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 RATE ADJUSTMENTS PANEL

Steven R. Adams
Joseph J. Syta
Ernest S. Walker

January 31, 2008

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RATE ADJUSTMENTS PANEL

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I. INTRODUCTION

Q. Please state the names, current position and business address of the members of the Rate Plan Panel.

A. (Mr. Adams) My name is Steven R. Adams and I am Vice President – Regulatory Policy of Energy East Management Corporation. My business address is 52 Farm View Drive, New Gloucester, Maine 04260.

(Mr. Syta) My name is Joseph J. Syta and I am Vice President, Controller and Treasurer of New York State Electric & Gas Corporation ("NYSEG" or the "Company") and Rochester Gas and Electric Corporation ("RG&E"). My business address is 89 East Avenue, Rochester, NY 14649.

(Mr. Walker) My name is Ernest S. Walker III and I am Manager, Revenue Requirements of NYSEG and RG&E. My business address is Corporate Drive, Kirkwood Industrial Park, Binghamton, New York 13902.

Q. Please summarize your educational background, work experience and prior testimonies.

A. A summary of our educational backgrounds, work experience and prior testimonies are provided in Exhibit __ (RAP-1).

Q. Has this Panel reviewed Staff interrogatory responses that are related to the Staff's direct testimony?

A. Yes. We have reviewed several such responses by Staff. However, additional analysis will be required as there was insufficient time to complete our review of these responses in the time provided to submit this Panel testimony. We further note that in certain responses, Staff has indicated that it intends to revise certain exhibits and we reserve the right to modify this Panel testimony at hearing to address any changes to Staff's exhibits.

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

A. The primary purpose of our testimony is to rebut the positive benefit adjustments ("PBA") proposed by Staff witnesses John W. Benedict and Robert H. Haslinger, to explain why their proposed rate plan modifications are inappropriate for this proceeding and, in the event they are nonetheless deemed relevant to the proceeding, to address serious flaws in the proposed rate plan modifications. More specifically, Staff witness Benedict reviews NYSEG's historical performance from a financial perspective, identifies regulatory adjustments that are described as potential positive benefits to ratepayers under the proposed acquisition, identifies further regulatory adjustments based on the NYSEG annual compliance filings made for the years 2002 through 2006, and suggests modifications to NYSEG's current gas rate plan and electric order. Staff witness Haslinger covers virtually the same topics for RG&E. We also will address issues raised by other Staff panels, including the elimination of the Gas Cost Incentive Mechanism ("GCIM") raised by the Staff Gas Rates Panel, and the Gas and

Electric Capital Expenditure proposals raised by the Staff Gas Rates Panel, respectively. We also address certain issues discussed in the testimony of the Staff Policy Panel.

II. SUMMARY

Q. Please summarize your testimony.

A. The testimony of Mr. Benedict and Mr. Haslinger attempts to inject a new and irrelevant rate proceeding into the Commission's consideration of the proposed acquisition. As discussed herein, and in the rebuttal testimony of the Petitioners' Joint Policy Panel ("JPP"), Staff's rate adjustment proposals are inappropriate, overstated, and beyond the scope of this proceeding.

As described in the rebuttal testimonies of the JPP and Mr. Meehan, the customers of NYSEG and RG&E will realize positive net benefits as a result of the proposed transaction. Several of the issues identified by Mr. Benedict and Mr. Haslinger are ones that might be appropriately raised in response to the companies' Annual Compliance Filings ("ACFs"), except that Staff has, for five years, repeatedly failed to provide a response to those filings. If Staff believes the companies are somehow obscuring over-earnings in their annual filings, the appropriate remedy is for Staff to file a response to the companies' ACFs. If Staff believes that modifications to the companies' existing rate plans and orders are appropriate, it should make its case in a rate proceeding, where rate case quality data regarding all of the companies’ costs and revenues can be fully explored, in contrast to Staff’s attempt in this proceeding to pick and choose modifications that only disadvantage the companies. Staff’s proposal, to hold hostage a transaction that will provide significant benefits to New York is inequitable and unadvisable, particularly in light of the positive impacts of this Proposed Transaction on the State.

Beyond this overarching objection, we also disagree with the merits of Staff's proposals. Staff proposes hundreds of millions of dollars’ worth of “Positive Benefit Adjustments” ("PBAs") through regulatory asset write-offs and reserve increases. After these write-offs, Staff next concludes that the NYSEG and RG&E are over earning. Staff then overlays a series of rate plan modifications, including an earnings sharing mechanism ("ESM"). Staff’s PBA proposals would contravene the existing rate plans and orders authorized by the Commission for NYSEG and RG&E, and they should be rejected.

As for Staff’s proposed rate plan modifications, those proposals ignore the fact that NYSEG and RG&E are currently operating under still-valid rate plans and orders that were the result of numerous contested proceedings involving a diverse group of parties and a wide range of complex issues. In its testimony, Staff proposes to fundamentally modify selected provisions of the companies’ existing rate plans and orders, ignoring traditional cost of service rate making and imposing a series of financial penalties upon NYSEG and RG&E. Staff justifies its proposals by applying a series of 'adjustments' to NYSEG and RG&E's 2006 returns on equity ("ROE") in an attempt to show that the companies are earning excessive returns.

Staff proposes to significantly modify the terms of NYSEG's and RG&E's existing rate plans and orders. Staff's proposals would impose write-offs, company-financed reserve increases, and earnings sharing mechanisms, resulting in what Staff characterizes as "Positive Benefit Adjustments", totaling over $1.7 billion. Staff's claim that its PBAs will have no cash impact is misleading and incorrect. Staff has essentially proposed two financial scenarios. Under Scenario 1, Staff would impose all PBAs and rate plan modifications with an ESM, but would not require immediate rate reductions. Under Scenario 2, Staff would require immediate implementation of all PBAs, rate plan modifications with an ESM, and rate reductions. The financial impact on the utilities under either scenario is roughly equivalent. Under Scenario 1, the financial impact over five years is $1.71 billion ($753 million for NYSEG and $957 million for RG&E). Under Scenario 2, the financial impact over five years is approximately $1.64 billion ($742 million for NYSEG and $896 million for RG&E). The reason that the results are similar is because Staff has proposed to implement an ESM and not exclude the PBAs from the ESM. Therefore, under either scenario Staff will require the Companies to either immediately build a huge customer liability through earnings sharing – Scenario 1 (with a cash outlay likely to occur when rates are reset – three to five years later), or provide a rate reduction to customers immediately – Scenario 2. Both Staff scenarios should be rejected by the Commission.

Our testimony below is organized into three main parts. Section III below addresses Staff's Positive Benefit Adjustments, and the impact of those adjustments on rates, and explains why they are inappropriate as conditions to approval of the transaction in this proceeding. Section IV of our testimony and exhibits responds to Staff's proposed adjustments to NYSEG's and RG&E's rates. Section V of our testimony discusses other accounting and rate issues addressed by various Staff witnesses.

To be clear, we believe it is highly inappropriate, and contrary to the Commission's authority for determining whether an acquisition or merger is in the public interest, for Staff to introduce these rate issues through its testimony in this proceeding. We are compelled by Staff's testimony, however, to respond here to the lack of merit in these proposed rate modifications, even though they should be considered, if at all, in a subsequent proceeding after consummation of the Proposed Transaction. Obviously, we believe that these issues have no place in this proceeding.

III. STAFF'S POSITIVE BENEFIT ADJUSTMENTS ("PBAs")

A. <u>Quantification of PBAs</u>

Q. What amount of PBAs has Staff proposed for NYSEG?

A. On Exhibit JB-4, staff witness Benedict proposes PBAs related to regulatory asset write-offs, reserve increases and purchased power costs absorption of $244.7 million for NYSEG Electric and $63.5 million for NYSEG Gas. In addition, Staff proposes that NYSEG write-off $70.3 million of capitalized software and increase the electric ASGA by $66.7 million for disagreements with the Company's calculation of its prior rate plan earnings sharing. Staff claims that the capitalized software and ASGA adjustments should not be considered PBAs. From the Company perspective, we have included all proposed staff adjustments in our evaluation. The resulting write-off value equals $445.2 million at NYSEG ($369.4 million for NYSEG Electric and $75.8 million for NYSEG Gas) as shown on Exhibit ___ (RAP-2).

Q. What amount of PBAs has Staff proposed for RG&E?

A. On Exhibit __ (RPH-4), Staff witness Haslinger proposes regulatory asset write-offs, reserve increases and decommissioning accrual absorption of $316.1 million for RG&E Electric and $22.2 million for RG&E Gas. The RG&E Electric value differs from the amount shown on Exhibit __ (RPH-4) because Staff double counted the delivery regulatory asset write-off. Staff also proposes that RG&E write-off $71.3 million of capitalized software. These adjustments equal $409.5

million at RG&E ($362.4 million for RG&E Electric and $47.1 million for RG&E Gas). These amounts are also shown on Exhibit ___ (RAP-2).

Q. Please describe the methodology used to prepare Exhibit ___ (RAP-2).

A. We started with a presumption that all of the Staff proposals were adopted. This means that all of the PBAs recommended by Staff were in fact adopted, as well as all other regulatory adjustments noted in Staff witnesses Benedict and Haslinger's testimony and exhibits.

Q. What were these "other" regulatory adjustments?

A. These included a recommendation that certain software investments at both NYSEG and RG&E be written off immediately and that NYSEG immediately add an amount to its Asset Sale Gain Account ("ASGA") to reflect preliminary Staff findings associated with NYSEG Electric compliance filings for 2002 through 2006.

Q. Were there other Staff proposals?

A. Yes. Mr. Haslinger recommended several significant changes to the existing RG&E Commodity program. These changes are reflected in Exhibit ___ (RAP-3). Both Mr. Benedict and Mr. Haslinger recommended significant changes in the ESMs for each Company, and these changes are also reflected.

Q. Did this panel use the data provided in Staff witness exhibits as the source for determining the financial impacts?

A. Yes.

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Q. Did this panel use the data provided in Staff witness exhibits as the source for the Return on Equity levels used in calculating the customer share of earnings sharing under Staff's ESM proposal?

A. Yes.

Q. In addition to the $855 million in adjustments above, are there additional Staff proposals which impact NYSEG and RG&E?

A. Yes. In our view, as previously mentioned, Staff has presented two scenarios. Scenario 1 represents the Staff PBA of $855 million plus the Staff earnings sharing mechanism and no immediate rate reduction. Scenario 2 combines the Staff PBA, the Staff earnings sharing mechanism and an immediate rate reduction for all four operating companies. As we will demonstrate, Staff Scenario 1 - without rate reductions - creates an additional PBA of $855 million over the next five years. The total PBA under Staff Scenario 1 is $1.71 billion as shown on Exhibit ___ (RAP-3). Staff Scenario 2 – with rate reductions – creates an additional PBA of $784 million over the next five years. Thus, the total PBA under Staff Scenario 2 is $1.64 billion as illustrated on Exhibit ___ (RAP-3).

Q. Are you stating that Staff's proposed PBA is actually close to $2 billion?

A. Yes. Staff first proposes a number of regulatory asset write-offs and reserve increases. If an asset is written off then the Company will no longer have an expense amortization. Likewise, the Company no longer has the regulatory asset and its rate base is reduced. When a reserve is increased, a future customer liability is pre-funded. Consequently, unadjusted fallout returns are naturally higher since income has increased and rate base decreased. Staff illustrates this point in its revenue requirement schedules. On Exhibits ___ (JB-2) and (JB-3), Staff shows ROEs after “Positive Benefit Adjustments” of 15.32% and 17.69% for NYSEG Electric and NYSEG Gas, respectively. Similarly, Exhibits __ (RPH-2) and (RPH-3) demonstrate ROEs after the PBAs of 35.91% and 15.98% for RG&E Electric and RG&E Gas, respectively. Staff then concludes that the Company’s current rates are too high and the Commission could require delivery rate reductions as a condition of the merger. However, even if the Commission does not require immediate delivery rate reductions after the Staffs' suggested $855 million write-off, Staff proposes an earnings sharing mechanism that will capture earnings from the manufactured higher returns. We have calculated the additional customer benefit from Staff’s ESM would be about $1.1 billion over the next five years.

Q. Why was a five-year period chosen to prepare Exhibit __ (RAP-3)?

A. Staff witness Benedict’s testimony, page 22, lines 11-15, indicates that “…five years…would seem to be reasonable as a proxy for the amount of time that the Commission would normally consider adequate for a stay out period”.

Q. What are the ESMs proposed by Staff?

A. Staff has proposed two different earnings sharing mechanisms. For NYSEG, at page 25 of Mr. Benedict’s testimony, Staff proposes delivery earnings between

9.0% and 10.0% ROE would be shared 50%/50% (customer/shareholder). Delivery earnings between 10.0% and 11.0% ROE would be shared 75%/25% (customer/shareholder). All earnings above 11.0% would be deferred for the customer. Staff has proposed a slightly different earnings sharing mechanism for RG&E. Mr. Haslinger, at page 37, proposes 50%/50% sharing begin at 9.35% ROE instead of the 9.0% proposed by Mr. Benedict. After this difference, the Staff proposed ESM for RG&E is the same as NYSEG's.

