BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

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Joint Petition of IBERDROLA, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by IBERDROLA, S.A.	Case 07-M-0906

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REBUTTAL TESTIMONY OF THE REVENUE DECOUPLING MECHANISM PANEL

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I. INTRODUCTION

Q. Please state the names of the Panel members.

A. The Panel members are James A. Lahtinen, David W. Segal and Neil S. Fisher.

Q. Please state your current positions and summarize your educational background and work experience.

A. The current positions and summaries of the educational background and business experience for each member of the Panel are included as Exhibit ___ (RDM_1).

Q. What is the purpose of the Panel's testimony?

A. The Panel will address the recommendations of Staff witness Dickens and the Staff Gas Rates Panel that, as a condition of the merger, NYSEG and RG&E (the "Companies") should be directed to file a Revenue Decoupling Mechanism ("RDM") for implementation on January 1, 2009. The Panel also will respond to the RDM-related issues raised by Natural Resources Defense Council ("NRDC") witness Gupta.

Q. What is the Panel's view as to the appropriateness of Staff's proposal for implementing an RDM for NYSEG and RG&E in this proceeding?

A. As discussed later in our testimony, the Commission has consolidated this case with Case 07-E-0996, regarding consideration of an RDM for NYSEG, and NYSEG and RG&E have both committed to filing RDM proposals in the second quarter of 2008. The commitment of NYSEG and RG&E to file RDM proposals

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in the second quarter of 2008 is consistent with the prior orders of the Commission and the previous commitments made by the companies, and will provide sufficient time for a timely review by the Staff and Commission. The recommendation by the Staff Gas Rates Panel that approval of the proposed transaction should be conditioned on implementation of gas RDMs for NYSEG and RG&E is inappropriate and unnecessary. We do not believe that approval of an RDM, or specific decoupling methodology, is relevant to the Commission's determination as to whether the proposed acquisition is in the public interest. Because Staff has proposed that the acquisition be conditioned on implementation of RDMs, NYSEG and RG&E are compelled to respond to Staff's proposals. Our response, however, is without prejudice to the petitioners' positions that these issues are unrelated to the proposed acquisition and should be considered in a subsequent proceeding following the filing of RDM proposals by NYSEG and RG&E in the second quarter of 2008.

Q. What are the Panel's conclusions concerning the recommendations sponsored by Staff and NRDC with respect to implementation of an RDM for NYSEG and RG&E?

A. As explained in this testimony, the Panel reached the four following conclusions. First, the Companies agree with Staff witness Dickens that the Companies should file RDM plans. Second, the Companies propose that the same reconciliation mechanism be used for both electric and gas services unless a compelling rationale can be established for separate procedures, unlike Staff who argue for different mechanisms for electric and gas.[1] Accordingly, the Companies recommend that the RDM targets chosen should be consistently applied as to both electric and gas. Third, NYSEG and RG&E endorse an RDM that includes an annual indexing of targets. That design feature will help avoid the need for frequent rate filings to recover general increases in delivery costs (e.g., due to inflation). Fourth, the Companies recommend that their respective fixed price commodity programs should not be subject to an RDM.

II. DELIVERY REVENUE DECOUPLING MECHANISM

Q. Would the Panel briefly summarize the RDM-related recommendations offered by Staff and NRDC?

A. Yes. Staff witness Dickens recommends that the Companies should be directed to file an RDM proposal for review by the parties so that it can be approved by the New York Public Service Commission ("Commission") for implementation effective January 1, 2009.[2] The Staff Gas Rates Panel[3] further adds that NYSEG and RG&E should each be required to implement a gas RDM as a precondition of

[1] Staff witness Dickens argues for a total revenue reconciliation mechanism for electric service while the Gas Rates Panel argues for a revenue-per-customer reconciliation procedure.

[2] Staff Testimony, Dickens at 14.

[3] Consisting of the testimony of Michael Salony and Michael Wayand.

