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January 23, 2002

Hon. Jeffrey E. Stockholm
Hon. J. Michael Harrison
Administrative Law Judges
Department of Public Service
Three Empire State Plaza
Albany, New York 12223-1350

Re: Case 01-E-0359 – New York State Electric & Gas Corporation – Petition For Approval of Its Electric Price Protection Plan.

Case 01-M-0404 – Energy East Corporation, RGS Energy Group, Inc., New York State Electric & Gas Corporation and Eagle Merger Corporation – Petition For Approval of Merger and Stock Acquisition.

Dear Judges Stockholm and Harrison:

In accordance with the Procedural Ruling issued January 18, 2002 in these proceedings, enclosed please find the Staff Statement in Support of Joint Proposal. A copy has been served on all active parties in conformance with the Ruling.

Very truly yours,

Leonard Van Ryn

Leonard Van Ryn
Staff Counsel

Enclosures
cc: All Active Parties

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 01-E-0359 - New York State Electric & Gas Corporation - Petition for Approval of Its Electric Price Protection Plan.

CASE 01-M-0404 - Energy East Corporation, RGS Energy Group, Inc., New York State Electric & Gas Corporation, Rochester Gas and Electric Corporation and Eagle Merger Corporation - Joint Petition For Approval of Merger and Stock Acquisition.

Staff Statement in Support of Joint Proposal

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Case 01-M-0404 - Energy East Corporation, RGS Energy Group, Inc., New York State Electric & Gas Corporation, Rochester Gas & Electric Corporation and Eagle Merger Corporation - Joint Petition For Approval of Merger and Stock Acquisition.

STAFF STATEMENT IN SUPPORT OF JOINT PROPOSAL

PRELIMINARY STATEMENT

In Opinion No. 98-6, the Commission adopted a Rate and Restructuring Plan (RRP) for New York State Electric & Gas Corporation (NYSEG).[1] Under the RRP, NYSEG was to divest its major electric generating facilities, unbundle its rates into delivery and commodity components, and open its service territory to retail access for customers seeking competitive alternatives to utility electric service. The RRP was also intended to reduce electric rates for all customers and promote economic development.

The term of the RRP extended through March 2, 2003. The proposals made in these proceedings would supercede the RRP.

[1] Case 96-E-0891, New York State Electric & Gas Corporation - Plans For Electric Rates and Restructuring, Opinion No. 98-6 (issued March 5, 1998); and Order Adopting Terms of Settlement Subject to Modifications and Conditions (issued January 27, 1998)(Short Order).

A. Procedural History

On March 14, 2001, NYSEG proposed adoption of an Electric Price Protection Plan (EPPP) that would be substituted for the RRP prior to its March 2, 2003 expiration. On March 23, 2001, NYSEG and Rochester Gas & Electric Corporation (RG&E) filed a petition requesting approval of a proposed merger between the two.[2] After extensive administrative proceedings, the parties to the EPPP and merger cases executed a Joint Proposal (JP) on January 15, 2002, resolving all outstanding disputes in the two proceedings.

The procedural history of these proceedings is set forth at JP 2-4. To summarize, after settlement discussions on the EPPP reached impasse, NYSEG submitted an evidentiary presentation on August 3, 2001. On August 8, Multiple Intervenors (MI) responded to NYSEG's presentation with a motion requesting that a temporary rate reduction be implemented expeditiously. Responsive comments and testimony on the NYSEG evidentiary presentation and the MI motion were filed on September 5, 2001, and replies to the responsive submittals were filed on September 12, 2001. Evidentiary hearings were conducted from October 15 through October 18, 2001. 1,442 pages

[2] NYSEG's parent, Energy East Corporation (Energy East) and RG&E's parent, RGS Energy Group, Inc. (RGS) joined in the petition, along with Eagle Merger Corporation (Eagle), an entity created to facilitate the merger.

of stenographic minutes (SM) were taken and 112 exhibits were introduced into evidence.

Following the close of the record, parties continued to engage in settlement negotiations. On January 10, 2002, the Commission, in the Temporary Rate Order,[3] directed that NYSEG's electric rates be reduced on a temporary basis, but made the reduction effective as of January 30, 2002. The issues raised in the Temporary Rate Order, and otherwise attending the EPPP, are addressed and resolved in the Joint Proposal.

The issues raised by the Merger proceeding are also addressed and resolved in the Joint Proposal. Settlement negotiations following the filing of the petition in that proceeding were initially unsuccessful, and Staff and other parties filed comments in opposition to the merger on September 11, 2001. NYSEG and RG&E filed comments in response and in support of the merger on September 25, 2001. Thereafter, negotiations among the parties to the EPPP and Merger cases were joined. The January 15, 2002 Joint Proposal followed.

B. The Criteria For Judging a Joint Proposal

The Commission should adopt the Joint Proposal because it satisfies the criteria the Commission has adopted for establishing the reasonableness of utility rate settlements. In

[3] Case 01-E-0359, supra, Order on Temporary Rates (issued January 10, 2002).

considering recent settlements, the Commission has generally evaluated each settlement on its own merits against a standard of reasonableness. It has also reviewed the adequacy of settlements in furthering the progress of implementing retail competition.[4] These reviews have been conducted in conformance with the guidelines the Commission established in Opinion No. 92-2 for consideration of settlements.[5]

Opinion No. 92-2 identifies a number of criteria for judging whether a settlement is in the public interest. In considering a settlement, the Commission also reviews the extent to which it is supported by generally adverse parties and determines that the record for decision is adequate. In order to win approval, a settlement should be consistent with law and public policy, have a rational basis, balance the interests of customers and the utility, and compare favorably with the probable outcome of litigation. The Joint Proposal here satisfies these criteria.

There is broad support for the Joint Proposal. Parties representing consumer groups adverse to the interests of

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[4] Case 01-M-0075, Niagara Mohawk Power Corporation, et al. - Merger and Electric Rates, Opinion No. 01-6 (issued December 3, 2001); Case 00-E-1273, Central Hudson Gas and Electric Corporation - Electric and Gas Rates, Order Establishing Rates (issued October 25, 2001)(Central Hudson Rate Order).

