

Brief

05-E-1222

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April 26, 2006

Hon. William Bouteiller
Hon. Elizabeth H. Liebschutz
Administrative Law Judges
NYS Public Service Commission
Three Empire State Plaza
Albany, NY 12223-1350

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

Dear Judges Bouteiller and Liebschutz:

In accordance with 16 NYCRR Section 4.8(a), enclosed please find the *Initial Brief of Nucor Steel Auburn, Inc.* Twenty-five copies have been hand-delivered to the Secretary. All parties currently on the Active Parties List in this case have been served via electronic mail, and hard copies have been sent by-first-class mail to those parties who did not consent to electronic service.

If you have any questions or comments, please give me a call.

Very truly yours,

/s/

James W. Brew

Enclosures: a/s

Cc: Hon. Jaclyn Brillings, Secretary
All Parties

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**BEFORE THE
NEW YORK PUBLIC SERVICE COMMISSION**

Case No. 05-E-1222 Proceeding on Motion of the Commission as to the
Rates, Charges, Rules and Regulations of New York
State Electric & Gas Corporation for Electric Service

INITIAL BRIEF OF NUCOR STEEL AUBURN, INC.

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Dated: April 26, 2006

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II. EXECUTIVE SUMMARY

On September 30, 2005, New York State Electric & Gas Corporation (“NYSEG”) filed what the utility described as a six year extension of the current multi-year electric rate plan approved by the Commission in Case No. 01-E-0359. There are four main components to the NYSEG proposal.

1. NYSEG proposes a substantial increase in electric delivery rates beginning January 1, 2007.¹
2. NYSEG proposes to continue its “Voice Your Choice” commodity programs for another six years in substantially the same form as the current rate plan. The commodity options include ESCO and variable price options, but the anchor of the program is the fixed price option that now is the default option for small users.
3. NYSEG proposes to eliminate the industrial or high load factor subclasses that were established as part of NYSEG’s 1998 restructuring plan. Eliminating these subclasses produces immediate triple digit delivery rate increases for manufacturing customers served under the industrial or high load factor classifications, even if no changes are made to the utility’s delivery revenue requirement. The rate impacts will be highest for the high voltage subclass that, according to NYSEG’s embedded cost of service study, already provides a return that is significantly higher than the system average under existing rates. This would occur at the same time that the Power for Jobs and other NYPA- funded economic development programs will expire absent legislative action.

¹ NYSEG’s September 30 filing proposed a \$91.6 million increase in annual delivery revenues, or an overall increase of roughly 17%. NYSEG’s January 9, 2006 update to its filing raised the increase to \$103.6 million. NYSEG’s rebuttal testimony filed February 20, 2006, reduced the requested delivery increase to \$58.3 million. Exh. 7 (RRP-2, sch. L).

4. NYSEG claims that consumers, on average, actually would see an annual “overall delivery” decrease of approximately \$71 million (9.5%), beginning in September 2006, due to two rate mitigating mechanisms that the Company proposes to implement. These are a \$23.7 million credit to the non-bypassable wires charge (“NBC”) for bills rendered in the months September- December 2006 that would be funded from the Asset Sale Gain Account (“ASGA”) balance, and a proposed shift in rate recovery of above-market non-utility generator (“NUG”) contract costs from the first two years of the proposed rate plan to the remaining years. NYSEG would collect roughly \$33 million in additional carrying charges from consumers as a result of this “NUG levelization” mechanism.

Nucor Steel Auburn, Inc. (“Nucor”) submitted testimony that addresses each of the basic elements of this rate filing. First, Nucor did not develop a complete delivery revenue requirement for NYSEG, but identified several significant adjustments that are required to the delivery revenue requirement. These include adjustments to NYSEG’s earnings base capitalization (“EBCap”), depreciation, capital structure and legal services expense as well as properly accounting for transmission revenues in delivery rates. The Department Staff, CPB, or both, propose comparable adjustments in their testimony. The fact that three independent assessments of NYSEG’s revenue requirement filing elicited nearly identical adjustments by Staff and Intervenors in these areas, each based on established Commission precedent, compels close scrutiny of these issues. That scrutiny, we believe, will show the adjustments to be fully justified. Moreover, notwithstanding the concessions made in NYSEG’s rebuttal filing, each of the above adjustments that Nucor proposes is still required to the delivery revenue requirement.

Next, the record shows that most residential and small commercial users take electric service today under the NYSEG fixed price option, due either to affirmative selection or a failure to take any action at all. As Nucor predicted in Case No. 01-E-0359², NYSEG has generated

² See Cases 01-E-0359 and 01-M-0404, *Order Adopting Provisions of Joint Proposal with Modifications*, issued February 27, 2002, mimeo at pp.8, 17-18.

substantial profits from this commodity service in each year of the current rate plan, and this has been true in both rising and declining wholesale energy markets. NYSEG's 2005 compliance filing with the Commission revealed that commodity profits exceeded \$100 million for the year, increasing NYSEG's electric return on equity by more than 500 basis points. Exh. 1, ERPE 1048. While smaller users remain interested in stable prices, and NYSEG has a clear interest in continuing some form of fixed price option, the Commission's August 2004 Retail Markets Statement of Policy³ contains an unequivocal policy preference for the Energy East utilities to exit the commodity business. The tension between consumer reliance on NYSEG's fixed price options and the Commission's policy guidance is further complicated by the exceptional profits NYSEG has generated from commodity services because the existing rate plan does not adequately recapture those excess profits.

Reconciling the competing electric commodity considerations in a fashion that leads to fair and stable prices for consumers is a core issue in this case. Ultimately, the consumer preference for a fixed price option should prevail in this circumstance, and it is equally apparent that a much more effective mechanism for returning excess commodity profits to consumers is required. Nucor proposes a fixed price commodity option that accommodates the demonstrated consumer interest in fixed price service, affords NYSEG a reasonable profit on commodity sales, and returns the bulk of excess profits (that likely will be produced under NYSEG's FPO method given past experience) to all consumers through offsets to stranded costs (above market NUG costs) collected through the NBC. Rather than attempting to re-cast NYSEG's mechanism for calculating FPO prices, Nucor's approach remedies the real fatal flaw in the current rate plan—

³ Case 00-M-0504, *Statement of Policy on Further Steps Toward Competition in Retail Energy Markets*, issued August 25, 2004 (the "Retail Market Policy Statement").

inadequate and untimely return of excess commodity profits to consumers. This NBC credit will also mitigate the rate impacts to consumers of the last few years of the above-market NUG contract costs far more effectively than NYSEG's badly conceived "NUG levelization" proposal.

Third, and in a broader context, Upstate New York continues to struggle to retain quality jobs, and this struggle is no more apparent than in the areas served by NYSEG. Many manufacturers in this region currently rely upon NYPA sponsored "Power for Jobs" or "Economic Development Power ("EDP") allocations. In light of the thousands of jobs that are linked to these NYPA programs, last year the Legislature extended most of those entitlements from 2005 to the end of 2006. Recognizing that this was merely a stop gap, Governor Pataki's 2006 budget address sought to extend the NYPA programs for another three months (through March 2007), and the Governor called for a multi-agency task force to be established to address this economic development dilemma. Tr. 2740-42; Exh. 100 (FWR-7).

Legislative action in this area cannot be presumed, but it is plain enough that establishing a legislative "fix" for the expiring NYPA programs will be a severe challenge. This circumstance certainly will require a fresh look at Commission-approved economic development rates that have been effective in the past, and that process inevitably will lead to the industrial/high load factor rate design approach that NYSEG proposes to eliminate in this case. Nucor's testimony demonstrates that, based on the results of NYSEG's embedded cost of service study, the high voltage I/HLF rate is cost-justified and should be retained. Taking the broader upstate economic factors into consideration, it is clear that a blanket elimination of even the below cost I/HLF rates at this time is ill-advised. Tr. 2737-40.

Fourth, the two "rate moderators" that NYSEG relies upon to offset its proposed delivery rate increase desperately require a proper context. The ASGA credit NYSEG proposes to use for

its "early" (September-December 2006) rate reduction is a return of only a portion of the ASGA account balance that should flow back to ratepayers at the end of the current rate plan (December 2006) anyway. NYSEG proposes to retain the remaining ASGA balance (roughly \$85 million) to offset "uncontrollable costs" and for other purposes for another six years. While return of some or all of the ASGA funds through a credit to the NBC is appropriate, NYSEG offers less than ratepayers otherwise should expect to see upon expiration of the current rate plan at the end of this year.

