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Brief

05-E-1222

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April 26, 2006

By Hand Delivery

Hon. Jacklyn A. Brilling
Secretary
New York State Public Service Commission
Three Empire State Plaza
Albany, NY 12223

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

Dear Secretary Brilling:

Enclosed please find an original and twenty-five (25) copies of the Initial Post-Hearing Brief of Direct Energy Services, LLC in the above-referenced proceeding.

Copies of this filing have been served on all parties on the Commission's Official Service List.

Very truly yours,

George M. Pond
Attorney for Direct Energy Services, LLC

GMP:cam

Enclosure (original and 25 copies)
cc: William Bouteiller, Admin. Law Judge
Elizabeth H. Liebschutz, Admin. Law Judge
NYS Dept. of Public Service

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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

INITIAL POST HEARING BRIEF
OF DIRECT ENERGY SERVICES, LLC

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Dated: April 26, 2006

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BEFORE THE
PUBLIC SERVICE COMMISSION
STATE OF NEW YORK

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INITIAL POST-HEARING BRIEF
OF DIRECT ENERGY SERVICES, LLC

Direct Energy Services, LLC ("Direct Energy") submits this Initial Post Hearing Brief pursuant to Rule 4.8 of the Commission's Rules of Procedure, 16 N.Y.C.R.R. § 4.8 (2005), and the Ruling Setting Case Schedule issued in this proceeding by Administrative Law Judge William Bouteiller on November 14, 2005.

INTRODUCTION AND BACKGROUND

Procedural Background

This general rate increase proceeding was initiated by the New York State Electric & Gas Corporation ("NYSEG") through the filing of amendments to its tariff schedules P.S.C. No. 120 – Electricity and P.S.C. No. 121 – Electricity. Those proposed tariff changes seek to extend NYSEG's existing Electric Rate Plan for six years, beginning January 1, 2007, with certain changes. Among these changes were an increase in NYSEG's annual electricity delivery revenues of $91.5 million or 15 percent, which NYSEG proposed to offset through the acceleration of benefits associated with the termination of certain generation contracts to produce an overall rate decrease of $71.2 million or 9.5 percent.

Direct Energy is a subsidiary of Centrica, PLC, a leading provider of energy-related services to over 18 million households world-wide with annual revenues of $31 billion, $17 billion in market capitalizations, and over 38,000 employees. In North America, Direct Energy has over 3 million gas and electricity customers. Recently, Direct Energy began providing retail electric and gas service to residential and business customers in the service territories of the Consolidated Edison Company of New York, Inc., Orange and Rockland Utilities, Inc. and National Grid.

SUMMARY OF POSITION

One of the major features of NYSEG's current rate plan and which NYSEG seeks to extend for an additional six years its Voice Your Choice retail commodity supply program. The principal feature of this program is that it enables NYSEG to earn not only a reasonable return on its capital invested in providing electric service, but also a substantial additional profit on the provision of fixed price default service to its residential and small commercial customers ("small customers"). The contribution of these two profit opportunities has permitted NYSEG to earn total profits roughly twice as high as the return which the Commission has approved for New York utilities other than NYSEG and its affiliate Rochester Gas & Electric Corp. ("RG&E").

As explained in greater detail below, under NYSEG's proposal, small customers that fail to elect an alternative form of service during a brief window every second year are locked into NYSEG's Fixed Price Option for the remainder of the two year commodity option period. The unfairness of this result is further compounded by the fact that NYSEG's Voice Your Choice Program recovers NYSEG's stranded costs from customers taking fixed price service from NYSEG customers through a fixed official

Nonbypassable Wires Change ("NBWC") while imposing a variable NBWC on similarly sized customers taking their commodity service from ESCOs.

Direct Energy opposes extension of NYSEG's Voice Your Choice Proposal on the ground that it violates the *Commission's Statement of Policy on Further Steps Toward Competition in Retail Energy Markets*, unduly restrains customer choice, permits NYSEG to charge rates that exceed its actual costs plus a reasonable rate of return, fails to provide small customers with a solid financial guarantee of NYSEG's performance or its obligation to provide long term fixed price service, and provides NYSEG with incentives to act to impede retail competition to protect the substantial profits on commodity sales that it can only earn if it remains the dominant provider of retail commodity services in its service territory. In addition, the Commission must reject NYSEG's discriminatory proposal to charge a different NBWC to customers taking commodity service from NYSEG than it charges to customers taking commodity services from ESCO.

In lieu of NYSEG's anticompetitive Voice Your Choice Proposal, the Commission should adopt the proposal of Direct Energy Witnesses Dr. L. Lynne Kiesling and Dr. Andrew N. Kleit. These expert witnesses recommended that NYSEG be limited to providing default service only and that for small customers such default service be purchased by NYSEG on a one-month forward basis and resold to such customers with no markup.

ARGUMENT

V. COMMODITY OPTIONS

A. Policy Issues

1. The Record Evidence Conclusively Establishes That The Public Interest Is Best Served By The Development Of Competitive Markets For Retail Commodity Supply

In the Statement of Policy[1], the Commission wisely recognized that competitive markets for commodity supply are the best way to provide consumers with the combination of quality service, low price, innovation and customer choice that the public interest requires:

> Competitive markets, where feasible, are the preferred means of promoting efficient energy services, and are well suited to deliver just and reasonable prices, while also providing customers with the benefit of greater choice, value and innovation.[2]

Consistent with this determination, the Commission adopted a long-rage vision of transitioning *all* retail commodity supply services to competitive suppliers:

> [R]obust competition, where feasible, should be our long-range vision. In the best of all worlds, all retail functions (except delivery) now provided by utilities would be competitive. To that end, all potentially competitive utility functions will be opened to competition, and, subject to the requirements of the Public Service Law and Transportation Corporation Law, regulated utilities should be replaced by ESCOs when markets become workably competitive.[3]

The conclusions reached by the Commission in the Statement of Policy are strongly supported by the record in this proceeding. Direct Energy submitted testimony by two economic experts, Dr. L. Lynne Kiesling and Dr. Andrew N. Kleit, who testified that the incentives for innovation produced by competitive markets "have been successful

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[1] Case 00-M-0504, *Statement of Policy on Further Steps Toward Competition in Retail Energy Markets* (issued and effective August 25, 2004).
[2] Statement of Policy, slip op. at 18.
[3] Statement of Policy, slip op. at 17-18 (footnote omitted).

in powering our Nation's economy for over 200 years and have given American consumers a standard of living that is the envy of the world."[4]

Drs. Kiesling and Kleit explained that competitive markets achieve these efficiencies by providing consumers with price signals that accurately reflect the costs of competing products and services, so that consumers may select the combination of price, service and quality that best fits their individual needs and preferences:

> These markets also provide consumers with accurate signals of the true costs of producing the goods and services they are interested in buying. These price signals permit consumers to take advantage of low cost goods and services to the extent that they are available and to protect themselves from excessive prices by switching to other substitutes when market conditions cause any particular good or service to become uneconomic.[5]

Drs. Kiesling and Kleit provided concrete examples of other industries where the introduction of competition into formerly regulated markets has produced unimagined and unimaginable benefits, such as cell phones and the widespread availability of low cost airline travel.[6] These witnesses also provided detailed evidence of the willingness of residential electric customers to respond to market prices by reducing their use of electricity in peak periods when costs are high, provided they are supplied with appropriate price signals.[7]

No party to these proceedings challenged any of this testimony. Indeed, NYSEG witnesses Segal and Fisher acknowledged in their rebuttal testimony that the benefits of properly functioning competitive markets are too well established to be disputed in this proceeding:

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[4] TR at 1267 lines 13-15.
[5] TR at 1267 line 20 to 1268, line 2.
[6] TR at 1271, lines 10-17.
[7] TR at 1298 line 16 to 1305 line 16.

> The potential benefits of competitive retail electricity markets have been considered for many years. While such arguments may be necessary in jurisdictions that are reevaluating their commitment to retail access, it is not necessary to debate them in New York in this proceeding. NYSEG and virtually all the parties in this proceeding have supported the development of a competitive retail market.[8]

On cross-examination, these witnesses further agreed that competition produced these benefits by providing consumers with clear and accurate signals concerning the prices of the various services available to them:

> A. (Segal) Prices signal whether entry is feasible and appropriate. They can signal consumption decisions by customers as well.
>
> Q. By consumption decisions, do you mean they can provide customers with signals concerning the relative scarcity of the products they consume?
>
> A. (Segal) Yes.[9]

Thus, the record in this proceeding strongly supports the Commission's finding in the Statement of Policy that robustly competitive markets for retail commodity services are in the best interest of all consumers and also demonstrates that the free operation of price signals is essential to the proper functioning of such markets.

2. NYSEG's Voice Your Choice Proposal Violates the Guidelines For the Promotion Of Competitive Markets for Commodity Supply Established By The Commission In The Statement of Policy

In order to balance the Commission's competing objectives of providing small customers with access to market prices for retail electricity supply while providing those small customers with reasonable protection against fluctuations in market prices, the

[8] TR at 1521 line 22 to 1522 line 3.
[9] TR at 1729, lines 12 to 19.

Commission adopted three principles in the Statement of Policy to govern the restructuring of utility commodity supply programs in future rate cases, including this one. NYSEG's Voice Your Choice Proposal violates all three of these requirements.

a. NYSEG's Voice Your Choice Program Conflicts With The Statement Of Policy's Requirement That Utilities Earn No Profits On Commodity Sales

First and foremost, the Commission recognized in the Statement of Policy that distribution utilities should be allowed to earn a reasonable return on invested capital, but must not be allowed to compound those earnings by also making a profit on the provision of commodity supply. In addition to violating the traditional ratemaking principles prohibiting utilities from earning a markup on their expenses as well as on invested capital, the availability of such additional profits on commodity sales provides utilities with inappropriate incentives to remain the dominant provider of commodity services in their service territories:

> ESCOs see a fixed rate offering as a value-added service that they can provide to customers. These parties argue that allowing utilities to provide this service, and to boost their earnings by treating commodity service as a profit center, creates a strong incentive for the utility to remain the monopoly provider in the commodity business and undercuts ESCO efforts to provide these services. We concur with these parties' concerns. We do not propose any changes to existing rate plans regarding commodity profit centers; however, *in future rate proceedings, utilities should not propose fixed rate commodity tariffs or tariffs creating a profit center for commodity sales.*[10]

Far from proposing to eliminate its profits on commodity service as required by the Statement of Policy – and as all other New York utilities except NYSEG's affiliate RG&E have done – NYSEG proposes in this case to *extend* its highly profitable Voice

[10] Statement of Policy, slip op. at 40 (emphasis supplied).