[5] Case 90-M-0255, Proceeding on Settlement Procedures and Guidelines, Opinion No. 92-2 (issued March 24, 1992).

NYSEG and RG&E, such as the Attorney General (AG), Consumer Protection Board (CPB), and Multiple Intervenors (MI) have executed it. Energy services companies (ESCO) like Strategic Power Management (SPM) and customer aggregators like the Municipal Electric and Gas Alliance (MEGA) have also joined in its terms. While the settlement is not unanimous, there is support for it among a broad range of parties representing consumer and ESCO interests.

The record is adequate to justify adoption of the Joint Proposal. In the Order Clarifying Data Required issued April 25, 2001 in Case 01-E-0359, the Commission articulated the quantum of information needed to consider extensions of multi-year rate plans. The Commission found that NYSEG had not supplied the requisite information, and that its March 14, 2001 EPPP filing could not be evaluated on the basis of the information that had been submitted. The Commission ruled that NYSEG must supply the level of detail consistent with the Order Clarifying Gas Policy Statement.[6]

NYSEG thereafter submitted additional information, meeting the standards established in the Order Clarifying Data Required. Moreover, NYSEG subsequently submitted further

[6] Case 93-G-0932, Proceeding on Restructuring of the Emerging Natural Gas Market, Order Clarifying Gas Policy Statement (issued April 1, 1999).

testimony and exhibits in support of the EPPP, and Staff and other parties submitted responsive testimony and exhibits. These presentations were the subject of the October hearings in this proceeding. Evidence drawn from this now-extensive record is sufficient to support the Joint Proposal.

The remaining Commission criteria for judging the reasonableness of a settlement are directed towards ascertaining whether the proposed terms are in the public interest. For the reasons discussed below, the Joint Proposal meets that standard.

C. Summary of the Joint Proposal

The Joint Proposal provides for rate reductions, unbundles commodity and delivery functions, increases customer choice, protects service quality and reliability, and expands economic development opportunities. Benefits from the sale of Nine Mile II and NYSEG's other generating facilities are dispensed for the benefit of ratepayers, to enhance rate reductions or offset impacts from mandated or unexpected uncontrollable cost increases. Moreover, the Joint Proposal opens the path to approval of the merger between NYSEG and RG&E, by establishing the proper allocation of synergy savings between ratepayers and shareholders. These provisions are in the public interest.

Under the Joint Proposal, rates are reduced as of March 1, 2002 by $205 million on an annual basis. For 2002, a disbursement of $45.8 million from the Asset Sales Gain Account (ASGA) assists in funding the rate reduction.[7] The annual $205 million rate reduction is then maintained for each of the remaining four years of the five-year Rate Plan, through December 31, 2006.

The Joint Proposal sets forth an earnings sharing mechanism that balances ratepayer and shareholder interests. For calendar year 2002, earnings above a 15.5% return on equity (ROE) would be split evenly between ratepayers and shareholders. During the remainder of the Rate Plan's five-year term, sharing would begin at either a 12.5% ROE on delivery service or a 15.5% overall ROE (including earnings on commodity service). The larger of the exceedance above either of those targets would be the amount shared.

Customer retail choice is expanded under the Joint Proposal. Beginning January 1, 2003, rates are unbundled. The fixed cost of distributing power to customers will be collected through a delivery rate. Costs of existing commodity commitments, like purchases from the New York Power Authority (NYPA), the new owner of the Nine Mile II nuclear plant and non-utility generators (NUG) will be recovered through a non-

[7] The ASGA was established as the repository for NYSEG's share of Nine Mile II sales proceeds in Case 01-E-0011, Niagara Mohawk Power Corporation, et al., Petition For Approval of Transfer, Order Authorizing Asset Transfers (issued October 26, 2001).

bypassable wires charge (NWC). Beyond this framework, customers will be offered a variety of choices for obtaining commodity supply.

Customers may opt for the ESCO Rate Option, where ESCOs provide the commodity. Under the Variable Rate Option (VRO), NYSEG will supply the commodity by flowing through to ratepayers, New York Independent System Operator (NYISO) day-ahead market prices. The utility will also offer a Bundled Rate Option (BRO) where commodity prices and the NWC will remain fixed for a two-year term from 2003 through 2004. The fixed rate option will be made available for a second two-year period from 2005 through 2006.

Customers may avail themselves of retail access through the ERO or through the BRO subject to market price and retail access back-out credits. Retail access will be promoted through a number of other mechanisms. NYSEG will conduct a survey that measures ESCO satisfaction and another survey that measures customer awareness of competition, and take steps to correct any deficiencies the surveys uncover. The utility will designate a company manager as an ESCO liaison, who will facilitate ESCO-utility interactions. It will conduct market match and market expo programs to assist customers in seeking out ESCO providers.

Under the Joint Proposal, service quality and reliability are enhanced, as customer satisfaction and reliability targets are tightened and the revenue adjustment payments due upon missed targets are increased. A low-income program is also continued.

Finally, the merger provisions of the Joint Proposal capture synergy savings for NYSEG and RG&E electric and gas customers. A Code of Conduct designed to prevent anti-competitive behavior and ensure access to affiliate books and records is instituted. Service quality and reliability and outreach and education initiatives are continued under individual gas and electric operation proceedings.

DISCUSSION

The provisions of the Joint Proposal satisfy the public interest. The rates for the delivery and commodity service are just and reasonable, and the retail access options are intended to promote the growth of retail competition. Existing public policy programs are continued and enhanced. Consequently, the Joint Proposal is in the public interest and the Commission should adopt its terms and conditions.

A. The Merger

The Joint Proposal resolves all outstanding disputes over approval of the merger between NYSEG and RG&E, and provides for the allocation of the estimated $164 million in net synergy savings expected over the first five years following consummation of the merger. The synergy savings from the merger will be evenly divided between ratepayers and shareholders for RG&E electric and gas ratepayers and NYSEG gas ratepayers over the five-year period. This allocation will be captured in future rate proceedings affecting those utility operational units. The share of merger savings for NYSEG electric ratepayers is included in the $205 million annual rate reductions for the five-year term. After the five-year terms end, NYSEG and RG&E are afforded the opportunity to demonstrate that merger synergies are still producing benefits that should be shared with shareholders for years six through ten following consummation of the merger (JP 6-8).

