributed to stabilizing the situation when up to 5,000 MW hours of energy were sold into PJM's spot market by sources as far away as Florida, the Midwest and Canada...PJM also supplied emergency energy to the NYPP"[10] The PJMISO not only had sufficient power to supply itself, but also to supply emergency power to the NYPP. In addition to the pricing indicators from multiple sources discussed above, this highly publicized incident should have spurred Rockland to question why it was not in the PJMISO as opposed to the NYPP. New Jersey utilities not only have the obligation to its customers to provide the lowest possible prices, but also the obligation to maintain highest level of reliability. Faced with the option to go to a lower priced more reliable PJMISO, the Company imprudently decided to stay with the less reliable NYPP.

D. Rockland Had Both the Motive and the Opportunity to Move to the PJMISO but Failed to Do So.

As stated earlier, the PJMISO was clearly the lower cost alternative to the NYISO. Furthermore, it has been proven that the PJMISO's reliability was far more certain than the struggling NYISO's. In addition, it is important to point out that Rockland's Eastern Division was already physically connected to PJM. Therefore, the Company could have easily switched to the PJMISO with minimal cost and effort. However, the Company's own witnesses admitted that there were no meetings or filings with the Board where it was specifically and plainly stated that it's Eastern Division was, with certain modifications "connected" to PJM, or had a possible connection to PJM. *R-4*, pp. 90-91. This is further evidence that the Company was either not interested or totally unaware of the benefits of moving to PJM.

Rockland has claimed that transferring to the PJMISO was prohibitive because of the high cost of such a transfer. *RECO-4*, p. 17. When Rockland finally transferred its Eastern Division, it actually incurred transfer costs and BGS Auction costs of $1,143,000 as shown at FPM-2, Page 4

---

9 *Id*.

10 *Id*.

of 5. As discussed later in this brief, of this amount, $325,428 were "internal" costs amounting to labor and overhead of employees. Therefore, the incremental cost of the transfer was at most, $818,000. The Company cannot support its claim that the transfer to PJM had significant attendant costs. In addition, there are costs of the BGS Auction included in this amount. In Year 4, the costs of the Auction (at Exhibit FPM-2, Page 4 of 5), appear to be at least $150,000. Therefore, the actual incremental cost of the transfer to the PJMISO that can be proven is as little as $668,000. This is a very small price to pay for estimated savings that amount to $28 million over a 2 ½ year period, not to mention the possible savings going forward. It is also important to point out that approximately two years later, Rockland did spend the money to join the PJMISO so that it could participate in the Year 4 Auction in New Jersey. Therefore, no real barrier to entry existed that prevented Rockland from joining PJM.

E. The Company Failed to Embrace the Pending Competitive Market and Failed to Make Choices That a Prudent New Jersey Utility in the Same Position Would Have Made.

It is questionable whether Rockland would have ever participated in wholesale competition through a power exchange had the NYISO not emerged. Therefore, Rockland should have seriously considered the perfect hedging tool – PJM. *R-4*. From 1995 to 1999, New Jersey's other major electric utilities were moving swiftly to competition, implementing new EDI communication technology and taking other steps as well. During this time, Rockland was "passively" waiting for the NYISO to emerge (which finally happened in late 1999). As stated earlier, this attitude wasted precious time that could have been used to decrease the BGS deferral. Although Rockland claims to have been devoted to competition, they admit they never investigated joining PJM during this time. T179:L21-24; T180:L17-20 (2/28/03). Rockland only joined the PJMISO because there was pressure on it to participate in New Jersey's Year 4 Auction. *RECO-7*, p. 9; T183:L3-5 (2/28/03).

Even though Rockland is and has been a New Jersey utility, it was run as a New York utility with divisions in New Jersey. Its New York management seemed more focused on New York energy markets and trends than the events affecting New Jersey. *R-4*, Appendix D. The Company made no timely efforts to evaluate the benefits of a transfer from the NYPP to PJM. Rockland was asked to "…provide any and all materials, including but not limited to, notes, reports, studies, or analyses, prepared by or for Company management discussing the costs/benefits of transferring the Eastern Division to PJM." Rockland responded with one study that was prepared by Rockland in June 2001 evaluating the economic impact of a transfer. *R-4*, Appendix D. The study revealed significant energy price savings as a result of a transfer to PJM. *Id*, p. 2.

Rockland has no employees of its own. T16:L9-16 (2/19/03). Rockland's has no management of its own; it merely is allocated a cost of O&R's Management, which is in turn, allocated the costs of Con Edison's Management. T18:L15-24. Rockland is a small operation in one of the world's largest utilities. As stated by the Company witness Mr. Holtman, when Con Ed bought power or hedging instruments in New York, it did not differentiate Rockland and the possibility of Rockland buying power through PJM. T179:L21-24 (2/28/03). All power was purchased through the NYISO for the Con Ed system as a whole. T15:L1-8 (2/19/03). All financial hedging was done on behalf of the Con Ed system as a whole. T180:L11-21 (2/28/03).

F. Rockland Failed to Properly Plan for Energy Purchases in the Face of O&R's Imminent Divestiture of its Generation Plants.

As the Ratepayer Advocate has shown, Rockland made an imprudent decision by remaining in the NYPP. However, in addition to the previously discussed exorbitant energy costs incurred, Rockland also incurred significant financial hedging costs waiting for and receiving energy through the NYISO. The Company's own data reveals that large financial hedging costs were incurred for both the twelve months ended July 31, 2001 and July 31, 2002. *RECO-7*, Schedule FPM-2, p.1. During this time period, Rockland was not part of the PJMISO and all hedging costs were related to its myopic New York only association. The Company has not incurred any financial hedging costs for its Eastern Division since the transfer of that Division to the PJMISO in March 2002. *R-4*, p. 38. In contrast, financial hedging costs have continued in the NYISO for Rockland's remaining divisions. Id. Had Rockland transferred the Eastern Division to the PJMISO it would not have been a participant in the hedging options associated with the NYISO. *Id.* The Ratepayer Advocate has calculated that, had the Eastern Division transferred to the PJMISO in August 1999, Rockland would have saved a total of $10,354,000, plus interest in hedging expenses. *R-6*, JDC-4, p. 5.

Rockland's Eastern Division also incurred hedging and bridging costs through the TPSA and IESA that were unnecessary within the framework of a transfer to the PJMISO in August 1999. As discussed previously, the TPSA between O&R and Southern was approved by the Board in the Divestiture Order to facilitate the sale of the Generating Assets. *R-4*, p. 10. The TPSA provided for O&R's purchase of installed electric generating capacity and energy to enable O&R and Rockland to meet their BGS requirements. *RECO-1*, p. 9. The TPSA was explained by Company witness Mr. Holtman as a "hedge on prices". T178:L115-16 (2/28/03). The TPSA hedge, by its terms, was only applicable in the NYISO. The IESA, between Rockland and three affiliates of Southern, was designed to provide incremental electric energy in excess of the TPSA commitment and certain ancillary services for June 30, 1999 until the commercial operation of the NYISO or May 1, 2000, whichever occurred earlier. Rockland witness Mr. Holtman agreed that the IESA was a way to bridge the time gap between the divestiture of its assets and operation of the NYISO. T178:L13 (2/28/03). Thus, because the PJMISO was already operational, the IESA would not have been necessary for the Eastern Division from August 1999 until its termination. The amount of the adjustment calculated by the Ratepayer Advocate to the deferred balance for the TPSA and IESA is $949,000, plus interest. *R-6*, JDC-3, Page 5. The total Ratepayer Advocate adjustment for hedging costs and the TPSA and IESA amounts to $11,303,000, plus interest.