Your Choice Program without significant change for an additional six years. NYSEG's reasons for seeking to avoid the requirements of the Statement of Policy are clear. In addition to earning the reasonable return on its capital invested in utility service, NYSEG has also received earnings on commodity service totaling $ 31 million in 2003,[11] $ 37 million in 2004, [12] and $ 58 million (unaudited) in 2005.[13] In their direct testimony, Drs. Kiesling and Kleit estimated that NYSEG's total return on investment in 2003 may have been over 20 percent.[14] In contrast, the Commission has limited the rates of return for electric utilities other than NYSEG and RG&E to between 7.48 percent and 10.5 percent.[15]

The problem caused by these substantial profits on commodity sales was candidly acknowledged by NYSEG's witnesses Segal and Fisher, who testified on cross examination that every time NYSEG loses a customer to an ESCO, NYSEG's total profits on commodity supply fall.[16] This fact, coupled with the anticompetitive structure NYSEG proposes for its Non-Bypassable Wires Charge ("NBWC"), as discussed at pages _ to __ below, provide compelling proof that NYSEG is in fact responding to the anti-competitive incentives that the Commission recognized in the Statement of Policy would arise whenever utilities are allowed to earn a profit on commodity service.

[11] TR at 1676, lines 16 to 28.
[12] TR at 1676, lines 16 to 28.
[13] TR at 1679, lines 7 to 16.
[14] TR at 1329, lines 4 to 9.
[15] TR at 1330, lines 12-17.
[16] TR at 1740, lines 12 to 19.

b. NYSEG's Voice Your Choice Program Fails To Establish Rates That Increasingly Reflect Market Prices Over Time As Required By The Statement of Policy

In recognition of the key role played by unregulated prices in the proper functioning of competitive markets, the Commission ruled in the Statement of Policy that utility rates for small customers should be gradually adjusted to reflect market prices as existing hedging arrangements expire:

> Generally, rates should increasingly reflect market prices over time. As markets develop and utility multi-year contracts expire, utility commodity rates should move towards a short-term market price flow-through. We therefore agree with the RD that in the final state of utility's offering of a competitive service the rates for that service should closely track the unadjusted spot market price.[17]

Far from gradually increasing the extent to which small customers are exposed to unadjusted spot market prices, however, NYSEG's proposal to extend its Voice Your Choice program for an additional 6 years would continue without substantial change a program that largely isolates NYSEG's small customers taking default service from market forces, except during a brief window every two years. This result would impede the development of robustly competitive retail commodity supply markets in NYSEG's service territory in violation of the Statement of Policy.

[17] Statement of Policy, slip op. at 40-41.

c. **NYSEG's Voice Your Choice Program Violates The Provisions Of The Policy Statement Prohibiting Utilities From Proposing Incentive Mechanisms To Minimize Utility Commodity Supply Costs**

In the Statement of Policy, the Commission also recognized that once retail markets for commodity supply were opened to competition, there would be no need to provide utilities with special incentives to minimize their commodity costs:

> Based on our experience and the responses to the January Notice, we conclude that there is no need for an incentive mechanism [for utilities to minimize their commodity costs]. We do not propose any changes to existing rate plans regarding such mechanisms, but, in future proceedings, utilities and other parties should not propose such mechanisms.[18]

Notwithstanding this clear Commission directive, NYSEG touts the incentives for NYSEG to minimize its commodity costs as one of the principal reasons why its Voice Your Choice proposal should be extended.

Accordingly, NYSEG's Voice Your Choice proposal in this proceeding violates each of the guidelines for utility commodity proposals established in the Statement of Policy. For these reasons alone, NYSEG's proposal should be rejected without further consideration.

3. NYSEG's Attack On The Commission's Authority To Establish Fully Competitive Markets For Retail Commodity Supply Is Unfounded

As previously noted, the Commission determined in the Statement of Policy that once robustly competitive markets for retail commodity services develop, utilities should be required to exit the commodity function, to the maximum extent allowed by the New York Public Service Law. In a footnote to that determination, the Commission noted that

[18] Statement of Policy, slip op. at 41.

because the Public Service Law and the Transportation Corporations Law both require utilities to provide service on demand, these statutes, "unless amended, would prevent the utilities from completely exiting the provision of utility service."[19]

Relying on this statement, NYSEG and the Public Utility Law Project have both sought to challenge the Commission's end-state version of utilities exiting the commodity function once robustly competitive retail commodity supply markets develop. Specifically, these parties contend that even after the development of robustly competitive markets for retail commodity supply, the Commission will be precluded (absent legislative action) from requiring utilities to exit the commodity function due to the statutory obligation of those utilities to provide electric service on demand.

This claim overlooks the Commission's broad discretion to construe and apply the provisions of the Public Service Law to promote the public interest. Although section 2 of the Public Service Law sets out over thirty defined terms, neither that section nor any other provision of the Public Service Law expressly defines the scope of the "service" which a utility is authorized and required to provide to residential customers on demand under section 31 of the Public Service Law.[20] Similarly, nothing in the Transportation Corporations Law purports to specify the scope of the service which a utility is required to provide to a non-residential customer under section 12 of the Transportation Corporations Law.[21]

Once robustly competitive markets for retail commodity supply have been established, the Commission will therefore plainly have the discretion to limit the scope of the "service" which distribution utilities are authorized and required to provide on

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[19] Statement of Policy, slip op. at 17 n.27.
[20] N.Y. Pub. Serv. L. § 31 (McKinney Supp. 2005).
[21] N.Y. Trans. Corp. L. § 12 (McKinney 1996).

demand to unbundled delivery service, since a rational basis for that action has already been established in the Statement of Policy. Indeed, the Commission has already approved the requests of numerous owners of generating facilities subject to the Commission's jurisdiction for authority to operate solely as wholesale suppliers of generation-related services.[22] Such a limitation on the scope of utility services would plainly be unlawful if, as NYSEG and PULP contend, electric "service" must necessarily be construed to include both delivery and commodity services. Accordingly, the Commission plainly has the jurisdiction and authority necessary to require NYSEG to confine its utility operations to the provision of unbundled delivery service only, provided the Commission finds such a limit to be in the public interest.

Further support for the Commission's authority to require NYSEG to limit its operations to the provision of unbundled delivery services is provided by sections 66 (1) and 66 (12) (e) of the Public Service Law. Section 66 (l) of the Public Service Law provides that the Commission shall have "general supervision of all . . . electric corporations."[23] Section 66 (12) (e) authorizes the Commission to require utilities to adopt specific tariff terms and conditions mandated by the Commission:

> The commission shall have power to prescribe the form of every [tariff], and from time to time prescribe by order such changes in the form thereof as my be deemed wise. The commission shall also have power to establish such rules and regulations to carry into effect this subdivision as it may deem necessary, and to modify or amend such rules or regulations from time to time.[24]

[22] *See, e.g.* Case 98-E-1670 – *Carr Street Generating Station, L.P.*, Order Providing for Lightened Regulation, slip op. at 4 (issued and effective April 23, 1999) (noting that Carr Street and certain other generating facilities "intend to operate as merchant plants in a wholesale market.").
[23] N.Y. Pub. Serv. L. § 66 (1) (McKinney Supp. 2005).
[24] N.Y. Pub. Serv. L. § 66 (12) (e) (McKinney Supp 2005).

Thus, NYSEG's claim that the Commission lacks the jurisdiction to exclude it from the business of providing electric service once robustly competitive markets for retail commodity supply have been developed is wholly without merit.

B. NYSEG'S Commodity Options Proposal

Even in the absence of the Statement of Policy and the commitment to transitioning New York's markets for retail energy supply from regulation to competition adopted therein, the Commission would still be required to reject NYSEG's Voice Your Choice program for the reasons noted below.

1. NYSEG's Fixed Price Option

NYSEG has actually proposed two distinct Fixed Price Options in this proceeding. For residential and small commercial customers ("small customers"), NYSEG would make its fixed price service the default, while offering its Variable Price Option to those customers on an optional basis. For its industrial and large commercial customers ("large customers"), NYSEG proposes to make its Variable Price Option the default and to make its Fixed Price Option available as an option.

In this section B.1, Direct Energy will present its reasons for opposing NYSEG's proposal to make its Fixed Price Offering the default option for small customers. Direct Energy does not oppose NYSEG's proposal to provide default service to large customers under its Variable Price Option, but does oppose any commodity offering by NYSEG other than a default service offering for the reasons noted in section B.2 of this Brief.

a. NYSEG Has Failed To Meet Its Burden Of Proving That Its Fixed Price Default Service Option Is Just And Reasonable

This proceeding was commenced as a result of a filing by NYSEG seeking a "major rate change" as that term is defined in section 66 (12) (f) of the Public Service Law. [25] That major rate increase was suspended by the Commission as authorized by section 66 (12) (f).[26] Section 66 (12) (i) of the Public Service Law provides that in any such proceeding filed by a utility, the burden of proof shall be on the utility to justify not only any change in rates, terms or conditions sought by the utility, but also the retention of any other rates, terms or conditions sought by the utility:

> At any hearing involving a rate, the burden of proof to show that a change or proposed change if proposed by the utility, or that the existing rate, if it is proposed to reduce the rate, is just and reasonable shall be upon the utility . . . .[27]

The imposition of this burden of proof on NYSEG is particularly appropriate in this case, since its existing commodity options are the result of a settlement that included numerous other provisions that NYSEG does not propose to extend in this case. As the Staff Commodity Options Panel noted:

> [C]ontinuation of an integral component of such a negotiated rate plan, without the other associated aspects/trade offs, is on its face inequitable. . . .
>
> NYSEG's electric rate plan contained numerous rate and other benefits which justified the establishment of the commodity program at that time. Among the more substantive concessions made by NYSEG were the following: a substantial ($205 million or 13%) rate reduction, followed by a delivery rate freeze for five years, limits on potential deferrals, sharing of excess earnings, an

[25] N.Y. Pub. Serv. L. § 66 (12) (f) (McKinney Supp. 2005).
[26] See Case 05-E-1222 – *Proceeding on Motion of Commission as to the Rates, Charges, Rules and Regulations of New York State Electric & Gas Corporation for Electricity*, Order Suspending Filing, slip op. at 1 (issued and effective June 25, 2006) ("NYSEG's filing constitutes a major rate increase, and public hearings are required by statue.").
[27] N.Y. Pub. Serv. L. § 66 (12) (i) (McKinney Supp. 2005).

enhanced service quality and reliability program and continuation of the economic development plan.[28]

By virtue of its decision to retain only selected portions of its last settlement while changing numerous other provisions of that settlement, including replacing a rate decrease with a substantial overall rate increase, NYSEG has placed itself in a position where it must justify all aspects of its proposal, including its Voice Your Choice program.