The Joint Proposal establishes a Code of Conduct that governs the operation of the merged NYSEG and RG&E entity, and holding company and affiliate relationships (JP 8, App. B). The new Code replaces various versions of prior Codes of Conduct that had adhered to NYSEG and RG&E operations, and combines the prior Codes into one document. Code provisions have been updated, simplified and clarified. The resulting document unifies prior provisions, facilitating a better understanding of the rules governing affiliate relationships among regulated entities, unregulated affiliates, and Staff (which is responsible for auditing those relationships).

The Code of Conduct proscribes anti-competitive behavior, by requiring that the NYSEG and RG&E retail businesses forgo favorable treatment of affiliates in their dealings with customers, ESCOs, and suppliers. The Code of Conduct also reinforces the Commission's statutory authority over access to books and records, by facilitating the auditing of transactions for goods and services and cost allocations between the NYSEG, RG&E and any affiliates. Guidelines for allocating costs between regulated entities and affiliates are established.

Upon these provisions, the objections Staff raised to the merger in its September 11, 2001 comments in Case 01-M-0404 are satisfied. The merger savings for NYSEG electric payers are folded into the overall rate reductions ratepayers will receive. This approach is reasonable because it accomplishes sharing even though the exact amount allocated to shareholders and ratepayers is not specifically identified, because it resolves the dispute between Staff and NYSEG over the interpretation of the RRP.

NYSEG had contended that the existing Rate Plan allowed it to retain all the estimated net synergy savings from any merger consummated during the RRP's term. Staff disputed that contention, maintaining that NYSEG had to demonstrate a "net positive benefit" to ratepayers existed in order to justify approval of the merger under Public Service Law (PSL) §70. Merging synergy savings into the overall rate reduction for

NYSEG electric ratepayers ends that dispute by ensuring ratepayers receive an adequate level of sharing.

For the NYSEG gas and RG&E electric and gas operating units, the Joint Proposal splits synergy savings evenly between ratepayers and shareholders over a five-year period. This allocation, which will be implemented in future rate proceedings involving those operational units, comports with precedent.[8] The "net positive benefit" test for justifying a merger has therefore been satisfied, for each of the NYSEG and RG&E operational units.

Staff had also opposed the merger on the grounds that the Code of Conduct was deficient; that NYSEG had failed to address the effect of accounting for "goodwill" on the capital structure of the merged entity and its operating units; and, that service quality and economic development were not adequately addressed. The Joint Proposal satisfies each of these concerns.

The Code of Conduct has been updated and revised to adequately protect ratepayers from anti-competitive affiliate abuses. "Goodwill" will be recorded under the purchase method

[8] Opinion No. 01-6, pp. 61-62; Case 00-M-0095, Consolidated Edison Company of New York, Inc., et al., Approval of a Merger and Electric Rate Plan, Opinion No. 00-14 (issued November 30, 2000); Case 97-M-0567, Brooklyn Union Gas Company et al., - Approval of Asset Transfer, Opinion No. 98-9 (issued April 14, 1998).

of accounting, which avoids the "pushdown" of "goodwill" to the RG&E and NYSEG operating units (JP 9). Ratepayers thereby escape bearing potential adverse "goodwill" cost impacts in calculating ROE.

The merger provisions also promote public benefit and economic development policies within the context of proceedings directed towards the NYSEG and RG&E operating units. This approach preserved the existing provisions for the RG&E gas and electric and the NYSEG gas operational units. The NYSEG electric operational unit is governed by the other provisions of the Joint Proposal, which, as discussed below, are reasonable.

Accordingly, the Joint Proposal creates a framework for the merger between NYSEG and RG&E that protects ratepayer interests. Staff therefore recommends approval of the merger.

B. Related Proceedings

The Joint Proposal properly coordinates the proposed Rate Plan with existing proceedings (JP 10-11). It resolves numerous petitions for rehearing and complaints that are currently before the Commission, and closes those matters. It provides that the Unbundling Proceeding will be implemented in conformance with the requirements that will be adopted there.[9] Moreover, NYSEG agrees to perform a fully allocated embedded cost of service study to be used in setting accurate delivery rates in the future. These provisions clarify NYSEG's obligations and so are in the public interest.

C. Electric Revenue Requirements

1. The Rate Plan

Under the Joint Proposal, NYSEG will reduce its annual electric delivery revenues by $205 million on March 1, 2002. This $205 million reduction continues in effect for the entire five-year term of the Rate Plan, including calendar Rate Years 2003 through 2006. This 2002 rate reduction is implemented for the ten months of 2002 by applying $45.8 million from the ASGA to an annualized revenue reduction of $150 million.[10] For calendar rate years 2003 through 2006 of the Rate Plan, the rate reduction of $205 million is achieved by flowing through $5 million of transmission revenues to delivery rates that reflect $200 million in revenue reductions (JP 12).[11]

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[9] Case 00-M-0504, Proceeding on Development of Retail Competitive Opportunities, Order Directing Expedited Consideration of Rate Unbundling (issued March 29, 2001).

[10] The annualized amount is reduced proportionately to reflect that the first two months of 2002 are priced at existing rates.

[11] Remaining transmission revenues during Rate Years 2003 through 2006 are offset against commodity costs.

The rate reduction in 2002 for bundled rate customers is approximately 13%. In rate years 2003 through 2006, annual delivery revenues are reduced by approximately 26%. These substantial rate reductions that are achieved through the Joint Proposal are advantageous to ratepayers and the Rate Plan is in the public interest.

2. Other Rate Plan Elements

The Joint Proposal details the future use of the ASGA, which is expected to initially contain $106 million after Nine Mile II sales proceeds and costs are reflected. The ASGA will accumulate interest at a 10.5% pre-tax return on the net of tax balance. After $45.8 million is expended to reduce rates in 2002, the remainder of the ASGA will be used to offset uncontrollable costs that arise during the course of the Rate Plan's term. Any remaining balance will be returned to ratepayers at the end of the term (JP 13-14).