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approval of any merger.[4] Staff witness Dickens outlines general guidelines for a future RDM filing for electricity, while the Staff Gas Rates Panel provides guidelines for a gas RDM. The NRDC also provides general principles for an RDM.[5]

Q. Do NYSEG and RG&E plan to file an RDM proposal that could be in effect for calendar year 2009?

A. Yes. While none of the parties specified a date for an RDM filing,[6] the Companies plan to submit an RDM proposal in the second quarter of 2008. That timeframe comports with the prior orders issued by the Commission and the previous commitments made by the Companies. Specifically, submission of an RDM will be in compliance with the Commission's April 20, 2007 <u>Order Requiring Proposals for Revenue Decoupling Mechanisms</u> ("RDM Order"),[7] and in response to the Commission's August 29, 2007 <u>Order Establishing Commodity</u>

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4 Staff Gas Rates Panel at 9.

5 NRDC, Gupta Testimony at 4-7.

6 NRDC proposes a three month stakeholder process and compliance filing process after the Commission's decision in this case. (Gupta Testimony at 6).

7 Case 03-E-0640, Proceeding on Motion of the Commission to Investigate Potential Electric Delivery Rate Disincentives Against the Promotion of Energy Efficiency, Renewable Technologies and Distributed Generation and Case 06-G-0746, In the Matter of the Investigation of Potential Gas Delivery Rate Disincentives Against the Promotion of Energy Efficiency Renewable Technologies and Distributed Generation,, <u>Order Requiring Proposals for Revenue Decoupling Mechanisms</u> (issued April 20, 2007).

Program for NYSEG ("NYSEG Commodity Program Order").[8] The NYSEG Commodity Program Order approved a Joint Proposal that, among other things addressed RDMs. Section II.F of the Joint Proposal in Case 07-E-0479,[9] dated July 10, 2007, states that NYSEG will address a revenue decoupling mechanism as part of any major electric rate case filed by NYSEG, a Commission-initiated review of NYSEG's electric rates or as otherwise ordered by the Commission. In its order approving that Joint Proposal, issued August 29, 2007, the Commission decided to begin immediately a new proceeding to develop an RDM for NYSEG.[10] By its Order Instituting Proceeding, issued the same day as the Commodity Program Order, the Commission commenced Case 07-E-0996 (later changed to Case 07-M-0996)[11] to examine the development and implementation of an RDM for NYSEG's sales of both electricity and gas.[12]

Subsequently, the Commission determined that the matters intended to be

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8 Case 07-E-0479, Tariff Filing of New York State Electric & Gas Corporation to Offer Customers a Single Fixed Supply Service, Order Establishing Commodity Program (issued August 29, 2007).

9 Case 07-E-0479, Tariff Filing of New York State Electric & Gas Corporation to Offer Customers a Single Fixed Supply Service.

10 Case 07-E-0479, supra, Order Establishing Commodity Program (issued August 29, 2007) ("Commodity Program Order").

11 By Notice of Case Number Change, issued September 10, 2007, the Commission noted that it was modifying the case designation in Case 07-E-0996 to "M" from "E" because the proceeding pertained to both electric and gas decoupling.

12 Case 07-E-0996, Proceeding on Motion of the Commission to Consider a Revenue Decoupling Mechanism for New York State Electric & Gas Corporation, Order Instituting Proceeding (issued August 29, 2007).

resolved in Case 07-M-0996 could more effectively be considered in Case 07-M-0906.[13] Case 07-M-0906 has been addressing, among other things, the effects upon NYSEG's operations should the Commission approve a proposed corporate acquisition. Accordingly, on October 22, 2007, the Commission issued a Notice Consolidating Proceedings in Cases 07-M-0996 and 07-M-0906, by which it determined that consideration of an RDM for NYSEG's sales of electricity and gas will be heard in Case 07-M-0906 and discontinued and administratively closed Case 07-M-0996.[14]

The Company commits to make a filing in the second quarter of 2008 so that the parties have adequate time to review the proposed mechanism. This timeframe also will afford the Commission sufficient time to consider and approve the implementation of the Companies' proposed RDM.

Q. What is the Commission's reason for implementing an RDM?

A. In its RDM Order, the Commission stated that the purpose of an RDM is to "significantly reduce or eliminate any disincentives caused by the recovery of utility fixed costs via volumetric rates or marginal consumption blocks."[15]

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[13] Case 07-M-0906, Joint Petition of IBERDROLA, S.A., Energy East Corporation, RGS Energy Group, Inc., Green Acquisition Capital, Inc., New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by IBERDROLA, S.A.

[14] Cases 07-M-0906 and 07-M-0996, supra, Notice Consolidating Proceedings (issued October 22, 2007).