With respect to the new rate year (beginning January 2007), NYSEG's claimed "overall delivery" rate reduction is tied to its NUG levelization proposal. In the plainest terms, over the proposed term of the rate plan, there is no overall "moderating effect" on consumer rates from this proposal at all. Reduced NBC recoveries in the first two years of the rate plan are matched (and then some) by increased NBC recoveries over the rest of the rate plan years. In fact, ratepayers would pay over \$33 million more through the NBC over the term of the rate plan than they would experience otherwise. Moreover, half of the claimed NUG levelization benefits (roughly \$81 million) are associated with NUG contract costs that will have expired by the time the rate year starts. Tr. 1208-09; Exh. 55. These are not above-market costs that will be levelized; they are costs that will no longer exist. Simply updating the NBC for the rate year will capture those benefits for consumers.

The proper measure of this proposal is the impact on consumers' overall delivery rates that would occur with or without levelization. In that regard, the historic NUG burden recovered through the NBC in 2006 is of no consequence since those contract obligations are finally winding down. Rather, the levelization recovery level must be compared to the much lower NUG burden expected in the rate years beginning in 2007 as the principal NUG contracts begin

to wind down. Properly viewed, shifting rate recovery of the remaining (and rapidly declining) NUG burden for ratepayers beyond the term of those expiring above-market contracts is an expensive effort to disguise a delivery rate increase by adding to ratepayer burdens in subsequent years. NYSEG's proposal is not in the public interest and should be summarily rejected. Instead, the Commission should use the tools that are available in this case, of which commodity excess profits are the most obvious, to minimize the impact on overall delivery rates of the few remaining years of the large NUG contracts.

Finally, Staff responded to NYSEG's six year rate plan proposal with a one year revenue requirement for delivery service and limited commodity service (hedged variable prices). This dramatic divergence in approaches is almost entirely explained by NYSEG's earnings history for commodity service that has produced consistently higher utility earned returns that the Commission normally would countenance. As is noted above, Nucor proposes a mechanism for addressing that concern that eliminates the prospect of excessive commodity earnings while allowing consumers access to stable commodity prices and helping to mitigate the rate impact (through the NBC) of the last years of the large NUG contracts. With the adoption of such a mechanism, Nucor does not object to a multi-year rate plan if delivery rates are re-set at a reasonable level in a manner consistent with the cost of service study results.

III. BACKGROUND

A. Procedural History

NYSEG's current rate plan runs through December 31, 2006. The utility filed its rate plan extension proposal on September 30, 2005, but this filing did not include proposed delivery tariff schedules for Commission approval. On November 18, 2005, NYSEG filed the missing schedules that NYSEG proposes to take effect on January 1, 2007. This filing oddity has left this docket with two suspension periods: one for commodity options and the ASGA credit, and a second for delivery rates. The litigation schedule established in this matter provided for evidence to be heard on all matters at the same time in order to accommodate a Commission decision on all issues in August 2006. Nucor urges that all issues be determined at that time.

B. Procedural Matters

Nucor has no additional procedural matters to address. We note that in accordance with the Administrative Law Judges' direction, the parties developed a common table of contents for these briefs. This brief adheres strictly to that table of contents although Nucor did not take a position on many of the listed issues. Consequently, there are numerous headings that are not followed by substantive argument. No inference should be drawn with respect to Nucor's silence on any of those issues.

IV. THRESHOLD POLICY/LEGAL ISSUES

A. Multi-Year v. One-Year Case

NYSEG proposes a new six year electric rate plan that substantially modifies the current rate plan in so many respects that it cannot be considered a mere extension of the existing rate plan. The Department Staff presents an entirely different approach: setting delivery rates and revamped commodity options without a fixed price alternative only for the test year without any

multi-year features in mind (i.e., a “one year rate case”). Most intervenor parties, including Nucor, favor some sort of multi-year arrangement under the appropriate terms. There generally is value to consumers in a multi-year rate plan that provides rate stability and continuity, and this feature is particularly important in times, such as these, of uncertain and volatile energy prices. On the other hand, there are twin deep-rooted concerns over continuing a multi-year rate plan for NYSEG: 1) there are terms of the plan, intended or otherwise, that produce supra-normal returns for the utility, and 2) overcoming the inherent financial disincentive for NYSEG to invest in rebuilding or modernizing its system.

Previous NYSEG multi-year plans have lent substantial credence to both of these concerns. The current rate plan, established in Case No. 01-E-0359, aimed to reduce bundled rates that had been producing returns on equity for NYSEG exceeding 35%.⁴ As evidenced by NYSEG’s 2005 compliance filing, the revamped rate plan is still yielding returns on equity approaching or exceeding 20%. Exhibit 1, Response ERPE-1048. An earnings sharing mechanism is no substitute for establishing electric rates that in the first instance are just and reasonable and designed to allow an opportunity for a reasonable, but not excessive, return on invested capital.

Second, there is little question that NYSEG has neglected needed capital investment in its transmission and distribution system during the prior multi-year rate plans. The clearest evidence of this is the need for the express provision in the current Joint Proposal (Article VI. E) that establishes a penalty if NYSEG fails to complete a minimum level of capital spending. A gross capital spending floor, however, is an insufficient solution. As the testimony of AES

⁴ Case 01-E-0359. *Petition of New York State Electric & Gas Company for Approval of its Electric Price Protection Price Plan: Order Clarifying Data Required* (issued April 25, 2001), p. 4; see also Exh. 1, ERPE 0203.

witness Goodenough demonstrates, NYSEG has avoided needed upgrades for years in its Ithaca division, the only load pocket on its system.

Both of these concerns must be addressed in this docket, but neither precludes a multi-year rate arrangement. As explained below, the record demonstrates that NYSEG's excessive profits from electric service are driven almost entirely by the mechanism approved for fixed price commodity service. In Nucor's view, a variety of solutions can be employed to correct commodity driven excess profits in the context of a multi-year rate plan. Nucor proposes, as detailed in the testimony of witness Radigan (Tr. 2758-60), an approach that applies the Commission's long experience with incentive fuel adjustment clauses to commodity pricing in a fashion that allows customers continued access to a utility-provided fixed price option, and allows NYSEG a profit incentive sufficient to ensure continued efficient management of commodity and hedge procurement. The approach recommended by Nucor provides for a timely recapture of excess commodity-related profits through credits to the NBC that will offset the burden to ratepayers of the remaining years of above-market NUG contract payments. Any rate plan, multi-year or otherwise, that allows a NYSEG fixed price commodity option, should adopt Nucor's commodity proposal or a mechanism that provides equivalent consumer benefits.

NYSEG's inadequate attention to capital investment in its electric network is an equally troubling concern, but Nucor is not convinced that setting delivery rates for one year would necessarily re-direct NYSEG's interest in its capital program. The record shows that NYSEG has an established voltage stability problem in its Ithaca division, that the problem is growing, and that NYSEG has become reliant on the operation of both of the AES (formerly NYSEG) power plants in the region for voltage support. NYSEG needs to implement an effective multi-year T&D capital improvements programs with active Commission oversight, beginning with

firm milestones for the required Ithaca upgrades.

Assuming that these key concerns are addressed, and that delivery rates are set at a reasonable level consistent with the results of the cost of service study, Nucor is not opposed to a multi-year rate plan. In fact, consumers would benefit from the stability and continuity of a longer term plan. The next question to consider is whether the Commission can, or should, approve a multi-year plan in a litigated case. From a jurisdictional perspective, the Commission has the same rate setting authority under the Public Service Law regardless of the vehicle followed by the parties in presenting rate alternatives for approval. Given the asserted right of a utility to file for new rates under PSL section 66-12, however, the Commission's authority to mandate a multi-year plan and reject any utility application for new rates that overlaps the plan (after the first year) is problematic.

In Case No. 01-E-0359, Nucor maintained, in opposition to the Joint Proposal in that docket, that the Commission's authority to fix electric rates for extended periods, by settlement or otherwise, indeed is limited by statute, but the Commission did not adopt that limited view of its authority.⁵ In Nucor's view, the Commission's jurisdiction in this arena is unsettled, but we recognize that the Commission has asserted its authority to approve multi-year rate plans of varying terms. In this instance, in addition to jurisdictional questions, any multi-year extension of NYSEG's electric rate plan without significant modification would not result in rates that could be considered just and reasonable in light of the earned returns NYSEG has realized under the terms of the existing rate plan.