The Joint Proposal reflects actual power supply costs for 2002, subject to reconciliation. The reconciliation protects both ratepayers and shareholders in the event that actual power supply costs deviate from forecast (JP 14).

Moreover, the Joint Proposal properly provides for recovery of the System Benefit Charge (SBC), and for coordination of SBC recoveries with spending on the Low-Income

Power Partner Program. This conforms with the Commission's approach to use of the SBC (JP 15-16).[12]

As noted in the Temporary Rate Order, NYSEG's capital expenditures raise an important issue that should be addressed in arriving at a Rate Plan. Under the RRP, NYSEG overearned in part because it failed to make expected capital expenditures on improvements to its electric systems. This deficiency is addressed in the Joint Proposal. NYSEG's capital expenditures during the term of the rate plan are presumed to reach $355 million. If actual capital expenditures fall short of that forecast by more than $40 million at the expiration of the Rate Plan, NYSEG will credit ratepayers at 25% of any shortfall beyond $40 million (JP 15).

These features properly establish a reasonable revenue requirement for NYSEG. Shareholders are allowed to recover all properly-incurred costs, while ratepayers enjoy substantially reduced rates.

3. Comparison to RRP and Temporary Rates

The Rate Plan contained in the Joint Proposal is superior to the existing RRP, and to the approach to rates set

[12] Case 94-E-0952, Competitive Opportunities Regarding Electric Service, Order Continuing and Expanding the System Benefits Charge For Public Benefit Programs (issued January 26, 2001), and Order Addressing Petitions For Clarification and/or Rehearing and Adjusting SBC Budgets (issued July 3, 2001).

forth in the Temporary Rate Order. The existing RRP provided for a rate reduction on March 3, 2002 that amounted to about $60 million on an annualized basis. The rate reduction under the Joint Proposal for 2002 is $150 million on an annualized basis,[13] not including the ASGA proceeds used to engender the overall annualized $205 million reduction in effect beginning on March 1, 2003. The Joint Proposal approach therefore creates $90 million in additional benefits for ratepayers during 2002, when compared to the RRP.

Moreover, the Joint Proposal enhances public policy programs, discussed below, that continue through 2006. The RRP public policy programs generally expire with it, and are inferior to the Joint Proposal programs in any event. Replacing the RRP with the Joint Proposal therefore furthers the public interest.

The Joint Proposal Rate Plan is also superior to the rate reductions adopted in the Temporary Rate Order. Under the Joint Proposal, ratepayers will see the same rate reduction in 2002 of $205 million on an annualized basis (including the ASGA

[13] Short Order, App. A, p. 12.

proceeds) that they would have seen had temporary rates been introduced. Moreover, temporary rates could have been adjusted upward even before 2002 ended.

Since the Joint Proposal Rate Plan followed issuance of the Temporary Rate Order, it was possible to avoid pitfalls that could have undermined the $205 million reduction provided for in the Order. Because temporary rates can be retroactively adjusted once a permanent rate level is arrived at, the Commission did not resolve the issues raised in this proceeding "concerning projected revenues, capital expenditures, operations and maintenance expenses, and other components of revenue requirements."[14] While the $205 million temporary rate reduction was reasonable, it was subject to potential evidentiary uncertainties that could have resulted in adoption of permanent rates at a higher level.

For example, if fuel and power purchase expenses rose while transmission revenues fell from the forecast levels assumed under the Temporary Rate Order, NYSEG might have been entitled to recoupment or reparation of a revenue requirement higher than that provided for in the Order. Under the Joint Proposal, the estimates for those three items are reconciled to actual costs in 2002, thereby flowing through to ratepayers any

[14] Temporary Rate Order, p. p. 11.

benefits if costs are lower than forecast (JP 14). Risk to ratepayers is reduced concomitantly.

The Joint Proposal's Rate Plan also freezes rates at the $205 million rate reduction for the four Rate Years after 2002. There is no guarantee whatsoever that the Temporary Rate Order's $205 million reduction would have continued beyond 2002. A rate case prior to the end of 2006 would most likely have produced a revenue requirement higher than the $205 million rate reduction that is frozen through the end of 2006 under the Joint Proposal.

Use of the $45.8 million in ASGA proceeds to arrive at the Joint Proposal's $205 million reduction in 2002 was appropriate under these circumstances. The actual fuel, purchase power and transmission revenue rate elements could have deviated by at least the amount from the forecasts underlying the Temporary Rate Order reduction. The value of the reduction could then have been reduced by even more than $45.8 million through recoupment or reparation.

In contrast, under the Joint Proposal, the $205 million reduction is certain, and if the fuel, purchase power and transmission rate elements prove more favorable to ratepayers than the Joint Proposal forecast, then the benefits are captured through the reconciliation mechanism. In that event, ratepayers would realize the benefit of the Temporary

Rate Order forecast, while avoiding the potential for volatility attending that Order. The Joint Proposal approach is superior to the Temporary Rate Order approach.

Other benefits attend the Joint Proposal. The Temporary Rate Order was subject to litigation risk. NYSEG argued strenuously in Case 01-E-0359 that the Commission as a matter of law could not rescind the rates provided for in the RRP. The Joint Proposal ends that litigation risk.

As already noted, the Order did not provide for public policy programs. The Joint Proposal does, and its programs conform to the most recent developments in crafting those programs. The Joint Proposal also creates strong cost control incentives through limitations and deferrals and uncontrollable cost recovery, and other provisions. The Temporary Rate Order's cost control incentives are weak, because NYSEG could seek recoupment or reparation of costs it incurred.

The Joint Proposal not only reduces rates by $205 million on an annualized basis in 2002, it preserves that level of rate decrease for another four years. The 2002 rate decrease is more than the RRP decrease and is comparable to the Temporary Rate Order decrease for 2002. As a result, the Joint Proposal is superior to the RRP and the Temporary Rate Order rate reductions.

