BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES

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

EXCEPTIONS TO INITIAL DECISION
BEING FILED ON BEHALF OF
THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE
VOLUME TWO

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POINT VI. BGS PROCUREMENT AND DEFERRED BALANCES

A. Introduction

The Company, Co-Steel, NJT, NJCU, DOD and IEPNJ all agree, without citing to any evidence in the record, "that the Company's entire MTC/BGS Deferred Balance through July 31, 2003 has been reasonably and prudently incurred and that the Company should be permitted to recover the full amount thereof." *Joint Position* at 10-11. The ALJ, with no findings of fact and no explanation, agreed that full recovery of the Company's entire deferred balance is reasonable. The rest of the Company's approximately 1 million New Jersey ratepayers apparently have no say. And yet, not one of the non-Company signatories to the Joint Position submitted testimony, offered evidence, cross-examined witnesses, or otherwise contributed to the evidentiary record concerning the deferred balances. Indeed, Co-Steel claimed that the deferred balance has nothing to do with them and managed to negotiate an MTC "credit" in the Joint Proposal in an attempt to bypass a non-bypassable charge. *Joint Position* at p. 17. Thus, there is simply no basis for the Board to adopt this Joint Position on the BGS deferral, agreed to among parties who exhibited little interest in the pertinent matters during the pendency of the proceeding, and who have not demonstrated in the least any concern for the ratepayer interests beyond their own narrow self interest.

For the reasons set forth herein, adoption of the Joint Position is inconsistent with both law and policy. The record in this proceeding supports the positions of the Ratepayer Advocate as set forth in its Initial and Reply Briefs. Accordingly, the Ratepayer Advocate respectfully submits that the Board reject the Joint Position that "the Company's entire MTC/BGS Deferred Balance through July 31, 2003, has been reasonably and prudently incurred."

B. Purpose and Goal of the Prudence Review.

EDECA provides for the recovery of BGS deferred balances that are "reasonable and prudently incurred." *N.J.S.A. 48:3-57(d)-(e), RAIB* at 1. The promise of EDECA was to lower rates and to provide better service to energy consumers in New Jersey through competition (*RAIB* at 1). The Joint Position belies this promise, ignores testimony of the Ratepayer Advocate demonstrating imprudence on the part of the Company and grants to the Company full recovery of a deferred balance of, at last estimate, $618 million. *Joint Position* at p.11. The Board has an obligation to all of the State's ratepayers to closely scrutinize the Company's deferred balance and to hold the Company to the standards and the promises of EDECA.

As described in the Ratepayer Advocate Initial Brief, the Board has broad and sweeping powers over all aspects of public utilities that are 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 the jurisdiction to set rates. *N.J.S.A*. 48:2-21. A public utility is required by statute to show that an increase in rates is just and reasonable. *Id.* The statute provides, "the burden of proof to show [that] 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). *See, also, In the Matter of the Petition of Public Service Electric and Gas Company for an Increase in Rates and In the Matter of 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). ("*Hope Creek Order*"). ("[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"); and *Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 222 (1950). *RAIB* at 1, 2.

In evaluating whether the Company met its burden to prove that the costs incurred were reasonably and prudently incurred during the transition period, the Board must evaluate the managerial conduct in light of the circumstances, information, and options in existence at the time management decisions were made. The Board described this process in the *Hope Creek Order*:

> [t]he Company's conduct should be judged by asking whether the conduct was reasonable at the time, under the circumstances considering 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* at 65, 66.

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

> [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.

The Joint Position ignores this standard. The ALJ erred in adopting the Joint Position because the agreement among those few parties skirts the requirement that the trier of fact must undertake an analysis and *make an affirmative finding* as to whether costs were incurred reasonably and prudently. The *Hope Creek Order* sets for the standards for the analysis, specifically,

(1) whether the Company's actions during the transition period were reasonable given the specific circumstances at the time decisions were made;

(2) whether the Company has demonstrated sufficiently the reasons why each BGS cost was incurred, and the benefits derived by the Company's actions; and,

(3) whether the Company mitigated risk sufficiently.

The Initial Decision, in adopting the Joint Position, considers none of these points, and instead accepts without question the Company's representation that the Company's entire BGS deferral was reasonably and prudently incurred.

The Company's showing that the costs were incurred, by itself, is insufficient to support full recovery. EDECA specifically requires that the Company carry its burden of proof that such costs were reasonably and prudently incurred. The legislature correctly left the burden on the utilities because the companies, not the ratepayers, had control over the outcome of the level of the Deferred Balance. The ratepayers could not hire the experts necessary to purchase the commodities. Ratepayers could not make hedging decisions for the Company. Rather, ratepayers pay rates to the utilities to compensate them for the Company's expertise. If the utilities fail to hire the experts necessary to make prudent decisions, they should rightly have to pay because, ultimately, they are in the driver's seat. The Board should summarily reject the Company's attempt to shift the burden of proof from the Company and onto New Jersey ratepayers. By adopting the Joint Position and allowing 100% recovery of the Company's Deferred Balance, the ALJ condoned this improper shifting of the burden of proof. The Board must reject the Initial Decision to properly reflect the mandates of EDECA.

As demonstrated throughout the Ratepayer Advocate Initial and Reply Briefs, the Company made imprudent decisions in its BGS procurement policies and decisions under the standards set forth in the *Hope Creek Order* and the *JCP&L Final Order*. Not only does the *process* of the Joint Position fail by Board-articulated standards, but the *substance* is also defective, and entirely inconsistent with the weight of evidence

introduced at hearings and analyzed in the Ratepayer Advocate's Briefs. Ultimately, the Board must determine whether the proposed recovery of the deferred balance is in the public interest. In whole-heartedly adopting the Joint Position, the ALJ ignored record evidence of the Company's imprudence and has provided no explanation for doing so. The Board must reject the Initial Decision and determine independently, based upon the evidence introduced at the evidentiary hearings, that the Company failed to incur its costs reasonably and prudently.