B. <u>Return Impacts of PBA Proposal</u>

Q. What is the potential highest return Company shareholders could receive under Staff's proposed ESMs?

A. Prior to the interest accrual on the customer share of earnings, the highest potential shareholder ROE is 9.75% at NYSEG and 9.93% at RG&E as illustrated on Exhibit __ (RAP-5). However, this "potential" level of return is illusory because as shown on Exhibit __ (RAP-6), the real highest potential ROE dramatically decreases after reflecting the interest expense on the customer share of earnings. By year five, the highest possible ROE is 8.0% for NYSEG Electric and 7.2% for NYSEG Gas, respectively. At RG&E the highest potential ROE is a mere 2.4% at RG&E Electric and 8.0% at RG&E Gas. These ROE levels are far below what has traditionally been deemed a reasonable range by this Commission.

Q. Do NYSEG and RG&E currently have ESMs?

A. Currently there is no ESM for NYSEG Electric delivery earnings since it does not operate under a multi-year rate plan. NYSEG Gas has an ESM which shares earnings above12.5% ROE equally (50/50) between customers and shareholders. The RG&E Electric rate plan provides for 50/50 sharing above 12.25% ROE and the RG&E Gas rate plan provides for 50/50 sharing above 12.0% ROE.

Q. Did Staff propose to exclude the impacts of its PBAs from the ESM?

A. No. Neither Mr. Benedict nor Mr. Haslinger proposes any exclusion to their ESMs.

Q. What is Staff's total PBA value and what percentage of five year delivery revenues does it equal?

A. Under Scenario 1 – no rate reduction – Staff's total customer benefit value is $1.71 billion and equals 26.3% of the Companies five-year delivery revenues. We utilized the Staff Exhibit ___ (Policy Panel- 21), five year delivery revenue amount for this calculation. Under Scenario 2 – immediate rate reduction – Staff's total PBA is $1.64 billion equaling 25.2% of the Companies five year delivery revenues. As discussed by Mr. Meehan, these percentages are staggering and well in excess of other approved mergers.

C. <u>Specific PBA and Other Staff Adjustments</u>

1. <u>PBA Adjustments</u>

Q. Does this panel accept Staff's PBAs or any of the other adjustments proposed by Staff as appropriate?

A. No. Other witnesses in this proceeding, the JPP and Mr. Meehan explain why the "creation" by Staff of these PBAs as a condition for acceptance of a non-synergy merger is inappropriate and bad policy. Our testimony addresses, from a factual and rate policy perspective, additional reasons why – even if the Commission were to view the PBAs as appropriate for consideration as conditions to approval – the PBAs should be rejected.

Q. Can you please describe each of the Staff proposed PBA adjustments and the reasons why this panel finds them unacceptable and inappropriate?

A. Yes. The following is a description of the proposed adjustments in the order depicted on Exhibit __ (RAP-2), and the reasons why this panel finds them inappropriate and unacceptable.

1. Loss on Reacquired Debt (NYSEG Electric, NYSEG Gas, RG&E Electric, RG&E Gas) – Staff correctly identifies that this item was created by early refunding of various debt issues that were approved by the Commission. NYSEG and RG&E periodically redeem outstanding debt issues when a more economic source of funds is available. Customers benefit from the reduction of the overall weighted average cost of capital. As part of the process of redeeming debt, losses may occur when the debt is reacquired, and these losses are considered in the economic analysis of whether to reacquire or not. To the extent that customers are benefited by the reacquisition of debt, they should bear the costs of the reacquisition. In addition, the accounting that the companies follow for the losses on reacquired debt is in accordance with generally accepted accounting principles ("GAAP").

2. Sarbanes Oxley and Other (NYSEG Gas) – Under its gas rate plan and joint proposal, in Section XV, NYSEG is allowed to defer the incremental costs of

adhering to new accounting mandates, such as Sarbanes Oxley. To not allow collection of these costs from customers is an inappropriate reopening of the rate plan. It is also unclear why the Staff Policy Panel places a high value on Energy East continuing to be subject to Sarbanes Oxley requirements (Staff Policy Panel testimony starting page 301, line 4) and then has other Staff witnesses propose that the costs of adhering to this mandate should not be recoverable.

3. Low Income and MTA Surcharge (NYSEG Electric) – With respect to Low Income, NYSEG spends money on low income programs which the PSC approved as part of its electric rates and a portion of that spending has been deferred. Recovery of these costs should be continued in light of the PSC's approval of this program. To disallow recovery would be an inappropriate reopening of the rate plan. With respect to the MTA Surcharge, Staff provides no specific explanation in its testimony for this item. This is a pass-through item for which the Company is simply acting as a collection agency for another entity, the Metropolitan Transit Authority. There is no logical reason why the Company should be harmed for acting in that capacity.

4. Gas Pension Deferral (NYSEG Gas) - This deferral is a long standing practice that the Commission has followed, as documented in its Statement of Policy on Pensions and OPEBs, which was established in the early 1990s in Case 91-M-0890. The current NYSEG Gas Rate Plan, in Section XVIII, clearly obligates the Company to defer any differences between the amount allowed in rates for pension costs/income and the amounts actually experienced as the result of two variables – the asset return rate and the discount rate. To have the Company absorb this accumulated deferral would be an inappropriate reopening of the PSC approved gas rate plan.

5. Deferred Gas Costs (NYSEG Gas) – NYSEG's accounting for deferred gas costs is in accordance with long standing Commission approved practice. The gas rate plan provided for a Gas Supply Charge, in Section X, which reconciles gas supply costs and gas supply revenues. At any point in time, NYSEG could have gas costs deferred that have not yet been collected from customers. Staff has not provided any adequate reason why this item was included. This proposed adjustment would force the Company to take a loss on gas supply costs, completely and inappropriately superseding the long standing policies of the Commission.

6. 2006 Flood (NYSEG Gas) – Under Section XV, the gas rate plan, NYSEG is allowed to defer incremental exogenous costs – a flood is an example of such

a cost listed in the JP associated with the rate plan. To not allow recovery of these costs from customers is an inappropriate reopening of the rate plan.

7. Environmental – SIR (NYSEG Electric, NYSEG Gas, RG&E Electric, RG&E Gas) – Staff, in a departure from Commission precedent, has proposed that both NYSEG and RG&E fully absorb the entire estimated remaining costs for environmental cleanup and site remediation associated with assets that have benefited customers through many years of service. Both NYSEG and RG&E have reflected on their books a regulatory asset that effectively matches the environmental and site remediation liabilities known by the Company. Under GAAP, the companies are required to recognize the liability, and the long standing regulatory practice of collecting those costs from customers over a period of time is enabled by the establishment of a regulatory asset for the expected costs. Deferral accounting for environmental costs is provided for on pages 55-57 of the NYSEG Electric Order in Case 05-E-1222, Section XV of the NYSEG Gas JP, Section XV of the RG&E Electric JP and Section XI of the RG&E Gas JP. As environmental costs are collected from customers, or as insurance proceeds or other proceeds from other responsible parties are collected, they are used to offset the environmental regulatory asset or to build up a reserve for environmental costs. It would be inappropriate for this long standing regulatory practice to be overturned at this time. This topic is discussed in more detail below under section III.C.2, "Other Concerns with Staff PBAs".

8. 2003 Ice Storm (RG&E Electric) – These types of restoration costs incurred due to major storm events and to restoring service to customers have traditionally been recoverable from ratepayers. Companies are strongly encouraged by the PSC to act with speed to get customers back on line expeditiously during and after a major storm event. On occasion, the restoration efforts required due to an extraordinary major storm turn out to cost significantly more than what is currently collected from customers in their rates. The long-standing practice of the Commission is to allow regulated companies to defer these excessive costs and recover them from customers over a future period. The 2003 ice storm that impacted the RG&E service territory was just such an extraordinary event. The Company appropriately petitioned the Commission in April 2003 to defer the restoration costs associated with that event. One of the Staff Policy witnesses in this instant proceeding is Mr. Thomas D'Ambrosia, who is also identified on page 2 of Staff witness Haslinger's testimony as the direct supervisor of Mr. Haslinger, specifically opined on the 2003 Ice Storm in a previous RG&E rate proceeding (03-E-0765). On page 69 of his testimony in case 03-E-0765, Mr.

D'Ambrosia describes the 2003 ice storm as "extraordinary" and further states "it is clear that the Commission could not have considered these costs in the 2003 Rate Order" and that "I recommend that the Commission allow RG&E to commence recovery of the $27 million of known 2003 storm costs". He goes on to state, on page 71, that "sound public policy would provide for recovery of storm restoration costs since prolonged storm related service disruptions have the potential for serious adverse impacts on the public …Cost recovery concerns should not distract the utilities from the crucial task of service restoration." On these points, Mr. D'Ambrosia clearly reflects the long-standing Commission practices noted above, and RG&E should not now have to bear these costs.

9. Property Tax Deferral (RG&E Gas) **–** This item is identified by Staff on exhibit RPH-4 as an "Annual Compliance Filing Deferral". This deferral was established under the terms of a multi-year gas rate plan, approved by the Commission in May 2004, which allows the Company to defer property taxes incurred in the gas business that are over or under a threshold amount for each year of the rate plan, Section X of the Gas JP. The provisions of that PSC approved plan assume a 4% increase in property taxes from a base year amount that acts as the threshold for deferral. To not allow collection of these deferred property tax costs from customers is an inappropriate reopening of the rate plan.

10. Voice Your Choice O&E (RG&E Electric) - This item is identified by Staff on exhibit RPH-4 as an "Annual Compliance Filing Deferral". This deferral was established under the terms of a multi-year electric rate plan, approved by the Commission in May 2004, Section XV. The rate plan allows the Company to defer costs associated with outreach and education for the newly established commodity rate program to the extent they exceed a $2 million threshold over the five year term of the rate plan. To not allow collection of these deferred outreach and education costs from customers is an inappropriate reopening of the rate plan. This item will be further discussed in this testimony in section III.C.3 below, "Other Staff Issues".

11. Pipeline Integrity (RG&E Gas) - This item is identified by Staff on exhibit RPH-4 as an "Annual Compliance Filing Deferral". This deferral was established under the terms of a multi-year gas rate plan, approved by the Commission in May 2004, which allows the Company to defer the incremental costs associated with new regulatory mandates, Section XII. This was a new PSC mandate for which the Company incurred incremental costs and deferred those costs according to the terms of the RG&E Gas Rate Plan.

To not allow collection of these deferred costs from customers is an inappropriate reopening of the rate plan.

12. Variable Rate Debt (RG&E Gas) - This item is identified by Staff on exhibit RPH-4 as an "Annual Compliance Filing Deferral". This deferral was established under the terms of a multi-year gas rate plan, approved by the Commission in May 2004, which requires the Company to defer the costs associated with variable rate debt incurred for the gas business that are over or under a threshold amount for each year of the rate plan, Section X. To not allow collection of these deferred variable rate debt costs from customers is an inappropriate reopening of the rate plan.

13. Storm Reserve (NYSEG Electric, RG&E Electric) – Both NYSEG and RG&E follow a reserve accounting approach to Storm accounting, which has been approved by the PSC in company-specific proceedings, NYSEG Electric Order in Case 05-E-1222, pages 57-58 and the RG&E Electric JP, Section XI. NYSEG currently accrues approximately $7.5 million per year into a storm reserve account. RG&E currently accrues $2 million per year into a storm reserve account. When storms occur that meet the criteria established in each company's rate proceedings, the costs incurred by the Company to recover from the storm are taken from the reserve. To the extent that the reserve does not have a large enough balance to cover the recovery costs, the balance in that reserve account could become a debit (in which case, conceptually, those costs would be deferred). Mr. Benedict proposes, on page 22 of his testimony, that the electric storm reserve be increased by $50 million, representing his estimate of under funding of about $10 million per year for five years. Mr. Haslinger proposes, on page 35 of his testimony, that the RG&E Storm reserve be increased by $10 million to pre-fund future storm costs. As noted in a previous item in this section of testimony, the previous methodology that a company would follow would have been to defer those storm costs and collect them from customers over a future period. The change to reserve accounting should not in any way change the long standing Commission practice to allow companies to recover costs of storms not already covered in rates. This proposed treatment, whereby the companies are asked to fund storm costs that have not even been incurred is unprecedented and inappropriate.

14. OPEB Top-Off to ASGA (NYSEG Electric) – Mr. Benedict, on page 23 of his testimony, suggests that this instant proceeding triggers a requirement in the Joint Proposal in Case No. 06-M-1413. He correctly states that one of the terms in that Joint Proposal require that if electric rates were reset or

superseded prior to 2010, an amount would be added to the ASGA. He also concludes that "the company's petition in this proceeding creates the need for the Commission to consider the level of NYSEG's electric rates". Mr. Benedict has clearly rushed to a conclusion that is not by any means inevitable. The company's petition in this proceeding clearly does not ask for or indicate that NYSEG electric rates be reset or superseded. The plain language of the Joint Proposal in Case No. 06-M-1413 is simply interpreted – to the extent that NYSEG electric rates are not superseded by the company's instant proposal, there would be no requirement to top off the ASGA. Since the company has not proposed nor does the company expect any change in NYSEG electric rates at this time, this item should be rejected.