D. ROE and Earnings Sharing

1. The Sharing Mechanism

Earnings sharing mechanisms further protect ratepayers and shareholders. Total regulated electric earnings that exceed a 15.5% ROE for the calendar year 2002 will be split evenly between customers and shareholders. During Years 2003 through 2006 of the Rate Plan, there are two earnings thresholds -- a 12.5% ROE for delivery earnings and a 15.5% ROE for total regulated electric earnings. The greater of the excess amount above either of these two levels will be shared evenly (JP 16-17).

If delivery earnings fall below an 8.5% ROE, NYSEG may petition for rate relief (JP 17). This proceeding would be reopened and the terms and conditions adopted here would be reviewed upon such a petition.

Common equity used to calculate earnings will be based on NYSEG's average actual common equity ratio for the year or 45%, whichever is less. Items included and excluded from the ROE calculation are also listed (JP 18). The earnings calculation will be based on NYSEG's actual rate base, ending the unique approach to earnings calculation taken in the RRP.[15]

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[15] Case 96-E-0891, supra, Order Clarifying and Modifying Rate and Restructuring Plan (issued December 3, 1998).

The controversies attending the RRP calculation are thereby resolved.

2. ROE and Sharing Benefits

Electric rates under the Joint Proposal are designed to produce an ROE of 15.5% in calendar year 2002, assuming NYSEG absorbs net merger costs in that year. Given Staff's view of expenses, delivery rates are intended to produce a 10.5% ROE for the remaining four years of the Rate Plan, during calendar years 2003 through 2006.[16] The 10.5% delivery ROE, which reflects a sharing of expected merger savings, provides reasonable compensation for the risks of NYSEG's delivery business over the term of this Rate Plan and is comparable to the rates return established in other multi-year Rate Plans.

The ROE projections mesh appropriately with the earnings sharing mechanism. While NYSEG may earn up to 15.5% in 2002 under the sharing mechanism, this level is far below the potential earnings of over 40% described in the Temporary Rate Order and the Order Clarifying Data Required. Moreover, the 15.5% trigger adheres to earnings for all of calendar year 2002, including the first two months of the year that are otherwise outside the ambit of the new Rate Plan. Through this sharing provision, ratepayers are afforded an opportunity to realize

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[16] Projections of NYSEG's delivery ROE for the years 2002 through 2006 are attached as Appendx A.

benefits from excess NYSEG earnings in early 2002 that the utility would otherwise retain for shareholders. The compromise between the ROE levels NYSEG was achieving and the ROE level that will trigger sharing for 2002 under the Joint Proposal Rate Plan is therefore reasonable.

The ROE sharing triggers for 2003 through 2006 are appropriate. NYSEG is limited both in delivery rate overearnings, and overall overearnings that reflect its earnings on commodity sales to ratepayers. The 12.5% earnings trigger on delivery rates is needed to ensure that merger synergy savings are appropriately shared between ratepayers and shareholders. Since NYSEG faces greater risk in supplying commodity over the two, two-year BRO fixed price terms, the higher 15.5% sharing threshold for overall earnings sharing is appropriate.

E. Rate Design

Rate design under the Joint Proposal accords with existing Commission policies. The basic service charge will increase by $4 for residential customers, bringing it in line with the charge at other utilities.[17] Increases in customer charges for other classes are similarly designed. Energy and demand charges are decreased to offset the increase in customer charges, in a manner that maintains appropriate cost and inter-

[17] See Opinion No. 01-6; Central Hudson Rate Order.

class relationships. The combination of higher customer charges and lower demand and energy charges results in bill impacts that are acceptable for all classes (JP 19-21).

The rate reduction is allocated among customer classes so that the relationship among those classes is properly aligned and moved closer to marginal costs. Certain industrial high-load factor customers that received a 20% out of a scheduled 25% rate reduction under the RRP will now receive an 11.8% reduction. Other classifications that were scheduled to receive only a 5% rate decrease under the RRP on March 3, 2002 are now afforded a 13.9% overall reduction. Given the weighting of the rate decreases provided for under the RRP, this weighing of the rate decreases here is appropriate.

Moreover, the relationship among classes will be reviewed once a fully allocated embedded cost of service study is received (JP 21). This will ensure that the various rate classifications are in proper alignment with each other in the future.

F. Commodity Supply

The Joint Proposal sets forth an ambitious program for affording NYSEG's customers with options in securing commodity supply. These options will be implemented commencing January 1, 2003. In 2002, NYSEG will continue to offer bundled rates, with retail access customers obtaining supply through the subtraction of back-out credits from the bundled rate.[18] 2002 thereby serves as a transition year (JP 22).

1. The Four Rate Options

In 2003, NYSEG accomplishes full rate unbundling while continuing to offer a bundled rate to those customers that desire it. The Joint Proposal provides for four rate alternatives commencing on January 1, 2003 (JP 27-35). The ESCO Rate Option (ERO) establishes a fixed delivery rate, and a floating non-bypassable wires charge (NWC). ESCOs then supply commodity. The Variable Rate Option (VRO) is structured the same as the ERO, except that NYSEG will provide the commodity by flowing through the cost of purchases from the NYISO day ahead market.[19] These rate options resemble the unbundled offerings of other electric utilities.

NYSEG, however, will also proffer a Bundled Rate Option (BRO) that begins with the same delivery rate as the other options, but the NWC and the commodity price will be fixed for a two-year term commencing on January 1, 2003. A second

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[18] Case 96-E-0891, supra, Order Adopting a Market-Based Retail Access Credit (issued January 26, 2001) and Order on Tariff Compliance Filings, Canceling Ordinary Tariff Filing and Rejecting Other Requests For Relief (issued April 26, 2001)(Tariff Compliance Order).

[19] Other than commodity, the ERO differs from the VRO only in that retail access credits of 2 mills for large customers and 4 mills for large customers are subtracted from the ERO rate.

two-year term will commence on January 1, 2005, with the NWC and the commodity price reset for that period.

The BRO commodity price will be established by averaging twenty trading day prices preceding October 1 of the year prior to commencement of the term for trades of two-year energy and installed capacity contracts. The trading day prices will be obtained from Natsource or a similar service. The resulting commodity price will be used to calculate the fixed NWC for the two-year terms. The fixed commodity rate will then be set at the commodity price plus a 35% adder, which will enable NYSEG to recover procurement and other costs, and a profit margin to compensate for the risk of assuming a fixed price obligation (JP 32-33).