POINT IV

COMMENTS ON THE STAFF AUDIT REPORT

A. Once the Imprudent Decision Was Made to Stay in the NYISO, the Company Continued to Have the Obligation to Mitigate the High Cost of NYISO Prices with Reasonable Parting Contracts.

The Rockland Electric Audit Report, like the Ratepayer Advocate testimony, covers several prudence issues including: 1) whether Rockland made reasonable decisions about the amount of spot market power to purchase and about how much power to purchase at fixed prices under longer-term contracts; 2) whether Rockland entered into power contracts at the right time and for the right duration; and 3) why Rockland didn't lock into a three-year contract at guaranteed BGS price levels as PSE&G did. *S-8*, p. 30.

In investigating these questions, the Auditors reviewed many of the same points examined by the Ratepayer Advocate. They point to the fact that O&R was one of the earliest utilities to divest its generation assets in New York and that their assets were sold to Southern Company Affiliates, which, became Mirant Corporation. The Auditors also agree that it was incumbent upon Rockland to find a prudent alternative, since the divested assets had previously provided most of O&R's power. *S-8*, p. 30.

Rockland's (and O&R's) next step was to enter into a TPSA and an IESA, which were short-duration parting contracts. As pointed out by the Auditors and the Ratepayer Advocate witness, the IESA expired when the NYISO market commenced operations on November 18, 1999, and the TPSA was phased-out by October 31, 2000. The Auditors contend that the decision to enter these short-term parting contracts was O&R's and led to Rockland's undoing. When the contracts expired, O&R (and Rockland) were left to the mercy of the NYISO market. *S-8*, p. 32.

The Auditors point out at Page 32 of their Report that the Company faced "great uncertainties" in 1998 and 1999 concerning the transition to the NYISO market- which did not commence operations on 11/19/99. Major points by the Auditors are that there were no reliable indications of NYISO prices prior to 11/19/99 and even after the commencement of NYISO operations, even "Con Edison viewed this as an immature market." *S-8*, p. 32. It was also not clear what portion of the load would migrate under retail access. An interview with Rockland witness Mr. Holtman cites Mr. Holtman's position as describing the energy market as extremely volatile. *S-8*, p. 33.

The Auditors point out:

> Unfortunately, the Company's response to this market and price uncertainty was to adopt a strategy whereby it would have to rely on these unproven and illiquid markets for nearly all of its energy requirements starting in April 2000 (a mere five months after the scheduled opening of the NYISO in November 1999) and nearly all of its capacity requirements starting in November 2000. Their near total reliance was imprudence.

S-8, p. 33. We agree with the Auditors. All evidence points to imprudence with regard to O&R. After divesting its assets, O&R had no options other than the NYISO market as a source for its power supply for ratepayers for the next four years or more. The Auditors claim that O&R (Rockland) should have had longer-term, two to four year TPSA (or parting contracts). In contrast, the Ratepayer Advocate contends that Rockland, having the unique opportunity to be in the much more established, much less expensive the PJMISO as early as 1998, should have made its early transfer to the PJMISO, albeit leaving its parent company and a small portion (10%) of its service territory behind.

The Auditors' alternative would have had O&R negotiate a two to four year parting contract with Southern Affiliates, the purchaser of O&R's divested assets. The Auditors give many examples of utilities that were able to negotiate these types of parting contracts upon divesting their assets. The Auditors also believe that O&R (Rockland) had a desire to maximize their 25% share of the portion of the gain (in NY and NJ) and therefore may have sought a higher divestiture sales price for the assets, rather than look to contracts for longer parting contracts. *S-8*, p. 40. The position of the Auditors has some merit when it concludes that Rockland was imprudent in not finding reasonable power supply alternatives rather than simply exposing itself and its customers to high NYISO prices and the volatility of the immature NYISO power market. Whether O&R could have negotiated better parting contracts may never be known, but it would have been a more attractive alternative to O&R and Rockland than leaving itself totally exposed to the untested marketplace of the NYISO, depending solely upon financial hedging devices as backup. Once the unsound decision was made to stay in NYISO, Rockland continued to have the burden of making prudent decisions within the NYISO market. As the Auditors correctly conclude, even within the limited confines of the NYISO, Rockland failed to act prudently.

B. The Conclusion in Staff's Audit Report That the Company Did Not Act Imprudently by Staying in NYISO Was Based on Flawed Assumptions.

The Auditors' Report also considers the question of why Rockland did not join the PJM system earlier. In other words, the question is whether the transfer to the PJMISO was imprudently delayed. In trying to answer this question, the Auditors claim to have developed a "detailed chronology of the events that lead up to the transfer." Unfortunately, the chronology is fatally flawed because the starting date of the chronology commences with the starting date of the NYISO, not the starting date of when the transfer to the PJMISO first presents itself in 1997 – almost two years before the analysis included in the Staff Audit. *S-8*, p. 47

This chronology is in stark contrast with Appendix "E" of Ratepayer Advocate witness Mr. Cotton's testimony. *R-4*. Appendix "E" properly acknowledges PJM Transfer Timeline as beginning with the date of November 13, 1996, when PJM was ordered by FERC to become an ISO. It then goes forward to April 1, 1997 when PJM Energy Markets were launched – a full 2-½ years before the NYISO operations were launched. It is of course no coincidence that the opportunities provided by the PJMISO track the evolution of competition in New Jersey. Rockland is a New Jersey utility, serving some 70,000 New Jersey customers. New Jersey and Pennsylvania were the driving force behind the PJMISO. Even the Audit had to insert the following historical statement under its chronology, which began at 11/18/99:

> The Pennsylvania-New Jersey-Maryland Interconnection (PJM), meanwhile, had been operating a real-time market since 1997. PJM added a day-ahead market on June 1,2000. It also operates a UCAP market. Both NYISO and PJM administer ancillary services markets for such services as black start capability and voltage support.

S-8, p. 47. The Auditors acknowledge that they considered setting the starting date of their chronology before the start-up of the NYISO, based on the history of lower electricity costs in PJM compared with the NYPP, but did not. *S-8*, p. 53. Instead, the Auditors simply agreed with the Company that it would be demanding too much of O&R and of Con Ed's Supply Department to find with "reasonable certainty" that the NYISO markets would have had higher prices than the PJMISO. The Ratepayer Advocate disagrees with this conclusion of the Audit.