In sum, in Nucor's view, a multi-year electric rate plan is the preferred approach if the

⁵ Cases 01-E-0359 and 01-M-0404, *Order Adopting Provisions of Joint Proposal With Modifications*, issued February 27, 2002, *mimeo* at p. 17-18.

core commodity earnings, delivery revenue requirement and capital expenditure problems are addressed properly. This outcome realistically can only be accomplished through a settlement involving NYSEG and the active parties. Nucor questions the Commission's authority to mandate a multi-year rate plan, but far too many changes are required to the existing rate plan and NYSEG's filing in this docket for the Commission to entertain a litigated multi-year rate order in any event.

1. NUG Levelization

NYSEG's Rate Plan Panel asserted that the rate plan originally filed would produce an "overall delivery" (delivery and non-bypassable wires charge) revenue reduction of \$71 million annually notwithstanding the increase in delivery rates (originally proposed at \$91.6 million). Tr. 1086. NYSEG proposed to achieve this alchemy by fixing the amount collected in the NBC for above-market NUG contract costs at \$54.2 million annually for the six year term of the rate plan. NYSEG claimed that this is roughly \$162 million less than the \$217 million in above market NUG costs collected in the NBC that was fixed for the years 2005 and 2006, and that this difference more than offsets the delivery rate increase. Tr. 1086-87. As is shown on Exhibit 60 (DWS-2), the levelized \$54.2 million payment is designed to cover the remaining expected above-market NUG costs, that largely would be incurred in 2007 and 2008, plus carrying charges (accruing at 10.5%) of approximately \$33.2 million. If the final above market costs prove to be greater than NYSEG estimates, NYSEG proposes to defer the balance for future rate recovery. Tr. 1492.

The unabashed purpose of this levelization proposal is to mask the rate impact of NYSEG's proposed delivery rate increase for the first two years of the rate plan and bill consumers for it later through a rate adder collected through the NBC after the NUG contracts

have expired (i.e., the last three years of the rate plan). NYSEG also relies on the “moderating” effect of the NUG levelization for rate design recommendations (assigning delivery revenue increases to energy charges) that flatly contradict NYSEG’s own articulated cost causation principles. There are a host of reasons for rejecting the levelization proposal, but the principal ones are these:

First, NYSEG dramatically overstates the rate moderating effect of its proposal from the outset. The measure of overall delivery costs is not what ratepayers paid in 2005 and 2006, but what they would have paid in NBC charges for delivery service in 2007-2012 with and without the levelization proposal. By NYSEG’s own estimates, the \$217 million in above-market NUG contract costs included in the current (2006) NBC will drop to \$135.5 million in the first rate year (2007). Exhibit 55. Since NYSEG would need to update its NBC charges for the rate year, this \$81 million decline in NUG burden (or half of NYSEG’s claimed benefit) will occur anyway because that portion of the NUG burden will have expired due to the combination of rising energy market costs and expiring NUG contracts. That expired burden is not levelized; it ceases to exist. The final wind down of the NUG contracts is not an opportunity to replace declining stranded cost payments with inflated delivery rate increases.

Viewed correctly, NYSEG’s original claim of an “overall delivery” rate reduction is a myth. Nucor witness Decker’s testimony demonstrated that, compared to NYSEG’s original and updated rate filings, there is no year in the proposed six year plan in which NYSEG’s NUG levelization actually would lead to an overall rate reduction compared to what would occur anyway. Tr.2768-70; Exh. 102. In rebuttal, NYSEG continued to press for a multi-year rate plan, but reduced its delivery revenue requirement to \$58.3 million. This changes the arithmetic with respect to the net overall effect of NUG levelization in each rate year, but nothing else

changes. Levelization still disguises the delivery increase in 2007-08 by adding to the overall delivery increase in 2010-12. Exh. 55.

More important, over the course of the proposed rate plan (2007-2012), there is no rate moderation of any kind. In fact, total NBC costs charged to consumers are \$33 million greater than if the NBC recovered the above market costs without levelization. NYSEG ratepayers bear the full brunt of the delivery rate increase and pay every dime of NUG above market costs, plus interest, over the term of the rate plan. Tr. 2767. NYSEG has not moderated anything, but has simply created an unwarranted inter-generational equity problem for ratepayers.

Next, although NYSEG relies on the claimed “rate moderating” effects of NUG levelization for a rate design that violates its own articulated rate design principles,⁶ NYSEG never attempts to address the other side of that equation: the impacts of its NUG levelization influenced rate design on ratepayers in the later years of the rate plan. Instead, NYSEG offers only that rates could be re-designed six years from now. Tr. 2463.

Finally, considering the delivery revenue requirement concessions contained in NYSEG’s rebuttal and further adjustments that are still required based on the testimony of Staff, CPB and Nucor, it is difficult to envision any material delivery revenue increase. Consequently, on this record, NUG levelization is unnecessary as well as unwise.

2. ASGA

The Joint Proposal that governs NYSEG’s existing rate plan established the Asset Sale Gain Account (“ASGA”) and provides: “If an ASGA balance remains at the end of the Rate Plan [December 31, 2006], it will be returned to customers in a manner to be determined by the

⁶ See Tr. 2462-63 (NYSEG Delivery Rate Design Panel reasons for recovering delivery revenue increases through energy charges).

Commission.” Joint Proposal, Art. VI.C. 5. It has been established that there is a substantial ASGA remaining balance of roughly \$110 million. Tr. 278. NYSEG proposes to refund about \$24 million of that amount early through a credit to the NBC that would appear on customer bills in the months of September-December 2006. Tr. 1075. The rest of that balance, under NYSEG’s proposal, would be retained by NYSEG for various uses over the course of the new rate plan. Nucor agrees generally with other parties that the ASGA balance should be returned to ratepayers more quickly than NYSEG proposes.

3. Other General Matters

B. Earnings Sharing

For its multi-year rate plan, NYSEG proposes to continue the earnings sharing mechanism (“ESM”) approved in Case 01-E-0359. Staff asserts that no earnings sharing is required for the one-year rates it proposes. The CPB proposes a 100 basis point cap on commodity earnings above whatever ESM is approved for delivery service. Tr. 2001. In a litigation setting, Nucor generally agrees that an ESM is not required for delivery rates. Staff’s case, however, assumes that NYSEG would no longer have an opportunity to profit from commodity service. If NYSEG is permitted to continue providing a fixed price option, as Nucor, CPB and PULP recommend, Nucor’s proposed mechanism for recapturing excess commodity profits should be adopted. (See “Commodity Options”, below).

C. Deferrals

D. Existing Joint Proposal Issues

V. REVENUE REQUIREMENT

A. General Matters

B. Revenue Adjustments

1. Sales and Revenue

- a. **Retail Sales and Revenue Forecast**
- b. **Other Revenue Adjustments**
 - i. **Power Partner**
 - ii. **ERO 2/4 mil Discounts**
 - iii. **Mandated Contract Discounts**
 - iv. **Transmission Revenues**

The Joint Proposal in Case 01-E-0359 imputed \$5 million of transmission revenues to base delivery rates. Imputing an expected level of revenues from other utility sources has been a long held practice by the Commission (e.g. transmission for others, off-system sales for resale or rent proceeds from utility property). In this docket, NYSEG shifted transmission revenues from base rates to the non-bypassable wires charge (NBC), and thereby increased the base delivery revenue requirement. Nucor witness Radigan testified that those revenues should remain as a credit to base delivery rates. Tr. 2756-57. Staff's Electric Rate Panel made a similar recommendation, and Staff determined that \$20 million is the correct level of revenues to impute based on a review of NYSEG's transmission revenues for the last three years. Tr. 2956-57. Staff also recommended that the any revenues in excess of the \$20 million be passed back to ratepayers via the NBC. Given the consistency of the level of transmission revenues, Nucor supports the Staff position.

C. O&M Expenses

16. Regulatory/Legal Expense

Nucor proposes a downward adjustment of \$0.9 million to outside legal services. NYSEG's Revenue Requirement Panel employed a five year average of legal services as the basis for its normalizing adjustment. This period of (2000-2004), included legal service expenditures for the Company's last multi-year rate plan which were far above the expenditure

levels that normally occur. Since one obvious purpose of NYSEG's multi-year rate proposal is to avoid continued re-litigation of rate issues, it is unreasonable to set legal expense using 2000-2001 data, as this does not represent a normal expenditure level. In 2001 and 2002, legal service expense for the firms involved in NYSEG's last multi-year rate plan averaged \$6.1 million. In 2004, the equivalent level of expenditures dropped to roughly \$1.0 million. Tr. 2756.