Finally, a fourth option permits BRO customers to select ESCO service during the BRO term. ESCOs would supply the commodity, with back-outs for market price and credit of 3 mills for large customers and 5 mills for small customers.[20] These credits would be subtracted from the overall BRO (JP 28).

A process is established for ensuring that the market price NYSEG uses in the BRO is set properly. NYSEG will

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[20] Because these credits are an integral component of the BRO, they are not subject to adjustment in the Unbundling Proceeding; the credits under the ERO, however, will be modified in accordance with the outcome of that proceeding, thereby effectuating policy objectives promulgated there.

promulgate monthly estimates from June through September of the commodity BRO price so that ESCOs may prepare their marketing efforts and customers may educate themselves. If data upon which an estimate is based appears distorted because of a market failure, or if the final BRO commodity price appears defective for that reason, NYSEG and Staff will confer immediately to establish a reasonable estimate or price. In the event they cannot agree, the Commission will resolve any disputes (JP 33).

NYSEG customers will be required to choose among the four options during an enrollment period running from October 1, 2002 to December 31, 2002. Those small customers that do not select an option during the enrollment period will default to the BRO option. Large customers, under Service Classification Nos. 3, 7-2, 7-3 and 7-4, default to the VRO. During a grace period running from January 1, 2003 to March 31, 2003, however, BRO customers may select the ERO Option. Provision is also made for the return from ESCO service to utility service, although gaming the options is prevented through limitations on some types of switches and their timing (JP 27-31).

2. The Four Option Approach and Customer Choice

These four Options enhance customer choice. Customers may exercise their options during a 90-day time period that should afford sufficient time to make a choice. The many options ensure that customers may select the plan tailored most to their benefit.

Retail access is fostered. Customers may move to an ESCO by selecting the ERO during the 90-day enrollment period or during the subsequent 90-day grace period. Since the ERO is an unbundled rate, customers and ESCOs can accurately ascertain their costs and risks.

The BRO is tailored to accommodate retail access while still affording customers the option of a bundled rate. The BRO's fixed price highlights a set target that the ESCOs can market against, by comparing their offerings to the utility's price. Since the BRO price subsumes a profit margin, ESCOs are automatically afforded the opportunity to undercut that margin.

Even if customers initially opt for the BRO, they may avail themselves of retail access and select an alternative provider through the back-out credits subtracted from the overall BRO. ESCOs should find this marketing opportunity attractive. They may offer products of varying commencement, termination and duration times, better meeting customer needs.

The Joint Proposal's options are intended to spur the growth of retail access above that experienced under the current RRP. There, only back-outs from a bundled rate were available. Greater retail access penetration should result under the Joint Proposal.

It is difficult, however, to forecast precise levels of retail access penetration that may be achieved under the Joint Proposal. The success of a Rate Plan, however, should not depend upon predictions of penetration that may prove inaccurate. Instead, the proper approach is to create an environment where retail access can flourish while still affording ratepayers options should retail access fail to take hold. The Joint Proposal takes this approach.

3. The BRO and the 35% Adder

The BRO provides NYSEG's ratepayers with a unique opportunity. They may continue to take service under a bundled rate at the same time as retail access options are made available. Customers in NYSEG's service territory have expressed a desire for the rate stability that can be achieved through a bundled rate offering. Fixing rates for two-year periods under the BRO meets this desire.

The 35% adder to the BRO commodity price offering allows NYSEG to recover its costs of offering supply under this option. Included in the adder are cost elements like installed capacity reserves, line losses and the expense of procuring wholesale supply. The remainder of the adder not consumed by these expenses compensates NYSEG for the risk it undertakes in guaranteeing commodity supply for a two-year period.

The risk that NYSEG bears is considerable. Weather-related fluctuations could drive wholesale prices higher than the amount fixed in the BRO. Moreover, NYSEG bears operational risk. If existing contractual suppliers, such as the new owner of the Nine Mile II nuclear plant, failed to deliver, it is NYSEG and not ratepayers that must bear the cost of seeking out and purchasing substitute supplies. The utility is also responsible for shaping the generation supply to its load, thereby shouldering the risk of hourly variations in load and supply that might drive costs higher than anticipated in a fixed price. Treating a portion of the 35% adder as compensation to the utility for assuming these risks is appropriate.

4. The NWC

For ERO and VRO customers, the NWC sums together the market value of NYSEG's hydro plant output, the cost of contracts with NUGs, NYPA and the new owner of Nine Mile Point II, all actual wholesale transmission-related revenues except for the $5 million flowed through to the delivery rate, ancillary services costs, the difference in cost between serving load located east and west of the total east NYISO interface, the NYISO NTAC charge, and GRT impacts. For these customers, the NWC will vary with actual costs. The NWC will also be adjusted to ensure that the benefit of NYPA contracts allocated solely to residential ratepayers will be restricted to those ratepayers.

For BRO customers, the charge will be fixed based on a forecast of the various existing contractual components. Those forecasts will be compared to the commodity price used in establishing the BRO, and the contract costs will be recovered accordingly (JP 33-34).

The NWC is in the public interest. It ensures that NYSEG recovers its contract costs, and serves a crucial function as a hedging mechanism for ratepayers. Through the NWC, residential ratepayers receive the benefits of the NYPA contracts that are specifically allocated to them. After recognition of this impact, the existing contracts subsumed in the NWC cover approximately 70% of the electricity supplied to residential customers and 55% of other customers' supply. The NWC reflects the costs of that supply, an important protection for ratepayers against the impact of weather-driven or other spikes in wholesale market prices.

Moreover, the NWC recovers ancillary services costs on a competitively neutral basis for both the regulated utility and ESCOs. In the BRO, the NWC mechanism further reduces ratepayer risk, because NYSEG is bound to the forecasts made of contract price and supply under the existing contracts. If forecast supply does not materialize, NYSEG must bear the cost of securing alternatives. The NWC resembles the variable cost recovery mechanism adopted in the Central Hudson Rate Order, and is appropriate for use here.