[15] RDM Order at 3.

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According to the Commission, such disincentives "may discourage utilities from actively promoting energy efficiency, renewable technologies and distributed generation"[16] because utilities' revenues are directly tied to the throughput of electricity and gas sold on their system. Because an RDM will protect a utility from lost revenues due to decreased sales from efficiency, conservation and other similar programs, it is believed that utilities will more likely support (or at least not oppose) efforts to improve energy efficiency and conservation if an RDM is in place.

Q. Do the Companies support economic energy efficiency programs?

A. Yes. The Companies have been, and continue to be, strongly supportive of economic energy efficiency efforts in the State. To that end, the Companies will continue to actively participate in the Commission's ongoing proceeding addressing energy efficiency matters.[17]

Q. Please summarize the structure articulated by Staff with respect to how an RDM program should be designed.

A. Staff's proposed RDM structure differs for electricity and gas. For the electricity businesses, Staff witness Dickens recommends use of a total delivery revenue target:

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16 RDM Order at 2.

17 Case 07-M-0548, Proceeding on Motion of the Commission Regarding an Energy Efficiency Portfolio Standard.

> Staff recommends a total delivery revenue reconciliation mechanism be designed and implemented for each customer service class, with the exception of the lighting, buyback, individually negotiated contract, and standby service classifications at this time. Forecasted delivery revenue targets, for each service class or sub-class will need to be established for each month of calendar year 2009.[18]

For the natural gas businesses, the Staff Gas Rates Panel proposes a different RDM methodology based on revenue-per-customer targets as opposed to total revenue targets.

> We recommend the development of a RDM structured on an average pure base delivery revenue per customer (RPC) basis premised on rate case quality sales forecasts. We contemplate the establishment of annual RPC factors for residential and commercial customer classes excluding cooking and large industrial customer groups...[19]

Q. Do the Companies agree with the structure identified by Staff?

A. At this time, the Companies oppose Staff's recommendation to apply inconsistent RDM target methodologies to gas and electric services absent a showing of a compelling rationale. In order to simplify administration, the Companies recommend that the same RDM methodology should be used for gas and electric. Therefore, the Companies plan to file a joint RDM proposal using a consistent methodology for both gas and electric businesses at NYSEG and RG&E.

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[18] Staff Testimony, Dickens at 14-15.

[19] Gas Rates Panel at 9-10.

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Q. Do the Companies propose to use fixed revenue or a revenue-per-customer RDM targets?

A. Currently, the Companies are compiling information that will be used to assess the merits and drawbacks of each approach. A fixed revenue target is simpler to implement and does not require tracking of customer accounts,[20] but ignores the impact of customer growth and economic development on delivery costs. An RDM plan that adjusts against a simple total revenue target implies that the Companies would absorb the incremental costs associated with any unanticipated increase in new customers or would retain the revenues associated with any unanticipated decline in customers, potentially causing a disincentive to attract new customers to the service territories.

A revenue-per-customer target would allow the Commission to achieve its stated goals to remove disincentives to promote energy efficiency, renewable technologies and distributed generation, yet would continue to accommodate economic development and allow delivery revenues to change with changes in customer counts in the service territories.[21] Given the Commission's and

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[20] The Gas Rates Panel at 10 states that an accurate accounting of customers within each service class or group is a critical element of the RDM and will require a reliable and transparent data source. Further, the Panel suggests that the number of open active gas meters may be a reliable proxy.

[21] The RDM Order at 8 notes that revenues calculated on a per customer basis can encourage economic development by allowing utilities to collect revenues for new customers.

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Governor's other goals of encouraging economic development in New York, including those related to the development of renewable resources, the revenue-per-customer target might better address energy efficiency <u>and</u> economic development goals. This method, of course, requires that a transparent and objective standard be agreed upon to monitor the number of customers on an ongoing basis. The Companies are currently evaluating the extent to which it is necessary in the Companies' service areas to reflect increases and/or decreases in the number of customers in the RDM methodology over time. If customer growth over time is relatively modest and stable, the importance of a revenue-per-customer target is somewhat diminished.