(i.) <u>NYSEG has failed to demonstrate that its Fixed Price Option Is Just And Reasonable Under Any Established Standard</u>

(A.) <u>NYSEG's fixed price default service proposal is plainly unreasonable under traditional standards of cost of service ratemaking</u>

As the Commission noted in its Opinion No. 96-12, the Commission has generally based its determination of whether utility rates are just and reasonable on the extent to which those rates permitted the utility to recover its prudently incurred expenses and to earn a reasonable return on its investment in rate base:

> The Public Service Law vests us with broad authority over the construction, safety and reliability of electric facilities, the prices charged by electric utilities to classes of customers, and the requisite customer service standards and protections. We have generally, but not always, set rates to allow the utilities sufficient revenues to recover prudently incurred costs and to provide a fair return on investment. However, we are not bound to any particular rate setting approach in exercising our authority to set "just and reasonable rates." [29]

When reviewed under this traditional standard of ratemaking, NYSEG's Fixed Price Option is plainly unreasonable. Instead of limiting the utility to rates that recover its

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[28] TR at 1779, line 12 to 1780, line 10.

[29] Case 94-E-0952 - *Competitive Opportunities Regarding Electric Service*, Opinion And Order Regarding Competitive Opportunities For Electric Service, Opinion No. 96-12 (issued and effective May 20, 1996) (footnotes omitted).

expenses plus a reasonable return on capital, NYSEG's proposal would allow it to earn *both* a return on capital *and* a hefty profit on its default commodity service to small customers.

NYSEG's hefty profits on default commodity service to small customers stem from the fact that prices for default service under its Fixed Price Option are based on *quotes* for electric energy on a forward basis provided to NYSEG by certain wholesale marketers.[30] These forward price estimates are then grossed up by an arbitrary 35 percent adder, only part of which is cost-justified. Specifically, as a number of witnesses have testified, a little over half of that 35 percent adder represents the cost of supplying electricity at the load share of NYSEG's retail customers rather than at a 100 percent load factor.[31] NYSEG contends that the remainder of that adder is required to compensate NYSEG's shareholders (subject to certain sharing provisions) for whatever risks may be inherent in providing service on a two-year fixed price basis.

NYSEG does not actually make any energy purchases at the prices produced by its proposed pricing mechanism. Indeed, according to its own witnesses it makes no energy purchases at all during the period when it is collecting price quotes for this analysis.[32] As a result, these price quotes clearly do not represent NYSEG's actual embedded costs of service.

Instead, NYSEG proposes that the Commission adopt a "formula rate" that would administratively determine the price NYSEG may charge its customers for fixed price default service. To the extent that NYSEG can supply such service at a cost below this administratively determined price, NYSEG proposes that it be allowed to pocket those

[30] TR at 1316, lines 8 to 14.
[31] Direct testimony of David Segal, TR at 1484, line 7 to 1485, line 8.
[32] TR at 1510, lines 14 to 19.

savings, subject to certain earnings sharing requirements. As noted at page 8 above, NYSEG's commodity revenues under this program have exceeded $ 30 million in each year of the current rate plan and reached an astonishing $ 58 million (unaudited) in 2005. Because NYSEG's total commodity revenues plainly exceed its out of pocket costs for commodity service by a substantial margin, and because NYSEG is also receiving a reasonable return on its capital invested in its distribution system, NYSEG's total earnings under this proposal clearly would exceed be unjust and unreasonable under established cost of service principles.

(B.) NYSEG'S fixed price default service proposal is not market-based

In recent years, the Commission has recognized that the rates and charges produced by robustly competitive markets are also "just and reasonable."[33] The prices charged under NYSEG's Fixed Price Option are not, however, the result of either a competitive solicitation by NYSEG or a purchase by NYSEG at an established index or spot market price, as NYSEG witnesses Segal and Fisher candidly acknowledged on cross examination:

> Q.: Is NYSEG's fixed price offering determined by – taken directly from an established exchange?
>
> A.: (Segal) The retail price is not.
>
> Q.: And is it based on prices NYSEG actually pays?
>
> A.: (Segal) The retail price? The wholesale price is based on prices that are offered and prices that are transacted but are not necessarily that NYSEG transacts it.[34]

Accordingly, NYSEG cannot claim that its Fixed Price Option is just and reasonable because it is the direct result of competition in a robustly competitive market.

(ii.) NYSEG has not met its burden of proving that its novel "formula rate" produces just and reasonable results

As NYSEG witness David Segal candidly admitted during cross-examination, NYSEG's Fixed Price Offering is actually a "formula rate" designed to administratively estimate the price that NYSEG would pay if it purchased two-year fixed price commodity

[33] Statement of Policy, slip op. at 18 ("Competitive markets, where feasible, are the preferred means of promoting efficient energy services, and are well suited to deliver just and reasonable prices, while also providing customers with the benefit of greater choice, value and innovation.").
[34] TR at 1739, lines 15-24.

service in a robustly competitive market.[35] In a sworn statement submitted to the Federal Energy Regulatory Commission in opposition to the Installed Capacity ("ICAP") Demand Curve originally developed by the Staff of this Commission, Mr. Segal testified that formula rates that seek to administratively estimate the prices that would be found in robustly competitive markets are inherently unreliable:

> The proposed Demand Curve is flawed because it seeks to administratively determine a value for capacity. Because it requires so many judgments, estimates or assessments to derive a price, the proposed Demand Curve will almost always result in the wrong value for capacity rather than relying on market force to establish the appropriate price.[36]

Because Mr. Segal's criticism of the ICAP demand curve applies with equal force to the formula rate he proposes in this proceeding, the sworn testimony of the sponsor of the formula rate embedded in NYSEG's Fixed Price Option demonstrates that this approach is inherently unreliable.

The formula rate proposed by NYSEG in this case is particularly unreliable for two reasons. First, NYSEG has failed to adduce any competent evidence in this proceeding to demonstrate that its 35 percent adder is a reasonable estimate of the premium over wholesale prices that commodity service suppliers would require to serve retail load at a fixed price in a robustly competitive market. Second, NYSEG has failed to demonstrate that the price quotes on which it relies are reliable.

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[35] NYSEG does not contend that this formula rate is a forecast of NYSEG's own costs of providing such fixed price service. In fact, NYSEG's own costs of providing such service have historically been substantially less than these forecasts. This has allowed NYSEG to achieve handsome earnings on fixed price commodity service in each of the first four years of the current five year rate plan.

[36] Ex. 67 at page 2.

(1.) NYSEG has failed to support its 35 percent adder with any competent evidence on the record in this proceeding

Astonishingly, NYSEG's pre-filed direct testimony contained no justification whatsoever for its proposed 35 percent adder beyond the statement that this adder was proposed in NYSEG's last electric rate case in 2002 and was adopted by the Commission as one part of a comprehensive settlement resolving that proceeding.[37] In its rebuttal testimony, NYSEG's Commodity Options Panel belatedly sought to redress this glaring lack of record support for the lynch-pin of their formula rate by providing their own estimates of the "adder" to wholesale forward prices implicit in the prices charged by suppliers of retail commodity in two other states: Texas and New Jersey.

Both of these analyses suffer from a common fundamental flaw: they represent an attempt by NYSEG to justify the lynch-pin of its formula rate by comparing it to two other, fundamentally different retail commodity programs. Texas and New Jersey have each adopted radically different forms of restructuring legislation. In contrast, the Commission is restructuring retail commodity markets in New York without legislative change. These radically different legal frameworks preclude any meaningful comparison of any single element of the programs developed in response thereto, such as their respective markups on commodity service.

[37] Direct testimony of David Segal, TR at 1484, line 12 to 1485, line 8.

(a.) Retail sales margins established under the "Price to Beat" Program in Texas cannot meaningfully be compared to retail margins under NYSEG's Fixed Price Offering

NYSEG's attempt to justify its 35 percent commodity markup over wholesale prices in this case by comparing it with the 78 percent markup over wholesale prices which its witnesses claim is implicit in certain rates charged by Direct Energy's affiliate West Texas Utilities ("WTU") is fundamentally flawed for several reasons. To begin with, WTU's rates for "Price to Beat" service are not established by the Public Utilities Commission of Texas ("Texas PUC") under the traditional "just and reasonable" standard applicable to ratemaking proceedings under the New York Public Service Law.

Instead, the Texas Legislature expressly displaced that "just and reasonable" standard by amending the Texas Public Utility Regulatory Act ("PURA") to provide that the Price to Beat would be determined according to a legislatively mandated formula:

> From January 1, 2002, until January 1, 2007, an affiliated retail electric provider shall make available to residential and small commercial customers of its affiliated transmission and distribution utility rates that, on a bundled basis, are six percent less than the affiliated electric utility's corresponding average residential and commercial rates, on a bundled basis, that were in effect on January 1, 1999, adjusted to reflect the fuel factor determined as provided by Subsection (b) . . . .[38]

Because WTU's Price to Beat has never been reviewed or approved by the Texas PUC under the "just and reasonable" standard applicable to NYSEG's Fixed Price Option, comparisons between the commodity markups implicit in WTU's default service rates

[38] The Texas Public Utility Regulatory Act, as amended, is publicly available on the Texas PUC's website at www.puc.state.tx.us/rules/statutes/Pura05.pdf.

and those in NYSEG's proposal cannot be relied upon to establish that NYSEG's Voice Your Choice proposal is just and reasonable as required by New York law.

Moreover, even if the Texas PUC had approved WTU's Price to Beat charge under the traditional just and reasonable standard, that rate would still need to be evaluated in light of the substantial differences between the Texas Price to Beat program and the Voice Your Choice proposal advanced by NYSEG in this proceeding. The Texas Price to Beat plan contains many procompetitive features which NYSEG has chosen not to incorporate into its Voice Your Choice program, making comparison of any single element of those two programs meaningless.