The Auditors appear to accept Rockland's claim that volatility in PJM's capacity market in the summer of 2000 was an excuse or justification for its failure to consider transferring the Eastern Division until the fall of 2000. *S-8*, p. 48. The Auditors erroneously conclude that "[d]uring the Summer 2000 period PJM (UCAP) prices exhibited major volatility, with UCAP prices being as high as $9.30/kW-month. In contrast, the NYISO installed capacity prices were approximately $1.50/kW-month during the same period." *Id.* This statement is misleading in three respects. First, the period in question is several months after the NYISO market became market-based, and hence after the transfer should have occurred. Second, the high PJM capacity prices Rockland referred to applied to only a very limited category of capacity purchases. They applied only for purchases made in June for July and August, and in purchases in July for August. At the time, market participants knew that the run-up in capacity prices was transitory; even in June and July, prices for September–December were in the $1.50/kW-year range. Third, of all the July capacity purchased by all market participants in the PJM auction, only a small fraction was purchased in June; similarly, only a small part of the August capacity was purchased in June and July. The vast majority of the capacity purchased in PJM was purchased in daily auctions, or in multiple-month auctions, which averaged out to less than half the $9.30/kW-month price, which applied to only 1% of the capacity transactions for August 2000. *R-21*.

Rockland witness Mr. Holtman, on rebuttal, argues that his hand-picked "high capacity" prices should be used for the comparison between PJM and NYISO costs, rather than the average capacity prices presented by Ratepayer Advocate witness, Mr. Cotton. The high prices represent the highest priced or worst monthly auction for each month, ignoring the lower-cost monthly auctions, the multi-month auctions, and the daily auctions. *R-21*. This computation implicitly assumes that Rockland would have purchased capacity for each month at exactly the worst time. *Id*. This is an unreasonable assumption. Rockland has only one other claim regarding high capacity prices. Mr. Holtman argues that the transfer of Rockland's Eastern Division to PJM would have increased the market price of capacity to the level of his high capacity prices. The Company has provided no information to support this assertion. Indeed, the evidence shows that capacity prices did not noticeably rise when Rockland joined the PJMISO. T187:L34 (2/28/03). Therefore, it is unreasonable to assume that PJM capacity costs would have skyrocketed had Rockland joined the PJMISO sooner.

The greatest imprudence in this case was that O&R failed to transfer 90% of its New Jersey operations to PJM and the PJMISO well prior to August 1999. To have ignored this opportunity for itself and its New Jersey customers was to deny Rockland's existence as a New Jersey utility and simply claim that O&R was a New York integrated utility, limited to buying its power needs in New York. As mentioned by Ratepayer Advocate witness Mr. Cotton on cross-examination, Rockland never mentioned in a single document that it was not only a member of the NYISO, but that it was connected to the PJMISO and could therefore transfer to the PJMISO. T91:L21-25.

Therefore, in summary, the Ratepayer Advocate does not agree with the Auditors' assessment that Rockland transferred to the PJMISO in a timely way. It was totally imprudent as early as 1997 for Rockland not to attempt to transfer 90% of its operations to the PJMISO and to become one of the first 100 members of the PJMISO by December 31, 1997. That transfer would have saved over $40 million in deferred charges.

On the same topic, as pointed out by Ratepayer Advocate witness Mr. Cotton, a transfer by August 1999 would have also meant that there would be no need to negotiate special parting contracts for 90% of Rockland's service territory, and there would be no specific need for hedging

90% of Rockland's load at the NYISO. *R-4*, p. 35. An earlier transfer to the PJMISO would have made these enormous deferred balance issues practically moot.

POINT V

POST TRANSITION PERIOD ADJUSTMENTS

A. Your Honor and the Board Should Order Rockland to Use its $3.7 Million Over-Recovered NUG Costs, Collected Through the ECA to Offset the BGS Deferral - Not as an Offset of its *Estimated Future* NUG Costs.

The BGS component of Rockland's deferral is actually more than 100% of the total deferral, due to the over-collection of the ECA. The ECA or "energy cost adjustment's" purpose is to recover Rockland's above-market NUG contract costs. In this particular case, during the transition period, the ECA revenues exceeded the ECA costs, resulting in an over-collection of above-market NUG costs amounting to $8.9 million. See *RECO-2*, FPM-1, Page 3 of 6. Rockland believes however, that this favorable balance will begin to "turn-around" in Year 4 due to a rate decrease, and will actually become unfavorable over the next five years. Therefore, Rockland proposes to offset its forecasted unfavorable ECA balances with current ECA favorable balances of $3.7 million.

The premise of the Company's proposal is that the prices of the NUG costs are predictable. However, these prices, which are set at the average market price, vary with the market from month to month. Therefore, as predictable as these monthly prices may seem over the next five years, they are still uncertain. The Ratepayer Advocate is opposed to the Company's proposal to offset the over-recovery by future speculative under-recoveries. Rockland has not met its burden of proving that these under-recoveries will occur. Moreover, Mr. Marino stated that the above market NUG costs are not a component of BGS costs. T45:L19-20 (2/19/03). In addition to the speculative nature of any under-recovery, it is inappropriate to offset BGS costs with unrelated over-recoveries. Finally, by offsetting a current over-collection from ratepayers with five years of estimated future costs, the ratepayers receive no interest on their over-collected ECA for the next five years. This results in an inequity to ratepayers and should be denied. The Ratepayer Advocate disagrees with the Company's flawed assumptions and respectfully request that Your Honor and the Board not allow the Company to offset the ECA over-recovered balance of $8,991,000 (see *RECO-2*, FPM-1, Page 3 of 6) with estimated under-recovered above market NUG Costs between 8/1/03 through 12/31/08 of $3,663,000.

B. Rockland Should Add its $1.6 Million Temporary Credit Excess Refund to the Deferred Balance and Be Prohibited from an Offset with Over-Recovered NUG Costs.

The Temporary Credit Excess Refund, scheduled to expire on July 31, 2003, was designed to fully refund to customers two items: 1) the ratepayer share of Divestiture Gains of $1,420,000, and 2) certain refunds amounting to $851,000 which are due to changes in depreciation rates or credits due ratepayers as a result of Rockland's Final Order. Final Order, p. 71. Both of these credits amount to $2,271,000. However, it appears that Rockland will have refunded too much to ratepayers by the end of the transition period, or July 2003. The amounts actually refunded by Rockland during the transition period will amount to $3,935,000 (see *RECO-2*, FPM-1, Page 3 of 6), or $1,664,000 greater than the ratepayers were entitled to receive. Therefore, the $1.664 million must be collected elsewhere. The Company's proposal is to use some of the over-recovered NUG costs to offset the excess refunds.

It is inappropriate to add an additional burden on the customers because of the Company's accounting errors. Rockland's ratepayers are now potentially facing a 25.6 % rate increase in addition to any increase due to the base rate case. Therefore, the $1.6 million temporary credit excess refund should be added to the total deferred balance and amortized as suggested by Mr. Rothschild. *R-6,* JDC-1 through JDC-4, Page 1.

C. Rockland Should Not Be Allowed to Offset its SBC Under-Collection with its Over-Collected Deferred ECA Balance.

In its petition, Rockland proposes to offset the deferred ECA balance at July 31, 2003 of $8.9 million, with the SBC under-collection at July 31, 2003 in the amount of $1,739,000. *RECO-2*, FPM-1, pp. 3 and 4. In this proposal, the Company is not distinguishing between the deferred amounts that relate in some way to its acquisition of supply for BGS service and its other deferred costs. EDECA and its subsequent amendment provide options for recovery of certain BGS-related deferrals that may not be available for SBC costs. For example, certain costs associated with the BGS deferral would be eligible for securitization while SBC costs would not be eligible. Therefore, it is appropriate to evaluate SBC deferrals separately from other deferrals in determining an appropriate recovery or refund mechanism.