15. Stray Voltage (NYSEG Electric) – Mr. Benedict, on page 22 of his testimony, proposes that NYSEG set up a reserve for stray voltage costs that could be incurred over the amount allowed in rates. The requirements associated with implementing the terms of the newly mandated stray voltage program required by the Commission were clearly treated as a deferrable item under the terms of the last NYSEG Electric Order on pages 58-59. In the last NYSEG Electric Case, 05-E-1222, the PSC established reserve accounting for Stray voltage costs similar to what it established for Storm costs, and allowed that approximately $5 million per year would be accrued to a reserve for this item. The PSC-initiated and approved change to reserve accounting for Stray Voltage should not in any way change the long standing Commission practice to allow companies to recover costs of mandates not covered in rates. This proposed treatment, whereby NYSEG is being asked to fund stray voltage costs that have not even been incurred is unprecedented and inappropriate.

16. Saranac IPP Cost (NYSEG Electric) – In perhaps the most egregious example of an attempt to reverse current and long-standing Commission practice and policy, Mr. Benedict, on pages 23 and 24 of his testimony, has proposed that NYSEG absorb the over-market costs associated with an Independent Power Producer ("IPP") contract during 2009. The Commission championed a complete restructuring of the electric industry during the last two decades, including the strong backing of IPPs as a source of electricity. Many companies, including NYSEG, were ordered to enter into long term supply contracts with IPPs, even though prices paid under those contracts were higher than market prices. Certainly, the Commission likely believed the greater good was being accomplished by the existence of these contracts, and to back up that belief, the costs associated with these contracts were fully the responsibility of ratepayers. Now, the Staff of the Commission is suggesting that NYSEG be burdened with the over-market costs of a contract that the

company was required to enter into by the Commission. This would clearly be inappropriate and should be disregarded.

17. Nine Mile 2 Sale (RG&E Electric) – This is one of two items that Mr. Haslinger proposes that are related to sales of generating assets by RG&E. He notes this on page 35 of his testimony. Mr. Haslinger correctly notes that RG&E had deferred losses associated with the sale of its ownership interest in the Nine Mile 2 nuclear plant. What he failed to identify in his testimony is the fact that the PSC strongly encouraged divestiture of generating facilities, with an understanding that sales of these assets could result in either gains or losses to the selling companies. With respect to Nine Mile 2, RG&E actually had exercised its right of first refusal to purchase Nine Mile 2 under terms and conditions of a proposed sale of that plant to a third party (AmerGen). This exercise of rights, while never consummated, caused all parties, including the PSC Staff, to move away from supporting the AmerGen deal, and a new auction of the Nine Mile 2 (and Nine Mile 1) plants ended up benefiting New York State ratepayers by several hundred million dollars (vs. the AmerGen proposed deal). RG&E's role in helping to produce this significant New York State ratepayer benefit was testified to by Mr. D'Ambrosia in the 2003 RG&E rate case (03-E-0765). On page 92 of his testimony in case 03-E-0765, Mr. D'Ambrosia states "RG&E's management's actions in exercising its right of first refusal ignited the process in which all the NM#2 owners (NYSEG and RG&E, et. al.) realized substantially higher auction proceeds than they would have had NYSEG's original proposal gone forward." He goes on to state, on page 93, that "I estimate that because of RG&E's actions, RG&E and NYSEG received $77 million and $100 million more, respectively in gross auction proceeds than they would have". The PSC, as part of its October 26, 2001 order authorizing the Nine Mile 2 sale, already required that RG&E write off $20 million as a condition of the sale, with the remainder of the book value not covered by sales proceeds set up as a regulatory asset. In a separate RG&E proceeding, Case 02-E-0198, Mr. D'Ambrosia testified, on page 72 of his testimony, that "RG&E has requested recovery of a significant amount of costs which were deferred during the term of the COB2 Rate Plan. Amounts included in this rate filing that were deferred include: Nine Mile #2 $282 million, Oswego #6 $63 million, and Kamine IPP buyout costs $105 million." He further states on the same page that "The Commission has approved RG&E's request to defer and recover the above costs". Given all of the evidence noted above and the previous Commission actions with respect to this item, to not allow collection of these deferred costs from customers is inappropriate.

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18. Nine Mile 2 Mirror CWIP (RG&E Electric) – Although described on page 35 of his testimony by Mr. Haslinger as an amount associated with RG&E losses associated with the sale of generation plants, this item long pre-dated the sale of the Nine Mile 2 plant and when established clearly contemplated the ownership of the plant through its licensed period. Because of significant construction costs, the PSC wanted the companies involved in Nine Mile 2 to stop accruing AFDC on the Construction Work-in-Progress balance. The companies instead booked a Regulatory Asset and a Regulatory Liability of equal amounts that represented the AFDC amount that would have been accrued over a designated period. After the plant went into service, the regulatory liability was used as a rate moderator by the PSC over a few years until its balance went to $0 and the regulatory asset was deemed recoverable over the remaining license life of the Nine Mile 2 plant at the time, through November 2026. Neither the company nor the ratepayers should be benefited or harmed from this series of actions by the Commission. Ratepayers have already received the benefit of reduced rates from the use of the regulatory liability as a rate moderator, and the recovery of the remaining regulatory liability over the PSC approved period ending November 2026 should continue.

19. Oswego 6 Sale (RG&E Electric) - This is second of two items that Mr. Haslinger proposes that are related to sales of generating assets by RG&E. He notes this on page 35 of his testimony. Mr. Haslinger correctly notes that RG&E had deferred losses associated with the sale of its ownership interest in the Oswego 6 generating plant. Again, he failed to recognize that the PSC strongly encouraged divestiture of generating facilities with an understanding that sales of these assets could result in either gains or losses to the selling companies. Under the guidance of the PSC, RG&E divested its 24% ownership share of the Oswego plant when Niagara Mohawk sold its 76% share. It would not have been feasible for the plant to sell had RG&E retained its share. In a separate RG&E proceeding, Case 02-E-0198, Mr. D'Ambrosia testified, on page 72 of his testimony, that "RG&E has requested recovery of a significant amount of costs which were deferred during the term of the COB2 Rate Plan. Amounts included in this rate filing that were deferred include: Nine Mile #2 $282 million, Oswego #6 $63 million, and Kamine IPP buyout costs $105 million." He further states on the same page that "The Commission has approved RG&E's request to defer and recover the above costs". Lastly, in the Joint Proposal associated with RG&E Case 03-E-0765, section XV.2.c clearly states "The outstanding petition in Case 96-E-0898 associated with RG&E's deferral of the net costs and loss associated with the Oswego Unit 6 sale is resolved". Given the evidence noted above and the

previous Commission actions with respect to this item, to not allow collection of these deferred costs from customers is inappropriate.

20. Allegheny Buyout (RG&E Electric) – Mr. Haslinger, on page 35 of his testimony, correctly identifies this item as related to the buyout of a Non-Utility Generator purchase power contract. Under the now infamous "6 cent law" an entity chose to build this gas-fired generating plant at a cost per MW capacity far higher than current market prices could support, and RG&E was required to enter into a purchase power contract with that entity. When the entity went bankrupt, RG&E was ordered by the Commission to buy the plant at a price in excess of $100 million, while at the same time told it could only put $15 million of the purchase price on its books as a capital investment (an approximation of the "true" market value for the plant). <u>See</u> Case 96-E-0898, Order and Decision (August 31, 1998). The remaining price paid by RG&E was placed on its books as a regulatory asset. This cost related to state policy/practice ordered by the Commission should not have to be borne by the Company. To not allow collection of these deferred costs from customers is inappropriate.

21. Russell and Beebee Decommissioning (RG&E Electric) – Mr. Haslinger states, starting on page 35, that these amounts are to fund future decommissioning costs of retired RG&E generation plants. Based on long-standing Commission practice and policy, there is no reason that customers should ever be relieved of their obligation to fund the decommissioning of plants which provide many decades of service and low priced power to them. With respect to Beebee decommissioning, RG&E is accounting pursuant to an Order in Case 02-E-0198. Ordering paragraph 9 of the March 7, 2003 order in that case states "Rochester Gas & Electric shall accrue $2 million annually to fund the decommissioning of Beebee Station." The text of the Order notes, on page 20 that "RG&E argues that it is unreasonable to ignore the fact that the facility will inevitably be decommissioned" and goes on to conclude that "We also find the Beebee decommissioning fund reasonable…and such a fund should be accumulated in advance to avoid an undue rate impact later." With respect to Russell decommissioning, the current RG&E rate plan joint proposal clearly contemplated that customers would be responsible for the costs of decommissioning the facility. For example, Section V.4.b.iv states "any costs related to Russell continuing after its retirement (property taxes, residual O&M, <u>**decommissioning**</u> [emphasis added] and remediation) will continue to be recovered through the NBC". To not allow collection of these decommissioning costs from customers is inappropriate and contrary to Commission orders.

Q. Are there any additional problems with some of the PBAs discussed above?

A. Yes, we discuss below more detailed issues associated with the RG&E Voice Your Choice.

2. <u>Environmental Reserve Increases</u>

a. <u>General Background</u>

Q. Referring to Exhibit ___ (JB-4), the Staff's PBA for environmental is called a "Regulatory Asset Cost Elimination". On Exhibit ___ (RPH-4), the corresponding PBA is referred to as a contribution to an "Operating Reserve". Is there any practical difference between the two terminologies?

A. No. Regardless of which term is used, the effect of the imputed pre-funding by the Companies would be a charge to Income with a corresponding amount reserved on the Balance Sheet to cover the future cost for the remediation of existing environmental liabilities.

Q. Please briefly explain how environmental costs are accounted for at RG&E and NYSEG?

A. The basic accounting is as follows:

1. The estimated potential cost of known environmental liabilities is credited to a liability.
2. A corresponding amount is debited to a regulatory asset consistent with long-standing Commission direction.
3. As funds are received from customers, insurance companies or other responsible parties, they are credited to the regulatory asset.

4. As the environmental remediation work is performed, the liability is reduced.

   Based on this accounting, at any point in time, the balance in the environmental regulatory asset shows the remaining amount that needs to be recovered from customers, insurance companies or other responsible parties and the balance in the environmental liability shows the remaining amount of environmental work that needs to be performed. Ultimately, the regulatory asset will go to zero as funds are received and the environmental liability will go to zero as the environmental work is performed. In the meantime, since the timing of the receipts and outlays may differ, there may be a net debit or credit balance between the environmental regulatory asset and liability. The net difference constitutes the Environmental Reserve.

5. To recognize the time value of money, it is customary that either interest be accrued on the (net-of-tax) difference between balances in the environmental regulatory asset and liabilities or that the (net-of-tax) difference between the asset and liability be added to, or deducted from, rate base.

These steps provide a basic outline of how environmental costs are accounted for at NYSEG and RG&E. While the actual accounting includes more steps and involves a number of asset and liability accounts, the net effect is as described.

Q. What are the sources of funding for environmental remediation?

A. There are three sources of funding for environmental remediation:

1. Retail rates,
2. Insurance company proceeds and
3. Other responsible parties.

Q. Does reserve accounting differ materially from the accounting described above?

A. No. The same effect is achieved. While reserve accounting might involve the use of different income or balance sheet accounts, the bottom-line on the income statement remains the same and the net effect on the balance sheet remains the same.

b. Rate Recovery from November, 2007 through December, 2008

Q. Referring to Exhibit __ (RPH-4), please explain what the environmental PBA adjustments, in the amounts of $36.738 million Electric & $15.745 million Gas, represent.

A. The sum of those adjustments is equal to the remaining $52.483 million balance in the regulatory asset that is on RG&E's books at November 30, 2007.

Q. To the extent that it was proper to require the Companies to pre-fund the environmental clean-up costs, are those the correct amounts to require RG&E to add to the Environmental Reserve on December 31, 2007, as suggested by Exhibit ___ (RPH-4)?

A. No. Staff has not recognized the fact that the current RG&E Rate Plans provide for $1,400,000 Electric and $600,000 Gas to be added to the Environmental Reserve annually. Accordingly, an additional $2.167 million will be added to the Environmental Reserve between November, 2007 and December, 2008, reducing the regulatory asset by a corresponding amount.

Q. Referring to Exhibit ___ (JB-4), please explain the source of the Regulatory Asset Cost Eliminations for Environmental - SIRC, in the amounts of $88.906 million Electric & $23.491 million Gas.

A. At page 22, lines 1 through 4 of his testimony, Mr. Benedict states that those amounts, are "the allocated amounts of the deferred environmental clean up expense balance at November 2007".

Q. To the extent that it were proper to require the Companies to pre-fund the environmental clean-up costs, are those the correct amounts to require NYSEG to add to the Environmental Reserve on December 31, 2008, as suggested by Exhibit ___ (JB-4)?

A. No. Similar to RG&E, the current NYSEG Electric Rate Order provides for $3.5 million and the current NYSEG Gas Rate Plan provides for $1.25 million to be added to the environmental reserve annually. Accordingly, an additional $5.146 million will be added to the environmental reserve between November, 2007 and December, 2008, reducing the regulatory asset by a corresponding amount.

c. <u>Rate Base Treatment</u>

Q. Did Staff reduce rate base by the amount of the imputed environmental PBAs?

A. Yes. Of course, because Staff has failed to justify the appropriateness of the PBAs, reducing rate base by the amount of the imputed environmental PBAs is inappropriate and should be rejected.