Q. Are there other policy objectives that should be considered in the design of an RDM?

A. Yes, there are several additional objectives that merit consideration at this time. First, an RDM must be implemented in a manner that maintains reliable service. An RDM should not be designed in a way that all but guarantees that utilities will suffer revenue insufficiency unless they file a rate case on an annual basis to recover inflationary cost increases. An RDM should seek to avoid expensive and time consuming rate cases due to cost increases.

An RDM provides for an automatic "true-up" mechanism (<u>i.e.</u>, either a credit or surcharge) that adjusts rates between rate cases based on the over- or under-recovery of the revenue-based targets. To the extent that the RDM revenue adjustments more closely track all changes in delivery service costs, there would be less need for time-consuming and costly rate cases in the future.

In the long run, the primary drivers of the utilities' delivery costs stem from increased demand for electricity/gas service and the impact of inflation on the utilities' cost structure. Increases in demand ultimately stress the infrastructure and necessitate significant investment in pipes, wires, substations and so forth. These long-run changes in delivery costs can and should be addressed either in the context of a rate or other appropriate proceeding such as the extension of an existing rate plan.

In the short run, or between rate cases, the primary drivers of the utilities' delivery costs are created by inflationary cost pressures and potential increases in customers. Therefore, to ensure that an RDM functions in the intended way, it must address the impacts associated with these cost drivers. The Companies are currently evaluating the need to adjust revenue targets for changes in the number of customers. However, the Companies strongly believe that in order to appropriately cover inflationary costs, RDM targets should be subject to an annual adjustment such as inflation less a productivity offset.[22] NRDC, in its testimony,

[22] The RDM Order at 8 suggests that an inflation and productivity adjustment mechanism may be incorporated in the RDM mechanism. O&R similarly suggests that the Commission should consider a formula based ratemaking approach that would provide utilities with a means to offset the impact of inflationary increases in operating costs and new infrastructure investments. Such an approach would afford

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also supports the concept of allowing utility revenues to adjust over time to capture expected growth in costs with a productivity offset, and recommends that the simplest approach possible should be used at the outset subject to later evaluation.[23] An annual adjustment for inflationary costs will enable the Companies and other parties to avoid the regulatory costs associated with more frequent rate cases.

Currently, the Companies are able to capture any revenue growth as system load and the number of customers increase between rate cases. Both this load and/or customer growth currently increase revenues directly based on average rates in effect at the time. Such revenue growth can help to offset general cost increases over time in operations, maintenance, capital costs and certain taxes. An RDM mechanism eliminates or significantly restricts the opportunity for the Companies to increase revenues, but provides for no relief from increased costs. Similarly, while it is important that an RDM remove disincentives for utilities to promote efficiency, it should not be designed in a manner that discourages economic development through new customer growth. Care in RDM design is required to align the Companies' interests with the economic interests of their respective service territories.

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utilities with the opportunity to seek ways to delay the filing of annual base rate cases. (O&R RDM filing at 9).

[23] NRDC, Gupta Testimony at 6-7.

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Second, the Commission recognizes that the recovery of any net lost revenues component of the mechanism should not, in and of itself, produce inter-class revenue re-allocations.[24] This suggests that RDM reconciliations should be performed on a service class basis to the extent possible. However, an RDM should also remain sufficiently flexible to accommodate significant, unforeseen events that may have large unintended rate impacts in a particular service class with a relatively small number of customers. In some cases, customers in the Companies' service territories can elect to switch between service classes and the RDM methodology should consider the potential impact of such switching so as to avoid unintended rate consequences.

In sum, a properly designed RDM should recover fixed delivery costs as they increase over time, should be consistent with economic development objectives, and should not inadvertently harm customers and/or shareholders.

Q. Do you agree with NRDC's assertion that allowed revenues "should be adjusted for desirable or unexpected and unavoidable factors that increase or decrease costs"?[25]

A. In theory, NRDC's recommendation has merit as long as such mechanisms are transparent and simple to implement. NRDC aptly notes that growth in customers, jobs, and businesses are all desirable factors that might drive up

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[24] RDM Order at 16.

[25] NRDC, Gupta Testimony at 4.

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delivery costs, while extreme storms or terrorist attacks represent unavoidable and unexpected factors that could increase costs. NRDC also correctly suggests that allowed revenues may need to be adjusted on a customer class basis if there are significant factors unique to a particular class.