For example, section 39.102(a) of the Texas PURA provides that all customers of integrated utilities may switch from WTU's Price to Beat service to an alternate supplier at any time on or after January 1, 2002. In contrast, NYSEG's Commodity Options Panel made clear in their rebuttal testimony that NYSEG would be taking on considerable additional risk if it adopted this aspect of the Texas Price to Beat plan:

> As anyone involved with the retail supply business knows, fixed price supply offers cannot be held open indefinitely without incurring considerable market supply risks. Limited enrollment periods serve a critical purpose – mainly to mitigate market price risk and allow the supplier (whether it is a utility, wholesale supplier, or an ESCO) to provide customers fixed price protection in an economic maneuver.[39]

On cross-examination, these witnesses acknowledged that this risk was not included in their 35 percent adder because NYSEG's Fixed Price Offering did not provide customers with this switching right.[40] These witnesses also acknowledged that they could not

[39] TR at 1496, lines 12 to17.
[40] TR at 1720, lines 2 to 17.

quantify the additional markup or exit fee that would be required to fairly compensate NYSEG for accepting the risk of such customer switching.

Thus, WTU faces what NYSEG's own experts acknowledge to be a substantial risk that NYSEG is unwilling to bear given the 35 percent adder it has proposed in this proceeding. In light of NYSEG's inability to quantify the additional commodity markup required to compensate WTU for this additional risk, no meaningful comparison can be made between the commodity markups received by WTU and the 35 percent commodity markup proposed by NYSEG in this proceeding.

Moreover, this is not the only difference between the Texas Price to Beat plan and NYSEG's Voice Your Choice proposal that precludes any meaningful comparison of any single element of those two programs. A review of Subchapter C of the Texas PURA reveals numerous other significant differences between the Texas Price to Beat rules which significantly affect the risks undertaken by WTU as a Price to Beat supplier, and which NYSEG has chosen not to include in its Voice Your Choice Proposal.

Section 39.105(a) of the Texas PURA prohibits any transmission or distribution utility from supplying retail customers on and after January 1, 2002 except through a separate marketing affiliate. Thus, under the Texas Price to Beat program, the distribution utility is precluded from supplying commodity services to its own customers except through a separate marketing affiliate.[41]

Separating the provider of distribution services from the default service provider promotes competition and increases the risks faced by the default service provider, since it deprives the default service provider of the ability to use control of the distribution

[41] In the West Texas area where Direct Energy's affiliate WTU is the Price to Beat supplier, the distribution utility is American Electric Power Company, which is not affiliated with Direct Energy or WTU in any way.

system to protect its own profits on commodity service. NYSEG's plan lacks this important safeguard, opening the door to the possibility that NYSEG may engage in anticompetitive actions to protect its dominant position in commodity supply.

In addition, section 39.202(h) of the Texas PURA places significant limits on the pricing flexibility of the default service provider by prohibiting all Price to Beat suppliers from charging any rates to residential and small commercial customers other than the Price to Beat price in their default service territories during the period from January 1, 2002 to the earlier of January 1, 2005 or the date on which 40 percent of that suppliers residential or small commercial customers have switched to other suppliers. In contrast, NYSEG proposes to offer not only default service, but also its Variable Price Option.

Yet another significant difference between the Texas Price to Beat plan and NYSEG's Voice Your Choice program is the so-called "claw-back" provision contained in section 39.262(e) of the Texas PURA. This provision requires that, as part of the true-up required at the end of the rate freeze period, Price to Beat suppliers must reconcile and credit to their affiliated transmission and distribution utilities the positive difference between the Price to Beat, reduced by a non-bypassable delivery charge, and prevailing market prices, subject to a cap of $150 per customer. Price to Beat suppliers can avoid this claw-back of commodity service revenues in excess of market prices on residential Price to Beat service if more that 40 percent of residential customers in its Price to Beat territory are served by other suppliers by January 1, 2004. Similarly, Price to Beat suppliers can avoid the claw-back on sales to small commercial customers if more than 40 percent of small commercial customers in their service territory are served by other suppliers by that date. In addition, the Texas PURA also provides Price to Beat suppliers with a credit that reduces the amount of the claw-back for every new customer those suppliers serve outside their Price to Beat service territory.

These claw-back provisions promote competition by giving the Price to Beat suppliers a powerful incentive to compete vigorously with other Price to Beat suppliers in other territories, while also penalizing Price to Beat suppliers that retain more than a 60 percent market share of small customer load in their default service territory after two years of competition. NYSEG's Voice Your Choice proposal contains neither of these provisions. Instead, NYSEG's Voice Your Choice proposal rewards NYSEG for retaining as many of its existing small customers on its default service as possible. Because NYSEG has not chosen to include any of these important elements of the Texas Price to Beat plan in its Voice Your Choice proposal, it is impossible to make any meaningful comparison any single provision of those two programs.

(b.) Retail sales margins established under New Jersey's Basic Generation Services auctions cannot meaningfully be compared to retail margins under NYSEG's Fixed Price Option

Like the Price to Beat program in Texas, New Jersey's Basic Generation Service ("BGS") auction plan is also the result of state legislation comprehensively restructuring the manner in which electric utilities are regulated. Specifically, section 9 (a) of New Jersey's Electric Discount and Energy Competition Law of 1999 directed the New Jersey Board of Pubic Utilities ("New Jersey BPU") to require New Jersey utilities to procure Basic Generation Services from wholesale markets:

> Simultaneously with the starting date for the implementation of retail choice as determined by the board pursuant to subsection a. of section 5 of this act, and for at least three years subsequent and thereafter until the board specifically finds it to be no longer necessary and in the

> public interest, each electric public utility shall provide basic generation service. Power procured for basic generation service by an electric public utility shall be purchased, at prices consistent with market conditions.[42]

The BGS auction adopted by the New Jersey BPU to implement this statutory requirement necessarily differs from NYSEG's Fixed Price Option in several very important respects that preclude meaningful comparison of any single element of New Jersey's BGS program with NYSEG's Fixed Price Option. To begin with, under New Jersey's BGS plan, fixed price commodity service is provided by one or more wholesale marketers selected in annual auctions. These wholesale marketers sell electricity on a fixed price basis to New Jersey's distribution utilities at their retail load factor. Those distribution utilities in turn resell that power to their retail customers without markup.[43] Thus, distribution utilities do not bear the risk of changes in commodity prices as under NYSEG's Voice Your Choice program. As a result, the distribution utility has no incentive to engage in conduct that would "tilt the playing field" in favor of its own default service and against competing retail suppliers.[44]

This difference also makes the BGS auction price a poor proxy for use in NYSEG's Fixed Price Option, since the New Jersey BPU requires successful bidders in the BGS auctions to post substantial security to ensure that they will perform their

[42] New Jersey Code § 48:3-57. A copy of New Jersey's Electric Discount and Energy Competition Law of 1999 is publicly available on the New Jersey BPU's website at www.state.nj.us/bpu/wwwroot/energy/Deneglas.pdr.
[43] Docket No. EX01050303, I/M/O The Provision Of Basic Generation Service Pursuant To The Electric Discount And Energy Competition Act, N.J.S.A 48:3-49 et seq., Decision and Order slip op. at 3-4 (dated December 11, 2001) ("BGS Order") (describing BGS program generally). This order is publicly available on the New Jersey BPU's website at http://www.bpu.state.nj.us/wwwroot/energy/EX01050303aORD.pdf.
[44] NYSEG's incentives to engage in such anticompetitive conduct and the anticompetitive actions that may have resulted from those incentives are discussed on pages 33 to 40, below.

obligations.[45] NYSEG provides its customers with no such security other than its equity in its distribution facilities in New York State, which equity cannot be sold off without imperiling NYSEG's ability to perform its public utilities obligation. Because NYSEG does not provide the kind of security required of BGS auction suppliers, no meaningful comparison can be made between the commodity margins resulting from the BGS auction program and NYSEG's Fixed Rate Option in this proceeding.

Moreover, any such comparison is also precluded by the fact that marketers supplying BGS service to utilities in New Jersey also bear not only the risk of fluctuations in wholesale market prices, but also the risk that customers will switch from utility default service to taking service from an ESCO.[46] As previously noted, NYSEG's Commodity Options Panel has testified that this is a substantial risk, and that NYSEG has not calculated the additional risk premium or "exit fee" that would be required to compensate it for accepting this risk.[47] As a result, the adder sought by NYSEG in this proceeding cannot be justified by reference to the commodity sales margins received by successful bidders in New Jersey's BGS auction program.[48]

Third, under the New Jersey BGS auction, the New Jersey PUC conducts a new auction for a portion of each utility's BGS needs every year. As a result, if prices for commodity services are initially set at levels that permit BGS suppliers to earn profits

[45] BGS Order, slip op. at 6 ("As conditions of qualification, applicants must: meet pre-bidding credit worthiness requirements; agree to comply with all rules of the auction; and agree that if they become auction winners, they will execute the BGS Master Service Agreement within two days of Board certification of the results and they will demonstrate compliance with the credit worthiness requirements set forth in that agreement.").

[46] TR at 1738, lines 23 -25 ("The bidders bear the risk [of customers switching under the BGS auction]").

[47] TR at 1727, lines 8 to 17.

[48] In an effort to minimize the impact of this difference, NYSEG witness Segal contends that shopping levels are very low in New Jersey. TR at 1739, lines 1-4. The obvious problem with this claim is that when levels of ESCO penetration are extremely low, as Mr. Segal testified, even modest changes in the retail access policies of the New Jersey BPU can have a significant impact on the number of customers converting to ESCO services.

that exceed competitive levels, other suppliers will be provided with strong incentives to compete for those above-market returns, leading to lower prices over time. NYSEG's Commodity Options Panel admitted on cross-examination that this is precisely how all competitive markets operate:

> Q.: And do prices have an important signaling role in allowing these efficiencies to occur?
>
> A.: (Segal) Prices signal whether entry is feasible and appropriate. They can signal consumption decisions by consumers as well.[49]

This feature of New Jersey's BGS auction plan is wholly absent under NYSEG's Fixed Price Option, which contains no mechanism for any other supplier to bid to supply NYSEG's small customers receiving default service at prices lower (or on terms and conditions more favorable to such customers) than those proposed by NYSEG in this case. Nor does NYSEG propose any mechanism to adjust its proposed 35 percent markup over time as retail markets become increasingly competitive. Instead, NYSEG proposes that the Commission fix its proposed 35 percent markup on fixed price commodity services for the entire six year period of its rate plan proposal. Nothing in New Jersey's BGS auction proposal provides any support whatsoever for this anticompetitive approach. Accordingly, the Commission must reject NYSEG's efforts to justify its 35 percent adder by comparing its proposal to rates in Texas and New Jersey, unless and until NYSEG agrees to modify its proposal to incorporate all or substantially all of the features of either one or the other of those programs.