C. The Company's BGS Procurement Costs Were Not Incurred Prudently.

1. New Jersey BGS Deferrals Are Dramatically Higher Than Those Incurred in Pennsylvania, Indicating Imprudence on the Part of New Jersey Management.

The need for careful Board scrutiny of the Company's deferred balance is evident in light of the large difference between the respective deferred balances amassed by the New Jersey and Pennsylvania affiliates of FirstEnergy. Indeed, the New Jersey Company almost always paid more per MWh for purchases than its Pennsylvania affiliate companies did in the same month. *See RAIB* at 23, *citing* R-59 at Schedule PLC-2. In fact, the average price that JCP&L's sister utilities, PennElec and MetEd, paid for non-NUG, non–transitional-PPA power (weighting the two companies equally) was about 12% less than the price that JCP&L paid. At the prices paid by the Pennsylvania utilities, the Company's $1.92-billion bill for non-NUG, non–transitional-PPA power through July 2002 would have been $239 million less.

Among the significant differences between New Jersey and Pennsylvania is that *Pennsylvania utilities operated without the assurances provided by future recovery of deferred balances. RAIB* at 23. Accordingly, the Pennsylvania utilities had greater incentive to control costs, since management errors and imprudence could not be recovered from the ratepayers, but would instead be reflected in shareholders profits. *R-59*,p. 7:25-8:9, 66 Pa. Cons. Stat. 2804 (1998).[1] By contrast, EDECA provided the utilities with a comfort-zone that prudently incurred costs would be fully recovered. The Ratepayer Advocate submits that this

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[1] *See also Joint Application for Approval of the Merger of GPU, Inc. with FirstEnergy Corp.; Petition of Metropolitan Edison Company and Pennsylvania Electric Company, as Supplemented, for Relief Under Their Approved Restructuring Plan and Electricity Customer Choice and Competition Act: Opinion and Order*, Pennsylvania Public Utility Commission Dockets No. A-110300F0095, A-110400F0040, P-00001860, P-00001861, at 15 (June 14, 2001).

allowance removed any incentive that the Company had to control costs in New Jersey. The evidence is striking, the New Jersey Company essentially paid $239 million more than its Pennsylvania affiliates. *R-59*, p. 8:14-15, and PLC-2.[2]

The comparison of New Jersey to out-of-state performances is especially important in light of the fact that three New Jersey utilities (Rockland Electric/RECO, Atlantic/ACE, and JCP&L) have merged with out-of-state utilities in the past few years. As evidenced by the JCP&L experience, New Jersey ratepayers appear to have suffered while their peers in Pennsylvania appear to have not been as adversely affected by energy markets. Adoption of the Joint Position perpetuates this uneven treatment. The New Jersey Board has an obligation to protect New Jersey ratepayers. Only continued vigorous oversight of the utility activities will ensure that New Jersey ratepayers are treated fairly. The Joint Position's attempt to avoid that scrutiny must be rejected.

[2] The Company's attempts to justify these differences were rebutted in Mr. Chernick's Direct Testimony. A complete discussion of this point can be found in the Ratepayer Advocate Initial Brief at pp.23-27.

2. X-Method

The Company's procurement strategies were alternately contrary to cost control principles or disregarded by management. The X-method was the first model that the Company used to purchase electricity, *RAIB* at 13, but the stated purpose, or the "goal," of the X-method was flawed. According to the Company, the goal of the X-method was to minimize the potential variation in the Company's earnings. *JC-14 Direct at 10.*

As established in the Ratepayer Advocate Initial Brief, *see RAIB* at 13, the first and foremost principle in utility regulation is the utility's obligation to ratepayers to provide safe and adequate service at the lowest available cost. *See Midwestern Gas Transmission Co.*, 36 *F.P.C.* 61, 70 (1961) (noting that utilities must use all reasonably available cost saving tools). By contrast, the X-method, according to the Company, was intended only to mitigate JCP&L's exposure to volume and price risk. *S-38* at VII-14.

Indeed, the Joint Position that all of the Company's Deferred Balances were incurred reasonably and prudently is even more astounding in light of the fact that it appears from Company witness testimony that it is doubtful that the Company even *tried* to control costs. Company witness Frank C. Graves argued that it would not have been possible for the Company to minimize costs, even if it had wanted to do so. *JC-19* at 18:6-13. Mr. Graves's testimony was premised, at least in part, on the theory that the Company could never expect to reduce costs by buying either forward or spot, and could endeavor only to buy "fairly-priced" power. The notion of "beat[ing] the market" or "tim[ing]" the market, according to Mr. Graves, has no bearing in this sort of a situation. *JC-19* at 18-20, 22-23. Therefore, according to Mr. Graves, the Company had no real opportunity to eliminate or reduce the differential between wholesale market prices and the capped BGS rate that JCP&L was permitted to charge customers. It appears from Mr. Graves's testimony that not only did the

Company not endeavor to contain expected costs, but that the Company believed that it was *impossible* to contain expected costs.[3] The Company's refusal to even attempt to contain costs should not be accepted by the Board as reasonable and prudent management behavior.