Q. Has this panel commented on the rate base treatment of the imputed Environmental PBAs?

A. Yes. In section III, C.5 we discuss the rate base treatment of all of Staff's PBAs.

3. <u>Outreach and Education – RG&E Voice Your Choice</u>

Q. Do you take issue with Staff witness Haslinger's proposal to adjust as a PBA the outreach and education ("O&E") costs associated with RG&E's Voice Your Choice ("VYC") program?

A. Yes. As discussed earlier in this testimony, the Company takes issue with each and every one of the Staff proposed PBAs. With respect to this item, the current RG&E Electric Rate Plan allows the Company to defer Voice Your Choice related O&E over a $2 million base amount.

Q. What is Staff's basic argument with respect to this issue?

A. Staff's basic argument, from page 21 of Mr. Haslinger's testimony, is that the $2 million identified in the RG&E Electric Rate Plan Joint Proposal represents the amount "expected to spend over the entire five year term". He continues on page 22 to state "The $2 million was a guideline for reasonable "required" outreach and education over the five year period of this agreement".

Q. Is there any indication in the Joint Proposal or the PSC Order associated with the RG&E Electric Case 03-E-0765 that the $2 million was a five year guideline or the expected amount to be spent over five years?

A. No. In fact, the Joint Proposal clearly anticipate that spending could exceed the $2 million amount, referencing section XV.3.e.iii, "To the extent that RG&E is required to spend more than $2 million for this purpose, RG&E may defer those incremental costs for future recovery". Appendix N of the Joint Proposal describes the mutually agreed upon approach to O&E for the VYC program.

Q. Was Staff involved in the development of Appendix N?

A. Yes.

Q. What are the main O&E activities identified in Appendix N that RG&E was required to do?

A. Required VYC O&E activities identified in Appendix N include:

1. Provision of information through the Call Center
2. Provision of information through the integrated voice response system
3. Inclusion of information on bill inserts and in bill messages
4. Update of the Company website to include enrollment via the web
5. Radio, newspaper and television media campaigns
6. Community events
7. Direct mail distribution of enrollment kits and enrollment confirmations
8. Conduct of customer surveys
9. Special messaging for certain customer groups (Seniors, Low Income, Retail Access participants, Commercial and Industrial customers)
10. Meetings with suppliers
11. Employee training
12. Meetings with community leaders

Q. Did RG&E work closely with Staff and other parties in the development of the annual enrollment kits and O&E plans?

A. Yes. Numerous meetings were held annually with PSC Staff as well as other parties to review the O&E efforts. During the first three years of the program, the Company worked closely with Staff from the Office of Retail Market Development and conducted several collaborative meetings to develop, review and discuss the O&E materials. Drafts of the enrollment kits were circulated, discussed and revised based on input from Staff and other parties in the meetings. Copies of all O&E materials, including television ads, radio ads, print ads, billboards, bill messages, bill envelopes, bill inserts, internet pages, outbound calling scripts, and IVR scripts were circulated to Staff and other parties before going into production. Because the Office of Retail Market Development was disbanded in early 2007, the Company made the Staff of the Office of Consumer Services aware of the O&E activities for the fourth year of the program.

Q. Did RG&E provide annual reports to Staff of the O&E activities taken following the completion of each enrollment period?

A. Yes.

Q. Did you receive any indication before Mr. Haslinger's testimony in this instant proceeding that Staff was not satisfied with the level of the Company's VYC O&E efforts?

A. No. In fact, it was just the opposite. Many positive comments were received from Staff regarding the O&E materials and efforts.

Q. Were there any other goals of the O&E program that should be discussed?

A. The Staff and the Commission expressed on numerous occasions that there was a strong desire to see migration of customers to non-regulated Energy Services Companies (ESCOs). For example, in Appendix N to the Joint Proposal, the first objective of the program is listed as "(To) educate customers that they may choose a supplier other than RG&E and that customers may purchase their supply separate from their delivery". In the PSC order associated with Case No. 03-E-0765, the Commission stated on page 37 "our competitive goals include … the development and facilitation of business relationships between utilities and ESCOs, and the fostering of retail access".

Q. In meeting the requirements delineated in Appendix N to the Joint Proposal, is it by any stretch of the imagination reasonable to conclude that $2 million would have been an adequate amount to cover five years' worth of related O&E expenditures?

A. No. Keep in mind that RG&E electric customers number approximately 350,000, and each one required multiple contacts for each year of the program. For the first four years of the VYC program, the costs of the production of the enrollment kits, the direct mailings, and the confirmation letters to customers approximated $2.7 million, with one additional year to go in the rate plan. The required media spending on radio, newspaper and television over the first four years was approximately $1.8 million. Additional costs to update the website and IVR system, conduct community outreach, conduct customer surveys, and attend to other requirements listed in Appendix N, while still trying to support the overall goals and objectives of the program contributed to the deferral that exists on the RG&E books today. It is beyond reason to assume that the intent of the $2 million amount was to cover all required costs for five years.

Q. Was the program successful with respect to the number one objective of fostering retail access?

A. Without any doubt. The awareness that was created in the customer community through this VYC O&E effort has resulted in an increase of nearly 40,000 RG&E customers being served by ESCOs, more than doubling the pre-program level. The overall load serviced by ESCOs as of the end of 2007 is nearly 50%, significantly above the pre-program levels.

Q. What can you conclude with respect to the VYC O&E program costs?

A. We conclude that they were reasonable given the size of the RG&E customer population, were reasonable given the requirements delineated in Appendix N of the RG&E rate plan joint proposal, were appropriately deferred under the terms of the RG&E rate plan, and were successful in accomplishing stated Commission goals. We therefore completely disagree with the Staff proposal that they be written off and absorbed by the Company at this time. Additionally, any O&E

costs associated with the VYC program going forward should be appropriately deferred under the terms of the rate plan.

4. <u>Staff's Additional One Time Adjustments</u>

Q. Can you please describe each of the Staff proposed additional one-time adjustments and the reasons why this panel finds them unacceptable and inappropriate?

A. Yes. The following is a description of additional one-time adjustments in the order depicted on Exhibit (RAP-2), and the reasons why this panel finds them inappropriate and unacceptable.

1. Capitalized Software (NYSEG Electric, NYSEG Gas) - Staff has proposed that both companies write off certain capitalized software investments. Mr. Benedict, starting on page 17, suggests that NYSEG Gas should be required to write off certain software investments allocated to the gas business that were ordered to be written off in the last NYSEG electric case. While the Company still maintains that the investments made in the IBO and WMS systems were valid, the Company also recognizes the Commission decision made in the NYSEG Electric case, although no such requirement was ordered for NYSEG Gas. The effect of applying that same decision to the NYSEG Gas business (whose current rate plan extends to the end of 2008 and is subject to continuation) is nearly moot, considering that the investments in those specific systems will nearly be fully depreciated by the end of the gas rate plan, and either one of these projects was in service or reflected in the current NYSEG Gas Rate Plans and therefore should not be considered here. Mr. Benedict goes further to suggest that NYSEG Electric and Gas should be forced to write off the software investment in a new Customer Care System ("CCS"). This issue was resolved in the last NYSEG electric rate case. It appears that the PSC Staff does not want to acknowledge this most recent PSC Order and intends on relitigating the issue. Mr. Benedict's untimely argument that the customers have paid for the cost of a new system twice is groundless. Any adjustment should be disregarded.

2. Capitalized Software (RG&E Electric, RG&E Gas) – Mr. Haslinger, on page 31, states that in the latest NYSEG rate case, the Commission has deemed the capitalized software a Cost-to-Achieve item. He concludes that it would be appropriate to treat RG&E's capitalized software in a similar fashion. Mr. Haslinger fails to distinguish between the types of software that the Commission addressed in the NYSEG Electric case, thereby failing to factor in the full Commission decision, particularly with respect to the CCS investment made at RG&E. Additionally, RG&E has a long history of capitalizing software investments, and those investments have always been accepted by the PSC. The adjustment proposed by Mr. Haslinger would represent a complete turnaround from RG&E history on this subject and should be ignored. This topic is more fully discussed in section III.F.4 of this rebuttal.

3. ASGA Adjustments – ACF (NYSEG Electric) – Mr. Benedict includes an Exhibit JB-7, which depicts an annual list of adjustments he proposes be made to the ASGA. While he spends several pages of testimony (page 8 and pages 36-40) on this topic, very little information is provided beyond the total amounts shown on Exhibit JB-7. NYSEG supports the annual compliance filings that it has made, and would expect that any adjustment proposed by Staff would be afforded the highest degree of scrutiny once relevant information is provided. Since that information has not been provided, it would be premature at best and inappropriate to consider any adjustments to the ASGA. As noted elsewhere in this rebuttal, the timeliness of Staff audits and reactions to the Company's compliance filings are problematic and should be addressed by the Commission in a separate proceeding.

5. <u>Additions to Reserves</u>

Q. Please quantify the amount that the Companies would be required to add to reserves based on Staff's proposed PBAs.

A. As shown on Exhibit RRP-2, $311.407 million of the PBAs proposed by Staff are to fund reserves.

Q. What is the source of the amounts on Exhibit __ (RAP-2)?

A. Staff Exhibit __ (JB-4) and Exhibit __ (RPH-4).

Q. How did Staff treat the $311.407 million of PBA Company contributions to the reserves in its calculation of the revenue requirement on its Exhibits?

A. As shown on Exhibits __ (JB-3) and (RPH-3), Staff reduced rate base by $305.990 million of the proposed Company contributions ($184.772 million, net of tax). According to Staff, the remaining $5.417 million is to be added to the Asset Sale Gain Account where it would accrue interest.

Q. To the extent that it would be appropriate to require Company-contributed capital to be used to fund reserves, would it be equitable to reduce rate base, as Staff did in its calculation of the revenue requirement?

A. No.

Q. When would it be equitable to reduce rate base by, or require that interest be accrued on, the amounts in a reserves?

A. It is normal and equitable to reduce rate base by the amount of <u>customer</u>-contributed capital that is in the reserves so that the customers receive the time-value of their contributions until the reserves are used to fund the cost for which it was intended. Alternatively, interest could be accrued on the customer-contributed capital in the reserve.

Q. When is it <u>NOT</u> equitable to reduce rate base by, or require that interest be accrued on, the amounts added to reserves?

A. It is not equitable to reduce rate base by, or to require that interest be accrued on, Company-contributed capital. Such actions would result in a back-door way of extracting even more from shareholders than was intended by the PBAs.

Q. What other reason can you give for why the Company-contributed PBA additions to the Reserves should not be used as rate base reductions?

A. The compelling argument against reducing rate base by any PBA reserve contributions made by the Companies is that the shareholders should not be penalized by having to pay for a return on their own contributions. In addition, such rate base reductions would assume that none of the Company-funded reserves would be used for their intended purposes. Indeed, for many of the reserves, that would not be correct. The Companies are spending millions annually for Environmental remediation alone and a significant amount of money is also spent on Stray Voltage. Furthermore, if Staff believes that it is necessary to add more to the storm reserves, then it is reasonable to assume, for revenue requirement purposes, that part of the Company-contributed capital in the storm reserve will be spent. Finally, amounts will definitely be spent for decommissioning at either Beebee or Russell Stations.

Q. What adjustment should be made to the Staff rate bases to address this issue?

A. First, we disagree with all of Staff's PBA imputations and they should be rejected. However, to the extent that they are considered at all, at a minimum, the reductions to the rate bases that Staff made for Company-funding of the reserves should be reversed. The rate base adjustments for all of the reserve items are set forth on Exhibit __ (RAP-7). That Exhibit also includes the corresponding deferred tax offset calculated at 39.615% of the reserve amounts.

Q. Please summarize your testimony concerning the PBAs and other one-time adjustments that Staff has proposed in connection with approval of the acquisition?

A. As discussed by other panels, we disagree with the need to create PBAs in the context of this merger proceeding. To the extent the Commission considers any of the Staff PBA proposals, such proposals must ultimately be rejected because as we have demonstrated above Staff's PBAs are expressly contrary to existing Commission precedent and/or the terms of currently-effective rate plans and orders.

IV. RESPONSE TO STAFF'S RATE PLAN TESTIMONY

Q. Are Staff's rate proposals appropriate and equitable given NYSEG's and RG&E's existing rate plans and orders?

A. No. As an initial matter, as we discussed above, it is not appropriate for the Staff to introduce, in piecemeal fashion, downward adjustments to rates in a Section 70 proceeding to consider the approval of this transaction. By responding here on the merits of Staff's proposals, we do not concede that Staff's testimony has any relevance to the issues in this proceeding or that, even if such issues were relevant, it is appropriate to selectively introduce them here. Nonetheless, because Staff has raised these issues in testimony, we are required to respond, and we explain below that Staff's proposal should be rejected because the existing rates for NYSEG and RG&E were established either under Joint Proposals (NYSEG Gas, RG&E Electric, RG&E Gas) or a one year rate order (NYSEG Electric). Staff's proposal to significantly modify these existing rate plans and orders is inappropriate outside the context of a litigated rate case and review of rate-case quality information. While Staff proposes to modify the gas and electric rates for NYSEG and RG&E, they have made no attempt to comply with the Commission's usual procedures for considering rate changes, including complying with the requirements of the <u>Statement of Policy on Test Periods in Major Rate Proceedings (November 23, 1977) which sets forth the basic ground rules for information to be provided in rate case proceedings.</u> NYSEG's electric rates were set after an intense eleven month litigated cost of service rate case. In that rate case, all financial issues were closely scrutinized and vigorously litigated and NYSEG's existing rates remain in place until NYSEG files for a new rate case. NYSEG Gas, RG&E Electric and RG&E Gas rates are governed by multi-year rate plans. We do not believe that it is appropriate or realistic to seek to modify NYSEG's and RG&E's existing rate plans and orders or impose drastic write-offs and rate reductions in the context of the merger proceeding. Furthermore, as one would expect, shareholder write-offs of legitimate assets and shareholder funding of reserve increases artificially reduce the cost to serve customers at shareholder expense. Shifting this financial burden to shareholders distorts existing rates and return levels, and using such one-time charges to create long term impacts through increased earnings sharing or rate reductions is clearly inappropriate.