In order to develop a normalized level of expenditures, Mr. Radigan used the more recent 2002-2004 expenditure level. This results in a rate year adjustment downward of \$0.9 million. Tr. 2755-56. NYSEG did not respond directly to Mr. Radigan's adjustment, but the Company contested a comparable adjustment offered by the CPB, essentially arguing that in a one-year rate setting, NYSEG would be preparing its next rate filing during the rate year. Tr. 306-309. Since NYSEG seeks a multi-year rate plan, NYSEG's rebuttal to the CPB does not disturb the reasons why this adjustment is required.

D. Merger Savings

E. Depreciation

Nucor witness Radigan routinely performed and evaluated depreciation studies during this 16 year career with the Department Staff. He is familiar with the Commission practice in this area as well as the depreciation methods employed in other regulatory jurisdictions. Tr. 2748-49; Exh.100 (FWR-1). Mr. Radigan identified three basic flaws to NYSEG's depreciation study that must be corrected. First, the Commission should reject Mr. Robinson's recommendation to convert to a remaining life method for calculating depreciation accrual rates for NYSEG in lieu of the whole life method that is used in New York generally and that has been used in setting NYSEG rates to this point. Tr. 2749-51; Exh. 100 (FWR-9). Second, Mr. Robinson used forecast retirements rather than actual retirement data to set the service lives for certain accounts. The forecast retirements introduce a speculative and unwarranted inflation in

the depreciation estimates. Third, Mr. Robinson used historic net salvage rates and forecasts them into the future. This untraditional approach improperly adds unwarranted speculation in trends of net salvage rates. Correcting these three deficiencies in Mr. Robinson's study reduces depreciation expense by \$19.5 million using 2004 plant balances. Tr. 2749-50. The Department Staff also addressed these deficiencies in NYSEG's filing.

1. Whole Life vs. Remaining Life

New York is a "whole life" state with respect to calculating depreciation rates. The Commission has consistently applied the whole life method to electric utilities for years. Tr. 2751; Exh. 1, (Staff Response 350-revised). And, Staff recently confirmed, in response to an on-the-record data request, that the Commission has followed that same practice in telecommunication for decades as well.

Notwithstanding this long established and consistently applied practice, NYSEG witness Robinson proposes that NYSEG convert to a remaining life method. There is neither a need nor a reasoned basis for changing methods at this juncture. As testified by both Mr. Radigan and Staff, the remaining life technique is a different approach to the whole life method, but is not a superior method. (Tr. 2750-52; 2961). Both are accepted techniques in depreciation which allow for the full recovery of utility investment. Tr. 2751. Both Nucor and Staff also explain that substituting one method for another can have rate impacts.⁷ When the remaining life technique supplants the whole life technique, it generally results in an increase in depreciation expense due to the fact that the remaining life of existing vintages is generally shorter than the whole life.

⁷ Using the whole life technique, an account with no net salvage and an average service life of 50 years will have a depreciation accrual rate of 1/50 or 2% per year. The remaining life technique takes the average service life of the account and uses vintage plant balances to develop the remaining life of each vintage. The weighted average of all of the vintages gives the composite remaining life of all accounts. For example, Mr. Robinson has a 50 year average service life for account 366 – Underground conduit and the depreciation rate using the remaining life per his calculations is 2.59%.

NYSEG acknowledges that the New York Public Service Commission has not widely adopted the technique. Exh. 100 (FWR-9).

In rebuttal, the Company argues, in essence, that certain depreciation articles and definitions favor the remaining life technique. Tr. 776-79. Thus is just not the case. Two of the definitions NYSEG cites (depreciation and depreciation accounting) are simple definitions of terms and do not mention either technique. Tr. 777-78. Mr. Robinson's third reference is the definition of the whole life technique from the NARUC manual. Tr. 778. That definition indicates that a depreciation reserve imbalance can occur under the whole life method if the wrong average service life is used. It is, however, equally true that if the wrong average service life is used in the remaining life technique, a reserve imbalance will occur. In short, NYSEG attempts to draw a distinction that does not make a difference.

The reasonableness of the Commission's practice of relying on the whole life method is not at issue here. What is presented for resolution is NYSEG's rationale for converting to a remaining life method. Such a shift would result in an increase in depreciation expense, but NYSEG has not shown that it is justified. Nucor opposes that unwarranted change in method.

Impact of the Infrastructure Improvement Program

At various places in his testimony, Mr. Robinson states that his proposed average service lives were developed through an analysis of NYSEG's historical data and considerations of future expectations. NYSEG's workpapers reveal that this future expectation was simply an adjustment to the average service life that resulted from the normal retirement rate method that Mr. Robinson describes in his testimony. For example, for Account 365 – Overhead Conductors and Devices, the statistical analysis indicated an average service life of 65 years, but Mr. Robinson's final recommendation is an average service life of 49 years.

Mr. Robinson's report on depreciation, supplied in workpapers, states that retirements relating to the Infrastructure Improvement Program were considered in performing "additional life analysis." Tr. 2752. Nucor witness Radigan reviewed the Company's presentation and found that the Company had not provided any additional support to shorten the lives. Tr. 2752; 2964; Exh.100 (FWR-10). When queried for workpapers that support the "additional analysis," NYSEG provided four items that do not support the Company's contention. Exhibit 100 (FWR-9). NYSEG's response No. ERRP-07 is the most instructive and states that infrastructure improvement impact schedule workpapers were included in one specific section of the workpapers, and the response states that the workpapers contains all supporting information utilized to prepare the calculations. The response concedes, however, that no detailed retirement information was available in total and/or by specific vintage and, therefore, no detailed analysis could be performed. Exh. 100 (FWR-9).

Instead, NYSEG estimated incremental retirements from the general additions contained in the capital budget, and then estimated the impact on average service lives. Additional retirements, if any, were also estimated. Tr. 2752-53. A review of the supporting information shows no information on retirements at all, but simply refers to the Company's construction forecast. NYSEG provides no analysis that compares the estimated retirements to historic amounts. Neither does it provide any analysis that compares how the infrastructure improvement program is in any way different than capital programs in the past other than fact that the projected expenditures are slightly higher. Tr. 2752. In short, there is no empirical support for NYSEG's service life adjustments.

On rebuttal, Mr. Robinson argues instead that a look should be taken to future conditions and not just historic results. Tr. 775. This amounts to little more than a re-statement of basic depreciation analysis (i.e., estimate the depreciation parameters of existing plant and not plant

that has already been retired). Plant that has been retired gives valuable and reliable information in that it shows how the plant has survived to date. Given no other information or changes in technologies or materials, the historic information can reasonably be used to predict future retirements. Ultimately, Mr. Robinson did not provide any credible analysis that the future retirements will be different markedly from the past. Absent that showing, his recommendations to shorten average service lives must be rejected.

2. Service Lives and Net Salvage

Nucor proposed no changes to service lives other than to those accounts affected by the Infrastructure Improvement Program. As to net salvage, in his depreciation study, Mr. Robinson applies an inflation factor to historical net salvage data, claiming analysis routinely shows that historical retirements have occurred at average ages significantly shorter than the property group's average service life. Tr. 2757. He claims that the occurrence of historical retirements at an age that is younger than the average service life of the property category demonstrates that the historical data does not appropriately recognize the true level of retirement cost at the end of its life. Accordingly, Mr. Robinson inflates the actual net salvage data to increase until the average service life is attained. For example, for Account 362 – Station Equipment Mr. Robinson review of historical data indicates a net salvage rate of negative 27.6%. He claims that this equipment had an average age of 20 years, and the equipment is forecast to live to 37 years. He reconciled this difference by increasing the historical data by a factor of 1.58, which results in a net salvage factor of negative 30.7% . Tr. 2754.

Nucor witness Radigan described three basic flaws with Mr. Robinson's approach. Tr. 2757. First, inflation in construction costs is inherently captured in asset costs. Developing a weighted average retirement age is a meaningless exercise as it does not recognize the different costs per unit being retired. Tr. 2757. Mr. Radigan explained that if an attempt were made to

develop inflation adjusted retirement costs (which he does not recommend), the proper way to account for the impact of inflation in historic net salvage data would be to restate historical data by vintage into today's dollars using the Handy-Whitman index. Tr. 2757. Once all of the dollars were placed on the same basis, the analysis of average age of the units being retired can then proceed.