POINT VI

CONSUMER EDUCATION PROGRAM ("CEP") COSTS INCURRED BY UTILITIES IN YEARS 1, 2 AND 3 ARE NOT RECOVERABLE THROUGH THE SOCIETAL BENEFITS CHARGE BECAUSE THE UTILITIES HAVE FAILED TO MEET THE "REASONABLE AND PRUDENT" STANDARD FOR THESE COSTS.

A. Background of the Consumer Education Program ("CEP").

By Order dated September 22, 1998[11], the Board established a consumer education program to educate consumers on the impending changes that would result from deregulation of the electric and gas markets pursuant to EDECA. The Board was required to establish a multi-lingual electric and gas consumer education program, with the goal of educating residential, small business, and special needs consumers concerning restructuring of the electric power and gas industries. *See N.J.S.A.* 48:3-85(d).

The Board, by Order dated May 29, 1998, created the Utility Education Committee ("UEC"), which represented the interests of the electric and gas utilities, and the Energy Education Council ("EEC"), which represented the interests of consumers.[12] The Board gave the UEC responsibility for developing and implementing the statewide consumer education program. The EEC was given a minor "consulting" role, but the ultimate decision-making power was left with the UEC. By Order dated August 11, 1999, the Board retained the Center for Research & Public Policy of Hartford, Connecticut ("Center") to advise the Board and to research the level of consumer awareness of energy deregulation and restructuring. The Center was required to present its findings on the effectiveness of the statewide CEP and also make recommendations for improvements to the Board.

[11] *I/M/O the Energy Master Plan Phase II Proceeding to Investigate the Future Structure of the Electric Power Industry,* BPU Docket No. EX94120585Y, Order on Consumer Education, (September 22, 1998). ("September 22, 1998 Order").

[12] The Ratepayer Advocate was a participating member of the EEC.

By Order dated October 15, 1999, the Board adopted performance standards and benchmarks that were called "Measures of Success," which were subject to review and refinement as necessary to assess the success of the CEP. These actions were consistent with *N.J.S.A*. 48:3-85(d), which requires the Board to "promulgate standards for the recovery of consumer education program costs from customers which *include* reasonable measures and criteria to judge the success of the program enhancing customer understanding of retail choice." (*emphasis added*). Subsequently, the June 23, 2000 Order established filing procedures for utilities that were planning to file for CEP cost recovery. The Board relied on their previous ruling in the restructuring proceedings, which stated that CEP costs would be recovered through the SBC. The CEP cost recovery filings would be accompanied by public notice and a public hearing in compliance with *N.J.S.A.* 48:2-32.2 and *N.J.S.A.* 48:2-32.4. The Board further recognized that evidentiary hearings would be needed to assess the reasonableness and prudence of the cost levels incurred to achieve the Board approved Measures of Success. *See* June 23, 2000 Order at 3.

Since the implementation of the CEP, the electric and gas utilities have been deferring costs for both the statewide and local CEP campaigns. Winning Strategies, the UEC's consultant, billed the utilities for the statewide program based on its determination as to the appropriate allocation between electric and gas utilities generally, and then, by utility, based on the utilities' number of customers. *Id.* Each utility paid for its own local campaign.

B. The Company Did Not Demonstrate Compliance With the "Reasonable and Prudent" Standard For Years 1, 2, and 3.

The Company is seeking recovery of CEP costs in Years 1, 2, and 3 without making the requisite showing that the costs were reasonably and prudently incurred. The Company merely sets forth the amount of actual and projected costs related to CEP through December 31, 2002. *RECO-7*, p.18. Rockland does not anticipate incurring any CEP costs beyond this point but states that if CEP costs are incurred in 2003 or 2004, "this will necessitate an increase in the SBC rate to be effective August 1, 2003 above the level proposed in this filing." *Id.*

The Company offers no basis for a determination as to the reasonableness and prudency of its CEP calculations. The determination that their CEP costs are reasonable and prudently incurred does not rest on the attainment of the Measures of Success or performance standards for that particular year. Even if the Measures of Success are achieved, there must be a showing that all costs incurred were reasonable and prudent. The Board in its June 25, 1999 Order stated that it would look to "the extent these [expenditures] represent prudently incurred expenses." Only then will the utilities be permitted to recover the CEP costs in a manner consistent with EDECA. Accordingly, the Company's recovery of costs is dependent on the Board's determination of prudence. This important step cannot be circumvented. Simply stated, the fact that the Measures of Success were attained does not by itself indicate that the Company's CEP expenses in achieving that target were reasonable and prudently incurred. It merely indicates that minimum benchmark levels were achieved for the performance standards established by the Board to measure the success of the CEP.

Equally problematic is the Companies' misplaced reliance on the "pre-approval" process whereby the UEC submitted its proposed consumer education materials to the Board and the EEC before dissemination, in addition to the UEC's factual presentation to the Board of its budgets and expenses for each year of the CEP prior to their implementation, as proof of prudence. The "preapproval" and "presentment of budgets" by the UEC to the Board is not equivalent to an automatic finding of prudence by the Board for each utility requesting CEP recovery. The August 9, 1999 Order, which established the pre-approval procedure, gave no indication that the Board's approval of the content of the consumer education material was also an approval of the costs that would be incurred. Even if the Board approved the content of the consumer education material, the prudence of the costs of producing these materials presented by the utilities was not considered by the Board at that time. Therefore, the UEC's "presentment of budgets" to the Board cannot be considered an "automatic" finding of reasonableness and prudence of the utility's statewide CEP costs.

From the inception of the CEP, the Board contemplated the manner in which utilities would be able to recover reasonably incurred expenses associated with carrying out the objectives of the CEP. By Order dated June 25, 1999[13], the Board began to lay the foundation for CEP cost recovery. The Board ordered that any electric or gas public utility that had incurred expenses related to the CEP would be able to defer those expenses, to be recovered at a later date, according to a two-part test. First, the CEP expenses must meet the standards for measures of success to be developed by the Board, and, second, the CEP expenses must have been prudently incurred, a determination also to be made by the Board. *See* June 25, 1999 Order at 2.

Again in April 2002[14], the Board restated the position taken in its October 15, 1999 and June 23, 2000 Orders allowing utilities to recover their CEP costs through the SBC. The Board repeated that in order for utilities to recover CEP expenses, the utility must file with the Board and be subject to public and evidentiary hearings. The Board decided to proceed in this manner because "CEP cost recovery through the SBC will result in an increase to the SBC now or at the time the deferral ceases and recovery commences in the case of electric utilities." *See* April 8, 2002 Order at 3. After establishing that public hearings would be held regarding CEP cost recovery through the SBC, the Board reiterated its position that, "[t]he reasonableness and prudence of the cost levels incurred to

[13] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket No. EX99040242, Decision and Order, (June 25, 1999). ("June 25, 1999 Order").