Q. If not appropriately addressed in the context of the merger proceeding, where would any rate issues be addressed?

A. To the extent that Staff believes that adjustments to the existing rate plans or rates of the New York utilities are required, such rate-related issues should be addressed in a later proceeding. The outcome of such dedicated, separate rate case proceedings, however, should not be pre-determined by this merger proceeding but should be assessed at a later date under applicable Commission precedents and policies.

A. <u>NYSEG Electric Rates</u>

Q. Does NYSEG's Electric Business operate under a rate plan?

A. No. NYSEG's electric rates were established in Case No. 05-E-1222 for the rate year 2007. That case was a traditional cost of service rate case. There are no rate plan provisions since rates were not set for a multi-year period. All financial and policy issues were fully litigated and NYSEG electric rates will remain in place until the Company files for a new rate case and new rates are approved by the Commission. As discussed later in this testimony, Staff's proposal to require multi-year rate plan provisions in this case is inappropriate and unwarranted.

NYSEG's electric business just completed its first year of operations under new rates. Furthermore a full cost of service and financial analysis is necessary before the rate of any utility can be reset.

Q. Do the delivery rates for NYSEG Electric remain in place beyond 2007?

A. Yes.

Q. What are the Staff’s proposed NYSEG Electric rate plan provisions?

A. On pages 24 – 26, Staff has proposed three rate plan provisions for NYSEG electric that would: (1) implement a revenue decoupling mechanism; (2) implement uncontrollable cost provisions similar to NYSEG Gas, but with thresholds modified to be equal to 50 basis points or $4.1 million; and (3) implement an ESM over 9.0% ROE where sharing is capped at an 11.00% ROE. As discussed later in this testimony, the implementation of the rate plan provisions in this merger proceeding is neither just nor reasonable.

B. <u>NYSEG Gas</u>

Q. Has Staff appropriately characterized and reviewed the NYSEG Gas Rate Plan?

A. No. Mr. Benedict provides a cursory overview of a detailed NYSEG Gas Joint Proposal. The NYSEG Gas Joint Proposal (“JP”) contains thirty-one sections and nine appendices covering numerous topics. The Gas JP was signed by 15 parties, including Staff, CPB, MI and numerous marketers, and Mr. Benedict was on the Staff team that negotiated and executed the JP.

Q. What is the term of the NYSEG Gas JP?

A. Section VI (Term) provides that the Phase 1 provisions (as delineated in Section IIII) became effective on October 1, 2002 and continue for a term of six years, three months through December 31, 2008. The Phase 2 provisions became effective July 1, 2004 and unless otherwise provided, also continue through December 31, 2008.

Q. Does the NYSEG Gas JP contain language regarding the continuation of the plan beyond December 31, 2008?

A. Yes. Section VI.(2) states that all Gas Rate Plan provisions shall continue beyond December 31, 2008 unless or until a new gas rate plan has been approved by the Commission.

Q. Does the NYSEG Gas Rate JP contain any provision regarding future mergers?

A. Yes. Section XXXI (4) addresses mergers and acquisitions. The provision states that in the event of a merger which is subject to a Petition filed jointly or individually by NYSEG, RG&E, RGS or Energy East, the terms of the NYSEG Gas Rate Plan will survive any such merger. The provision goes on to state that any Commission proceeding addressing such merger will establish the conditions of such merger and may include the disposition of incremental net synergy savings to the extent there are any savings.

RATE ADJUSTMENTS PANEL

Q. Does Mr. Benedict's proposal violate Section XXXI (4) of the NYSEG Gas JP?

A. Yes, it does violate the term of the JP by requiring fundamental changes to the rate plan that are unrelated to incremental net synergy savings.

C. <u>RG&E Rate Plans</u>

Q. Has Staff appropriately described the RG&E Gas and Electric Rate Plans?

A. No. Mr. Haslinger presents only a brief overview of RG&E's Gas and Electric Joint Proposals. The RG&E Gas JP includes twenty-two multi-part provisions and eight appendices, and was agreed to by six parties. The RG&E Electric JP contains 22 multi-part provisions and 15 appendices, and was agreed to by eight parties.

Q. What are the terms of the RG&E Gas and Electric JPs?

A. Section III (Term) of both JPs provides that, except as otherwise noted, the provisions of the JP become effective January 1, 2004, and continue for a term of five years through December 31, 2008.

Q. Do the RG&E Gas and Electric JPs address continuation of the rate plan beyond December 31, 2008?

A. Yes. Under Section III (4) of both JPs RG&E may, after consultation with Staff, submit a filing by February 1, 2008, to continue the Gas and/or Electric JP beyond 2008.

RATE ADJUSTMENTS PANEL

Q. Does RG&E plan to make a filing to continue the Gas and Electric JPs?

A. Yes. RG&E has consulted with Staff and plans to file for a continuation of the Gas and Electric JPs on February 1, 2008.

Q. Do the RG&E Gas and Electric JPs contain any provisions regarding future mergers?

A. Yes. As with the NYSEG Gas JP, the RG&E Gas and Electric JPs include a provision (Section XXII (3)) that states that in the event of a merger or acquisition by RG&E, RGS Energy Group, Inc., or Energy East, the terms of the JP will survive any merger or acquisition. The provision also notes that the disposition of any "incremental net synergy savings" from such a transaction will be determined in the Commission proceeding addressing that transaction.

Q. In light of the NYSEG Gas JP, the RG&E Gas JP and the RG&E Electric JP, are Staff's rate and accounting proposals appropriate?

A. No. Staff seeks to modify fundamental terms of the three JPs unilaterally. These JPs were the result of extensive negotiations among a large and diverse group of parties and reflect settlement on a wide range of issues. Staff now proposes to unilaterally make significant changes to certain terms of the JPs – all of which would shift costs to shareholders and have an adverse financial impact on the companies. Under the provisions of each JP, the JP survives any subsequent merger or acquisition of Energy East. The Commission should not consider, in isolation and without rate-case quality information, any isolated modifications to the JPs as proposed by Staff. Considering Staff's proposal, outside of the context of a full rate proceeding, would unilaterally modify settlements reached by a variety of parties on a host of issues and further undermines the settlement process.

D. <u>Staff's Audits of Annual Compliance Filings</u>

Q. Has either NYSEG or RG&E received audit reports about Staff's audit efforts related to the annual compliance filings ("ACFs") filed under the two companies' most recent rate plans?

A. Neither company has received any formal audit reports related to any of their ACFs for the periods noted below. Despite the requirement that ACFs be made annually, Staff has apparently treated inappropriately such annual filings as multi-year filings to artificially build up an IOU to the customer and potentially have the Company accrue multiple years of charges and interest long after the final year of a rate plan is completed. Staff should be directed to review these annual compliance filings in a timely manner.

Q. How many ACFs have the companies made for which no formal feedback has been received?

A. NYSEG Electric has made five such filings for years 2002 through 2006, NYSEG Gas has made four such filings for years 2003 through 2006, RG&E Electric has made three such filings for years 2004 through 2006, and RG&E Gas has made three such filings for years 2004 through 2006. In addition, NYSEG Gas, RG&E

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Electric and RG&E Gas will make an additional annual filing for 2007 within the next few weeks. Once those filings are made, there will be 18 NYSEG and/or RG&E ACFs outstanding at the Commission.

Q. What reasons has Staff indicated for not providing feedback?

A. Mr. Benedict notes in his testimony on page 38 that the reason is "Staff has not formally presented its findings on NYSEG's electric rate plan ACFs to NYSEG or the Commission because the ACFs were not completed at the time of NYSEG's last rate case, nor have they been completed at this time". Mr. Benedict does not specifically provide a reason for no feedback on the NYSEG Gas ACFs. Mr. Haslinger notes his reason, covering both RG&E Electric and RG&E Gas, on page 12 of his testimony, that "Given the rate plans are on-going and the pattern of annual revisions to prior year's filings, Staff's audits are ongoing".

Q. Do these reasons comport with past practice of the Commission Staff?

A. No. For example, with respect to the RG&E rate plan that was effective during the period 1997 to 2002, Staff provided both the Company and the Commission with reports associated with RG&E's annual compliance filings long before the conclusion of the rate plan, even though that plan had a true five- year earnings calculation compared to the five, one-year calculations in the current rate plan.

Q. Why is it beneficial to have information related to Staff's audit findings associated with annual compliance filings on a timely basis?

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A. As discussed at length in the last NYSEG Electric proceeding, Case No. 05-E-1222, the companies are required to set aside amounts for ratepayers in the event of earnings sharing mechanisms being triggered. By raising issues more contemporaneously, the Company and Staff would have an opportunity to work out differences so that the amount associated with such an issue might not grow disproportionately. In addition, any necessary changes in method or approach could be incorporated in the next year's filing.

Q. Staff has argued that one primary reason no audit information is provided is the companies' tendency to update prior year filings. Does this seem reasonable?

A. No. It is important to update prior year information, especially when earnings sharing thresholds are involved, to assure that the proper amounts are set aside for customers or the proper amount of deferrals are reversed. Given the complexities involved in many areas of finance and accounting, it should be expected that prior year adjustments might take place. Staff even indicates that one very common prior year adjustment deals with truing up actual filed income tax data with estimated year-end data reflected in the ACFs (Staff witness Benedict page 38).

Q. Do external auditors typically audit financial records even if those records are subject to update or completion?

A. Absolutely yes. Many external financial auditors will begin year-end audit efforts long before the end of a fiscal year, and only subsequently audit changes to estimates or expected results after the end of the fiscal year. This makes the audit process less intense, and also provides the Company with early indications of issues that can be addressed before the end of a fiscal period. Additionally, every external financial auditor clearly understands that income tax estimates reflected on a company's books at the end of a fiscal year may change when more detailed work is done in support of the Company's actual tax return filing.

Q. Staff witness Benedict on pages 38 and 39, suggests that NYSEG is aware of Staff disagreements with certain of its computations via the informal data request process. Is this a reasonable conclusion?

A. In general, no. Mr. Benedict may have implied in some data requests that he is interested in obtaining information about a specific subject or type of cost, but absent an audit report from Staff, the Company does not know of the conclusions that have been reached by Staff. Deducing Staff's positions from information requests is not an exact science and certainly is not a practice Staff would rely on in determining the Companies' positions.

Q. In his response to Information Request IBER/EE No. DPS 90 in this instant proceeding, Mr. Benedict states "Staff has also informed NYSEG of at least two errors it has made in its filings, but the Company has failed to correct those errors in subsequent compliance filings or in subsequent revision." Does NYSEG have an audit report from Mr. Benedict relating his opinion on errors in ACFs?

A. No. NYSEG has received no such report, which would be the appropriate vehicle to inform a company that Staff believes there is an issue with an ACF.

Q. Does Staff mention anything in its testimony in this current case regarding ACF related adjustments?

A. Yes. A few examples are noted in Mr. Haslinger's testimony and exhibits, and Mr. Benedict includes an exhibit which totals his calculation of electric adjustments. Both of these areas will be addressed later in this rebuttal.

E. <u>Staff's Rate Of Return Calculations</u>

1. <u>NYSEG Electric</u>

Q. Are Staff's rate of return calculations for NYSEG Electric accurate and consistent with the Commission's order in Case 05-E-1222?

A. No. Mr. Benedict offers an inaccurate and skewed calculation of NYSEG's 2006 ROE, allegedly based upon the "approaches" used by the Commission to set rates in Case 05-E-1222. Referring to Exhibit __ (JB-2), Schedule A, Staff's analysis begins with a column labeled "Commission Decision 2007", but the numbers contained in that column do not match the Commission's decision in Case 05-E-1222. For example, Sales Revenues in the Order are shown to be $586,673 million and Mr. Benedict's Exhibit shows $587,960 million. Staff's calculation of NYSEG's Electric 2006 ROE is also overstated because Staff removes commodity uncollectible expense but includes the comparable merchant function charge revenues.

Q. Is Staff's approach consistent with the Commission Order in Case No. 05-E-1222?

A. No, it differs in many respects. For example, Staff proposes an adjustment for software related to the Customer Care System ("CCS) based upon its litigation position and testimony in NYSEG's last electric rate case, not based on the Commission's final order. Staff's testimony in this case, as it did in Case 05-E-1222, alleges that NYSEG failed to request a change in accounting to capitalize software and continues to seek to penalize the Company for its accounting of CCS that was reviewed and accepted by the Commission in the Company's last rate case.