After the inflation run up in the 70s, Mr. Radigan and Colonel Dickens were part of a Department Staff team that worked in conjunction with staff of Rochester Gas and Electric Corporation to investigate the impact of inflation on the cost of removal. That effort revealed that no additional steps needed to be taken to address the issue other than to review historical data. Tr. 2758.

Second, Mr. Radigan explained that under accepted practice, the average service life and net salvage both use the same data. It is illogical to use data showing one service life for average service life purposes and another for the net salvage analysis. Tr. 2755.

Finally, inflation costs are reflected in the historical data. The historical data base that Mr. Robinson used for Account 362 had thirty years of historical data, Exhibit 100 (FWR-12). For an account with an average service life of 37 years, if net salvage costs steadily increased over time due to the effect of inflation, it would be in this data. Instead, the net salvage amount and its components (gross salvage and cost of removal) have risen and fallen over time. Tr. 2755. In short, the data do not support Mr. Robinson's position which should be rejected.

On rebuttal, the company clings to the theory that historic data are not representative of future expectation for utility plant. Mr. Robinson provides no new data to show why this is the case but simply repeats his view that historic net salvage does not provide information relative to the complete life cycle of property. Tr. 787. That is, the estimate is based upon the salvage

generated from a retirement that occurred at an age that is less than the average service life of the property. Tr. 788.

Mr. Robinson acknowledged that his reported average age of retirements is a dollar weighted age. TR 822-823. A thorough explanation of how this calculation works was developed on the record for Account 353 which had retirements going back as far as 1939. Tr. 823-824. He also admitted that he used this method for all accounts. Tr. 825. Applying this methodology to his illustration of cars retired at different ages revealed that the results change if inflation expected in the cost of similar cars purchased at different times is taken into account. TR 826. This is exactly the point that Mr. Radigan made in his original testimony -- developing a weighted average retirement age is a meaningless exercise as it does not recognize the different costs per unit being retired TR 2757. There is no credible basis for the NYSEG net salvage adjustments.

3. Tracking Adjustments

F. Taxes

G. Rate Base

- 1. Electric Plant in Service**
- 2. Cash Working Capital for Purchased Power**
- 3. Deferred Debits (Credits)**
- 4. Deferred Taxes**
- 5. Earnings Base Capitalization ("EBCAP") Adjustment**

For many years, the Commission has employed an EBCAP adjustment to correct misalignment between the "earnings base" (rate base and interest bearing construction work in progress ("IBCWIP")) and a utility's capitalization. In very broad terms, the earnings base represents the utility assets used in rendering service to ratepayers. Tr. 2772. Utilities frequently own other non-utility property and assets, and the earnings base is distinguished from total utility

assets for rate setting purposes. The EBCAP is not a matching adjustment. Rather, it requires an assessment of the reasons for a misalignment of earnings base and capitalization.

NYSEG's originally filed and updated revenue requirement contained a \$95.7 million increase to rate base to reconcile an "earnings base capitalization differentia." Exh. 7, RRP-2, Sch. I. In effect, NYSEG determined that its capitalization exceeded rate base and marked up rate base to bring it "in synch" with capitalization. Tr. 2772; Exh. 102, ERPE 0770. As Nucor witness Jesse Decker explained, ratepayers are not expected to support utility assets that are not part of the earnings base, and NYSEG has misapplied the EBCAP adjustment. Tr. 2772-73. The Department Staff made the same adjustment and noted an additional \$1.7 million in required corrections to remove certain items from NYSEG's capitalization. Tr. 2103-2114.

Following established practice, Nucor and Staff each established NYSEG's earnings base and compared it to the Company's capitalization. NYSEG muddled this issue by following a different methodology in which the utility made various adjustments to its capitalization, including adding IBCWIP, which it then compared to rate base (and marked-up rate base to match its adjusted capitalization). NYSEG's rebuttal did not respond to Nucor, but addressed Mr. Decker's adjustment in the context of responding to Staff. Tr. 288-303.

In rebuttal, NYSEG conceded the bulk of the Nucor and Staff adjustments, but proposed several other changes to its capitalization that, it argues incorrectly, are required to implicitly increase rate base. As revised, NYSEG seeks to add \$35.7 million to rate base, Exh. 7, RRP-2, Sch. K-3, p. 7 of 7; and Sch. I. The problem with NYSEG's remaining revisions, however, is that the items listed (Temporary Cash Investments (TCIs), non-qualified director's trust and Rabbi Trust) should not be included in rate base. Tr. 2108-12. NYSEG claims that TCIs generally have been allowed in rates although the Company concedes that they were not allowed

in rates in the last RG&E general rate case (Cases 02-E-0198 and 02-G-0199). Tr. 301; also Tr. 2109. The record shows that NYSEG has previously included TCIs and the above noted trusts in rate base only indirectly through its EBCAP adjustment. Tr. 467. NYSEG maintains that this was the vehicle it chose to reflect those items in rate base, but it could have accomplished the same result more directly if it chose. Tr. 467-68. Nucor disagrees. The EBCAP adjustment is not a surreptitious back door for building rate base. If NYSEG directly sought rate base treatment for TCIs and the above-noted trusts, we expect the result here would be the same as in the RG&E case. Nucor urges the Commission to reject NYSEG's remaining \$35.7 million rate base increase.

H. Cost of Capital

1. Capital Structure

The Joint Proposal in Case No. 01-E-0359 established electric rates and based earnings sharing calculations assuming a capital structure of 45 equity/ 55% debt. In this case, NYSEG wants to set rates using a target equity ratio of 50%. NYSEG's actual average equity ratio for 2004 was roughly 47.7%; Exh. 1 (ERPE 0203).

There are two basic problems with NYSEG's proposal. First, further increases in equity levels are not required and unnecessarily drive up rates. Second, NYSEG's actual equity ratio is a function of Energy East corporate policies and that ratio is leveraged by Energy East, which maintains a substantially lower (roughly 40%) equity ratio. This circumstance requires that the consolidated capital structure of Energy East be taken into account. As Nucor witness Decker explained, NYSEG's equity is backed in part by Energy East debt on a consolidated company basis. Tr. 2770. The Staff financial panel, which addressed this matter in greater detail, showed, for example, that \$100 million is equity that Energy East transferred to NYSEG (after Energy

East had drained NYSEG of most of its retained earnings) was funded by Energy East debt. Tr. 3328. The Staff panel testimony goes to considerable lengths to follow the convoluted financial chain between Energy East and its regulated affiliates. Tr.3325-36.

Nucor recommends that, on balance, an equity ratio of 42-45% for NYSEG is reasonable to accommodate Energy East's express desire to improve its equity ratio on a consolidated basis. Tr. 2771. This recommendation allows NYSEG ratepayers to bear their share, but not the brunt of Energy East's efforts. It also is consistent with NYSEG's historic per books equity ratio. *Id.*

Staff and the CPB recommend somewhat lower equity ratios. While Nucor maintains that its recommendation is reasonable, we agree that Staff has made a compelling case on this issue. Based on the Staff testimony, Nucor could support a lower equity ratio for NYSEG.

2. Cost of Equity

3. Overall Rate of Return

VI. COMMODITY OPTIONS

A. Policy Issues

NYSEG proposes to continue to offer the menu of commodity options that are available under its current rate plan for another six years. This includes a fixed price option ("FPO") developed using two year forward estimates of market energy prices and a 35% markup to cover certain ancillary supply costs and a risk premium. Tr. 1483. The fixed price option would continue to be the default option for residential and small commercial users. Under the current rate plan, most of these smaller customers, by action or default, remained with NYSEG on the fixed price plan. Exh. 1 (ERPE 0428).

NYSEG has managed its commodity programs very profitably. In fact, wholesale energy prices have moved both up and down substantially over the first four years of the plan, and

NYSEG has realized significant commodity profits in both rising and falling markets. *See* Exh. 1 (ERPE 0779 and ERPE 1048); and Exh. 52 (RPP-4). Since the markup is a percentage of estimated market prices, NYSEG's commodity profits increased as market prices rose, reaching a high of \$106.6 million in 2005. Exh. 1, ERPE 1048, sch. A.

NYSEG maintains that its high commodity profits actually provide several benefits. It claims that consumers receive stable prices, that NYSEG (not consumers) bears the risk of market price volatility, and that the "headroom" provided by a high markup above market prices creates competitive marketing opportunities for ESCOs. Tr. 1500. NYSEG asserts that excess profits credited to the ASGA and used to offset "uncontrollable costs" as a result of the rate plan's earnings sharing mechanism also benefit consumers. Tr. 1080.