Q. Please respond to Staff's recommendation that the Companies need to file an up-to-date forecast of delivery revenues, sales and number of customers for each service class or sub-class for each month of calendar year 2009 to establish an RDM.

A. The Companies agree with Staff's statement. A properly-designed RDM should include approved RDM targets based on reasonably achieved revenue targets. To that end, the Companies plan to base their targets on a forecast of the likely revenues that would be realized in 2009, absent the implementation of an RDM and absent the impact of any new energy efficiency programs that may be implemented.

The Companies will propose RDM targets that are calculated on a monthly basis for each applicable RDM service class or grouping of service classes (as described later). The Companies plan to file RDM targets using their approved delivery rates, a weather-normalized 2009 sales forecast by service class,[26] the resulting forecast 2009 delivery revenues by service class, and a 2009

[26] Weather-normalized sales will be used to establish targets at appropriate levels, that is, so as not to include the impact of "abnormal" weather on actual revenues.

forecast of customers by service class. Based on this information, the Companies will establish the "Allowed Delivery Revenue" or "Allowed Delivery Revenue-per-Customer" for each service class. The "Actual Delivery Revenue" will be measured as the sum of the billed revenue from all energy, customer and/or demand charges related to delivery service for each service class.[27]

Q. Please describe the reconciliation process that the Companies endorse.

A. The Companies envision an approach similar to the recommendations of Staff witness Dickens and the Staff Gas Rates Panel to use a reconciliation process based on 2009 monthly RDM targets. Under the approach endorsed by the Companies, each month, the difference (if any) between the Allowed Delivery Revenue and Actual Delivery Revenue for each service class will be tracked. At the end of the calendar year (or appropriate RDM period), the deferral balance will be refunded or surcharged to the appropriate service class via an "RDM Rate Adjustment" mechanism. The RDM Rate Adjustment will be calculated on a dollars per kWh or dollars per therm basis. This true-up would include, among other things, any net lost revenues attributable to the implementation of energy efficiency programs. For example, if at any time during the year the value of the deferral account exceeds a certain amount (e.g., $10 million) (positive or negative), the utility would employ an interim RDM Rate Adjustment in the

[27] The Weather Normalization Adjustment currently in place for NYSEG's gas service will continue and be implemented prior to any RDM adjustments.

following month.[28] The Companies will implement interim RDM Rate Adjustments by service class on no less than ten days' notice. These interim adjustments would be subject to reconciliation at the end of the annual RDM period.[29] The deferral account will be subject to a carrying charge at the rate most recently adopted by the Commission for other deferral accounts.

Q. Do you agree with NRDC that any adjustments to revenue targets, actual revenues, or true-ups should be calculated in a transparent manner?[30]

A. Yes, the input information and formulas should be straightforward, subject to review, and readily replicable.

Q. Please address Staff's recommendation concerning those customers that should be covered by an RDM.

A. Staff proposes that the RDM should be implemented for each electric customer service class or subclass, with the exception of: (i) the lighting, buyback,

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[28] The RDM Order at 8 specifies that the true-up should occur no less frequently than once per year, but the intent should be to avoid the accumulation of large liabilities and the ensuing bill impacts and general price instability for ratepayers. The definition of significant accumulated balances is not specified in the RDM Order.

[29] If for any reason, a service class, as defined for the purposes of the RDM, no longer has any customers, the revenue target for that discontinued service class, plus any delivery revenue excess or shortfall, would be reallocated to other remaining service classes to provide for equitable treatment of revenue deficiencies or surpluses from the discontinued service class. The Company will consult with Commission Staff regarding such reallocation.

[30] NRDC, Gupta Testimony at 4-5.

individually negotiated contract, and standby service classifications at this time[31]; and (ii) certain gas customers (residential and commercial customer classes excluding cooking and large industrial customer groups).[32]

Q. What customers do the Companies currently plan to include in their RDM proposal?

A. The Companies currently plan to apply RDM to the vast majority (over 99%) of electric and gas customers. These customers represent a significant portion (approximately 96%) of sales volume. Exhibit ___ (RDM_2) summarizes the applicable RDM service class categories and lists those service classes that will be excluded from the Companies' RDM proposal. In general, it is important that revenue decoupling be applied across a broad customer base in order to stabilize rate impacts. Otherwise, energy efficiency improvements (or any sudden change in load) could have dramatic rate impacts for customers within the service class. For example, the addition of a new customer among large users or a large change in the consumption of a key customer could have a disproportionate effect on rates for other customers in that service class.