[49] TR at 1729, lines 10-14. This point was also made by Direct Energy witnesses Kiesling and Kleit in their direct testimony, TR at 1267, line 11 to 1269, line 6.

(2.) NYSEG has failed to meet its burden of proving that the price quotes used in its formula rate accurately reflect actual forward market prices

One of the unusual features of NYSEG's proposed Fixed Price Option is that NYSEG seeks to base its prices for commodity service not on prices established by its own purchases and sales, or even by purchases and sales by other similarly situated utilities, but rather on price *quotes* provided by certain marketers deemed to be reliable by NYSEG. As Direct Energy witnesses Drs. Kiesling and Kleit testified, this approach suffers from two fundamental defects:

First, NYSEG's proposal contains no requirement that any energy actually be sold at the prices quoted by the marketers in question. As a result, NYSEG bears a heavy burden to demonstrate that these price quotes are a reasonable reflection of actual market prices. As Drs. Kiesling and Kleit pointed out, many price quotes provided by buyers and sellers are in fact out of the market. Using publicly available data concerning offers to buy and sell the stock of NYSEG's parent, Energy East, obtained from Yahoo.com, these witnesses made this fact perfectly clear:

> On [January 23, 2006], Yahoo.com reports that the market price for Energy East ranged from $24.50 to $24.82 dollars per share. As the order book indicates, however, a large number of offers existed well "away" from the market. Thus, on the sell side (the side most relevant here), there was a relatively large number of offers well above the trading price for Energy East. In particular, there was an offer outstanding to sell Energy East stock at $32.89 per share, approximately 33 percent above the market price.[50]

[50] TR at 1317, lines 12 to 18.

Thus, as anyone who has ever negotiated to purchase a new car is well aware, price "quotes" provided by industry participants are not necessarily an accurate measure of true market prices.

NYSEG offers two weak responses to this compelling argument. First, NYSEG's Commodity Options Panel points out in their rebuttal testimony that NYSEG requires that all quotes used in its formula rate include both a purchase price and a sale price, and that NYSEG takes the average of those two values.[51] These facts alone do not, however, provide any assurance that the resulting average is an accurate reflection of market conditions. Marketers short of energy can be expected to quote sell prices that are high relative to the market, but competitive buy prices. In contrast, marketers long on energy can be expected to quote buy prices that are low relative to market levels, but competitive sell prices. Thus, NYSEG can manipulate the price produced by its formula rate by carefully selecting the marketers from whom it solicits quotes.[52]

Second, NYSEG asserts that its price quotes represent real prices at which marketers are prepared to buy and sell energy. This statement proves nothing, however, since it is patently obvious that marketers who offer quotes to sell energy at above market rates, or to buy energy at below market rates, are ready, willing and able to complete those deals (just as every car salesman is ready to sell NYSEG's witnesses a new car at the price quoted on its window sticker).

[51] TR at 1510, lines 17 to 19.

[52] As Drs. Kiesling and Kleit note in their Direct Testimony, "[T]he relevant firm has better information about its own costs than the regulator, and is able to move faster in various dimensions than the regulator." TR at 1288, lines 3 to 5. To the extent that NYSEG has a better knowledge than Staff about the competitive challenges facing different wholesale marketers, it will be in a position to manipulate these price estimates without detection by Staff.

The second problem with NYSEG's reliance on price quotes noted by Drs. Kiesling and Kleit is that the number of buyers and sellers active in forward markets decreases substantially the further out in time one goes. As a result, the two year forward commitment in NYSEG's Fixed Price Option can itself be expected to inflate the price quotes NYSEG receives. Specifically, Drs. Kiesling and Kleit testified that:

> This lack of liquidity can lead to locking in prices for retail customers that are unlikely to reflect market conditions two years hence, when delivery occurs. Such actions could impose a price risk premium on customers that they do not realize, and that they might not be willing to pay if the choice were transparent. Thus, NYSEG's proposal to acquire a large amount of power through two-year forward and/or futures contracts may generate serious "liquidity impacts," increasing the price of power which NYSEG is allowed to impose on its small customers.[53]

NYSEG responds to this claim by asserting that it refrains from making any forward purchases during the period when it is obtaining the price quotes used in its formula rate.[54] What this contention ignores is that marketers are sophisticated enough and flexible enough to take into account likely future events as well as current events. Thus, if the marketers from whom NYSEG solicits quotes are aware that NYSEG will be purchasing some sort of hedge for most of its retail load either before or after it solicits the quotes used in its formula rate, marketers can be expected to take those demands for forward contracts into account in formulating their price quotes. As a result, NYSEG has fallen far short of meeting its burden of proof that these price quotes are sufficiently reliable for use in setting commodity rates for retail customers.

[53] TR at 1319 lines 6 to 13.
[54] TR at 1510, line 20 to 1511 line 2.

b. NYSEG's Fixed Price Option is Inherently Unjust And Unreasonable

Even if NYSEG had met its burden of proving that the inputs to its formula rate were reasonable, and even in the absence of the Statement of Policy, the Commission would still be compelled to reject NYSEG's Fixed Price Option as inherently unjust and unreasonable for two additional reasons: First, NYSEG's proposal to sell energy to default service customers at rates fixed for a two year period imposes unwarranted and unreasonable risks on all of NYSEG's customers. Second, that proposal provides NYSEG with powerful incentives to limit competition by restricting the ability of ESCOs to market effectively in NYSEG's service territory.

(i.) NYSEG Fixed Price Option exposes all NYSEG customers to unfair and inappropriate risks

In their efforts to justify NYSEG's proposal to mark up its estimate of two-year fixed price service at the wholesale level by 35 percent to establish the energy rate under the Fixed Price Option,[55] NYSEG witness Segal and Fisher contend in their rebuttal testimony that even after NYSEG purchases forward energy or equivalent hedges at the wholesale prices they calculate, NYSEG still faces substantial unhedged risks that justify approximately one half of the 35 percent mark up of projected wholesale commodity costs included in NYSEG's proposal.[56] If the Commission accepts this claim, it must then reject NYSEG's Fixed Price Option on the ground that NYSEG's proposal imposes unfair and unwarranted risks on all of NYSEG's customers.

[55] If the Commission rejects this testimony and concludes that these risks either do not exist or are substantially overstated, then it must reject the portion of NYSEG's 35 percent adder that is ostensibly designed to compensate NYSEG for these alleged risks.
[56] TR at 1503, lines 6 to 23.

Unlike BGS suppliers in New Jersey, to whom NYSEG witnesses Segal and Fisher seek to compare NYSEG for other purposes, NYSEG is under no obligation to post firm security – such as a letter of credit or a guarantee from a financially responsible entity – to provide consumers with assurance that it will be able to meet its obligations even if its allegedly substantial business risks cause it incur substantial losses in meeting its fixed price obligations. As Direct Energy witness Dr. Andrew N. Kleit explained during his cross-examination, this creates an unacceptable "heads NYSEG wins, tails customers lose" situation, where NYSEG profits if it is fortunate enough to avoid these contingencies, but consumers are ultimately called upon to cover the majority of NYSEG's losses if those contingencies occur:

> [I]f NYSEG is unhedged they are in the position of either perhaps making or losing a lot of money, and if they lose a lot of money there is a very good chance that NYSEG could come back to the political entity, the Commission, and ask for a bail out. So what it does is it puts customers of NYSEG in a position where heads NYSEG wins, tails, customers lose.[57]

In response to a question from NYSEG's counsel for an explanation of how NYSEG could come to the Commission for a bail out, Dr. Kleit explained that it would be difficult or impossible for the Commission to allow NYSEG to go into bankruptcy, and that NYSEG had in fact requested such relief in the recent past:

> I think there are a variety of reasons for that. One is that the Commission as a political entity would have great difficulty were NYSEG to go bankrupt and place NYSEG customers in a position of not receiving service. Second, as I believe we cited in our statement, just a few years ago NYSEG came to the Commission and asked to be compensated for losses it had made in the natural gas markets.[58]

[57] TR at 1402, line 18 to 1403 line 1.
[58] TR at 1403, lines 8-16.

In their direct testimony, Drs. Kiesling and Kleit explained that this type of "asymmetric risk" has been widely acknowledged as the cause of the infamous savings and loan collapse, as federal insured Savings and Loan institutions took inappropriate risks secure in the knowledge that they would receive any gains and that any losses would be borne by the Federal Savings and Loan Insurance Company and/or all federal taxpayers.[59]

(ii.) NYSEG Fixed Price Option is unjust and unreasonable because it provides NYSEG with incentives to hinder rather than promote the transition to competitive retail markets.

NYSEG claims that its Fixed Price Option promotes competition and new entry by creating a substantial margin between wholesale commodity costs and the price of NYSEG's default service, which NYSEG refers to as "headroom." In reality, however, the benefits to competition provided by this headroom are more than offset by the anticompetitive and exclusionary acts that NYSEG has taken in its efforts to retain for its shareholders as much of the revenues associated with that headroom as possible.

The source of NYSEG's incentive to undermine competition is clear. As NYSEG witnesses Segal and Fisher explained, every time NYSEG loses one of its Fixed Price customers to an ESCO, the total profits that NYSEG can earn on commodity service declines:

> A. (Segal) . . . We believe that the company is entitled to an opportunity for profit [on its commodity sales] based on the risk that it bears.
>
> Q. And what happens to that profit opportunity with respect to any particular customer when that

[59] TR at1290, lines 9-12 ("As occurred in the infamous Savings and Loan collapse, utilities may have incentives to take inappropriate risks in the knowledge that much of their downside risk is covered by regulation.").

> customer elects to take service from an ESCO instead of from the company?
>
> A. (Segal) The profit opportunity diminishes.[60]

In their direct testimony, Drs. Kiesling and Kleit predicted that distribution utilities that are also allowed to earn not only a reasonable return on their investments in utility rate base, but also a profit on their commodity sales can be expected to respond to that additional profit incentive by taking two types of anticompetitive conduct: discriminating against ESCOs and in favor of their own commodity sales service and seeking to obtain a competitive advantage in markets for commodity supply by allocating commodity related costs to the delivery function.[61] The record in this case convincingly demonstrates that NYSEG has taken both these actions in its efforts to maximize its highly profitable sales of Fixed Price Service.