Most consumers seem to perceive excess commodity profits differently. They see those profits as a sign that they have been over-charged for the fixed price product. Consumers have not shown any particular interest in seeing commodity prices further inflated to create headroom for ESCOs, and they see the eventual ASGA credit from excess commodity profits as too little, too late. Nevertheless, PULP and the CPB both argue that price stability has become a paramount concern for small users, and strongly advocate continuation of a NYSEG fixed price product.

Alternate energy service providers by and large oppose continuation of the NYSEG fixed price service as antithetical to the development of competitive retail markets, and assert that the Commission need look no further than its August 2005 Retail Markets Policy Statement. NYSEG's commodity proposal certainly does not square well with that Policy Statement, but that hardly ends the matter. The Policy Statement plainly intends for utilities to focus on transmission and distribution services (the "wires" business) and leave energy commodity

services to ESCOs, but the Commission also noted at the outset that this was by no means the “last word” on retail access issues. (P.10).

With that said, a dramatic increase in energy prices followed immediately on the heels of the August 2005 Policy Statement, creating serious concerns throughout the State for lower income households and manufacturing facilities struggling to remain going concerns. The worst fears were not realized during the winter due to relatively mild weather, but those concerns have not abated. Last week, oil traded at more than \$75 per barrel, and gasoline now averages \$3.00 per gallon. With ever increasing energy prices and volatility a constant concern, the Commission needs to consider consumer interest in price stability much more seriously. Thus, the basic policy question is whether NYSEG should continue to offer fixed price service. Under present circumstances, Nucor supports the CPB and PULP in recommending continuation of a NYSEG fixed price commodity option. Price stability is a paramount consumer concern.

Stable commodity prices must, however, arise from a process that produces rates that are just and reasonable. Notwithstanding some interesting academic arguments on “headroom,” consumers do not benefit from an inflated fixed commodity price that creates excess profits unless there is a prompt recapture of most of that excess. The collection of mechanisms employed in the current rate plan (i.e., a large markup of price estimates that already reflect risk premiums leading to excess profits that flow through an earnings sharing mechanism before being credited to an account controlled by NYSEG until the end of the rate plan) is altogether inadequate. Thus, the second core policy question concerns how to permit a NYSEG that fixed price option and still provide rates that are just and reasonable.

As is explained below, in Nucor’s view, the Commission should allow NYSEG an opportunity to earn a reasonable, but not excessive, profit on commodity service. The current

rate plan is clearly deficient in the latter regard. Nucor proposes to cap NYSEG's commodity profits at 50 basis points on its equity return (roughly \$7-8 million), with commodity profits having shared on an 80/20 (ratepayer/ shareholder) basis until the cap is reached. This method tracks the Commission's historic partial pass through fuel adjustment incentive clauses, which is highly applicable to this situation. Staff and the CPB offer alternative approaches for providing relatively stable prices while limiting NYSEG's commodity profits, but, as is discussed below, both proposals have practical limits that Nucor's method avoids.

B. NYSEG's Commodity Option Program

C. Staff Proposal

Staff eliminates NYSEG's profit opportunity altogether with its hedged variable price commodity approach. Tr. 1775. Nucor is concerned that this approach is an insufficient response to the consumer preference for a fixed price. Nucor recognizes that electric rates generally were not fixed in their entirety when utilities in New York were vertically integrated because regular adjustments occurred through operation of fuel adjustment clauses. In fact, as is explained below, Nucor borrows from past Commission partial pass-through FAC policies in its commodity options recommendations. However, the historic adjustment clauses reflected fuel cost recovered on a weighted average basis that did not experience anything resembling the volatility associated with wholesale energy prices in recent years.

D. CPB Proposal

The CPB supports continuation of a NYSEG fixed price option, but not as the default option. Tr. 2001. The CPB would credit all earnings above that level to the ASGA or some other mechanism established for consumer benefit. Tr. 2001. This is an approach that is similar in concept but different in execution to Nucor's recommendation described below. Both

recognize that NYSEG's formula for developing fixed commodity prices is too rich. Rather than changing NYSEG's formula, procurement or hedging methods, both aim instead to remedy the problem by establishing a hard cap on NYSEG's commodity earnings. Nucor could support the CPB's approach in concept, but the approach we recommend will return excess commodity profits to consumers sooner and more efficiently.

E. Nucor's Proposal

As noted above, the immediate reaction to NYSEG's commodity profit levels is that the markup is too great. The problem in proposing a different adder or method lies in establishing a better target given the vagaries and volatility of energy markets and risk management. This situation bears close parallels to the Commission's historic concerns with generation fuel costs of vertically integrated utilities where fuel volumes and prices often were difficult to predict accurately and the risks associated with inaccurate forecasts were significant. The Commission left the management of this problem to each utility and took an after the fact look at actual and forecast costs. Over time, the Commission generally embraced an incentive formula truing up fuel costs to actual levels, allowing the utility to retain 20% of savings (or bear 20% of losses) up to a limit of 50 basis points on its return on equity.⁸

Nucor similarly recommends that the Commission focus on commodity sales end result and apply a partial pass-through incentive approach to commodity profits and losses. Tr. 2759. NYSEG stands to earn a reasonable profit (in excess of \$7 million annually) on commodity service above the cost of procuring and hedging prices for FPO loads. *Id.* Consumers would continue have access to stable commodity prices through NYSEG if they wished. Commodity

⁸ E.g., Case 91-E-0462, Consolidated Edison Company of New York, Inc., Opinion No. 92-8, issued April 14, 1992.

profits, which would still be expected given NYSEG's track record, should immediately flow back to customers through credits applied to the NBC. This will provide a more complete recapture of commodity profits than running them through an earnings sharing mechanism, and it certainly will provide more timely recapture than credits to the ASGA. As Mr. Decker observed, for the next three years, commodity credits to the NBC benefit consumers by mitigating the remaining above-market NUG contract costs. Tr. 2770. Overall, this approach provides a more complete solution than Staff recommends, stable prices for consumers, and a more timely recapture of excess commodity profits than CPB proposes. NYSEG did not file any rebuttal in response to Nucor's proposal.

F. Direct Energy Proposal

G. Energetix Position

H. Other Positions

In a letter dated April 3, 2006, the New York State Attorney General urged the Commission to continue to permit NYSEG to offer fixed price commodity option at rates that allow the utility to earn a reasonable but not excessive profit. Nucor's commodity pricing proposal would satisfactorily address the Attorney General's recommendations. The AG further supports the use of long term power supply contracts to restrain energy price volatility, although it does not develop that notion any further. Nucor takes no position on long term power supply contracting at this time.

VII. COST OF SERVICE/NYSEG ECOS STUDY

VIII. REVENUE ALLOCATION/RATE DESIGN

Delivery rate revenue allocation and rate design should be guided by the results of the embedded cost of service study ("ECOS") and bounded by accepted tolerance band movements

to limit rate impacts on any single customer group. As is discussed in detail below, although the ECOS establishes that the high voltage (SC 7-4) I/HLF class provided a return nearly four times the system average,⁹ the ECOS shows most other I/HLF subclasses have deficient returns. NYSEG relies upon these ECOS findings to justify a blanket elimination of all I/HLF subclasses. Next, NYSEG proposes to consolidate the I/HLF loads with each of their parent classes without regard to the serious rate impacts this creates. NYSEG's excuses for ignoring both the ECOS results as to SC 7-4 customers and the bill impacts as to all SC 7-x I/HLF loads can be reduced to: 1) NYSEG's claim that the ECOS results as to high voltage loads should be completely ignored based on the "law of small numbers" (of customers), 2) NUG levelization will mask the impact, at least in the first two years of its proposed rate plan, and 3) delivery rates are not really a big part of the overall electric bill. There is not a shred of credibility, or record support, for any of these reasons to support the end result NYSEG proposes.

In designing rates, NYSEG similarly ignored the basic concept of assigning fixed costs to fixed charges. For its multi-year plan, NYSEG relies instead on the NUG levelization energy credits (in 2007 and 2008) and proposes to recover all delivery revenue increases through energy charges. The net result are a proposed revenue allocation and rate designs that are contradicted by the ECOS and produce monumental rate increases for various customer groups. NYSEG does not discuss the impacts of its proposal for rate years when the NUG levelization credits become rate adders and asks the Commission to ignore it as well. In a one year rate order, without NUG levelization, NYSEG concedes that its rate design must be completely re-done. Tr. 2530-31.