Furthermore, the X-method utilized a strategy referred to as dollar cost averaging ("DCA") characterized by the Company as "a process of small purchases each month over the procurement planning horizon rather than a single large purchase. This definition is inconsistent with both the definition given by the Company's consultant and with the Company's purchasing decisions. RAIB 12-16. As discussed in the Ratepayer Advocate's Initial and Reply, the Company's purchasing practices were hardly indicative of "small purchases spread over time." Moreover, as described in the Ratepayer Advocate Initial Brief, the Company believed that large purchases on the broker market would create "panic buying" but admittedly indulged in anonymous bilateral purchases with silent third-parties who conducted business on behalf of the Company. T78:L25-79:L6 (3/4/03). None of these parties were ever identified, leaving an incomplete picture of how the Company operated. The Company bragged about the secretive nature of these transactions, noting that, "in our case there is no equivalent to an SEC filing requirement, nobody knows unless we tell them." T80:L23-25 (3/4/03). Although the Company cited discretion as a method by which to avoid affecting the

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[3] In so arguing, however, Mr. Graves disagreed with his client and contradicted the HOST model assumptions and results. According to its own modeling, the Company's efforts to reduce its earnings risk increases the expected cost of power purchases. *See, i.e., R-56*(3) (upper-right quadrant of seventh non-numbered page), emphasizing that this assumption was "rooted firmly in financial theory and practice." The HOST model documentation and HOST model assumed that hedging would increase expected cost. Indeed, the Company's own process document stated that the HOST output results present a range of "portfolio targets [that] represent an efficient tradeoff between expected costs and the variance of costs." *JC-50*-(2) at 7. It is not surprising that the Company accumulated such a large deferred balance in light of the Company's belief that controlling costs was virtually impossible. *See RAIB* at 14, 15.

market, the anonymity of these sales similarly shields the Company and its purchasing practices from scrutiny. The Joint Position continues this flight from scrutiny as it asks the Board to now approve the shifting, unchecked, and undocumented course the Company took as it amassed its BGS deferral.

3. HOST Model

The second model utilized by the Company was as ineffective as the first. The Company jumped to the HOST model because its ability to deal explicitly with Company risk tolerance represented an improvement over the X-model. *RAIB* at 16, *citing JC-14 Direct*, p. 22:15. It was established at the evidentiary hearings that the HOST model outputs present a range of portfolios for different Risk Tolerance values. T42:L24-43:L7 (3/5/03). The Company decision-maker could face a menu of possibilities, a choice among which would reflect the Company's tradeoff between earnings risk and expected cost. Yet, the HOST Model was run using ill advised risk tolerances and without clear directions as to target levels. *See RAIB* at 16-18.

Despite the range of risk tolerance available to the Company that should have permitted the Company to blunt the effect of BGS costs, the Company ignored the advice of its professional consultants and selected risk tolerances on the basis of surveys that, essentially, asked managers to assess how much they would gamble to win a hypothetical lottery:

> (Graves) My understanding is that there were some surveys conducted of the five key members, I guess, in which they were individually asked to react to various so-called lotteries which are in effect bets where someone comes up to you and says, "If I were to offer you a deal where you could win twenty dollars with a fifty percent chance or lose ten dollars with a fifty percent chance," the expected value of that would be five dollars. . . .
>
> By asking a series of such questions you can get a measure of the tolerance for that end of the risk of each individual in that fashion, and a parameter called risk tolerance was estimated that described the point at which they would generally be willing to participate in those kinds of risk equation. . . . in effect it captures

> how much more nervous they become as more moneys [sic] are at stake.
> T.38:L1-10, 39:L1-11 (3/5/03).

By contrast, the Brattle Group, a consulting firm hired by the Company, reported that GPU was exploring, not a hypothetical lottery process, but risk management policies that would consider "ideally, internal cost-risk tradeoffs consistent with NJ BPU views about ratepayer preferences." *R-51*(2), p. 17,. *See RAIB* at 16-18.

Further, no rational or consistent scheme can be discerned with regard to the Company's *own* accounts of its purchasing strategies. The HOST model was not mentioned in the Company's initial testimony. Rather, the HOST model was first mentioned in discovery as the basis for targets in the period February 2001 through June 2002. *See RAIB* at 19, 20, *R-57.* Then, the Company's Rebuttal Testimony revealed that the Company rejected the HOST and replaced it with the Lock & Load Strategy. *JC-15 Rebuttal*, p. 2:5-19. The late-arrival of this information is further evidence of the haphazard manner in which the Company apparently selected, implemented, and recorded its BGS procurement processes. *See RAIB* at 18-19. The Company has turned review of its BGS procurement strategies into a game of "hide and seek," and adoption of the Joint Position would reward this process by shielding the Company's BGS deferral from necessary scrutiny.

4. Even the Company Witnesses Failed to Perform a Thorough Review of the Processes.

Even the Company's own witnesses did not review adequately the model inputs, which are crucial to the determination of whether a particular model was effective. As described in the Ratepayer Advocate's Initial

Brief, the Company witness's assessment was based upon his review of the X-method and HOST models. *See RAIB* at 20-21, T57:L24, 25 (3/5/03). Yet, the witness acknowledged on cross-examination that his assessment of the models was based upon his opinion of the Company's *selection* of the X and HOST models, T58:L6-12 (3/5/03), rather than a thorough investigation into the inputs. The witness acknowledged that the reasonableness of input values speak to the success of the models, stating that, "if you put in bad data you can get spurious recommendations, no doubt about that." T58-23-59:L2 (3/5/03). He then testified that he reviewed those values that Company used in those models only "[f]rom time to time." T58:L15-19 (3/5/03). When asked whether he had "reviewed the variation of those input values," the Company witness responded, "No." T58:L20-22 (3/5/03). Without adequate review of the inputs to the models, any opinion as to appropriateness of the models is flawed. The models are only as good as the input. The witness testified with authority only as to the models themselves, but was unable to testify as to the reasonableness of the inputs and their variations. Accordingly, the Company never presented adequate proof as to the effectiveness or appropriateness of its selected models, and the Board therefore cannot assume that their implementation was prudent.