One area in which NYSEG has discriminated against ESCOs and in favor of its own Fixed Price Service is by seeking to retain its present confusing array of commodity options. The confusing nature of NYSEG's commodity options was noted by Staff's Commodity Options Panel:

> NYSEG's rate plan offers an array of commodity services, needlessly confusing customers as well as ESCOs, and detracting from further market development.... For example, on October 20, 2002, the Buffalo News ran an article under the headlines ELECTRICITY DEREGULATION — "Powerfully" difficult choices," where a NYSEG customer is quoted as saying "[i]t's hard for a regular person like me to understand ... It's really confusing. For me, it would take a lawyer or a mathematician to figure out."[62]

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[60] TR at 1740, lines 12-21.
[61] TR at 1282, line 4 to 1283, line 16.
[62] TR at 1813, lines 4-18.

Further, confirmation of the needlessly confusing nature of NYSEG's commodity program are provided by NYSEG witness Marini, who testified that information concerning historic levels of the variable credit that customers need would receive if they switched from NYSEG's Fixed Price Option to taking service from an ESCO under NYSEG's ESCO Option with Supply Adjustment ("EOSA") were too complex to provide on customer bills:

> A. (Witness Marini) As a customer, I think it would be very confusing if you tried to do that. The customer has chosen a fixed price for a two-year period, and if you start putting a variable price in there, without the customer being knowledgeable I assume. I think there's going to be considerable customer confusion.[63]

Clearly, if this one element of NYSEG's Voice Your Choice proposal is too complex for NYSEG to describe to its customers in its own bills, then the program as a whole is far too complex for most small customers.

As Mr. Robert J. Hobday of NYSEG's ESCO affiliate Energetix testified, Customers who are confused by NYSEG's program are likely to "choose not to choose." Specifically, Mr. Hobday testified that:

> [M]any customers will simply choose not to choose a new competitive offer and stay with the incumbent's service, not because they compared the two and decided they preferred the incumbent's offer, but because they had no way to compare the two, lost patience with trying to think the matter through, and so chose to stay with the company that had supplied them for decades.[64]

This same point was also made by Direct Energy witnesses Drs. Kiesling and Kleit:

> Any facet that makes retail choice more complicated increases the "search costs" to customers of switching.

[63] TR at 3575, lines 10-16.
[64] Hobday Direct, TR at 1965, line 19 to 1966, line 2.

> Choosing a design with high embedded customer search and switching costs creates an entry barrier for other retailers. By making it more expensive to switch, in terms of the effort customers may make, NYSEG's complicated retail access proposal encourages customers to stay with their incumbent utility. This barrier restricts such customers from benefiting from retail electric competition.[65]

The threat which this customer confusion poses to the competitive process is further magnified by the tendency of consumers to assume that they will be protected by the Commission if they opt for the utility's regulated default service,[66] and by the further fact that customers who choose not to choose during the brief open period available under NYSEG's proposal would then be locked into taking service under NYSEG's Fixed Price Option for the remainder of that two-year commodity period.[67]

Thus, while the confusing array of choices provided under NYSEG's Voice Your Choice program is unreasonable on its face, that complexity must also be seen as a symptom of the deeper problem of NYSEG's inappropriate incentives to maximize the number of customers who wind up on NYSEG's profitable Fixed Price Service. Other anticompetitive actions which NYSEG may have engaged in to maximize the number of customers serviced on its profitable default service offering include foot dragging on EDI certification[68] and the inappropriate allocation of certain commodity related costs to the delivery function.[69]

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[65] TR at1312, lines 1 to 7.

[66] TR at 1815, line 21 to 1816, line 2 ("Customers may be more likely to gravitate to NYSEG's fixed price offering because NYSEG's offering bears the imprimatur of the Commission. ESCOs do not have that advantage.").

[67] Such customers would, of course, have the option of purchasing variable priced energy from an ESCO under NYSEG's ESCO Option with Supply Adjustment, but would be foreclosed from taking service under either the ESCO Price Option or the Variable Price Option until the next open season.

[68] Staff's Retail Access Panel criticized NYSEG's performance in EDI certification, noting in their direct testimony that: "In some cases, ESCOs have had to wait up to four months to get into a testing queue. Once

Yet another example of the way in which the opportunity to earn substantial profits on commodity sales may distort utility incentives is provided by a recent dispute between NYSEG's affiliate RG&E and an ESCO by the name of MX Energy. The merits of RG&E's claims against MX Energy are beyond the scope of this proceeding, but RG&E's actions in that case are not. In that case, RG&E unilaterally suspended MX Energy as a result of its own "internal investigation".[70] As NYSEG's Rate Plan Panel acknowledged on cross examination, however, RG&E's suspension of MX Energy was recently overturned by the United States District Court for the Northern District of New York in an order granting MX Energy a preliminary injunction restraining both NYSEG and RG&E from excluding MX Energy from their retail access programs pending further action by that court or by the Commission.[71]

In granting this preliminary injunction, United States District Judge Charles J. Siragusa ruled that the evidence cited by NYSEG and RG&E as justification for their unilateral exclusion of MX Energy fell far short of the legal requirement to justify that action:

> With respect to clean hands, MX Energy points out that prior to October 29, 2005, each time RG&E brought a concern to its attention, it expeditiously resolved it. Moreover, MX Energy points out that denial of the preliminary injunction would detrimentally impact all their marketing efforts to date and adversely affect their ability to offer energy consumers choice in this area. *The Court finds MX Energy's position meritorious and concludes that*

Phase III testing begins, it appears to take longer to complete testing in this service territory than similar testing in other service territories." TR at 3603, lines 12 to 17.

[69] For example, Staff's ECOS Panel noted in their direct testimony, "We believe that the special study conducted by NYSEG to assign customer care costs attributes an insufficient amount of these costs to commodity supply." TR at 2632, lines 11 to 14.

[70] Rebuttal Testimony of NYSEG Rate Plan Panel, TR at 1121, lines 1 to 3.

[71] TR at 1244, line 10 to 1245, line 14.

> *the balance of hardships tips decidedly in favor of MX Energy.*[72]

The inability of RG&E -- and NYSEG's Rate Plan Panel in this case – to understand the flaws in the evidence on which its suspension of MX Energy may be attributable, at least in part, to the fact that MX Energy was offering fixed price services to RG&E's residential customers, threatening RG&E's dominant position in that profitable market.[73]

Other actions taken by NYSEG and RG&E to protect their ability to supply these profitable retail commodity markets include vigorous opposition in other proceedings concerning ESCO referral programs and default commodity service proposals advanced by other utilities, as well as NYSEG's failure in this proceeding to submit a default service proposal that complies with the Commission's Statement of Policy. While NYSEG may have been acting within its legal rights in taking these actions, the Commission would also be within its legal rights if it found that these actions, taken together, constitute clear evidence that NYSEG and its affiliates are responding to the inappropriate incentives created by its current fixed price offering. This is especially true given that no utility in New York State that provides default commodity service on a pass-through basis has joined with NYSEG in its vigorous pursuit of these contentions.

The cumulative impact of all these actions can be seen by comparing the success of ESCOs in NYSEG's service territory to the success of ESCOs in other parts of the State. What is perhaps most telling about these statistics is that despite providing "headroom" that has enabled NYSEG's shareholders to pocket tens of millions of dollars of commodity markups annually since 2002, the share of NYSEG's residential and small

[72] *MX Energy, Inc. v. Rochester Gas & Electric Corp.*, 2006 U.S. Dist. LEXIS 13958 at 11 (N.D.N.Y. 2006) (emphasis supplied).
[73] *See* Exhibit 57, page 4 of 5.

commercial customers served by ESCOs in 2006 does not differ significantly from the state-wide average. This result can only be explained if other factors, such as the anticompetitive actions described above, are counterbalancing the stimulus to new entry provided by the "headroom" established by NYSEG's current rate plan.

Further support for this conclusion is provided by a comparison of the proportion of NYSEG's residential customers served by ESCOs (around 9.6 percent as of October 2005) with the proportion of residential customers served by Orange & Rockland Utilities, Inc. ("O&R") that receive commodity services from ESCOs (almost 33 percent).[74] Unlike NYSEG, O&R provides default commodity supply on a pass-through basis and was an early adopter of two programs supported by the Commission in the Statement of Policy: Purchase of Receivables and an ESCO Referral Program. NYSEG has only recently implemented Purchase of Receivables to comply with the requirements of the Statement of Policy,[75] and has yet to take any affirmative steps to institute a workable ESCO referral program. Direct Energy respectfully submits that the only way to provide NYSEG with the incentives required to support the restructuring of retail commodity markets – rather than to oppose that restructuring at virtually every opportunity – is to remove the profit incentive that fuels NYSEG's opposition to any actions that would reduce the dominant share of small customers in its service territory currently taking default service from NYSEG.

2. NYSEG's Variable Price Option Should Be Rejected.

As previously noted, the Commission determined in the Statement of Policy that the public interest requires that, to the maximum extent allowed by law, "regulated utilities

[74] Rebuttal Testimony of Direct Energy Panel, TR at 1363, lines 14 to 15.

[75] Case 05-M-0453 – *In the Matter of New York State Electric & Gas Corporation's Plan to Foster Retail Energy Markets*, Order Adopting the Terms and Conditions of the Joint Proposal for the Purchase of Accounts Receivable (issued and effective December 27, 2005).

should be replaced by ESCOs when markets become workably competitive."[76] Until commodity markets become workably competitive, Direct Energy agrees with the Commission's determination in the Statement of Policy that utilities should continue to provide default service, but should be precluded from providing optional commodity services of any kind. This includes both the extension of NYSEG's optional Variable Price Service to small customers and the extension of NYSEG's optional Fixed Price Service to large customers.

As Direct Energy witnesses Drs. Kiesling and Kleit explained in their direct testimony: (1) the only rationale for allowing NYSEG to provide commodity service of any type during the transition from regulation to competition is to protect default service customers from spot market fluctuations until such protection becomes evidently available from ESCOs; and (2) that rationale provides no justification for any utility commodity offering to small customers beyond default service:

> [T]he only reasons for the utility to offer a default service are to ensure that all consumers have supply service during the transition to competition. Thus, there is no justification for permitting NYSEG to offer more than one form of commodity service to any particular customer.[77]

Moreover, as Drs. Kiesling and Kleit went on to point out in their direct testimony, such optional utility commodity service offerings can impede the transition to competitive markets by creating unnecessary customer confusion:

> The presence of additional utility options increases consumer search costs, thereby erecting an unnecessary barrier to the transition to robustly competitive markets for the reasons discussed above. Indeed, if small customers are willing to search for something different than the default service rate,

[76] Statement of Policy, slip op. at 7-18.
[77] TR at 1314, lines 14-18.