5. Customer Education and Promotion of Competition

NYSEG will undertake extensive educational efforts to ensure that customers are aware of their options. Further efforts will be made to match customers desiring to participate in retail access with available providers. These program features should ensure that the transition to a more competitive marketplace proceeds smoothly.

The Rate Plan provides for outreach and education. The utility will propose a budget and design an informational campaign to ensure that all customers are adequately informed about their rate option choices. NYSEG will also survey ESCO satisfaction and customer awareness of competition. Deficiencies revealed by the surveys will be ameliorated as is appropriate (JP 23-24).

NYSEG will undertake a number of competitive market initiatives, including a market match program designed to facilitate the exchange of data between customers seeking alternative sources of supply and ESCO providers. The utility will further conduct a market expo for the same purpose. NYSEG also agrees to foster opportunities for customer aggregation for residential and small commercial customers and will create an ESCO ombudsman that will assist ESCOs in their dealings with the utility (JP 25-27).

The aggressive consumer education campaign identified in the Joint Proposal is necessary to ensure that customers understand their commodity service options during the options enrollment period.[21] Staff and other parties will be directly involved in the design and implementation of the education campaign, and will participate in the evaluation of the understandings consumers garner through the campaign. The campaign will afford NYSEG's customers with the tools needed to make an informed choice among the various rate options during the enrollment periods.

G. Uncontrollable Cost Recovery

The Joint Proposal provides for uncontrollable cost recovery that protects NYSEG from bearing costs it cannot predict or control while limiting the exposure of ratepayers to cost increases that are the utility's responsibility to manage. Category 1 uncontrollable costs address *force majeure* issues. Category 2 uncontrollable costs are related to inflation and mandates imposed on NYSEG. For a number of Category 2 costs,

[21] See Case 97-G-1380, Proceeding on Gas Competition, Policy Statement Concerning the Future of the Natural Gas Industry in New York State (issued November 3, 1998), p. 6.

NYSEG must bear a level of cost exposure up to an identified target, before seeking recovery from ratepayers for costs above the target (JP 35-37, App. F).

To the extent that delivery or total earnings after sharing in a rate year exceed a 15.5% ROE, NYSEG will forgo deferral of both Category 1 and Category 2 uncontrollable costs. Deferral of inflation costs is further limited and tied to ROE targets. Deferred uncontrollable costs are first recovered from the unamortized balance of the ASGA, and if that source of funding is insufficient, they are deferred for recovery after the term of the Rate Plan.

Further explication of the "All Other Uncontrollable Cost" category is not needed. Uncontrollable inflation costs are adequately identified through the 4% inflation trigger. Otherwise, these unknown costs should be recovered without reference to a floor price. Since these costs are unknown, by definition no portion of them is reflected in rates. Since the Commission retains the discretion to determine if a cost is definable as "unknown," risks to ratepayers under this provision are controlled.[22] Responsibility for uncontrollable costs that may occur during the five-year term of the Plan are therefore reasonably apportioned between ratepayers and shareholders.

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22 See Tariff Compliance Order, pp. 16-17.

H. Public Policy Programs

The Joint Proposal furthers public policy programs. Detailed provisions ensure that economic development will be furthered, that low-income customer needs are met, and that service quality and reliability is preserved.

1. Economic Development

Under the Joint Proposal, NYSEG will continue to implement a variety of economic development incentives. It will also continue to participate in the Power for Jobs (PFJ) program and will facilitate service under the Economic Development Power (EDP) Program. EDP rates are frozen at existing levels for existing customers throughout the term of the Plan. Moreover, customers serving only a portion of their load under economic development programs will be permitted to obtain commodity for the remaining portion through the various retail access options, in accordance with the approach to partial requirements customers under the RRP (JP 38-41).[23]

The Joint Proposal also provides for the funding of economic development programs. NYSEG will expend $8 million, and any excess above that level up to $12 million will be recovered as an uncontrollable cost from the ASGA. Further

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[23] Case 96-E-0891, supra, Order Concerning Tariff Amendments to Establish a Retail Access Program (issued April 30, 1998) and Order Denying Rehearing (issued July 7, 1988).

flexibility is afforded in that the Commission may order expenditures above the $12 million limit if necessary to promote economic growth, with those amounts also treated as an uncontrollable cost (JP 41). This approach ensures that economic development will be adequately funded.

NYSEG will review its economic development programs and formulate an Economic Development Plan in consultation with Staff and the Empire State Development Corporation. This review will address the effectiveness and the benefits of the existing programs in comparison to the expenditures made. Programs and expenditures can be adjusted after the Economic Development Plan is promulgated (JP 40-41).

These detailed provisions ensure that economic development will be promoted. Fostering economic growth is an important Commission objective in reviewing any electric Rate Plan. This Plan satisfactorily meets that objective.

2. Low-Income Program

The Joint Proposal also continues the existing Low-Income Power Partners Program. This program has already been approved by the Commission as adequate to meet the needs of

NYSEG's low-income customers.[24] Funding of the program is ensured, and the Joint Proposal establishes the sources for that funding (JP 15-16). NYSEG will expend $2.5 million per year from the sales of excess land to fund the program, but if those sales do not generate the requisite amount, it may recover the shortfall from the ASGA.[25] As a result, the program is both adequate to meet the needs of low-income customers, and is funded with the minimum feasible impact on other customers.

3. Service Quality

The Joint Proposal also ensures that service quality will be maintained. Standards are established both for customer satisfaction and for reliability, and the financial consequences for failure to maintain customer satisfaction or reliability are placed on a comparable basis. NYSEG will report annually on service quality performance.

Customer satisfaction is measured through a customer satisfaction index, a customer contact satisfaction index, and the PSC complaint rate. The overall customer satisfaction index is measured through an annual customer expectation survey.

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[24] Case 96-E-0891, supra, Order Requiring Continuation of Low-Income Program Upon Conditions (issued September 28, 2001).

[25] While, as discussed above, existing Commission policies prohibit recovery of this type of low-income program expense from the SBC, if the Commission in the future modifies its policies to permit SBC recovery, these expenses will thereafter be recovered through that mechanism.