5. The Company Failed to Utilize Financial and Weather Hedging Properly to Mitigate the Risk of Sharp Electric Price Increases.

Consequent to the restructuring of the electric industry and JCP&L's decision to sell most of its generation assets, the Company was compelled to purchase electricity in the open market. Since the spot market, by its nature, risks price spikes, a prudent utility would seek to balance the risk of spot purchasing by taking steps intended to provide a measure of stability in energy purchase expenditures. One method of managing risk is the utilization of various hedging tools. Other industries that rely heavily on commodities typically rely on hedging to reduce the risk of price run-ups. Only the utility industry, with its guaranteed "pass-through" costs, has lagged behind.

Financial and weather hedging provide a method for the Company to protect itself against adverse effects of cost variances. Yet, the Company failed to take advantage of these available tools. The Auditors report that the use of "financial options as a hedge against BGS procurement costs" was "widely utilized in the electric utility industry . . . and the Company was late in incorporating their use as part of its BGS procurement program." *S-38* at VII-53. The Auditors also noted that even when the Company followed the lead of its industry peers and used financial instruments, that usage amounted to only 0.05% of the Company's total BGS expenditures. *Id.*

The Company's imprudence can also be discerned from its failure to adopt multiple recommendations intended to utilize weather hedging. As described by the Auditors, "[t]he Company was aware of, but did not avail itself of weather hedges that may have provided some additional volume protection during the summer of 2001." *S-38* at VII-54. Risk Oversight Committee ("ROC") meetings minutes reveal that Anood Kapoor of GPU requested authorization to use weather derivatives as hedges as early as December 1999. *S-38* at VII-

55. Subsequently, in an April 2001 presentation, Dr. Kapoor again advised GPU to examine the suitability of weather derivatives as procurement hedges. *R-56(1)*, p. 43, entitled, "HOST: All You Want to Know, and Some More." The Company, however, failed to heed this advice. The Ratepayer Advocate does not propose that the Company should have followed every recommendation presented to it, but significant questions as to the Company's prudence surface when management ignores repeated advice. In sum, the Company failed to adhere to common current industry practice, and disregarded specifically recommendations presented to it on multiple occasions.

6. The Adverse Inference Rule

As described in the Ratepayer Advocate's Initial Brief, during the course of this proceeding, JCP&L was repeatedly late in providing information in response to discovery requests (*R-59*, p. PLC-3), and Ratepayer Advocate review of that information, when it was finally received, revealed that the Company could produce little documented justification for its actions. *R-59*, p. 31:1-32:2. *See RAIB* at 10.

The Company's poor documentation process was further evidenced by the response to RAR-BGS-124, *R-82* in which the Company states that "[w]ritten notes and price quotations from these discussions [analyzing volatility in PJM capacity auctions and other capacity markets] and resultant views were not kept." The Company also stated in response to RAR-BGS-66, *R-80* that "[n]o operational reason existed to record such [broker] quotes in a historic database and JCP&L did not do so."

The Company's case is weakened by its failure to produced adequate evidence. The "adverse inference rule" provides that when a party has within his control relevant evidence that he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him. *International Union (UAW) v.*

NLRB, 459 *F.2d* 1329, 1336 (D.C. Cir. 1972). The adverse inference rule has been adopted specifically by FERC and its predecessor agency, the FPC, *see, e.g., New England Power Co.*, 27 F.E.R.C. 65,168, and should similarly be adopted by the Board. The rule is articulated in *Alabama Power Co. v. F.P.C.*, 511 *F.2d* 383 (D.C. Cir. 1974), wherein the court stated: "It is a familiar rule of evidence that a party having control of information bearing upon a disputed issue may be given the burden of bringing it forward and suffering an adverse inference from failure to do so." *See* McCormick, Evidence sec. 337 at 787 (2d ed. 1972). As described in the Ratepayer Advocate Initial Brief, *RAIB* at 11, 12, the Company failed to document its processes and inputs adequately. The Company's haphazard processes of power procurement are mirrored in the Joint Position – a final conclusion with no documented support.

D. The Audit Report Lacked Evidence of Independent Analysis and Should Not Be Relied upon by the Board.

The Joint Position's statement that it "consider[ed], among other things, the Phase I Audit of Deferred Balances report of Mitchell and Titus, LLP and Barrington-Wellesley Group, Inc.," is a circular and self-congratulatory exercise. As set forth in the Ratepayer Advocate Brief, the Audit Report was a series of unsupported conclusions that lacked evidence of independent analysis. *RAIB* at 39. In its brief and in evidentiary hearings, the Ratepayer Advocate highlighted numerous instances in which the Audit Report presented as its findings nearly-direct (and sometimes completely direct) quotes of the Company's direct testimony and discovery responses without attribution . *RAIB* at 44. The Audit Report merely parroted the Company's position, thereby failing to establish that it was the product of thorough and independent analysis.

Moreover, the Auditors revealed on cross-examination that an apparent lack of records did not affect

their ability to audit the Company. In a discovery response, the Company described various reviews that it conducted, but concluded that "[w]ritten notes and price quotations from these discussions and resultant views were not kept." *R-82*. The Company also stated in response to RAR-BGS-66, *R-80* that "[n]o operational reason existed to record such [broker] quotes in a historic database and JCP&L did not do so." When asked how the analysis could be completed if "quotations" had never been retained by the Company, the Auditors responded that they "didn't care." T38:22-39:23 (4/28/03).