> that willingness implies a confidence in retail markets that eliminates any need for a "safety net."[78]

Any claim that optional commodity offerings by the utility should be viewed as increasing the total number of options available to customers and therefore pro-competitive is wholly without merit. As Drs. Kiesling and Kleit explained in their direct testimony, all commodity offerings by the incumbent utility represent a threat to competition and must therefore be limited to essential services such as default service:

> Any offering by the incumbent distribution utility poses a host of problems for the regulator and for competition in general, as discussed above. Thus, any such offerings should be limited to default service, and should be provided only in a form consistent with the rationale for default service.[79]

Moreover, precluding NYSEG from offering such service will not restrict competition or consumer choice, since NYSEG's parent Energy East will remain free to offer any such optional service through its ESCO affiliates Energetix and NYSEG Solutions.[80]

Moreover, limiting NYSEG to a single commodity option will eliminate one more layer of unnecessary complexity in NYSEG's retail access program, making it easier for customers to understand their choices. This greater clarity will enable more small customers to obtain the comfort level with their choices required to elect an alternative commodity supplier.

C. Staff's Proposal

Direct Energy agrees with almost all of the conclusions reached by the Staff Commodity Options Panel, including without limitation, that panel's conclusions that

[78] TR at 1314, line 20 to 1315, line 4.
[79] TR at 1315, lines 9-12.
[80] TR at 1315, lines 12-15 ("Should NYSEG's parent, Energy East, Inc., desire to offer customers multiple options, it would be free to do so through its non-regulated affiliates, NYSEG Solutions and Energetix.")

NYSEG's Fixed Price Option: (a) violates the Statement of Policy;[81] (b) unreasonably enriches NYSEG's shareholders at the expense of ratepayers;[82] (c) creates customer confusion that impedes progress towards competitive retail commodity markets;[83] while producing rates that somewhat are more stable, but no more equitable overall than shorter term options.[84] Direct Energy also agrees with Staff's recommendation that NYSEG's default service rates should vary on a monthly basis.[85]

The only area in which Staff and Direct Energy disagree is with respect to how NYSEG's default commodity service should be acquired. Staff recommends NYSEG continue to purchase additional hedges for at least a portion of this commodity service, as appropriate, under the established prudent investment rule.[86] Such purchases will inevitably distort the market by causing NYSEG's default commodity service rates to rise above market rates in some periods and to fall below market rates in other periods.

To avoid these fluctuations while still providing default service customers with a reasonable degree of protection from spot market volatility, NYSEG must be required to purchase its commodity requirements on a one-month forward basis. Customers desiring to avoid month-to-month fluctuations in their bills while remaining on default service could elect budget billing.[87] Alternatively, those customers could take service from an ESCO offering fixed price service.

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[81] TR at 1802, line 16 to 1804, line 8.
[82] TR at 1804, line 9 to 1806, line 2.
[83] TR at 1814, line 1 to 1817, line 7.
[84] TR at 1796, lines 19-21.
[85] TR at 1841, line 14 to 1843, line 10.
[86] TR at 1847, line 15 to 1848, line 12.
[87] *See* discussion at pages 46 to 47 below.

D. CPB's Proposal

Direct Energy commends CBP for recognizing the fundamentally anticompetitive nature of NYSEG's fixed price default service offering.[88] While CBP's proposal to make NYSEG's Variable Price Option the default and to make NYSEG's Fixed Price Option available only to those customers that affirmatively elect that option would moderate the anticompetitive impact of NYSEG's proposal to some degree, more aggressive action is required to promote the development of robustly competitive retail supply markets. Moreover, contrary to CPB's concerns, such actions can be taken without exposing small customers to excessive market risks for the reasons noted in the discussion of Direct Energy's proposal at pages 46 and 47 below.

The fundamental problem with CPB's proposal is that it fails to eliminate NYSEG's incentives to undertake anticompetitive actions in order to protect its ability to earn additional profits on commodity sales. These inappropriate incentives can only be eliminated by prohibiting NYSEG from receiving any markup over cost or its sales of electricity to retail customers. In addition, CPB's proposal would perpetuate the current confusing array of retail service options provided by NYSEG. As explained at pages 35 to 36 above, the confusion that results from the bewildering array of options proposed by NYSEG tends to frustrate customers and cause them to remain on default service. Accordingly, the Commission should not adopt CPB's proposal to retain NYSEG's existing commodity options, but make the Variable Price Option the default service.

[88] *See* TR at 2019, line 8 to 2020 line 5 (explaining the substantial competitive advantage which NYSEG receives as the default service provider).

E. Nucor's Proposal

Nucor witness Frank Radigan proposes to retain NYSEG's existing Voice Your Choice proposal, both with higher levels of customer sharing of the net revenues earned by NYSEG on fixed price commodity service. This proposal should be rejected for several reasons. First, this proposal does not remove the incentive for anticompetitive conduct by NYSEG that arises wherever the utility is allowed to profit from its commodity sales. Second, this proposal retains the bewildering array of utility service offerings that is itself an obstacle to increased customer migration to ESCO service. Moreover, because NYSEG's excess earnings from fixed price commodity service are shared with delivery customers as well as with those purchasing their commodity services from NYSEG, and because Nucor and most other large customers are unlikely to take fixed price service from NYSEG, this proposal would amount to an inappropriate subsidization of large customers by those small customers remaining on NYSEG's fixed price default service.

F. Direct Energy's Proposal

Direct Energy agrees with the Commission's determination in the Statement of Policy that retail delivery rates and commodity options should be designed with two goals in mind: (1) to promote the development of robustly competitive retail energy supply markets; and (2) to provide default service customers with reasonable protection from fluctuations in wholesale spot market until similar protections are available to those customers from ESCOs.

To achieve these two important goals, NYSEG's retail delivery rate and commodity offerings must both be radically simplified, as Direct Energy witnesses Drs. Kiesling and Kleit testified:

> [I]f the Commission is to succeed in its goal of fostering a robust competitive electricity market, it is vital that the Commission limit the role of utilities as suppliers of commodity services to the minimum extent possible. Given this contrast, the utility should be limited to offering a simple transparent default service offering to any customer.[89]

In designing commodity service provisions for default service, the Commission must recognize that while default service customers should receive some protection from fluctuations in spot market prices, competitive markets cannot develop if customers are completely isolated from the price signals that make competitive markets work, as Drs. Kiesling and Kleit testified:

> Given that New York is working through its transition to a competitive retail electricity market, it is not unreasonable for the utility default service rate to protect small customers from short-term spot changes in energy prices. But the proper utility default service rate must also recognize that *price signals are critical for well-functioning markets and that consumers can respond to price signals.*[90]

In addition, it is also essential that default service customers not be locked into long term supply commitments that will limit their ability to shop for energy without their express consent.

In order to procure crucial price signals and customer flexibility while still providing default service customers with a reasonable degree of protection from spot market volatility, Direct Energy recommends that the Commission require NYSEG to purchase commodity services for its small customers receiving default service on a one-month forward basis and

[89] TR 1295, line 17 to 1296, line 3.
[90] TR at 1296, line 18 to 1297, line 3 (emphasis supplied).

to supply such services without markup. This approach has a number of very important advantages, including the possibility of significantly reducing the cost of default service for small customers, as Drs. Kiesling and Kleit noted in their direct testimony:

> Using one-month contracts will have the advantage of allowing continuous open enrollments for small customers in ESCOs. It will also eliminate the need for small customers to pay any risk premium to NYSEG, thereby potentially reducing rates and avoiding incentives for NYSEG to remain in the commodity function. Using actually purchased contracts will also avoid the problem discussed above of evaluating "offered" contracts. In addition, this approach would also reduce the "market liquidity" effects of "searching" for long-term contracts, which have the potential of further increasing prices to small customers.[91]

Moreover, these one-month forward contracts will provide default service customers with a reasonable degree of protection from spot market volatility, without isolating those customers from price signals for long periods of time as occurs under NYSEG's proposal.[92] Drs. Kiesling and Kleit explained this point in their direct testimony:

> [W]hile hourly spot prices for electricity do exhibit significant market volatility, a monthly fixed price arrangement is able to smooth out any extreme price impacts during any one hour during a given month. Put another way, while in any month there may be high prices in some hours, there are also many hours that have low prices. Given that a forward contract represents the expected value of all future prices during a specific time frame, a monthly price will include some higher priced hours and some lower priced hours, in effect averaging away the most excessive volatility. Therefore, one-month contracts will to a great extent protect small customers against severe electricity price fluctuations found only in the hourly market. Of course, such forward contract prices will reflect the expected seasonality of

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[91] TR at 1339, lines 2-11.

[92] Direct Energy acknowledges that even during the months when customers are precluded from selecting either the Variable Price Option or the ESCO Price Option, NYSEG's proposal would still permit such customers to elect the EOSA rate. But this energy backout rate is not an effective substitute for full retail access, inducing the ability economically to take fixed price service from an ESCO rather than from NYSEG.

> wholesale electricity prices, but this price signal is important for keeping retail markets and wholesale markets related.[93]

Moreover, customers desiring greater stability in their bills for electric service will have other choices available to them to achieve that objective, including budget billing and taking fixed price service from an ESCO, as Drs. Kiesling and Kleit explained:

> Allowing default service rates to fluctuate monthly, however, does not imply small customer bills will necessarily fluctuate simultaneously. Small customers will have many options to mitigate this variability. If they choose to stay on default service, they will have access to levelized billing, which will allow them to balance their payments across time. If they choose an ESCO, they will have access to fixed price options.[94]

NYSEG and other proponents of fixed price default service offerings have questioned the extent to which ESCOs will in fact provide NYSEG's small customers with fixed price service if NYSEG is prohibited from doing so. These parties generally claim that such fixed price services are not yet generally available to small customers in NYSEG's service territory.