2. <u>NYSEG Gas</u>

Q. Is Staff's calculation of a 2006 ROE for NYSEG Gas accurate and appropriate?

A. No. As with its calculation of the NYSEG Electric ROE, Staff makes selective and one-sided adjustments which inflate the calculated ROE. For example, Staff eliminates recovery of certain costs such as incentive compensation, yet Staff makes no adjustments for cost increases or rate base increases that NYSEG will experience prospectively. Examples of such costs increases include labor cost, inflation, property taxes, depreciation, and capital expenditures. Staff also eliminates the Gas Cost Incentive Mechanism ("GCIM"). As discussed in more detail later in this rebuttal testimony, the GCIM was a provision that was integral to NYSEG's Gas JP, provides appropriate incentives to lower gas costs and was specifically bargained for by NYSEG, accepted by Staff and approved by the Commission. Elimination of the GCIM is inappropriate and produces an artificially high ROE. Finally, Staff makes adjustments to remove NYSEG's capitalized software which is inappropriate.

3. RG&E Electric

Q. Is Staff's calculation of a 2006 ROE for RG&E Electric accurate?

A. No. As with the NYSEG Gas calculations, Staff removes recovery of certain expenses such as incentive compensation and uncollectibles associated with commodity sales, and fails to reflect any cost increases or rate base increases. As explained below, Staff also makes an erroneous adjustment relating to capital software for both RG&E Electric and Gas.

4. RG&E Gas

Q. Is Staff's calculation of a 2006 ROE for RG&E Gas accurate?

A. No. In calculating a 2006 ROE for RG&E Gas, Staff inappropriately eliminates incentive compensation and GCIM, while ignoring cost increases and rate base increases, producing a skewed and inflated ROE.

F. Specific Rate Plan Issues

1. Application of Pension Policy Statement

Q. Does Staff comment on the applicability of the PSC's Statement of Policy on Pensions and OPEBs ("PPS")?

A. Yes. Staff witness Benedict, on page 19, states that "after incorporation of NYSEG's gas OPEB reserve in rate base, that all other aspects of the

Commission's Statement of Policy on Pensions and OPEBs apply to both NYSEG and RG&E except for the accrual of interest and the expense true-up provision".

Q. Do you agree with Mr. Benedict's statement?

A. No. The PPS currently applies to the NYSEG Electric business based on the resolution of issues in Case 06-M-1413, and the application of the PPS to that business is as Mr. Benedict has stated. Mr. Benedict paints with too broad a brush when he then includes NYSEG Gas as well as RG&E Electric and Gas in his statement.

Q. Do you agree that treating the NYSEG gas-related OPEB reserve as an offset to rate base could be appropriate?

A. Yes. However, this treatment would require specific Commission approval as it is a departure from the current practice and the way rates have been set.

Mr. Benedict has nevertheless reflected the impact of this change as an adjustment to O&M on his Exhibit __ (JB-3), Schedule B, Page 1.

Q. Do you agree that the simple change of treating the NYSEG gas-related OPEB reserve as an offset to rate base automatically triggers some domino effect whereby the expense true-up provision under the Statement of Policy becomes moot for both OPEBs and Pension as suggested by Mr. Benedict's testimony?

A. Clearly not. There are more ramifications to Mr. Benedict's statement than meets the eye. For example, as discussed below, under the terms of the Gas JP approved by the PSC in Case No. 01-G-1668, the NYSEG Gas business currently conforms to the PPS for pensions, except that it limits its true up of pension cost to only those changes that result from a change in the assumed return on assets and the assumed discount rate. In that same JP, the NYSEG gas business is specifically exempted from the true-up provision of the PPS for OPEBs.

Q. Why is this issue relevant?

A. As noted in Mr. Benedict's Exhibit __ (JB-4), one of the so-called PBAs for the NYSEG Gas business proposed as a condition of the Proposed Transaction is an adjustment of $24.9 million for "Gas Pension Deferral". While Mr. Benedict proposes that the Company absorb this $24.9 million that was appropriately deferred under the applicable true-up provision noted above, he fails to then apply the financial impact of his statement regarding forward applicability of the PPS except for true-ups on his financial schedules.

Q. With respect to RG&E, what is the current practice followed by the electric and gas businesses regarding the PPS?

A. According to the terms of the current PSC approved electric and gas rate plans, the PPS applies in full to both businesses, with the only exception being the inclusion of the OPEB reserve in rate base.

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Q. Do any of Mr. Haslinger's exhibits or testimony reflect the financial impacts of applying Mr. Benedict's statement regarding no longer truing up pension and OPEB costs at RG&E?

A. No. Based on this inconsistent treatment within the Staff's testimony and exhibits for RG&E and for NYSEG Gas, the proposed modification indicated on page 19 of Mr. Benedict's testimony should be disregarded.

2. <u>NYSEG Gas Pension Deferral Rebuttal</u>

Q. Please discuss Mr. Benedict's proposal to eliminate the gas pension deferral on page 34 of his testimony.

A. Section XVIII of the NYSEG Gas JP provides that a true-up for pensions will be limited to the incremental or decremental financial market changes from the assumed 9.0% return on assets and the 6.75% discount rate. Beginning in 2003 and every year thereafter, NYSEG's actuaries have calculated the gas pension deferral. NYSEG submits its gas pension deferral calculations and work papers to Staff in its annual compliance filing. The NYSEG gas pension deferral in 2006 was $6.5 million. Thus, gas customer rates reflect pension income that is $6.5 million higher than actual pension income. This amount is significant for the gas business equaling 14% of gas earnings or 139 basis points on equity using the Company's 2006 annual compliance filing rate base and equity.

Q. Did Staff adjust its gas revenue requirement to reflect its proposal to eliminate future gas pension deferrals?

A. No. Staff fails to reflect the elimination of the gas pension deferral in its gas revenue requirement. The impact of the pension deferral increase to 208 basis points based on Staff's Exhibit __ (JB-4), using Staff's lower rate base and equity. Staff has overstated the NYSEG Gas ROEs by 208 basis points because it failed to adjust operating expenses to reflect its recommendation to eliminate deferred accounting for gas pension costs. Staff's rate of return schedules are incorrect and misleading.

Q. Does the Company agree with Staff's proposal to eliminate the NYSEG Gas pension deferral?

A. No. Deferred accounting for pension costs is provided for in the PPS and the Gas Joint Proposal. Staff has proposed to eliminate the gas pension deferral. This proposed rate plan modification is inequitable and should not be permitted.

3. <u>Commodity Uncollectibles</u>

Q. Did Staff propose to remove commodity uncollectibles in its calculation of NYSEG's ROE?

A. Yes.

Q. Referring to Exhibit __ (JB-2), Schedule B, did Mr. Benedict, who sponsored that exhibit explain in his testimony why he made adjustment 1-a to "remove commodity uncollectibles" in the amount of $5.617 million from operating expenses?

A. No.

Q. Do you agree with the adjustment?

A. No. Mr. Benedict only made one side of the adjustment. These expenses are not gone, it is just geography. The uncollectibles that he removed are recovered through the Merchant Function Charge ("MFC") that was implemented as part of the last NYSEG Electric Rate Decision. The associated MFC Revenue is included in the $588 million of Sales Revenue from the last rate Order that Mr. Benedict used as a starting point for his Revenue Requirement calculation on Exhibit __ (JB-2).

Q. What is the impact of Mr. Benedict making only half of the adjustment?

A. By failing to remove the corresponding amount of MFC Revenue from Sales Revenue to match the removal of the Uncollectibles from O&M expense, the returns in the "As Adjusted by Staff" columns on Exhibit __ (JB-2) are overstated and the negative Revenue Requirement Adjustment is overstated (too negative) by the same $5.617 million.

Q. What is your recommended adjustment to correct this mismatch?

A. The simplest fix is to reverse the O&M expense adjustment and leave both the Uncollectible expense and the matching MFC Revenue in the calculation. Alternatively, an adjustment must be made to remove the Uncollectible portion of the MFC revenues from the Sales Revenues, before the Staff earnings sharing amounts are calculated or the "Revenue Requirement Adjustment" (rate reduction) is calculated.

Q. Does Exhibit __ (JB-2) include other MFC Revenues and costs?

A. Yes. The Sales Revenue and Operating costs in Exhibit __ (JB-2) both include matching amounts of approximately $18 million that are recovered through the MFC.

Q. Did Staff provide any backup to its $5.617 million adjustment to "remove commodity uncollectibles"?

A. No.

Q. Setting aside the fact that either O&M expenses should not have been reduced or a corresponding revenue adjustment should have been made, do you agree that $5.617 million represents the amount of Commodity uncollectibles that are in the O&M expenses per the Commission Decision in Case 05-E-1222?

A. No. As shown on Staff Exhibit (SECOSP-5) in the last NYSEG electric rate case, $4.008 million was identified as Commodity-related and included in the MFC.

Q. Did Mr. Haslinger make a similar expense adjustment in Exhibit __ (RPH-2)?

A. Yes. Mr. Haslinger reduced O&M expenses by $727 thousand "to remove the Commodity portion of Uncollectible Expenses".

Q. Did Mr. Haslinger provide support for that amount?

A. No.

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Q. How are Commodity Uncollectible costs recovered at RG&E?

A. Commodity Uncollectibles are recovered through the Non-Bypassable Charge ("NBC").

Q. Please explain where the NBC revenues are shown on customers' bills.

A. The NBC is shown on customers' bills as a Commodity component of the bill.

Q. Please explain where the NBC revenues are shown on RG&E Income Statements.

A. For accounting purposes, the NBC is split between Commodity and Delivery. The portions of the NBC relating to Uncollectibles and fixed generation are shown as Delivery revenue. The balance of the NBC that relates to Commodity costs is shown on the Commodity Income Statement.

Q. Why is the NBC relating to Uncollectibles and fixed generation are shown as Delivery revenue?

A. This accounting matches the revenues with the expenses and obviates the need to separate a myriad of expenses (including Uncollectibles) between Commodity and Delivery.

Q. Does the $370.608 million of Delivery Revenues that is shown in the first column of Mr. Haslinger's Exhibit __ (RPH-2) include the NBC revenues associated with Commodity Uncollectibles (and fixed generation)?

A. Yes. That amount was taken from RG&E's response to Data Request "IBER #218 (DPS-137). The backup to that data request response shows that Delivery revenues include $111.1 million of NBC revenue that was transferred from

Commodity to Delivery. The backup also shows that $1.8 million of the $111.1 million is Uncollectibles and the balance is fixed generation.

Q. Is Mr. Haslinger's adjustment "to remove Commodity portion of Uncollectible Expenses" correct?

A. No. The adjustment is inappropriate for a similar reason as is Mr. Benedict's NYSEG adjustment. Mr. Haslinger only made the expense side of the adjustment. The uncollectibles that he removed are recovered through the NBC, which is part of the Delivery Revenue in Exhibit __ (RPH-2). He did not make an adjustment to remove the corresponding amount of NBC revenues. As a result, the "As Adjusted by Staff" columns on Exhibit __ (RPH-2) are overstated and the negative Revenue Requirement Adjustment is overstated (too negative) by $727 thousand. To correct this error, either the expense adjustment should be reversed or a corresponding amount of NBC revenues should be removed from the revenues before earnings sharing amounts are calculated or the "Revenue Requirements Adjustment" (rate reduction) is calculated.

4. <u>Capitalized Software</u>

Q. Please summarize the adjustments that Mr. Haslinger made relating to Capitalized Software in the RG&E Electric and Gas Rate Bases and Revenue Requirement Exhibits ___(RPH-2) and ___(RPH-3).

A. Mr. Haslinger excluded 100% of RG&E's Capitalized Software, including IBO, WMS, and CCS from rate base and reduced Depreciation expense by the annual amount of depreciation that is accrued on capitalized software. The specific amounts of the adjustments were:

		Electric ($ 000)		Gas ($ 000)		Total ($ 000)
Depreciation	$	(4,865)	$	(2,620)	$	(7,485)
Net Plant		(39,703)		(21,379)		(61,082)

Q. On what basis did Mr. Haslinger justify these adjustments?

A. At page 31 of his testimony, Mr. Haslinger states:

In the latest NYSEG rate case (05-E-1222), the Commission deemed the capitalized software was a Cost-to-Achieve item of the merger of Energy East and RG&E. These Cost-to-Achieve expenses were to be written off by the end of 2008. We have removed capitalized software to reflect it as a cost to achieve in the same manner as the Commission ordered in the 2005 NYSEG electric rate case.

Q. In the NYSEG case, did the Commission deem that all Capitalized Software was a Cost-to-Achieve item of the merger?

A. No.

Q. Please describe the positions taken by Staff regarding Capitalized Software in the NYSEG Electric rate case and the decisions that were reached by the Commission.

A. NYSEG's Capitalized Software relates to three major projects: the Integrated Back Office ("IBO") and Work Management System ("WMS") and the Customer

Care System ("CCS"). For IBO and WMS, Staff argued that these costs were part of the costs to achieve the NYSEG/RG&E merger and, according to the 2002 Rate Plan, were to be fully amortized by the end of the 5-year rate plan (December, 2006). For CCS, Staff attempted to remove 50% of CCS on the grounds that part of the system might provide value to other Operating Companies. For all three, the Staff threw in the argument that NYSEG did not have permission to capitalize Software. In its Order, the Commission was persuaded by the cost to achieve argument that Staff presented for IBO and WMS but did not agree with Staff on the other grounds. Accordingly, 100% of the CCS project was allowed in rates.