E. Summary and Conclusion

The Company, which bears the burden of proof in this proceeding, has not demonstrated that it incurred its BGS costs prudently. Therefore, the Ratepayer Advocate recommends that the Board assume that what the Company did in Pennsylvania it should also have done in New Jersey - that is, keep energy supply purchase costs to a reasonable level. The New Jersey Board has an obligation to first and foremost protect New Jersey ratepayers. Accordingly, the Board should deny recovery of $239 million of the deferred balances as well as the $59,463,586 in interest collected on the Company's NUG above market costs. Furthermore, with respect to the Freehold Buyout, it appears from Susan Marano's Schedule SDM-4 that the Company may be including the Freehold Buyout balance in their interest calculation. This is in violation of the Board's *Final Order* and should be adjusted by the Company. Finally, the Board should disallow the Company's self-authorized collection of a 14.64% return on its generation assets through BGS revenues.

VII. DEMAND SIDE MANAGEMENT

The Board Should Reject the Joint Position's Proposal for Guaranteed Recovery of its Claimed Lost Revenues from Energy Efficiency Programs. This Proposal Violates the Board's Mandates That Such Lost Revenue Recovery May Continue Only Through 2003, and Will Be Allowed in Rates Only After the Board Has Determined the Protocols for Measuring Energy Savings.

A. Introduction

JCP&L's Joint Position includes provisions which improperly guarantee the Company full recovery of "lost revenues" claimed to result from Board's Clean Energy Program. The Joint Position purports to eliminate an improper "lost revenue" adjustment to test year revenues, but provides no basis for the Board to assure that the proposed base rates actually reflect this adjustment. Moreover, the Company has included a provision that would grant the Company guaranteed recovery, through its SBC, of the "full amount" of all lost revenues deferred on the Company's books "from May 1, 2001 until the Board approves the protocols for measuring energy savings under the New Jersey Clean Energy Program ...." This provision should be rejected as a violation the Board Order governing the utilities' claims for "lost revenues" arising out of the Clean Energy Programs. As explained below, the Board has mandated that the utilities may recover lost revenues asserted to result from the Clean Energy Programs only through 2003, and has further required Board approval of the protocols for measuring energy savings before such lost revenues may be collected in rates.

B. Background

A brief review of the history of JCP&L's energy efficiency and renewable energy programs will be helpful in placing the Company's various claims for "lost revenues" in context.

In the 1990's, the New Jersey electric and gas utilities implemented programs known as demand side management, or "DSM," programs. These programs were designed to establish and maintain cost-effective energy efficiency technologies by providing financial incentives for customers and energy efficiency contractors to install energy-saving technologies such as insulation and high-efficiency lighting, appliances, and heating and cooling equipment. These pre-EDECA programs are often referred to as "legacy" programs. The Board's DSM regulations permitted the utilities to fund the DSM programs, including lost revenues, via monies collected from ratepayers through an adjustment clause mechanism. "Lost revenues" refers to the revenues lost when energy efficiency programs reduce sales, net of corresponding reductions in the utility's variable costs. *R-69*, p. 5.

With the enactment of EDECA, the Board was directed to undertake a comprehensive review of the utilities' existing energy efficiency programs, to determine the appropriate level of ratepayer funding for energy efficiency measures, and to establish the appropriate funding levels for new programs to promote the development of renewable energy sources such as wind, solar, and biomass. This process was the Comprehensive Resource Analysis program, known as "CRA." In its *March 9, 2001* Order,[4] the Board decided the specific CRA programs and budgets to be implemented by the utilities

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[4] *I/M/O the Petition of the Filings of the Comprehensive Resource Analysis of Energy Programs Pursuant to Section 12 of the Electric Discount and Energy Competition Act of 1999*, BPU Docket No. EX99050347 (Generic) *et al*., (Final Decision and Order March 9, 2001) (*"March 9, 2001 Order"*).

through the end of 2003. The Board determined which energy efficiency programs should continue, and also included guidelines for the establishment of renewable energy programs for the first time. The Board subsequently renamed the CRA program the New Jersey Clean Energy Program, and modified the programs and budgets in effect for 2003.[5]

The *March 9, 2001 Order* specifically addressed the recoverability of lost revenues that JCP&L now claims resulted from its new programs. In that Order, the Board adopted a joint position of the utilities and the National Resources Defense Council ("NRDC") which allowed lost revenue recovery for new energy efficiency programs, but not for renewable energy programs. Further, lost revenue recovery would not continue indefinitely. As the Board noted, the utilities/NRDC joint position provided that lost revenue recovery "would not count as a new program cost and would only be in effect through 2003." *March 9, 2001 Order* at 73. The Ratepayer Advocate was not a party to this joint position. This office had proposed a joint position that allowed no lost revenue recovery for new programs at all. However, the Board chose to adopt the utilities/NRDC joint position, meanwhile noting that:

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[5] *I/M/O the Petition of the Filings of the Comprehensive Resource Analysis of Energy Programs Pursuant to Section 12 of the Electric Discount and Energy Competition Act of 1999*, BPU Docket No. EX99050347 (Generic) *et al*., (Order dated January 22, 2003); *I/M/O the New Jersey Clean Energy Program – Incentives,* BPU Docket No. EO02120955 (Order dated February 27, 2003); *I/M/O the New Jersey Clean Energy Program – 2003 Budget Allocation,* BPU Docket No. EO02120955 (Order dated April 29, 2003).