This claim must be rejected for two reasons. First, as Exhibit 57 makes clear, Con Edison Solutions is already offering fixed price service to customers in NYSEG's service territory at rates substantially below NYSEG's Fixed Rate Offering, while Community Energy offers fixed price service from wind power at a modest premium over NYSEG's Fixed Price Option.[95] As an affiliate of both the Consolidated Edison Company of New York and Orange and Rockland Utilities, Inc., Con Edison Solutions plainly has access to the resource required to expand its service to meet the needs of NYSEG's small customers seeking fixed price service.

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[93] TR at 1339, line 16 to 1340, line 7.
[94] TR at 1340, lines 9-14.
[95] *See* Exhibit 57 at page 1 of 5.

Moreover, Direct Energy has recently entered the New York Market, providing fixed price service to residential customers of Con Edison, O&R and National Grid.[96] In addition, the experience of NYSEG's affiliate RG&E demonstrates that more ESCOs can be expected to offer fixed price service if NYSEG is forced to adopt a less anticompetitive commodity options program. As previously noted, RG&E's commodity options differ from NYSEG's in two important respects: (1) RG&E's default service is its Variable Price Option; and (2) customers electing the Fixed Price Option are locked in for only one year. As Exhibit 57 makes clear, these modest changes have increased the number of ESCOs offering fixed price service from two in NYSEG's service territory to seven in RG&E's service territory.[97]

Two of the ESCOs offering Fixed Price service in RG&E's service territory but not in NYSEG's service territory that do not provide such service to NYSEG's small customers are NYSEG's ESCO affiliates, Energetix and NYSEG Solutions. As Drs. Kiesling and Kleit pointed out in their rebuttal testimony, this result is in all likelihood due to the fact that NYSEG's parent Energy East does not want its ESCO affiliates to be competing away revenues that NYSEG can otherwise earn under its Fixed Price Option:

> While we are not privy to the actual decisions made by Energy East and its affiliates, it appears that Energy East has decided that it would not be in its overall best corporate interest to permit either of its ESCO affiliates to offer fixed price services to NYSEG's residential customers, since as we noted in our direct testimony the profits that NYSEG is earning on fixed price default service to such customers appear to be very substantial.[98]

[96] TR at 1382, lines 8 to 16. Direct Energy further requests that the Commission take administrative notice of in information concerning Direct Energy's participation in these retail access programs appearing on the Commission's website at www3.dps.state.ny.us/e/esco6.nsf.
[97] Three of these ESCOs offer only premium priced renewable energy.
[98] TR at 1356, lines 12-17.

Thus, the Commission can be assured that NYSEG's ESCO affiliates and other ESCOs that are not presently offering fixed price service to small customers in NYSEG's service territory will begin providing those services once Direct Energy's pro-competitive commodity options program is adopted.

The record in this proceeding therefore demonstrates that for small customers, the delicate balance between promoting the transition to competitive markets and providing default service customers with a reasonable degree of protection from spot market fluctuations can best be met by adopting Direct Energy's proposal that NYSEG be required to purchase commodity service for its default service to small customers on a one-month forward basis and to resell such commodity services without markup.

G. <u>Energetix Proposal</u>

Energetix witness Robert J. Hobday, makes two fundamental points in his direct testimony. First, Mr. Hobday contends that the Commission must adopt NYSEG's proposed six year rate plan to provide the certainty required for ESCOs to make the investments needed to compete in NYSEG's service territory.[99] Second, Mr. Hobday supports NYSEG's proposal to make its Fixed Price Option the default service for small customers.

Mr. Hobday's support for these NYSEG proposals is hardly surprising since, as previously noted, NYSEG and Energetix are both wholly-owned subsidiaries of Energy East. As Direct Energy witnesses Drs. Kiesling and Kleit pointed out in their rebuttal testimony, this common control ensures that Energetix and NYSEG will both act in the best interests of their common parent:

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[99] TR at 1960, line 5 to 1961, line 9.

Q. What impact does [Energy East's ownership of NYSEG and Energetix] have on the weight that the Commission should give to Mr. Hobday's testimony?

A. Mr. Hobday should not be viewed as speaking on behalf of an independent ESCO. Rather, he should be viewed as speaking on behalf of NYSEG's and Energetix's common parent, Energy East.[100]

Drs. Kiesling and Kleit also noted the fallacy in Mr. Hobday's claim that the Commission must approve NYSEG's six year rate plan proposal in its entirety in order to promote the transition to robustly competitive retail commodity supply markets:

> We do not agree with Mr. Hobday, however, that the Commission needs to adopt all aspects of NYSEG's multi-year rate plan to create a stable environment for retail access. In particular, we see no need to fix NYSEG's revenue requirement for a six-year period, to make NYSEG's fixed price service the default option for most small customers, or to restrict conversion from default service to competitive suppliers under NYSEG's ESCO Price Option to a three-month period every other year.[101]

Mr. Hobday's suggestion that requiring NYSEG to provide default service on a variable price basis will harm competition is absurd on its face. At one point in his testimony, Mr. Hobday contends that most small customers prefer fixed rates.[102] (This statement is belied, however, by the previously noted fact that Energetix does not presently offer fixed price service to small customers in NYSEG's service territory.)[103] He then goes on to assert, however, that these same customers will become frustrated if forced to compare fixed price offers from ESCOs with a variable price default service and will therefore "choose not to choose" and stay with the variable price default service.[104] Energetix's claim

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[100] TR at 1355, lines 6-10.
[101] TR at 1358, lines 15-21.
[102] TR at 1960, lines 15 to 20.
[103] TR at 1965, line 19 to 1966, line 2.
[104] TR at 1360, line 19 to 1361, line 2.

that small customers would remain with variable priced service from the utility when they preferred fixed price service and such service was available from ESCOs is absurd on its face and must be rejected.

Moreover, Mr. Hobday's analysis actually serves to confirm the anticompetitive nature of NYSEG's Fixed Price Option, where customers are subject to a bewildering array of options which must be evaluated in a limited period of time and then locked in to a fixed price option if they "choose not to choose." As Drs. Kiesling and Kleit noted in their rebuttal testimony:

> Mr. Hobday's statement is a perfect rationale why NYSEG's proposed enrollment window would serve to create an entry barrier. Signing up a new customer takes a discrete amount of time, as Mr. Hobday explains. Anything that serves to reduce the amount of time ESCOs have to attract customers therefore would act as an important impediment to robust competition.[105]

Accordingly, the Commission should reject Mr. Hobday's commodity option proposals.

VII. <u>REVENUE ALLOCATION AND RATE DESIGN</u>

B. <u>Non-Bypassable Wires Charge</u>

NYSEG's proposal to impose a fixed Non-Bypassable Wires Charge ("NBWC") on customers taking service under its Fixed Price Option and a floating NBWC on customers selecting either the ESCO Price Option or its Variable Price Option is unreasonably discriminatory on its face. As Direct Energy witnesses Dr. Kiesling and Kleit explained in their direct testimony, there is no cost justification whatsoever for charging different delivery rates to customers in the same rate class solely on the basis of the commodity service option under which they receive service:

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[105] TR at 1360, lines 11-15.

> The source of any consumer's commodity supply does not affect the costs to the distribution utility of delivering electricity to that customer. Thus, the price of that delivery should not be a function of that consumer's retail choice.[106]

This is especially true in the case of NYSEG's NBWC, which is used to recover stranded costs that are wholly unrelated to the forward looking costs to serve any particular customer, as Drs. Kiesling and Kleit explained:

> Stranded costs represent those above-market generation-related obligations incurred by NYSEG in the past. They are based in no way on any customer's forward-looking retail access choices. The Commission should be careful to ensure that it is very clear to consumers that their stranded cost payments will remain the same regardless of whether they take their commodity service from the utility or from the ESCO, since any difference in stranded cost recovery levels will act as a barrier to competition.[107]

NYSEG's discriminatory NBWC adversely affects competition in two ways. First, to the extent that the differences between these charges is easily understood, this difference in delivery charges tilts the playing field in favor of one commodity option and against other commodity options, thereby interfering with the ability of pricing signals to provide consumers with accurate information concerning the relative cost of supplying those competing services, which NYSEG's own witnesses have conceded are necessary for competitive markets to achieve their efficiency benefits.[108]

Where the difference the fixed NBWC and the variable NBWC is unclear, which is likely to be the case for most small customers, search costs for small customers will be substantially increased, making it more likely that such customers will, in the words of Energetix witness Hobday, "choose not to choose" and will therefore remain with their

[106] TR at 1294, lines 9-12.
[107] TR at 1313, line 15 to 1314, line 2.
[108] TR at 1729, lines 12 to 17.

default service provider. This concern was noted by Drs. Kiesling and Kleit in their direct testimony:

> Any customers who seek to switch from NYSEG to an ESCO must evaluate the relative costs of a fixed versus variable payments for stranded costs. This may not be a simple calculation. Indeed, it is not simply ever to describe this calculation. To the extent that consumer[s] are unable or unwilling to perform this difficult calculation, they are likely to continue to take default service on the assumption that the Commission will protect them from overcharges under that rate option.[109]

Accordingly, the Commission must reject NYSEG's discriminatory proposal to impose a fixed NBWC on customers serviced under NYSEG's Fixed Price Option while imposing a floating NBWC on customers electing either its ESCO Option or its Variable Price Option.

CONCLUSION

WHEREFORE, for the above-stated reasons, Direct Energy Services, LLC respectfully requests that the Commission reject NYSEG's Voice Your Choice Program on the grounds that this program violates the Statement of Policy, imposes excessive charges and risks on NYSEG's customers, and unduly restrains competition in retail commodity sales in NYSEG's service territory.

In lieu of extending NYSEG's Voice Your Choice Program, Direct Energy respectfully requests that the Commission limit NYSEG to providing only default service and that further it require NYSEG to provide such default service to small customers by purchasing fixed price service on a one-month forward basis and reselling that service without markup to its small customers taking default services. Direct Energy further requests that the Commission require NYSEG to establish delivery charges, including its

[109] TR at 1313, lines 13 to 20.

NBWC that do not discriminate among customers based on whether they purchase commodity service from NYSEG or a competitive energy supplier.

Respectfully submitted,

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April 26, 2006

CERTIFICATE OF SERVICE

I hereby certify that I have caused a copy of the foregoing Application to Intervene of Direct Energy Services, LLC to be served by electronic mail on all parties on the Secretary's official service list in Cases. 05-E-1222.

Dated at Albany, New York, this 26th day of April, 2006.

Claudia A. McDowell

Claudia A. McDowell