⁹The high voltage non -I/HLF class also provides a return that is substantially greater than the system average.

Nucor proposed basic corrections to NYSEG's revenue allocation and rate design that are required to move all rates in the direction indicated by the ECOS and to limit rate movement for all customer classes based on accepted tolerance levels in order, as is common practice, to mitigate rate impacts. Nucor generally agrees with Multiple Intervenor's additional adjustments to revenue allocation, but even without those adjustments, NYSEG's proposals should be rejected. MI and the Department Staff take similar approaches to correct the basic flaws in NYSEG's proposal and differ with Nucor only slightly with respect to NYSEG's plan to eliminate the industrial or high load Factor ("I/HLF") sub-classes.

Though the ECOS indicates revenue decreases actually are needed for the high voltage classes, Nucor conservatively proposes to retain the SC 7-4 I/HLF rate at its current levels, and Nucor agrees with Staff and MI that SC 7 delivery revenues should be recovered through demand rather than energy charges. Nucor also recommends retention of the other I/HLF sub-classes for now, noting that there are other Upstate economic development problems to consider.

MI follows the ECOS indications, suggests a decrease in the SC 7-4 I/HLF demand charge, and offers basic criteria to be applied to any movement to merge the I/HLF classes. Without discussing the high voltage class results, Staff concludes generally that the I/HLF classes are not cost justified, but Staff proposes a gradual approach to merging the classes. Staff, however, underestimates the bill impact on existing I/HLF customers and adjustments to further mitigate bill impacts are required if Staff's approach were to be adopted.

A. Revenue Allocation Methodology/Use of ECOS Study

As in any rate case, NYSEG prepared an embedded cost of service study ("ECOS") as

the fundamental premise for allocating revenue responsibility and designing rates. The ECOS breaks down (i.e., classifies, functionalizes and allocates) NYSEG's historic costs for the test year. The ECOS is, therefore, a zero sum game. If, for example, the costs associated with transformers are over-allocated to industrial users, those costs by definition have not been properly allocated among other classes as well. Also, there is nothing about the ECOS that is forward looking. In performing the ECOS, NYSEG did not endeavor to forecast or anticipate changes in customer loads, costs or system performance. Tr. 1047-49.

Based on the ECOS results, NYSEG's cost of service panel declared that the relative rates of return for the I/HLF service classes "... are significantly below the 15 % tolerance band. Tr. 864. The COS panel, however, acknowledges that return for the transmission voltage (SC 7-4 I/HLF) class (32%)¹⁰ (along with the SC 3S (14.7%) and SC 7-4 non I/HLF (17.4%)) provided a return that is significantly higher than the system average return. Tr. 864. The NYSEG panel discounts these results, asserting that it views them to be outcomes due to the "law of small numbers." *Id.* NYSEG offers no analysis as to how costs should be re-allocated to produce what it would consider a more representative cost of service for these customer groups. Instead, it states only that there are small numbers of customers in each of these groups and offers its sense that the study results might be "... very heavily impacted by the unique usage characteristics of a single customer or small group of customers relative to load factor and contribution to peak." Tr. 864. Thus, the NYSEG COS Panel argues that the ECOS results are correct but that the results could be different if customers in the class changed or if the company changed the way it performed the cost study (e.g., if the demand allocators were changed). Tr. 916. The purpose of the ECOS, however, is to allocate embedded costs among existing loads based on observed data, and not to speculate concerning how the results might be different if the

¹⁰ See Exh. 49 (COS-2, p. 4 of 4).

inputs or the allocators changed.

While NYSEG ignores the ECOS results as to the SC 7-4 classes, the Company relies completely on the ECOS results for its other conclusions. Of course, in terms of “small numbers,” the coincident peak demand for the SC 9 class is less than both the SC 7-4 and SC 7-4 I/HLF, and the demands for SC 2 I/HLF, SC 7-1 I/HLF, and SC 3P are only marginal greater than the high voltage loads. See Exh. 51(Demand Allocator Page1). NYSEG, however, relies strictly on the ECOS for its revenue allocation for each of these classes. Similar observations can also be made for the contributions of these classes relative to the high voltage classes based on non-coincident peaks and metered energy. Exh. 52. Relatively small volumes associated with those other classes suggest that, if NYSEG’s “small numbers” concerns were valid, the results for those other customer classes might be similarly distorted by the load of a single or small group of customers. NYSEG, however, does not appear to be troubled by such concerns where the ECOS shows below rather than above system average returns.

Further, the costs related to high voltage (115 kv and above) service are allocated almost exclusively on the basis of demand. Tr. 845, 3703. The SC 7-4 classes are billed based on interval metered data that NYSEG relies upon for various purposes, including billing, forecasting, planning, and cost allocation. Tr. 1049-51. Consequently, NYSEG has highly reliable data for allocating costs to these loads based on their actual characteristics.

Next, as MI witness Rosenberg correctly observes, since most of the costs involved are fixed, the load factor of demand-metered classes should not change the results of the cost study. Tr. 3702. Moreover, since both demand and energy usage for these loads are accurately metered, the ECOS should accurately assign costs based on the observed class load factor. In sum, the record shows that NYSEG irrationally disregarded the ECOS results to achieve a pre-determined

result (eliminating all I/HLF sub-classes). The "law of small numbers" claim is not germane to the viability of the ECOS results for these customers because the number of customers did not distort any classification, functionalization or allocation of NYSEG's costs. NYSEG's secondary arguments in this regard, as discussed below, are even less credible.

Significantly, the NYSEG Delivery Rate Design accepts the mathematical results of the ECOS and does not claim that the data inputs for the SC 7-4 classes were random or aberrant in any way. Tr. 2591. The panel had no independent reasons for rejecting the ECOS results, but volunteered two twists on the above arguments that also make little difference. First, Mr. Host-Steen indicated that the two loads currently served under the SC 7-4 I/HLF rate operate at lower load factors than NYSEG expected. Tr. 2558. As noted above, however, customer load factor should not alter the ECOS results for demand-metered loads.

Next, Mr. Host-Steen noted that one of the customers had a very low coincident peak (CP) relative to its non-coincident peak. Tr. 2593-94. But, Mr. Host-Steen agreed that NYSEG designs its system and incurs its fixed costs on the basis of its system (coincident) peak. Tr. 2593-94. Consequently, on a cost causation basis, a customer that manages its load to minimize its contribution to the system peak allows the utility to avoid incurring additional fixed costs. Indeed, such a customer better utilizes NYSEG's system resources when other loads are lower. Unless this occurs by accident (which NYSEG does not suggest is the case here), this is a desired load shape (which demand response programs actually encourage) and the ECOS correctly allocates costs to that load.

Finally, Mr. Host-Steen suggests that if SC 7 delivery rates followed the ECOS results they might attract efforts to migrate to that rate by loads that were not entitled to it. Tr. 2561; 2595. To qualify for SC 7-4 service, however, a customer must have a load greater than 500 kw,

be demand metered, and agree to install and maintain equipment capable of taking service at 115,000 volts,¹¹ and I/HLF loads must meet additional manufacturing or high load factor criteria.¹² There is no record basis indicating that SC 7-4 delivery rates that are consistent with the ECOS results would initiate an effort by existing loads to migrate to 115 kV service in which those loads would incur the cost of installing and maintaining high voltage transformation equipment. In deed, there is no record basis that such service might even be physically available. In sum, NYSEG's rank speculation is no reason to disregard the ECOS results for the purpose of allocating costs and designing rates in this case.

B. Non-Bypassable Wires Charge

NYSEG's reliance on the NUG levelization proposal completely distorts NYSEG's "typical bill impact" analysis, shown on Exhibit 93 (DRD-3). Without NUG levelization, NYSEG agrees that it is proposing significant delivery rate increases for all SC 7-x I/HLF loads simply by consolidating the I/HLF sub-classes into the parent rate. See Exhs. 96 and 97. NYSEG also admits that its rate design would need to be completely different absent NUG levelization. Tr. 2482-83; 2531. The company does not address the fact that its rate design would be even worse for demand metered customers after 2009 if the levelization proposal were adopted. Either way, NYSEG's decision to "marry" its revenue allocation and rate design recommendations to the levelization proposal is a mistake and should not be relied upon in deciding those issues in this case.

¹¹ PSC No. 120- Electricity, tariff leaf Nos. 211 and 221.

¹² PSC No. 120-Electricity, tariff leaf No. 244.