> Lost revenue recovery and incentives were allowed under the DSM regulations only for programs with measured and verified savings. The amount of fixed cost revenue erosion resulting from energy efficiency measures can be significant and it is therefore important for the calculation of these costs to be accurate. This need for accuracy is the reason the Board was historically unwilling to allow the recovery of lost revenues for programs that did not have verified, measured savings.

Id. The Board also directed that "any continued recovery beyond 2001 for legacy program lost revenues shall decline to 80% in 2002 and 70% in 2003." *Id.* at 74. No lost revenue recovery would be available for renewable energy programs. Additionally, recovery for lost revenues that were a result of new energy efficiency programs would be subject to the approval of the calculation methodology by the Board "prior to their eligibility for collection of lost revenues". *Id*. at 77.

1. Proposed Lost Revenue "Annualization" Adjustment to Test Year Revenues.

In its base rate and deferral petitions, the Company sought cost recovery of its claimed lost revenues through two different mechanisms. First, JCP&L included in its proposed SBC rates lost revenues from the "legacy"energy efficiency programs that were established pursuant to the DSM regulations issued by the Board prior to the enactment of EDECA. *R-69*, p. 3. The Ratepayer Advocate did not object to this proposal, which was in accordance with the Board's DSM regulations.

The Company also proposed a novel "annualization" adjustment, by which it sought to account for lost revenues from the new energy efficiency programs through an adjustment to test year revenues. As Ratepayer Advocate witness Dr. David Nichols explained in his pre-filed direct testimony, this proposed "lost revenue" adjustment was improper as a matter of principle. Calendar year 2002 is the test year for the Company's base rate proceeding. *RA-69,* p. 6. Electricity savings from the Company

energy efficiency programs were reflected in the final actual retail sales revenues for the year. *Id*. In effect, the Company's adjustment incorporated an additional level of lost revenues in its proposed base rates. The Board has never allowed this type of embedded recovery of lost revenues through base rates.

Paragraph 7 of the Joint Position states that the Company's proposed revenue requirement reflects the reversal of the "lost revenue" adjustment. However, since the Joint Position proposes a "black box" position on revenue requirements, it is impossible to determine whether the proposed rates include this or any other specific adjustment. The rates to be established by the Board should be based on test year revenues that do not reflect the Company's proposed adjustment to test year revenues.

2. Proposed Guaranteed SBC Recovery of Lost Revenues.

The Joint Position, while purporting to reverse the improper adjustment to test year revenues, includes a new proposal that is no less improper. The new proposal is set forth in paragraph 12 of the Joint Position which provides as follows:

> 12. The Parties agree that from May 1, 2002 until the Board approves the protocols for measuring energy savings under the New Jersey Clean Energy Program (formerly Comprehensive Resource Analysis), the Company shall defer lost revenues based on the Company's energy savings as reported in the quarterly New Jersey Clean Energy Program Reports filed with the Board and shall receive full and timely recovery thereof through its SBC for the full amount thereof. Once approved, the Board-approved protocols will be used to calculate lost revenues on a prospective basis from the effective date of that written Board approval.

The above provision would grant the Company *guaranteed recovery* of all lost revenues *in the amounts claimed by the Company* from May 1, 2002 through the effective date of a Board Order approving the protocols for determining energy savings. This provision is in direct violation of the

Board's *March 9, 2001 Order*, which permits lost revenue recovery only through 2003, and allows such recovery in rates only after the Board has approved protocols for measuring the energy savings resulting from the New Jersey Clean Energy Program.

In its *March 9, 2001 Order*, the Board made it clear that it did not undertake lightly the task of allowing recovery for new energy efficiency programs, including "lost revenue" recovery. The Board carefully noted that lost revenue recovery for the New Jersey Clean Energy Program would continue only through 2003. *Id.* at 73. The Board was equally clear that it was going to be the sole arbiter for determining the methodology of determining energy savings (usually referred to as the protocols). Unequivocally, the Board stated in its Findings that, "[t]he program evaluation plans for determining energy savings must still be approved by the Board, *prior to eligibility for collection of lost revenues* for the new energy efficiency programs." *Id*. at 77. (Emphasis added). The language is specific and clear. There can be no recovery of lost revenues without Board approval of the protocols by which lost revenues will be determined.

The Board clearly stated in its *March 9, 2001 Order* that it intended to carefully review the utilities' propose protocols for estimating energy savings. The Order states, "[t]his need for accuracy is the reason the Board was historically unwilling to allow the recovery of lost revenues for programs that did not have verified, measured savings….[t]he Board wished to ensure that continued lost revenue recovery is based on accurate savings data." The Board also directed the continued decrease in collection of lost revenues for legacy programs "to protect ratepayers from paying too much." Ratepayer protection is also why the Board correctly insisted that, "the basis for determining the collection of lost revenues for the new energy efficiency programs must still be approved by the Board."

The Board did not state that protocols could be implemented and after the fact the Board would examine them. The Board wisely insisted that the protocols be approved *before* ratepayers begin to pay for alleged lost revenues.

Company witness Siebens correctly stated that the proceeding in which the Board is considering the utilities' proposed protocols "is still pending before the board." T15:L8 (3/7/03). "Pending" means that the protocols have not yet been approved, and at this point neither we nor anybody else knows what or how much the Board may approve. Until this is determined, there should simply be no lost revenue recovery. Ratepayers should not be made to pay in advance for lost revenues that the Board may or may not approve for recovery. To do so would benefit the Company shareholders at the expense of ratepayers.