[31] Staff Testimony, Dickens at 14.

[32] Gas Rates Panel at 9-10.

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Q. Do the Companies plan to aggregate any customer classes for the purpose of the RDM?

A. Yes. Rate volatility associated with RDM adjustments is more of a concern in service classes where there are relatively few customers and/or there is more diversity of customer load. Therefore, the Companies currently plan, in some instances, to aggregate particular service classes for purposes of establishing RDM targets and reconciliation. Specifically, the Companies will combine customer service classes that have relatively similar consumption characteristics or classes that have too few customers to warrant stand-alone treatment.

The aggregation of certain service classes achieves several objectives. First, and most importantly, combining certain classes for RDM purposes provides a more stable rate adjustment mechanism, especially in service classes where there are a relatively small number of customers and an RDM could have a disproportionate impact on the rates for those customers in that service class. Second, combining certain service classes will avoid the potential for customer gaming or inadvertent revenue changes in those instances where a customer can move easily between service classes.[33] Third, aggregation of certain service classes reduces administrative complexity by limiting the number of rate adjustments that need to be calculated and communicated to customers.

[33] For example, if a customer moves from a low average revenue-per-customer class to a high average revenue-per-customer class, this could impact total revenues.

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Q. Do NYSEG and RG&E recommend the exclusion of any customers from the RDM?

A. As noted above, the Companies propose the exclusion of a small number of customers from their RDM proposal. The Companies will exclude service classes in which (1) customers have individual service agreements (e.g., flex rate contracts, bypass rates), or interruptible transportation service; (2) there are few or no customers; and/or (3) the rate designs for such class(es) already recover fixed delivery costs on a non-volumetric basis (e.g., standby service).

III. COMMODITY REVENUE DECOUPLING MECHANISM

Q. Does Staff recommend an RDM for electric commodity revenues on the sale of the fixed price option ("FPO")?

A. Staff does not recommend an RDM applicable to electric commodity revenues at this time. However, Staff does propose that NYSEG should address the FPO commodity issues the Commission raised in its earlier Orders.[34]

Q. What is the Companies' position concerning whether an RDM should apply to commodity revenues?

A. The Companies oppose extension of an RDM to commodity revenues. In support of the Companies' position, the Panel will briefly summarize the NYSEG and

[34] Staff Testimony, Dickens at 16.

RG&E commodity programs and then provide the rationale for the exclusion of associated revenues from an RDM.

Q. Would the Panel provide an overview of the NYSEG and RG&E commodity programs?

A. The NYSEG Commodity Program Order requires NYSEG to address the applicability of an RDM to NYSEG's electric FPO. NYSEG's FPO is a one-year fixed price commodity product that most customers of the utility can choose during a two-month enrollment period beginning each November. The FPO rate is determined based on forward wholesale prices for energy and capacity, and is converted to a retail price using a conversion factor consisting of a percentage of 16.9% and an adder for risk and a profit opportunity of 6 mills per kWh. Any profits realized by NYSEG are shared as follows – the first $10 million of pre-tax profits goes to NYSEG, and any additional profits are shared 85% to customers and 15% to NYSEG. Any losses are absorbed completely by NYSEG. The FPO is charged to customers entirely on a volumetric cents/kWh basis.

RG&E's FPO is a one-year fixed price commodity product that most customers of the utility can choose during a three-month enrollment period beginning each October. The FPO rate is determined based on forward wholesale prices for energy and capacity, and is converted to a retail price using a conversion factor of 35% that covers certain costs, risks and a profit opportunity. Any profits realized by RG&E flow through the Company's overall earnings

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sharing provision in which customers receive 50% of earnings above a 12.25% overall ROE for commodity and delivery combined. Any losses are absorbed completely by RG&E. The FPO is charged to customers entirely on a volumetric cents/kWh basis.

Q. Why do the Companies believe that an RDM should not be applied to these commodity programs?

A. There are three main reasons. First, an RDM is not appropriate for the Companies' FPO because the economics of the commodity and delivery businesses are fundamentally different. Second, an RDM is not appropriate for FPO because the Companies have little incentive to increase sales. Third, an RDM is not appropriate for FPO because of other program design features. Each of these reasons is described in more detail below.