Satisfaction targets are established, and revenue adjustments are imposed on NYSEG if it fails to meet the satisfaction targets. The revenue adjustments rise on a sliding scale from $100,000 to $1 million per year, depending on the deviation from the satisfaction target level considered adequate (JP 42-44).

Similar targets and sliding scale revenue adjustments are established for contact satisfaction and the PSC complaint rate. Again, the greater the deviation from the target level, the higher the revenue adjustment. The Joint Proposal also provides for the process to adjust the PSC complaint rate targets and performance mechanism if changes are made to PSC complaint handling procedures.

Electric reliability is preserved through measurement of performance under the customer average interruption duration index (CAIDI) and the system average interruption frequency index (SAIFI). Two-step CAIDI and SAIFI targets are established, at levels that require NYSEG to meet more stringent reliability standards. If the first step of a target is missed, a revenue adjustment of $875,000 is imposed. Failure to meet the second step target triggers a $1,750,000 revenue adjustment (JP 45-46).

The service quality mechanisms and performance standards accord with Commission policy, and resemble the service quality mechanisms the Commission has adopted in other proceedings. The revisions to the targets require NYSEG to meet more stringent performance objectives. The revised revenue adjustments increase the consequences for missing the targets, ensuring that NYSEG has an incentive to maintain service quality. The new performance mechanisms should be approved.

I. Other Provisions

The Joint Proposal contains a number of additional provisions that are similar to those the Commission has adopted in the past. Moreover, NYSEG asks for extension of the existing Global Financing Order for the term of the Rate Plan, a reasonable request (JP 47).[26]

The Joint Proposal addresses its binding effect, in an approach similar to that adopted in other proceedings. As is standard in most Joint Proposals, parties may withdraw if the Commission modifies the Joint Proposal. The Joint Proposal further provides that the Commission's authority to act on electric rates is reserved in the event that actual electric return on equity is unreasonable or insufficient for the

[26] See Case 97-M-1915, New York State Electric & Gas Corporation - Permission For Global Financing Authority, Order Extending and Modifying Multi-Year Financing Programs (issued February 4, 1998).

provision of safe and adequate service at just and reasonable rates (JP 48). This reservation of authority resembles those the Commission has previously adopted. These provisions are acceptable, and should be adopted with the Joint Proposal.

CONCLUSION

For the forgoing reasons, Staff requests that the Administrative Law Judge and the Commission approve the Joint Proposal, because it provides for lower and stable rates, furthers the Commission's objectives in bringing retail competition to NYSEG's service territory, furthers other Commission policy objectives, balances the interests of all parties, and constitutes fair resolution of the issues in these proceedings.

Respectfully submitted,

Leonard Van Ryn

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Staff Counsel

Dated: January 23, 2002
Albany, New York

Case 01-E-0359 Staff Appendix A

Projections Supporting Joint Proposal

Staff October 25	
Prior Year Retail Revenue	$1,499.4
sales level 2002	14066
Growth	0.5%
dollars of growth prior year	$7.90
Retail Revenues 2002	$1,507.3
Less	
RAC adder change	(26.9)
Rate Reduction	125.0
retail	$1,409.2
Plus	
Transmission Revenue	$18.9
Other Revenues	$15.5
Net Revenues	$1,443.6
Rate Decrease From ASGA	$45.8
Net Revenue	$1,397.8
Amort of ASGA	$45.8
Final Revenue	$1,443.6
Fuel and Purchased Power	$754.8
O&M	$269.0
Depreciation	$87.6
Other Taxes	$95.3
Total operating exp	$1,206.7
Operating Income	$236.9
Interest	$64.7
Before Tax Income	$172.2
State Tax	$12.9
Federal Tax	$55.7
Preferred Div	$0.3
Net Income	$103.2
Actual Equity	$663.2
ROE	15.6%
Assumed Equity Ratio	42.5%

Staff October 25 Years 2003-2006	2002	2003	2004	2005	2006
Sales Level	14066	14134	14240	14346.8	14454.4
Growth		0.005	0.0075	0.0075	0.0075
Price Before Decrease		0.04536	0.04069	0.04069	0.04069
Retail Delivery Revenues Before Decrease		$641.2	$579.4	$583.7	$588.1
Add Other Revenues		15.5	15.5	15.5	15.5
Add Transmission		5.0	5.0	5.0	5.0
Less Rate Reduction		66.1	0	0	0
Total Retail Delivery		$575.1	$579.4	$583.7	$588.1
Total Delivery		$595.6	$599.9	$604.2	$608.6
Average retail Price		$0.0407	$0.0407	$0.0407	$0.0407
Fuel and Purchased Power		$0.0	$0.0	$0.0	$0.0
O&M		$243.0	$248.0	$254.0	$259.5
Depreciation		$90.0	$91.0	$92.0	$94.0
Other Taxes		$80.8	$85.4	$85.2	$86.9
Total operating exp		$413.8	$424.4	$431.2	$440.4
Operating Income		$181.8	$175.5	$173.0	$168.2
Interest		$60.7	$58.5	$56.8	$55.0
Before Tax Income		$121.1	$117.0	$116.2	$113.2
State Tax		$9.1	$8.8	$8.7	$8.5
Federal Tax		$39.2	$37.9	$37.6	$36.7
Preferred Div		$0.3	$0.3	$0.3	$0.3
Net Income		$72.5	$70.0	$69.6	$67.8
Actual Equity		$664.9	$665.9	$667.5	$668.3
ROE		10.9%	10.5%	10.4%	10.1%
		42.5%	42.5%	42.5%	42.5%

Rate Reduction Delivery (125+66.1)	$191.1
Rate Reduction Commodity Transmission	$13.9
Total 2003 Rate Reduction	$205.0

Four Year Average ROE	10.5%

Staff 2002 Unbundle Delivery	
Total Revenues After Reduction	1,443.6
Less:	
Commodity Costs	754.8
Transmission Revenues	13.9
Commodity GRT	16
NTAC	5.3
Delivery Revenues	653.6
Other	15.5
Retail Delivery	638.1
Sales 2002	14066
Volumetric Retail Delivery	0.04536