Moreover, the Ratepayer Advocate has presented evidence demonstrating that the Board's caution is well justified. Dr. Nichols has identified a number of JCP&L protocols which, as presently proposed, significantly over-estimate annual energy savings. Lost revenue calculations are based on estimated energy savings. To the degree that energy savings are over-estimated, so will be lost revenues. *R-69*, p. 10, Schedule DN-1. In Schedule DN-1, Ratepayer Advocate witness Dr. David Nichols provides some examples of the problems with the utilities' proposed protocols.[6]

Dr. Nichols explained his particular concerns about the protocols after initially noting that JCP&L has a long history in the area of DSM. The Company was one of the first leaders in the field, promoting efficient lighting more than twenty years ago. T50:L1-4 (3/7/03). With respect to electricity

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[6] Dr. Nichols addressed programs and key issues that figure explicitly in JCP&L's calculation of lost revenues as shown in Schedule MJF-6.

savings and "lost revenues" from commercial lighting programs, Dr. Nichols noted that development in the marketplace and the spread of information indicated that there would be "some level of efficient lighting that would take place even if there were no utility program." *Id.* at L6-15. Indeed, Dr. Nichols noted that in parts of the country where no utility DSM programs exist, there are still customers who purchase efficient lighting. *Id.* at L17-18. In other words, it is simply inaccurate to use a baseline measurement reflecting an assumption that no efficient lighting would be installed in the absence of the New Jersey Clean Energy Program. Yet that is exactly what the utilities' measurement protocols used by JCP&L assume for all existing facilities that participate in DSM programs.

To determine whether the Company's commercial lighting programs have made a <u>net</u> impact, producing savings *above and beyond* the efficiency improvements occurring in the market anyway, a field study such as a market evaluation or market assessment must be conducted. However, Mr. Siebens stated that the Company has not yet used this tool to determine the accuracy of its "protocol" estimates of electricity savings. Accordingly, there is no way to know if the protocols have adequately estimated the energy savings from the New Jersey Clean Energy programs. T50-51, L19-2 (3/7/03). In any event it is unrealistic to assume, as do the protocols, that not even a single customer would choose efficient lighting for an existing facility were it not for the utility's New Jersey Clean Energy Programs.

Dr. Nichols' rebuttal testimony noted that the JCP&L Clean Energy Program of efficient lighting in new facilities contains many installation measures that happen frequently on a statewide basis. T52:L8-12 (3/7/03). Some of them are addressed in Ratepayer Advocate Exhibit R-71, which is a baseline study that was done in order to establish what was actually happening in New Jersey with regard to

efficient lighting in renovation and new construction. Dr. Nichols noted that, while the JCP&L savings measurement protocol assumes that efficiency lighting in new construction is 30% more efficient than standard, "the [protocol] standard for at least half of the year seems to have been ASHRAE 90.1 1989, which is an old standard, not a state-of-the-art standard." Dr. Nichols therefore "remain[ed] persuaded that there is some level of free ridership, and that lost revenues are being overestimated simply by applying the protocols in their present form." T52:L13-23 (3/7/03).

The same rationale applies to the measurement protocols applied to estimate savings from efficient residential central air conditioners. The Company claims that the least efficient air conditioning unit on the market is the "predominant" unit bought. But unless *every single customer* who purchases an air conditioning unit would buy the least expensive but also the least efficient unit, the baseline for the protocol should not be the least efficient unit, as it is rather, it should be something above that. Again, without a market assessment, it is impossible to determine the accuracy of the estimates upon which the protocols are based. By assuming the least efficient unit is the baseline, "we are making a generous estimate about how much is being saved." Indeed, Dr. Nichols noted that, when we are talking about lost revenues that will affect the revenue calculation, "we should be making the most cautious estimates possible, and that is not what these protocols do." T53:L24 - T54: L7 (3/7/03).

Company witness Mr. Siebens responded in his rebuttal to Dr. Nichols' criticism of the protocols by stating that, "the protocols proposed by the utilities do not exaggerate impacts in the aggregate. Of course, JCP&L welcomes the opportunity to further discuss the protocols themselves, within the context of the CRA hearing." *JC-16*, p. 3. However, the Company had already been provided with the opportunity to discuss the protocols. As Dr. Nichols noted at the March 7, 2003

hearing:

> There was a meeting of the parties in the CRA proceeding in October of 2001 where I, and the utilities were present, JCP&L, Public Service and the others, where I detailed measure by measure my concerns with these protocols. There was a consultant to the utilities from out of town, another out-of-town consultant who was present, who was responsible for the protocols. And my understanding was that he was going to take my detailed measure-by-measure criticisms and go out and do some re-working of the protocols.

T48:L8-18 (3/7/03). Dr. Nichols concluded that he continued to have the same concerns about the overstatement of lost revenues as he did in 2001, for the "the protocols in their form as submitted are being used to calculate the lost revenues." T48:L19-24 (3/7/03).[7]

C. Conclusion

For the foregoing reasons, the Board should reject the Company's proposals for recovery of lost revenues claimed to result from the energy efficiency programs included in the Board-approved New Jersey Clean Energy Program. The base rates established by the Board should reflect the reversal of the "lost revenue" adjustment proposed in the Company's base rate petition. The Company's proposal for guaranteed recovery of lost revenues through the SBC should also be rejected.

POINT VIII. CONSUMER EDUCATION

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[7] A meeting to discuss the utilities' proposed protocols was held on May 20, 2003. However, at Staff's suggestion the discussion at the meeting, as well as written comments subsequently filed by the Ratepayer Advocate, focused on a technical review of the Company proposal. Discussion of policy issues, including the application of the protocols to lost revenue recovery, was deferred to a later date. The Ratepayer Advocate is currently awaiting guidance from the Board's Staff as to the appropriate forum for raising its concerns about the application of the utilities' proposed protocols to lost revenue recovery.