[14] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket No. EX99040242, Order of Extension, (April 8, 2002). ("April 8, 2002 Order").

achieve the Board approved measures of success will need to be assessed in reviewing the SBC filings." *Id*.

Prudence requirements are imposed on a public utility's ability to recover costs in order to encourage efficient managerial behavior.[15] According to New Jersey law and Board precedent, the utility must prove that all costs incurred were reasonable and prudent before these costs can be collected from ratepayers. *See N.J.S.A.* 48:2-2(d), *I/M/O the Petition of Public Service Electric and Gas Company for an Increase in Rates -Hope Creek Proceeding*, BPU Docket No. ER85121163, OAL Docket No. PUC 0231-86 (April 6, 1987).

As discussed previously the Board set forth the two-part standard of review for a prudence determination in the *Hope Creek Order*. The standard provides that before a cost can be recovered in rates, each Company must: 1) show that the Company's actions meet the reasonable person standard given the specific circumstances at the time decisions were made; and 2) show the reasons why each cost was incurred and the benefit to ratepayers by the Company's actions. In effect, the prudence review determines whether the Company performed in a manner that was reasonable at the time, and allows regulators to prevent unreasonable costs from being passed on to ratepayers.

The Measures of Success relied on so extensively by the utilities were only a benchmarking tool, used to measure the level of awareness energy customers achieved through the education program. They were never intended to replace the prudence standard. In this proceeding, Your Honor and the Board must ascertain whether the costs expended to achieve the task were prudently incurred. In order for the utilities to show that they prudently incurred these expenses, the Company must meet the two-part prudence test as stated in the *Hope Creek Order*.

Throughout the consumer education proceedings there has been no Board scrutiny of CEP costs. The Company presented no testimony in this proceeding demonstrating that they satisfied the *Hope Creek Order* prudence standard. Instead, the Company incorrectly relied upon the attainment of the Measures of Success and also on the "pre-approval" and "presentment of budget"

---

15 *See El Paso Natural Gas Co. v. FPC*, 281 *F.2d* 567, 573 (5th Cir.), *cert denied*, 366 *U.S.* 912 (1960).

phases of the CEP to show that their costs were prudently incurred. Because no assessment of the Company's cost levels ever took place, the Company is not permitted to substitute other components or phases of the CEP to show compliance with the prudence standard. As stated previously, the utility bears the burden of proving that their costs are reasonable and prudently incurred, and in this case, the Company has failed to present evidence sufficient to meet its burden. Thus, Your Honor and the Board should disallow $446,000, plus interest of Rockland's recovery request. RECO-2, FPM-4, p.1.

C. Even Under The Erroneous Assumption That Achieving Measures of Success Is Synonymous With Prudence, The Failure of the Statewide CEP to Satisfy the Measures of Success Established by the Board in Years 2 and 3 Should Preclude Rockland's CEP Cost Recovery.

Even if Your Honor and the Board were to determine that the achievement of the Measures of Success was equivalent to prudence, the fact that the statewide CEP failed to achieve its objectives for Year 2 and Year 3 should necessarily preclude the recovery of costs incurred by the Company in those two years.

The Board hired the Center to conduct research on the level of awareness of gas and electric consumers regarding energy deregulation and restructuring. In order to evaluate consumer awareness in different areas, the Center developed performance standards and benchmarks referred to as Measures of Success. The Year 1 Measures of Success were accepted by the Board by Order dated October 15, 1999[16] and focused mainly on increasing consumer awareness of deregulation and

[16] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket No. EX99040242, Decision and Order, (October 13, 1999).

choice of alternate energy suppliers.[17] However, Year 1 Measures of Success were changed in Year 2 and Year 3 to reflect later developments in the energy market.

Year 2 of the consumer education program failed to raise the awareness of gas and electric consumers of competition and the ability to switch to alternate energy suppliers, which was vital to the success of the program. The Ratepayer Advocate expressed its concerns to the Board in a letter dated January 11, 2001, which stated that the continued focus on deregulation in Year 2 was inappropriate given the high awareness levels achieved in Year 1, and recommended that the CEP should instead focus on the benefits of deregulation such as increased competition and a choice of energy suppliers. *See* Exhibit A, attached to this brief. However, the data compiled by the Center for Year 2 of the CEP indicated that consumers were still very much in the dark about alternate suppliers and their pricing plans as well as information on the mechanics of making a switch.[18] Equally problematic was consumer ignorance of the term "price-to-compare" and how this information could be used to shop around for a new supplier.[19] Therefore, it came as no surprise when the Center revealed in its Sixth Report to the Board that the switching activities of consumers

---

[17] The Year 1 Measures of Success were as follows:

A. **Awareness** - awareness of deregulation across all market segments of at least 70%. This would include the General Consumer Market (GCM), Hispanic Consumer Market (HCM), African-American Consumer Market (AACM), Small Business, Low Income, Seniors and the Disabled.

B. **Knowledge** - at least a 50% correct knowledge level of deregulation facts across the four-core markets: GCM, HCM, AACM, and Business.

C. **Selection Process Awareness** - at least a 30% Avery of somewhat aware@ level for the supplier selection process.

D. **Decision Making** - at least a 30% level of making a conscious decision to switch, not to switch or not to decide.

E. **Call Center Satisfaction** - at least 80% satisfaction level among consumers utilizing the NJ Energy Choice call center.

F. **Response to Recommendations** - CEP campaign officials are to respond to any recommendations made in the Center=s reports which are endorsed, accepted and forwarded by the Board in memo form only.

[18] The Fifth Report submitted to the Board by the Center showed a 10% decline in the number of consumers who were very or somewhat aware of the process to follow in selecting an energy supplier. In addition, the Fifth Report also revealed that 55.4% of consumers were still waiting for more information in order to make a decision to switch to a energy supplier. Fifth Report at 8.

[19] The Center in its Sixth Report to the Board acknowledged the need to provide consumers with the necessary information so that they may make a switch and recommended that Aconsumers need to be taught by both utilities and the CEP how to find and just what their price-to-compare is. This may be a very large barrier to participation. Nearly 100% of consumers don=t know what or how to find what they pay per-kilowatt hour or per-therm.@ See Center=s Sixth Report at 12.

in Year 2 did not meet its benchmark target for residential markets. Switching statistics continued to show a steady decline in Year 3, as shown in the Center's Seventh Report.[20] Presumably, if more consumers were provided with information that would give them the necessary tools to research their switching options, make a decision, and initiate a change in energy providers, then residential switching numbers would have increased**,** not decreased, in Years 2 and Year 3.