Q. If Mr. Haslinger were to be consistent with the Commission Order in the NYSEG Electric rate case, what amounts of Capitalized Software should Mr. Haslinger have removed from the Revenue Requirement?

A. While not agreeing that any amount of Capitalized Software should be removed from rates, based on the Commission Decision, that Mr. Haslinger claims that he relied on, only IBO and WMS should have been removed. CCS and all other Capitalized Software should remain in the Revenue Requirement. The correct amount of those adjustments would be

	Electric ($ 000)	Gas ($ 000)	Total ($ 000)
Depreciation	$ (1,391)	$ (749)	$ (2,140)
Net Plant	(11,626)	(6,260)	(17,886)

Q. Setting aside the fact that CCS and other (non-IBO & WMS) Capitalized Software should not have been excluded from the Revenue Requirement in the first place, are there any other problems with the amount of the adjustments made by Staff to remove Capitalized Software from the RG&E Revenue Requirements?

A. Yes, there are. First, the amounts of the adjustments are overstated. Second, Staff failed to remove from the RG&E Rate Base the deferred tax credit that relates to the Capitalized Software that it removed.

Q. Can you explain why the adjustments are overstated?

A. We have not been able to fully reconcile all of the reasons for the overstatements because the adjustments exceed all of the RG&E Capitalized Software and Staff did not provide any backup to their calculations. Nevertheless, we can explain the apparent reason for much of the overstatements. The major reason for the overstatements by Staff of its adjustments appears to be that Staff did not consider the fact that RG&E CCS went into service in October of 2006. Staff appears to have removed a full year's worth of CCS depreciation from expenses and the rate base adjustment appears to have been calculated as if CCS had been in rate base all year. However, due to the plant going into service in October, only 2 months of CCS Depreciation were actually recorded in 2006 and the average 2006 rate base only included 2½ twelfths of the CCS Net Plant Value. Since Staff started with the 2006 RG&E regulated earning calculation and since that only included a partial year of costs and Rate Base amounts, those are the only amounts that Staff should have included in its adjustments (assuming that it were correct to remove CCS from the Revenue Requirement, which, it is not, based on the Commission Order.)

Q. Considering the facts that (a) CCS is a legitimate capital cost to be included in rates; (b) that RG&E's CCS went into service in October of 2006; and (c) that Staff was using calendar year 2006 data upon which it projected its forward-looking revenue requirements for RE&G, should Staff have made an adjustment to annualize CCS?

A. Yes. Proper ratemaking requires that normalizing adjustments be made for major capital additions such as CCS. Depreciation expense should have been increased by $1.523 million Electric and $820 thousand Gas and rate base should have been increased by $9.623 million Electric and $5.181 million Gas.

Q. Please summarize the adjustments that are needed to correct the RG&E Revenue Requirement for Staff's errors relating to Capitalized Software.

A. First, all of the Staff adjustments should be reversed. Second, the Depreciation and rate base should be increased to annualize the CCS costs. Third, if the Commission deems it necessary to exclude IBO and WMS, Depreciation expense and Rate Base should be reduced to exclude the cost of these items. All of these adjustments are summarized on Exhibit RAP-8.

5. RG&E Commodity Program

Q. Has Staff recommended changes to RG&E's Commodity Program?

A. Yes. Staff witness Haslinger has, on page 30 of his testimony, proposed that the RG&E commodity program be modified to be similar to the recently approved NYSEG commodity program. These modifications would include the reduction of the FPO conversion factor, a reconstructed earnings sharing mechanism that provides no downside risk to customers and shares any upside potential on the same basis as NYSEG's, and the adoption of other aspects of NYSEG's program.

Q. Does the Company accept Staff's recommendations?

A. No. The Commodity Program is one of the provisions that continues under the RG&E Electric Rate Plan. It is not appropriate to modify the commodity program in this proceeding. Similar to other staff rate plan modifications, this matter should be addressed in a separate subsequent proceeding.

6. Property Taxes

Q. What has Staff proposed with respect to RG&E property taxes?

A. Staff witness Haslinger, on page 38, line 10, of his testimony, has indicated that "property tax … would no longer be eligible for deferral treatment".

Q. What has been the experience of RG&E with respect to property tax costs?

A. Under the current rate plans, RG&E has been deferring property taxes above or below threshold amounts, that included a dead band and were based on a base year amount inflated at 4%, and included adjustments anticipating the sale of the

Ginna nuclear plant and the retirement of Russell fossil plant. In each year since 2004, the annual compliance filings made for RG&E property tax are summarized below:

Year	Business	Low End Threshold	High End Threshold	Actual	Deferral
2004	Electric	$36.636M	$38.515M	$37.4M	None
2005	Electric	$35.454M	$37.272M	$36.4M	None
2006	Electric	$36.872M	$38.762M	$39.872M	$1.11M
2004	Gas	$13.367M	$14.053M	$13.5M	None
2005	Gas	$13.902M	$14.614M	$16.405M	$1.79M
2006	Gas	$14.458M	$15.199M	$17.716M	$2.52M

Q. Did Mr. Haslinger, in concert with his proposal to eliminate the deferral of property taxes over or below a threshold amount, reflect property taxes at an appropriate level in his financial Exhibits __ (RPH-2) and (RPH-3)?

A. No. He ignored the realities of property tax cost being incurred and merely took the calendar 2006 high end threshold as the property tax amount for his schedules. Given that actual property tax has been exceeding the high end threshold in the last couple of years, and is expected to for the remaining two years of the rate plans, and certainly can be expected to increase in each subsequent year, Mr. Haslinger's approach has shortchanged the Company by at least $3 or $4 million annually.

Q. What should be done with Mr. Haslinger's carefully crafted proposal to not allow the Company to recover property tax costs?

A. It should be disregarded along with his proposal to treat the already deferred property tax costs as a PBA write-off.

7. <u>Stray Voltage Costs</u>

Q. What has Staff proposed with respect to RG&E stray voltage costs?

A. Staff witness Haslinger, on page 38, line 11, of his testimony, has indicated that "stray voltage costs … would no longer be eligible for deferral treatment".

Q. What has been the experience of RG&E with respect to stray voltage costs?

A. Under the current RG&E electric rate plan, the costs associated with implementing the terms of the newly mandated stray voltage program required by the Commission were appropriately treated as a deferrable item. RG&E incurred about $5.5 million in stray voltage costs which were deferred during the 2005 through 2007 period. Additional annual costs are expected to be experienced, as the Company has not been given any indication from the PSC that requirements associated with adhering to the requirements of the stray voltage mandate will be relaxed in the future.

Q. Did Mr. Haslinger, in concert with his proposal to eliminate the deferral of stray voltage costs, reflect those costs at an appropriate level in his Exhibit __ (RPH-2)?

A. No. He neglected to recognize the additional O&M costs that would be incurred to continue to meet the requirements of the stray voltage mandate, which by our calculation have averaged nearly $2 million per year, and in fact reached $2.4 million in calendar 2007.

Q. What should be done with Mr. Haslinger's proposal to not allow the Company to recover costs associated with the Stray Voltage mandate?

A. It should be ignored and the Company should still be allowed to defer any stray voltage costs incurred.

8. <u>NYSEG and RG&E Gas Cost Incentive Mechanisms</u>

Q. What is the Gas Cost Incentive Mechanism ("GCIM")?

A. The GCIM provides a sharing between customers and shareholders of gas cost savings derived from optimizing the Energy East utility companies' gas supply assets. There are two categories of GCIMs. The first gas supply cost savings category is GCIM 1 and relates to activities conducted by NYSEG Gas and RG&E Gas on a stand-alone basis and includes migration capacity release, non-migration capacity release, off-system sales and savings from local production. The second gas supply cost savings category is addressed by GCIM 2. GCIM 2 relates to gas cost savings attained through the joint optimization activities of the gas supply portfolios of the Energy East LDCs. The joint optimization activities include storage optimization; transport optimization and joint optimization demand and variable savings associated with turn back of capacity.

Q. Is GCIM sharing part of the NYSEG and RG&E Gas Rate Plans?

A. Yes. Section XII of the NYSEG Gas Rate Plan and Section VII of the RG&E Gas Rate Plan specifically provide for sharing of gas supply savings. The parties to the Gas Rate Plans, including Staff, recognized that it is appropriate to provide a sharing incentive to Companies for creating gas supply savings based on the joint optimization of Energy East LDC gas assets. GCIM 1 savings are allocated as follows: 100% of the savings attributable to migration capacity release are assigned to customers; there is an 80%/20% sharing between customers and shareholders of the savings activities of non-migration capacity release, off-system sales and savings from local production. GCIM 2 savings were initially designed to be shared 50% customers and 50% shareholders.

Q. Has there been a recent proceeding regarding the GCIM methodology?

A. Yes. On October 7, 2005, in Case No. 01-G-1668 and 04-G-1278 the Commission issued an <u>Order Approving Gas Cost Incentive Mechanism Methodology</u>. The Order approved the GCIM methodology by which NYSEG calculates and allocates its GCIM 1 and GCIM 2 incentives. NYSEG and Staff held numerous meetings during 2005 regarding the proper GCIM allocations and ultimately reached an agreement regarding the allocations GCIM sharing. As noted in the Commission Order, NYSEG and Staff worked together to resolve concerns related to GCIM classifications and developed a new method for classifying the gas supply activities and calculating the GCIM incentive. GCIM 2 categories were detailed in the "Interpretation and Application of the Provisions of the Gas Cost Incentive Mechanism" filed with the Commission in June 2005. A new NYSEG GCIM 2 sharing percentage was developed which increased the benefit to customers. The new GCIM 2 sharing equaled 56.25% to customers and 43.75% to shareholders. The new GCIM methodology was approved by the Commission and recognized the benefits for customers.

Q. What is the Gas Staff Rates Panel proposal in this proceeding regarding GCIM?

A. On pages 7 and 8, the Gas Staff Rates Panel proposes to eliminate GCIM 2. Staff states that GCIM 2 "unnecessarily over-compensates the companies" for procuring and managing its gas supply. Staff fails to mention any background of the GCIM, the benefits it has created for customers, the fact that the savings were brought about because of the joint optimization of the combined EE LDC gas supply assets and that merely two years ago the Company and Staff reached agreement regarding the allocation and methodology for the GCIM sharing. [cite]

Q. What was the amount sharing of NYSEG GCIM 2 in the Company's 2007 annual gas cost reconciliation filing?

A. The amount of GCIM 2 sharing for NYSEG gas was $1.25 million for customers and $975,000 for shareholders, after alliance costs.

Q. What was the amount of sharing of NYSEG GCIM 2 in the Company's 2007 annual gas cost reconciliation filing?

A. The sharing of GCIM 2 for RG&E gas equaled $840,000 for customers and $840,000 for shareholders, after alliance costs.

Q. Should the GCIM 2 sharing be eliminated as a result of this merger filing?

A. No. The GCIM is part of the respective gas rate plans for NYSEG and RG&E and should not be eliminated because of the merger filing. The Commission and Gas Staff have previously endorsed the gas rate plans as well as the GCIM allocation methodology. The Company has worked hard to create savings in gas supply costs by entering into joint optimization agreements so customers can benefit from a larger portfolio of gas supply assets. The Commission has recognized and approved this incentive mechanism and it should continue.

9. <u>Capital Expenditure Proposals</u>

Q. Has Staff proposed a procedure to reconcile capital expenditures for both gas and electric businesses at both RG&E and NYSEG?

A. Yes. The Staff Gas Rates Panel and Staff witness Dickens include testimony recommending the establishment of "one-way" capital spending reconciliations based on average planned capital spending (after adjusting for certain projects).

Q. Do the Companies accept Staff's proposals?

A. Generally, the Companies would be amenable to such a proposal if there was a symmetrical reconciliation such that any overspending would be subject to a carrying charge as well as any under spending. The exact spending levels and the reconciliation methodology could be the subject of a collaborative meeting of the Companies, Staff and other parties.

V. OTHER STAFF ISSUES

A. Storm Accounting

Q. Has Staff raised issues with RG&E's accounting associated with Major Storms?

A. Yes. Mr. Haslinger raises essentially three points. The first, on page 19 of his testimony, is whether a heat wave meets the definition of a major storm. The second, on page 20, suggests that the company has deferred non-incremental costs associated with a major storm. The third, on page 25, is an interpretation question of what costs constitute "counting" toward the total costs of a major storm.

Q. Do you agree with the first of Mr. Haslinger's points regarding the heat wave event?

A. No. While Mr. Haslinger correctly notes that the Company has deferred $354,605 associated with the restoration efforts caused by the heat wave event, he changes the definition of a major storm from both the joint proposal and the order associated with case 03-E-0765. In his testimony on page 19 he states that "in the case of the major storms, the company is allowed to charge to the major storm reserve costs of storms that affect at least 10% of its customers and/or results in service interruptions and cost more than $250,000 to restore service". The actual definition of a major storm on page 29 of the joint proposal is "a period of adverse weather during which service interruptions affect at least 10% of RG&E's customers within an operating area and/or result in customers being without electric service for a duration of at least 24 hours unless RG&E receives a determination from the Commission that such event does not constitute a Major Storm." (emphasis added). This definition is effectively replicated in footnote 29 of the May 20, 2004 Order associated with Case 03-E-0765.