Q. What is the basis for the first reason?

A. An RDM is being contemplated in New York State in order to align utility incentives for revenue recovery with the desire to promote energy efficiency and conservation of usage. A typical utility delivery business has two key attributes which lead policy makers to perceive that utility incentives are not currently aligned to achieve these goals. First, delivery costs are substantially fixed and do not vary with changes in load. Second, rates are currently designed to collect a substantial portion of fixed delivery costs through volumetric charges (e.g., per

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kWh). Therefore, incremental usage results in relatively large contributions to fixed cost recovery.

The Companies' FPO programs do not share these same attributes. First, supply costs are almost entirely variable. Changes in usage by FPO customers can cause the Companies to incur substantial expense through purchases of power at market prices. If a customer uses an additional kWh, the Companies must purchase incremental energy and incremental line losses. If a customer uses one less kWh, the Companies' costs decline similarly.

Second, unlike the delivery business, an incremental change in usage from what is expected creates real costs and substantial risks. Incremental usage is often associated with high-priced periods during on-peak or during super-peak periods because periods of high demand due to weather are strongly correlated with increases in supply costs. In these periods, the Companies are likely procuring power in the wholesale spot market at costs that exceed the retail fixed price charged to the customer. Thus, not only are the Companies not realizing a margin of 6 or more mills per kWh during these periods, they are probably incurring a loss to acquire the incremental energy. Therefore, the economics are fundamentally different for the commodity and delivery businesses.

With respect to commodity, the Companies do not have any incentive to encourage additional usage, especially during on-peak and super-peak periods. Similarly, a decrease in usage creates costs and causes risks in a different way.

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Lower than expected usage is often correlated with lower than expected prices. Unexpectedly mild weather causes low demand and low prices as low-cost generation sets the market price. In these periods, the Companies must sell power previously purchased at higher prices and will receive a lower spot price. In these times, the Company loses the opportunity to earn any of the above-referenced margins because the customer is not using electricity. Finally, it makes no economic sense to blindly fix the FPO commodity program revenues – either with a total revenue target or with a revenue per customer target – when the costs of service vary substantially with changes in load and time of use, and customers are able to freely switch to an energy services company ("ESCO") from FPO service.

Q. What is the rationale supporting the second reason identified above?

A. An RDM is not appropriate for the FPO because the Companies have little incentive to increase sales. For a residential electric customer paying the SC1 rate, consumption of an additional kWh costs the customer 3.47 cents at NYSEG and 2.27 cents at RGE in incremental delivery charges. As discussed above, this incremental revenue largely increases profit margin since the delivery costs associated with this additional usage are largely fixed. Presuming for the moment that consumption of an additional kWh creates an additional 0.6 cents per kWh in net commodity margin (although this is far from an expected outcome), the Companies have roughly one-sixth to one-fourth as much perceived incentive to encourage additional usage. At NYSEG, this incentive is reduced substantially once the earnings sharing mechanism of the commodity program is triggered. NYSEG's share of this margin is 15%, or 0.09 cents per kWh – roughly 2.5% of the magnitude of incremental margin created by delivery rates. Therefore, the underlying motivation for RDM does not apply to the Companies' commodity programs. The Companies have little incentive to increase commodity sales above expected levels.

Q. Would the Panel explain the third reason?

A. An RDM is not appropriate for FPO because of other program design features. In addition to the lack of incentive caused by the rate and earning sharing features of the FPO programs, there are design features to the programs that further warrant leaving the structure unaffected by an RDM. First, customers must affirmatively elect a fixed price rate from the Companies during a two or three-month enrollment period. For 2008, only 11.7% at NYSEG and 17.8% at RGE of the load will fall under this rate option. This further narrows any perceived incentive. At NYSEG, beginning in 2008, customers have the freedom to switch to an ESCO at any time during the one-year period the FPO is in effect. This new ability creates substantial additional risk for NYSEG with no additional upside opportunity – customers can not return to the FPO program if leaving an ESCO during the year. Third, the percentage of load choosing the FPO program has been falling over time. As fewer customers choose the FPO, the total potential margins from the program fall.

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Q. Does this complete your rebuttal testimony at this time?

A. Yes, it does.