In Year 3, because of sharp increases in energy prices, the Ratepayer Advocate recommended that the statewide component of the CEP should be re-directed to address concerns related to high energy costs. *See* February 15, 2001 letter to Board, attached as Exhibit B. This would include providing information to consumers about the reason for high energy costs, advising consumers of ways to manage their energy usage and energy bills, and increasing awareness of financial assistance for which consumers may be eligible. Although Year 3 of the statewide CEP did include Measures of Success related to consumer awareness of energy conservation and efficiency, as well as the availability of financial assistance,[21] these Measures of Success were very general and not detailed or specific enough to be truly effective in ensuring that consumers had the necessary information to respond to high energy costs. These shortcomings became very obvious when the Center's Seventh Report to the Board revealed that the CEP fell short of Year 3 goals in the areas of awareness of conservation/efficiency and financial assistance. If the conservation and efficiency messages circulated to consumers by the utility were truly effective, then the residential customer average load use would show a decrease. In fact, the Board's statistics indicate that, in Year 3, the overall load per customer increased from .0050 MW/customer in May 2001 to .0058

[20] The Seventh Report revealed declining levels of switching activities among consumers. For example, 96.9% of all respondents could not name or estimate the amount they pay per kilowatt hour which serves as a barrier to shopping. Approximately 60% of respondents were still not familiar with the term price-to-compare and how to use this information in making a decision to switch. Also, only 6.6% of respondents had actively shopped around for a new energy supplier. See Seventh Report at 8.

[21] The specific measures were general consumer awareness that: (1) "[l]ocal utilities have energy conservation and efficiency programs;" and (2) "[f]inancial assistance programs are available to help low income households pay their energy bills." See Seventh Report at 33.

MW/customer in April 2002. *See* Exhibit C, attached to this brief. Clearly, the Year 3 efforts were not successful in this regard.

In conclusion, the statistics from both Year 2 and Year 3 demonstrate that the statewide CEP failed to increase awareness among gas and electric customers in the critical areas of competition, switching to alternate energy suppliers, energy conservation and efficiency, and the availability of financial assistance to eligible consumers. The apparent foible in the statewide CEP was its continued focus on the message of deregulation in Year 2 and Year 3 when there were issues of greater concern worthy of consumers= attention. Therefore, it is improper to allow utilities to recover statewide CEP costs for Year 2 and Year 3, when the statewide CEP failed to achieve its Measures of Success in the aforementioned areas. It follows that if ratepayers did not benefit from the CEP during Year 2 and Year 3, utilities should not be permitted to recover from ratepayers costs associated with a failed program. The disallowance for CEP costs for years 2 and 3 is $200,000, plus interest. Moreover, the Company should not recover its projected costs for year 4 of 10,000, plus interest. *RECO-2*, FPM-4, p. 1. Thus the total disallowance for CEP years 2 and 3 and projected year 4, total $210,000, plus interest. *Id.*

POINT VII

FINANCIAL ISSUES

A. The Company Should Only Be Permitted to Recover Interest Calculated Using the "Net of Tax" Methodology.

The Board permitted the Company to earn interest on the deferred balance accrued during the transition period. The Final Order specifically dictates the method in which interest is to be calculated for any deferrals accrued. Final Order, p. 69. Upholding its prior ruling on interest calculation, the Board held that interest on the deferred balance should be calculated on said balance "net of tax." *R-4*, Appendix B. When the "net of tax" method is used, interest is applied to the deferred balances after the deferred taxes associated with the balance have been applied. This in turn reduces the balance that interest is ultimately applied to when calculating the "total" deferred amount owed by ratepayers. As discussed later, the appropriate tax rate to apply in this case is 40.85%. Therefore, whether or not "net of tax" methodology is utilized for interest accrual calculations has a substantial effect upon the total deferred balance.

As noted previously, Rockland filed a motion for reconsideration on, among other things, the net of tax issue which was pending at the time the Company filed its petition in the instant case. Thus, Rockland did not use the net-of-tax methodology to calculate the appropriate interest to be applied to the deferred balance in its filing. Rockland calculated interest on a gross deferred balance that was not net of deferred taxes. By using a gross rather than a net-of-tax balance, Rockland recorded and estimated $14,787,000 in interest accruals.

However, since that time, the Board upheld its prior decision that interest must be calculated on the net-of-tax balances basis in an October 16th Order. *R-4*, Appendix B, p. 4. Rockland now acknowledged that the net of tax methodology should be used to calculate the interest on the deferred balance pursuant to the Final Order. See *RECO-2*, *RECO-7*, p. 22. Therefore, the Ratepayer Advocate recommends that Your Honor and the Board calculate the interest using the net-of tax methodology, as has been reflected in the Company's updated filing. *RECO-2*.

B. The Company Should Use the Composite Tax Rate of 40.85% in Calculating the Deferred Balance Interest on a Net of Tax Basis.

When computing the deferred balance interest on a net of tax basis, Rockland only used the Federal income tax rate of 35% instead of the composite tax rate of 40.85% which includes the New Jersey corporate income tax rate of 9%. The Ratepayer Advocate asserted that the composite Federal and state tax rate is appropriate and must be used. *R-4,* Appendix B. Rockland used the 35% income tax rate in its initial filing. *RECO-1,* Exhibit FPM-8, page 4 of 4.

The Company recalculated the deferred balance interest rate using 40.89% composite tax rate. *RECO-2.* For the issue regarding the net-of-tax calculation for the calculation of interest, and for the composite tax rate of 40.85%, the amount of the adjustment, including interest, is $5,540,000, however this has been reflected in the Company's updated filing. *RECO-2.*

C. Labor and Overhead Costs of $325,428 Are Already Recovered in Base Rates and Should Not Be Recovered Through the Deferred Balance.

The BGS Auction/PJM adjustment, which amounts to $1,143,000, represents the costs associated with Rockland's participation in the Year 4 statewide auction, as well as the related costs incurred with implementing the transfer of Rockland's Eastern Division to PJM. In response to discovery, these costs were itemized by Rockland. See *R-4,* Appendix C. These costs should be all incremental and should not include costs already included in base rates.

However, it is evident that "Labor and Overheads," which amount to $325,428, are costs already recovered through base rates and should not be a cost recovered in this proceeding. This charge does not represent an incremental expense for Rockland as shown in the Company's response to discovery. *R-4,* Appendix C.

These charges, which only include labor and materials should be removed from the deferred balance recovery in this case. Therefore, the Ratepayer Advocate recommend that Your Honor and the Board remove $325,428 from the deferred balance. cotton, See *R-6,* JDC-1 through JDC-4.

POINT VIII

IN ORDER TO MITIGATE RATE SHOCK, ROCKLAND'S PROPOSED FOUR-YEAR DEFERRED BALANCE RECOVERY PROPOSAL SHOULD BE REJECTED, AND THE TEN-YEAR RECOVERY PROPOSAL RECOMMENDED BY MR. ROTHSCHILD SHOULD BE ADOPTED.

The Final Order in Rockland's restructuring, stranded cost, and unbundling case provided that the manner and timeframe of the recovery of Rockland's deferred balance would be determined by the Board.[22] Rockland's proposal for recovery of its deferred balance relies on a truncated recovery period and applies the interest rate to a balance that is considerably higher than the actual amount it has to finance. The combined effect of the shortened recovery period and an excessive total interest cost would result in an unreasonable increase in rates, if Rockland's proposal were adopted. The combined effect of what the Company has requested means that if Rockland's proposal is adopted, its ratepayers will face a 24.5% increase in rates; an increase that will result in unreasonable rate shock in rates for electric service. *RECO-7*, FPM-1, p. 1. In contrast, the recovery proposal recommended by Ratepayer Advocate witness James Rothschild extends the amortization period, locks-in the interest rate at a level reflective of the Company's borrowing costs, and considers tax effects of the expenses and revenues associated with the deferred balance, thereby resulting in a substantial mitigation of the rate impact of recovery on Rockland's ratepayers. *See R-14*. Adopting Mr. Rothschild's recommendations would significantly lower the annual charge to recover the deferred balance, from 1.9614 cents per kWh to 0.8849 cents per kWh, a reduction of 55%. *R-14*, p. 10. If the Ratepayer Advocate's deferred balance adjustments are adopted, the rate increase will be even lower.