Consumer Education Program ("CEP") Costs Incurred by JCP&L Are Not Recoverable Through the Societal Benefits Charge Because the Company Has Failed To Establish That The Costs Were Reasonably and Prudently Incurred.

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* prudence standard. Rather it simply asserts monetary amounts with no explanation of the prudence or reasonableness of these amounts. The Company may not recover CEP costs until it has shown 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, as discussed in the Ratepayer Advocate's Initial and Reply Briefs, the Company has failed to present any evidence in order to meet its burden

Continuing in the philosophy that to say it makes it so, the Joint Position provides:

> As part of the resolution of the 2002 CED Filing, the Parties also agree that the total CED costs, which have been audited by the Board's Auditors, Mitchell & Titus, LLP, through July 31, 2002, are reasonable.

The Joint Position implies that the Board's Auditors made some kind of substantive finding regarding the Company's CEP costs, that the Auditors made a determination that the CEP were reasonably and prudently incurred. In fact, the Auditors made no such finding. The Auditors merely reviewed the interest calculation and concluded "[w]e noted no material non-compliance issues with JCP&L's accounting of the rate recovery or recording of expenses related to the SBC component." Mitchell & Titus, L.L.P., III-10. If this is the basis for the ALJ's finding that the $5,382,000 in CEP

costs can properly be collected from ratepayers, it is woefully inadequate. Indeed, there is no support in the record for such a finding.

The Ratepayer Advocate, first of all, reiterates its position, discussed at length in the our Initial and Reply Briefs that CEP costs should not be collected from ratepayers without proof from the Company, and a finding by the Board, that the costs for this program were reasonably and prudently incurred. As the Board stated in its June 23, 2000 Order, "[t]he reasonableness and prudence of the cost levels incurred to achieve the Board approved measures of success will need to be assessed in reviewing the SBC filings." The Company has failed to provide any evidence that the CEP costs that it seeks to recover were incurred in accordance with the prudence standards that were clearly set out in the Board in the *Hope Creek Order*. With no evidence from JCP&L, the Board cannot find that the Company's expenditures were reasonable, prudent, and therefore eligible for recovery from ratepayers.

Additionally, and again, as discussed in the Ratepayer Advocate's Initial and Reply Briefs, as the statewide CEP did not attain all of the Measures of Success benchmarks in Years 2 and 3, recovery is automatically precluded. The Company's ratepayers should not be made to pay for a program from which they received little or no benefit. Accordingly, the Board should disallow recovery of the Company's CEP costs.

POINT IX. DEFERRAL RECOVERY

At its agenda meeting on March 20, 2003, the Board recalled several issues related to the securitization and amortization of deferred balances. The Board's action was memorialized in a letter dated March 25, 2003 from Board Secretary Kristi Izzo ("Secretary's Letter"). The letter recalled "the issue of how much of the prudently incurred deferred balances should be securitized and how much should be amortized, what is the appropriate length of the amortization and the interest rate." Secretary's Letter, p. 1. The Secretary's Letter also recalled the issue of "whether all or part of the prudently incurred deferred balances are legally eligible for securitization under EDECA." *Id*. However, the Secretary's Letter also provided that "[t]o the extent that the parties have offered opinions on the setting of transitional amortization and interest rates in their cases, those portions of their briefs will be reserved to the Board and decided by the Board as part of their final rate Order." *Id*., p. 2. The Ratepayer Advocate, Board Staff, and the Company addressed the amortization and interest issues in their briefs before the OAL. *See* RAIB vol. 2, pp. 74-79; SIB, pp. 173-175; PIB, pp. 191-193; PRB, pp. 115-117.

The signatories address recovery of JCP&L's deferred balance in the *Joint Position* at pp. 11-13. The signatories propose different interim carrying charges depending on when the Board approves JCP&L's securitization proposal, and alternative rates should the Board not approve JCP&L' securitization proposal. *Id*. As set forth in the testimony of its witness, Mr. James Rothschild, and in its brief before the OAL, the Ratepayer Advocate recommends a ten-year amortization period for the

Company's deferred balance, with interest fixed at the seven-year treasury rate.[8] *RA-50*; RAIBvol2, pp. 74-79. The record is bereft of any showing of ratepayer benefits tied to the signatories' alternative proposals. In contrast, Mr. Rothschild demonstrated that the Ratepayer Advocate's proposal would be less costly to ratepayers than the Company's proposals. *RA-50*. For the reasons set forth in the Ratepayer Advocate's brief and testimony of its witness before the OAL, the Ratepayer Advocate respectfully submits that the Board should adopt the recovery mechanism recommended by the Ratepayer Advocate.

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[8] Seven-year treasury rate shown in the Federal Reserve Statistical Release on or closest to August 1, plus 60 basis points.

POINT X. CONCLUSION

The Joint Position adopted by the ALJ arrived at a result that is excessive and unfair to the vast majority of the Company's ratepayers. As discussed more fully in the Ratepayer Advocate's Initial and Reply Briefs, and incorporated herein by reference, the agreed upon result is not supported by the record and should be summarily rejected by the Board. The Company has placed the interest of shareholders and a few large energy users over the interest of New Jersey consumers. The New Jersey Board must not do the same.

For all the foregoing reasons, as well as those set forth in the testimony of the Ratepayer Advocate's witnesses, the Ratepayer Advocate respectfully requests that the Board reject the Joint Position and adopt the recommendations of the Ratepayer Advocate in this matter.

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