C. Customer Charges

D. I/HLF AND NON-I/HLF CUSTOMERS

As discussed above, NYSEG proposes to eliminate all I/HLF subclasses, relying upon the ECOS study results showing, except for the SC 7-4 class, that the I/HLF subclasses generally provide deficient returns. The Company combined each I/HLF subclass with its parent class for rate design purposes, although the ECOS allocated costs by subclass. The merging of subclasses produces delivery rate increases of 96% (SC 7-3) to 160% (SC 7-4) for I/HLF customers without any change in the delivery revenue requirement. Tr. 2552. NYSEG also proposes to add to those impacts by applying the increase in delivery revenues to energy charges, although the delivery costs for SC-7 class customers are primarily fixed and should be recovered in demand charges. With its proposed delivery rate increase, revenue allocation and rate design, SC 7 -x I/HLF loads would see increases of 117% (SC 7-1) to 273% (SC 7-4). Exh. 96. Other than the above-discussed NUG levelization, NYSEG makes no effort to mitigate these monumental impacts.

At the outset, it is important to recognize that the reasons the I/HLF rates were established remain valid today. Tr. 3702. In its 1998 electric restructuring case, NYSEG established the Industrial/High Load Factor subclass to support job retention and economic development efforts. As Nucor witness Radigan notes, New York's struggle to retain quality manufacturing jobs is, if anything, more pressing today given nationwide concern over the cost of energy services and the expected expiration of core NYPA economic development programs (Power for Jobs and Economic Development Power allocations). Tr. 2739-42. Governor Pataki signaled in his 2006 Budget Address that developing effective energy and economic development solutions was a vital State concern to be tackled this year. Tr. 2741-42.

In case 01-E-0359, NYSEG designed unbundled I/HLF delivery rates to preserve a rate

differential for economic development purposes while ensuring that the rates were at or exceeding marginal costs. Tr. 2738-39. In short, the rates were designed in the first place to provide a lesser return but at least cover marginal costs. Eliminating all I/HLF rates in this case solely based on the ECOS results would put the Commission at odds with the State's broader efforts to resurrect or re-create effective energy-related economic development initiatives. Consequently, Nucor urges caution in eliminating the I/HLF sub-classes.

There is, of course, much more to consider. As discussed above, the ECOS demonstrates that the SC 7-4 I/HLF rate remains cost justified, and NYSEG's excuses for disavowing the ECOS results for high voltage loads lack merit. There is no justification for a revenue allocation for this class that runs contrary to the ECOS findings. Next, if consolidation of the I/HLF rates were contemplated, mitigation of rate impacts must be paramount. NYSEG offers no mitigation at all.

Nucor witness Radigan addressed the patent flaws in NYSEG's revenue allocation and rate design, and crafted a rational approach that mitigates rate impacts for all classes. Nucor used the ECOS as a guide consistently throughout the revenue allocation and rate design. First, Mr. Radigan re-allocated revenues to all subclasses based on the ECOS results. Tr. 2736-37; Exh. 100 (FWR-5). Mr. Radigan noted that increases to any single customer class normally are limited to no more than 1.5 times the overall average increase. Tr. 2743-44. Taking a multi-year rate setting into account, he widened the tolerance to no more than 2.5 times the increase in overall revenues or no less than one times the overall decrease (delivery, commodity and NBC) bills. Tr. 2744-45; 100 (FWR-8). The sole exception to this is the SC-7(4) I/HLF class. Mr. Radigan recommended holding the delivery revenues for that class constant out of conservatism rather than further reducing the rates as the ECOS indicated they should. Tr. 2745. NYSEG

criticizes Mr. Radigan for relying too heavily on the ECOS results. Tr. 2477-78. As discussed above, however, NYSEG did not provide a reasoned justification for disregarding the ECOS results.

Overall, Mr. Radigan's recommendations moves the relative rates of return for all service classes toward the system average, all classes move in the direction indicated by the ECOS, and rate impacts are held to justifiable levels for all classes. Tr. 2745. Nucor's approach is conservative based on the ECOS results and should lead to sustainable delivery charges for these customers over the longer term. Unlike NYSEG, Nucor does not speculate about possible future changes in the make-up or characteristics of customer classes. If changes do occur in customer groups, those changes can be reflected in future cost studies and addressed at the time they become evident. In terms of overall rate design, Nucor recommends retaining all I/HLF subclasses at this time for the reasons noted above.

Staff relies on the deficient returns shown for most I/HLF subclasses in the ECOS for its conceptual support for a phased consolidation of the I/HLF and parent classes. Staff acknowledges and attempts to address the large rate impacts associated with that consolidation by advocating a gradual approach. Tr. 2971-72. Staff also proposes to eliminate SC-7 delivery energy charges, which is echoed by MI, is consistent with the cost causation principles reflected in the ECOS and should be adopted. All agree that NYSEG's reliance on NUG levelization to disguise delivery rate impacts (for two years, and magnify them in subsequent years) is inappropriate and not in the public interest.

There are, however, two basic problems with Staff's approach to I/HLF rates. First, the Staff recommended SC 7-4 I/HLF demand charge of \$1.20/ Kw. is roughly triple the current

rate.¹³ Staff does not address the ECOS results demonstrating that existing rates for the high voltage SC-7(4) I/HLF class are well above the system average return. Consequently, for this subclass, Staff's recommend movement toward the non-I/HLF delivery rate is contrary to the direction the I/HLF rate should take based on the ECOS (i.e., the rate should go down, not up).

Second, Staff's bill impact analysis looks only at the effects on customers with load factors of 68% and higher. Tr. 3017-18; *see* Exh. 110 (ERP-3). The record reveals that the existing SC-7(4) I/HLF customer actually operate at substantially lower load factors. Tr. 2558. With delivery rates applied to demand charges, bill impacts will be greater for lower load factor customers, a point that Staff recognizes but did not evaluate. Tr. 3018. Consequently, Staff's analysis understates the expected bill impact on I/HLF loads.

Nucor opposes Staff's approach because it would move rates for SC 7-4 I/HLF loads in the wrong direction. If Staff's approach, however, were adopted, the delivery increase for the SC 7-4 I/HLF should be further limited to reflect the fact that Staff has underestimated the bill impacts on the existing I/HLF loads. That increase should in no event be more than twice the existing delivery charge, or no more than \$0.84 /Kw.

MI proposes, after correcting NYSEG's cost functionalization, that the Commission should allocate revenue responsibility for all classes based on the results of the ECOS. This means that delivery rates for SC-7(4) I/HLF customers should be reduced, not increased. *See* Exh. 143, (AR-1, sch. 5). MI recognizes that other I/HLF subclasses currently do not provide adequate returns on rate base, but MI correctly notes, as did Staff, that caution must be taken in merging I/HLF subclasses to accommodate bill impacts. MI suggests the following criteria that must be taken into account in taking any action in this regard.

¹³ The existing SC 7-4 I/HLF energy charge of \$0.00202 / kwh equates to a demand charge of \$.42/ kW.

- Modify the cost of service study to remove all merchant function costs.
- Allocate all increases using the cost study as a guide with approach bandwidth and constraints to moderate bill impacts.
- Eliminate the delivery energy charge.
- Equalize the rates at a measured pace.

Tr. 3706. More specifically, Dr. Rosenberg recommends that the initial increase to an SC 7-x I/HLF should not exceed 15% of current delivery revenue, and subsequent increases should not exceed 10%. Tr. 3707. If the SC-7 I/HLF rates are to be merged with their parent classes, these guidelines certainly should be taken in to account.

On balance, Nucor has proposed the most sensible approach to revenue allocation and rate design. NYSEG's approach is not remotely cost justified and produces rate impacts that are unacceptable on their face. NUG levelization, either in a one year or multi-year context, is not actually a rate moderator and should be disregarded. Staff's approach is not consistent with the ECOS for high voltage customers and underestimates bill impacts. Nucor and MI take similar approaches based on the ECOS results, but Nucor's recommendations are, we believe, more appropriate overall.

E. Rate Impacts

The rate impacts of the various revenue allocation and rate design proposals are reflected in the discussion above.

F. Standby Rates

G. Economic Development

VIII. RETAIL ACCESS ISSUES

- IX. SERVICE QUALITY PERFORMANCE MEASURES**
- X. LOW-INCOME (POWER PARTNER) PROGRAM**
- XI. UPDATES**

CONCLUSION

Nucor urges the Commission to adopt each of its adjustments and recommendations to NYSEG's electric rate filing for the reasons stated herein.

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