The Company proposes to use a four-year amortization period, with interest accrued at a rate reflecting its 7-year debt rate. *RECO-7*, pp. 12-13. In contrast, Mr. Rothschild's deferred balance amortization recommendation lengthens the recovery period from four-years to ten-years and uses a fixed accrual interest using the same rate parameters as those currently used to accrue interest.

[22] *I/M/O Rockland Electric Company*, BPU Docket Nos. EO97070464, EO97070465, and EO97070466 (Final Order dated July 22, 2002), p. 69.

R-14, p. 8. Additionally, Mr. Rothschild recognizes the income tax impact associated with the deferred balance amount and its recovery. *Id*., pp.14-15. As demonstrated below, Mr. Rothschild's recovery recommendations would mitigate the impact of a rate increases on Rockland's customers and should be adopted.

In November 2002, Rockland filed a petition with the Board seeking to securitize its deferred balance.[23] Even assuming, *arguendo,* that Rockland's securitization petition is approved by the Board, the deferred balance recovery mechanism at issue here is relevant and remains an outstanding issue to be decided. The rates and recovery mechanism set in the instant proceeding will remain in place until a transition bond charge is set by the Board, assuming, *arguendo,* that the Board approves the Company's securitization petition. Furthermore, securitization should only be approved by the Board if it is found that "[t]he issuance of such [transition] bonds will provide tangible and quantifiable benefits to ratepayers, including greater rate reductions than would have been achieved absent the issuance of such bonds and net present value savings over the term of the bonds." *N.J.S.A.* 48:3–62(b)(3). The method of recovery found to be reasonable in this proceeding will define the reasonable alternative to securitization used for computing any securitization-related savings.

[23] *I/M/O Rockland Electric Company*, BPU Docket No. EF02110852 ("securitization petition").

A. The Amortization Period Should be Extended to Ten-Years.

Amortization of the deferred balance over a four-year period, as proposed by Rockland, would result in an unreasonable rate increase for its ratepayers. Rockland witness Frank P. Marino testified that Rockland's ratepayers would face a BGS deferral-related rate increase of 24.5% for the Transition Recovery Charge Component, assuming a deferred balance of $110,489,000.[24] *RECO-7*, FPM-1, pp. 1-2. While the percentage increase attributable to the Company's deferred balance amortization proposal is significant in itself, it is especially burdensome when considered in the context of the Company's other proposals. For example, the proposed deferral amortization related-increase would occur concurrently with increases in its SBC and Temporary Credit, as well as the rate increase proposed by Rockland in its pending base rate case. *RECO-7*, FPM-1, p. 1.

Mr. Rothschild examined the Company's amortization proposal. For purposes of illustration, Mr. Rothschild performed numerous calculations using the Company's deferred BGS balance estimate of $110,489,000. *R-14*, p. 3. Mr. Rothschild concluded that extending the amortization period from four-years to ten-years produced a steep drop in rates.[25] *Id.*, Table 2, pp. 10-11. Mr. Rothschild found that using a ten-year amortization period instead of a four-year period would significantly lower the annual charge to recover the deferred balance, from 1.9614 cents per kWh to 0.8849 cents per kWh, a reduction of 55%.[26] *Id.*, p. 10. Clearly, the ten-year amortization period recommended by Mr. Rothschild would result in significant savings for Rockland's ratepayers *vis-à-vis* the Company's four-year amortization proposal.

One of the reasons proffered by the Company in support of a four-year recovery period is that it "mirrors" the period in which the deferred costs were incurred. *RECO-8*, p. 22. The Company's symmetry argument ignores the realities of the rate impact attendant with a four-year

[24] Rockland proposes to recover its deferred BGS balance through a Transition Recovery Charge. *RECO-1*, p. 1.

[25] While amortization of the balance over a period longer than ten-years is possible, Mr. Rothschild found that the rate impact of extending the amortization period beyond ten years was more gradual. *Id.*, pp. 11-12.

[26] For purposes of comparison, Mr. Rothschild used a fixed interest rate to compare the rate impacts of the four-year and ten-year recovery periods. Mr. Rothschild used the seven-year treasury rate plus 60 basis points for his comparison, found in Table 1 of his direct testimony. *R-14*, p. 10;T183:L16-20 (2/21/03).

recovery period and should be rejected. Symmetry should not be used as the basis for setting the recovery period where the result would be an unreasonable rate increase for the Company's ratepayers.

Furthermore, contrary to the insinuations of the Company, the Board did not adopt the four-year recovery proposal contained in paragraph 30 of Rockland's Plan in its restructuring, unbundling and stranded cost case.[27] *RECO-1*, p. 24. Instead, as noted above, the Board ruled that the manner and timeframe of the recovery would be decided by the Board in this proceeding.[28]

As demonstrated above, a longer recovery period provides significant, quantifiable benefits for ratepayers, in terms of mitigating the impact of the proposed rate increases. The Ratepayer Advocate respectfully submits that the rate increase mitigation offered by a longer recovery period outweighs any vague concerns about the impact of a longer recovery period on the investors' perceptions of the Company. A ten-year recovery period significantly lowers the burden on ratepayers, whereas the Company's concerns about its perception among investors is speculative, at best.

Company witness John E. Perkins testified that he is "concerned that an extended recovery period would be viewed negatively by the rating agencies and by investors." *RECO-9*, p. 3, ln. 4-6. However, Mr. Perkins' testimony does not fully consider the certainty afforded by the resolution of the instant proceeding, resulting in a Board Order setting forth the terms for the recovery of the Company's deferred balance. In his surrebuttal testimony, Mr. Rothschild addressed Mr. Perkins' concerns and testified that the positive cash flow and the elimination of uncertainty concerning the recovery of the Company's deferred balance places its investors in a better position than they are now:

> Q. ... On Page 3 of Mr. Perkins' rebuttal testimony, he is concerned that an extended recovery will be viewed

---

[27] Paragraph 30 of Rockland's Plan set forth a sliding scale of recovery periods depending on the total amount of the Company's deferred balance, where a total deferred balance of between $4.5 million and $5.0 million called for a four-year recovery period. Rockland Plan, p. 23, para. 30.

[28] Rockland Final Order, p. 69, para. 30.

negatively by the rating agencies and by investors. Could you please comment on that?

A. ... [A]t the moment, there is uncertainty over how much is going to be recovered and the company is not receiving any positive cash flow from that amount. When these proceedings are over, investors will know what the Board is going to allow. And they will know what the time period is.

And whatever is allowed and whatever the time period is, the cash flow will change from negative to positive. So the result is that the investors will be better off than they are now. So I think it's a matter of your starting point and your perspective and the matter of degree. Going to improve the company's cash flow perhaps in a different way than perhaps Mr. Perkins would prefer if his recommendation were adopted, than if my recommendation were adopted. But it's still going to be putting the company in a situation where they're turning the corner on that risk and on that cash flow. T176:L25-T177:L20 (2/21/03).

In contrast to the concrete ratepayer benefits, the Company's concerns about an extended recovery period are unsupported in the record. Although in his rebuttal testimony Mr. Perkins states that he is "concerned that an extended recovery period will be viewed negatively by the rating agencies and invertors," Mr. Perkins did not avail himself of the financial analysis tools that investors and rating agencies might use to evaluate the Company. *RECO-9*, p. 3, lines 5-6. In response to a discovery request, Mr. Perkins stated that he "did not rely on any projected coverage ratio data and balance sheet data in order to make that claim." *R-3*, p. 1. Furthermore, the Company did not perform any analyses of its coverage ratios, balance sheet, or cash flow under four-year and ten-year recovery scenarios, using the 60 basis points over the seven-year treasury interest rate. *Id.*, pp. 1-2. In sum, the Company's vague and unsupported concerns, addressed by Mr. Rothschild, should not be allowed to block the concrete benefits of a ten-year recovery period.

B. The Accrual Interest Rate Should be Fixed at the Beginning of the Recovery Period at the Seven-Year Treasury Rate Plus 60 Basis Points.

Ratepayer Advocate witness Mr. Rothschild recommends that interest on the deferred amount accrue at rate equivalent to the interest rate on seven year constant maturity treasuries,[29] plus

[29] As shown in the Federal Reserve Statistical Release on, or closest to, August 1. *P-3*, p. 10.

sixty basis points. *R-14*, p.8. The rate recommended by Mr. Rothschild is consistent with the rate that was approved by the Board for the accrual of interest on the Company's outstanding deferred balance during the most recent portion of the Transition Period, from July 22, 2002 through July 31, 2003.

Mr. Rothschild recommends that the rate should be set at the time the recovery rate is established by the Board. *R-14*, p. 16. Mr. Rothschild's fixed interest rate recommendation reflects the nature of the deferred balance. During the Transition Period the deferred balance was growing, resulting in negative cash flow and the need for financing to offset the negative cash flow. In contrast, during the recovery period, the deferred balance will decline over time, with a positive cash flow stemming from its recovery through rates. Mr. Rothschild aptly noted that since the full amount of the deferred balance would have already been financed before the recovery period, a fixed interest rate should be used, set at the beginning of the recovery period. *R-14*, p. 8. At hearing, Mr. Rothschild provided further support for his use of a fixed rate during the recovery period :

> Because the difference in the accumulation period during the time the deferred balance was growing and going forward, is that during the deferral period, the company is continually having to finance these expenses that it incurred. And so it has to ... raise the money.
> However, as you go forward, the money's already been raised. And so what it has to do then, is it's in a cash flow situation. It's paying the money back. So if the rate is fixed up front to the company, then the risk isn't there anymore because it's locked in.
> T180:L13-25 (2/21/03).

Additionally, Mr. Rothschild recognized that his recommended fixed interest rate would be applied to a declining deferred balance, since rate recovery would reduce the amount of the outstanding deferred balance going-forward:

> The entire balance would not be outstanding for ten years. ... [T]hen the company will receive a return, and on that money gradually over the years such that the approximate, not exact, but approximate amount of time that the money will be outstanding is a little bit more than five years. The last dollar is outstanding. The whole ten years the first dollar is outstanding for a day. T181:L24-T182:L11 (2/21/03).

Furthermore, using a fixed interest rate would have additional, practical advantages. Mr. Rothschild noted that using a fixed interest rate would "have the additional advantages of 1) not having to change the recovery rate annually; and 2) making the non-securitization more directly comparable to the securitization case, because if securitization financing is used, that financing must be accomplished at a fixed rate." *R-14*, p. 8, ln. 19-22.

In contrast, under its four-year recovery proposal, the Company originally proposed to accrue interest during the recovery period at a rate which it claims reflects it seven-year debt rate.[30] *RECO-7*, p. 12. Later, in rebuttal testimony, a different Rockland witness opined that the Company's weighted average cost of capital should be the basis of the interest accrual if a ten-year recovery period is approved. *RECO-9*, p. 6. However, although the Company's witnesses opined on the use of the rate proposed by Mr. Rothschild, they did not provide any quantification of the impact of various interest rates on the Company's cash flow, coverage ratios, or balance sheet.

C. The Amount Upon Which the Interest Accrual is Based Should be Adjusted to Reflect Tax Savings.

Mr. Rothschild found that Rockland's claimed deferred balance is comprised of expenses which the Company could deduct from its federal and state income taxes. *R-14*, pp. 14-15. Hence, the deductibility of the deferral-related expenses caused a reduction in the Company's current tax liability. The related reduction in the Company's current tax liability works as an offset to the deferred balance, reducing the amount which the Company needs to finance. Mr. Rothschild estimated that out of a total claimed deferred balance of $110,489,000, Rockland only needed to finance $65,354,000 of that amount, based on a combined state and federal income tax rate of 40.85%. *R-14*, p. 14. Using a tax rate of 40.85%, the deductibility of expenses comprising the deferred balance reduced the Company's tax liability by $45,489,000 [40.85% x $110,489,000]. *Id*. It is only the difference between $110,489,000 and $45,489,000, or $65,354,000, which the Company needed to finance. *Id*. Rockland incurred no interest expense on the portion of the total

[30] Company witness Frank P. Marino set forth his method for calculating his proxy for a seven-year rate in his direct testimony. *RECO-7*, pp. 12-13.

deferral balance financed by an income tax deferral ($45,489,000) and, therefore, that portion of the total deferred balance should be excluded from the amount upon which the interest accrual calculation is made. As recommended by Mr. Rothschild, the Company should only be permitted to earn a return on that portion of the deferred balance which it had to finance. *Id*.

D. Rockland Should not be Permitted to Include a Tax Gross-Up in its Interest Expense Recovery Revenue.

Finally, the revenue associated with the recovery of the interest on the deferred balance should not be subject to an income tax gross-up, as set forth in the testimony of Mr. Rothschild. Mr. Rothschild considered the tax treatment of the deferral-related expenses in the context of the post-Transition Period recovery of the deferred balance. Since the interest expense incurred each year in the recovery period and associated recovery revenue cancel each other out, Mr. Rothschild concluded that it would be improper to add an income tax gross-up to the interest expense recovery revenue. *R-14*, pp. 14-15.

CONCLUSION

For all of the foregoing reasons, 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,

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

By: ______________________________
Susan E. McClure, Esq.
Assistant Deputy Ratepayer Advocate

Dated: March 18, 2003

On the Brief:
Ami Morita, Esq., Deputy Ratepayer Advocate
Susan E. McClure, Esq., Asst. Deputy Ratepayer Advocate
Kurt S. Lewandowski, Esq., Asst. Deputy Ratepayer Advocate