Q. Does Mr. Haslinger suggest that the heat wave event is not a storm?

A. Yes, on page 20 of his testimony. He goes on to state that it is a predictable, recurring event. This event was in reality an unprecedented heat wave causing numerous outages affecting 39,156 customers, about 11% of RG&E customers over a period of 4 days (July 11, 2005 to July 15, 2005). It clearly meets the definition of "adverse weather" that is included in the Commission approved definition of a Major Storm. Also, the concept that such an unprecedented event is predictable and recurring is without merit.

Q. What else does Mr. Haslinger posit in his testimony associated with the heat wave event?

A. He states that the company billed customers for their use of increased consumption during the event and that perhaps those "extra" revenues should be counted as an offset to the costs of the event. While the fact that some customers were billed for increased consumption, this is only true for customers who did not have interrupted service during the event. It was not true for all customers and there are no data immediately available to determine how usage would have balanced out between interrupted and non-interrupted customers during the time of the event. Additionally, this comment by Mr. Haslinger would suggest to the company that they should include in their storm related incremental costs the lost revenues that occur during a storm event and count those toward an amount to be recovered from customers. This is not something the company has done in the past but, to be symmetrical with Staff's proposals for heat, we would be willing to consider.

Q. Mr. Haslinger follows his points regarding the heat wave event with a statement, on page 20, that "The company included labor, benefits, and costs of its transportation equipment to calculate the heat "storm" costs…Removal of these non-incremental costs would decrease its costs below the $250,000 expense deferral threshold". Do you agree with that statement?

A. No. The $354,605 deferred by the Company related to the heat wave event represented only incremental O&M costs incurred to restore service during and as a result of this event. The total costs including non-incremental O&M exceeded $700,000.

Q. The third point raised by Mr. Haslinger, on page 25 of his testimony, is that the Company re-interpreted the joint proposal language related to major storms and began to count all costs, including both capital and O&M, as an amount to compare to the $250 thousand threshold for purposes of deferring incremental O&M costs. Is he correct?

A. No. Mr. Haslinger correctly identifies the Company's interpretation of the costs that count toward the $250,000 threshold. The Company reads the definition to say restoration efforts costing more than $250,000 constitute a major storm – the definition does not state incremental O&M restoration costing more than $250,000. It is important to point out that in the last four years there has been only one event, a May, 2004 thunderstorm, that accumulated over $250,000 in total costs and at the same time less than $250,000 in incremental O&M costs. The company has deferred about $115,000 of incremental O&M associated with that event.

Q. Do you believe that RG&E is following an appropriate methodology for its storm related accounting?

A. Yes.

B. <u>Site Remediation Allocation</u>

Q. What is Staff's position with respect to the allocation of Site Remediation costs?

A. Mr. Haslinger, starting on page 25 of his testimony, claims that RG&E has modified the allocation of common site remediation costs from a 70% electric, 30% gas allocation implicit in the RG&E electric and gas Joint Proposals, to an 80% electric, 20% gas allocation in the Company's annual compliance filings.

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Q. Is Staff correct in their assertion?

A. Yes, but only to a point. In the annual compliance filings submitted to the Commission for calendar year 2004 and 2005, RG&E inadvertently reflected an 80% electric, 20% gas allocation of site remediation costs incurred through November 2005. Subsequent to November 2005, the Company used a 66% electric and 34% gas allocation of these costs, which reflected the sale of Ginna during 2004.

Q. What would be the financial implications of the use of an 80% electric/20% gas allocation through November 2005?

A. The implication would be that approximately $700 thousand would be shifted between electric and gas deferred amounts. Since both the RG&E Electric and the RG&E Gas rate plans exclude site remediation deferrals from consideration for offsets due to earnings sharing, this would be a balance sheet only transfer between the electric and gas businesses, and would not impact RG&E's income statement or RG&E's customers as a group.

Q. What do you conclude with respect to this issue?

A. The Company would be willing to make the balance sheet transfer indicated in the prior response to reflect the deferred site remediation costs on its balance sheet between the electric and gas businesses, although in doing so, we would not concede that it is an appropriate issue to be addressed in this proceeding. This would create a shift of approximately $700 thousand between the two businesses.

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Since the Company is not accepting any of Staff's proposed PBA adjustments, including those related to site remediation, this issue is effectively and materially irrelevant.

C. <u>Security Cost Deferral</u>

Q. Does Staff suggest that RG&E's deferral of security costs greater than a target amount included in the electric and gas joint proposals was not correct?

A. Yes. Mr. Haslinger covers this topic on page 23 of his testimony.

Q. Do you agree with Staff's suggestion?

A. No. Staff inexplicably bases their conclusion on their statement that says "The Joint Proposals set targets for the costs of obtaining security services from outside vendors". This statement is not backed up by the language in the joint proposals. In fact, footnote 2 of Appendix K of the electric joint proposal specifically states that "Security Costs are reconciled in total".

Q. Has RG&E experienced an increase in security costs over the past several years?

A. Yes. RG&E, like many other companies, has become even more security focused than ever. Much of the deferral amount that exists on the Company books resulted from increased security costs experienced in 2004 at the company's Ginna nuclear plant. As everyone knows, the need for heightened security at critical facilities is a real issue for our times. The Staff Policy Panel has focused on the security of the transmission and distribution system and of company data in their testimony in this proceeding, on pages 28 & 29, further supporting the need for security costs.

Q. What should be done with Mr. Haslinger's suggestion that RG&E not be allowed to recover security costs over the joint proposal threshold amount?

A. It should be ignored and RG&E should still be allowed to defer and recover any security costs incurred to protect the assets of the company.

D. <u>ASGA Depletion</u>

Q. Do you share Staff witness Haslinger's concerns related to the utilization of the ASGA balance as an offset to the costs paid for power under the Ginna PPA?

A. No. Staff witness Haslinger has identified that the current balance in the ASGA could be depleted sometime in 2010 due to the its utilization as an offset to the prices paid for power under the Ginna Purchase Power Agreement ("PPA"). This is an assumption that electric commodity market prices over the next three years are comparable to those experienced in the last couple of years. He has also concluded that RG&E rates would have to increase when the ASGA is depleted, which is generally true.

Q. What else could happen to affect customer rates or minimize the impact of the ASGA depletion on customer rates?

A. There are several possibilities. First, the Commission could act within its authority to hold current rates constant while adding to a regulatory asset that could be recovered over a future period of time. Second, the electric commodity market pricing could change such that the draw from the ASGA due to the prices paid under the Ginna PPA will be minimized over the next several years, leaving a positive balance in the ASGA. Third, the ASGA balance could increase by the operation of other terms in the RG&E rate plan, thereby staving off the time frame when it would otherwise be depleted.

Q. Do you agree with Mr. Haslinger's approach of treating the end of 2008 ASGA balance as a deduction to rate base?

A. To the extent that the ASGA is no longer used as an offset to the Ginna PPA and the customer rates better reflect the costs incurred, then moving the ASGA to rate base, as long as any variances from the assumed rate base balance accrue a return, makes little difference to the company.

E. <u>Standby Lost Revenues</u>

Q. Does Staff take exception to NYSEG's calculation of the amount of lost revenues associated with a specific standby customer?

A. Yes. Staff witness Dickens identifies an issue of which "otherwise applicable rate" should be used when calculating the amount of lost revenues to be applied by NYSEG when determining the draw from the ASGA. Staff witness Benedict has identified that the amount calculated by Mr. Dickens is included in his JB-7 amounts of ASGA adjustments.

Q. Do you agree with Staff's position?

A. No. As discussed in the Rate Design and Retail Access Panel rebuttal testimony, we disagree with Staff's adjustment.

F. <u>Under Spending on Capital</u>

Q. On page 32 of his testimony, Staff witness Benedict suggests that based on his review of the last NYSEG report on capital expenditures submitted to the Commission, NYSEG might be under spending on capital. Is that allegation accurate?

A. No. As Mr. Benedict noted, his review was of data through September 30, 2007 that was reflected on the required quarterly capital report to the Commission. NYSEG has completed a preliminary draft of the fourth quarter capital report to the Commission, which reflects the full year of capital spending. This preliminary draft is included as Exhibit RAP-9. As noted on the exhibit, NYSEG has spent 100% of the rate case allowed amount of capital during 2007.

G. <u>NYSEG Debt Cost Adjustment</u>

Q. Does Staff claim that the Proposed Transaction had a negative impact on NYSEG's recent financing?

A. Yes. On pages175-176 of its testimony the Staff Policy Panel asserts that the investment community rendered an assessment on Iberdrola's effect on NYSEG and RG&E. Staff alleges that it is the "risk of a potential relationship with

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Iberdrola that accounts for the discrepancy in yields" between NYSEG and a select peer group. As explained below, Staff's allegation is unfounded.

Q. Do you agree with the Staff Policy Panel's recommendation on page 178 that there should be a 30 basis point adjustment to NYSEG's cost of debt "to remove the effects of Iberdrola from the company's cost of debt"?

A. No. We emphatically disagree. The 30 basis point differential was caused by several factors including ratings differences in the proxy group and issues relating to the relative size and frequency of NYSEG offerings compared to the proxy group.

Q. What are the size and frequency issues that caused NYSEG's offering to price higher than Staff's proxy group?

A. The size of an offering is important because any deal over $250 million in size is an "index eligible" deal, which opens up the issuance to more potential buyers and makes the deal more liquid in the secondary market. Investors are willing to pay a price premium (i.e., tighter spread) for this secondary market liquidity. The $200 million NYSEG transaction was not index eligible. Given the recent volatility in the market, the "liquidity premium" for a non-index eligible deal like NYSGE's has been significantly higher than has been experienced in several years. Of the three comparables the Staff Policy Panel focused on, all were over $250 million and were "index eligible" and all would be expected to price tighter and have a more liquid secondary market than the NYSEG.

Q. How does the frequency of an issuer in the market affect pricing?

A. Those names that come to market more frequently – including the three comparables that the Staff Policy Panel identified – can command a slight price premium (i.e., tighter spread), because investors are more familiar with the issuer and as a result are required to do less up-front credit review before purchasing. The frequent issuer premium tends to be manifest during periods when the market is particularly busy and/or volatile, as was the case during the period from November 27, 2007 to November 29, 2007 when NYSEG was in the market. During such periods of volatility, those companies that come to market frequently attract more investor interest.

Q. Can you explain the ratings difference between NYSEG and Staff's proxy group?

A. Of the three comparables the Staff Policy Panel utilized, two were on review for a potential upgrade and have subsequently been upgraded. Dominion was upgraded by S&P from BBB to A- on December 27, 2007 and Pacific Gas and Electric was upgraded by Moody's from Baa1 to A3 on December 27, 2007. It is highly likely that the pricing for these two "comparables" anticipated the impending upgrades resulting in somewhat tighter spreads. Therefore, two of the three comparables priced their offerings with the anticipation that the issuers would carry at least one A-rating in the near future. In comparison, NYSEG priced its offering with the overhang of the negative outlook on its Baa1 / BBB+ ratings, which has been in place since the Commission's decision in NYSEG's rate case in August 2006.

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Q. Are there earlier comparables that demonstrate that the proposed transaction with Iberdrola is not the most likely explanation for NYSEG's spread difference?

A. Yes. NYSEG priced a $100 million, non-index eligible 10-year bond on December 14, 2006 at a spread of 110 basis points over the treasury. Southwestern Electric Power (SWEPCo), one of the three companies the Staff Policy Panel chose as a December 2007 comparable, came to market three weeks later with an index eligible 10-year bond that priced at 93 basis points over the treasury. NYSEG and SWEPCo share the same Moody's rating (Baa1); NYSEG's S&P rating is one-notch above SWEPCo (BBB+ versus BBB). Despite NYSEG's superior S&P rating, SWEPCo priced inside of NYSEG. We would attribute this primarily to the liquidity premium and to the negative outlook overhang on NYSEG (which, as noted by Mr. Fetter, was due to the August 2006 rate order in the NYSEG Electric proceeding). In December 2006, the market was not factoring in "the risk of a potential relationship with Iberdrola" yet the pricing differential between NYSEG and SWEPCo still existed.

Q. In response IBER/EE IR No. 45 Staff responds with an additional argument that they believe explains the spread discrepancy. ". . . it could be because NYSEG no longer files financial statements, in conformance with Energy East's strategies that have led to a lack of transparency, and this lack of information is perceived as creating additional risk". Do you agree with Staff's assertion?

A. No. A 144A transaction, such as the December 2007 NYSEG deal, includes all of the information which, in a public transaction, would be included by reference to SEC filings. Further, NYSEG continues to make available on its website its interim and annual audited financial statements and the SEC filings made by Energy East continue to include significant disclosure and management discussion and analysis (MD&A) pertaining specifically to NYSEG. In fact, the decision to cease filing NYSEG reports with the SEC resulted in very little change in the amount and quality of information on NYSEG reaching potential and existing investors.

H. <u>Cost of the Imputed Debt</u>

Q. Do you agree with Staff's use of the average embedded cost debt to calculate the cost of the debt that is imputed into its capital structure as a result of the 38% cap on common Equity that Staff used to calculate its revenue requirements?

A. No. NYSEG and RG&E both have significant amounts of pollution control notes in their capital structures. The cost of those notes is significantly below the cost of the remainder of the Companies' debt and has the effect of reducing the average embedded cost of debt. By pricing the imputed debt at the average cost of the embedded debt, it is presumed that more debt capital could be raised through low-cost pollution control notes. However, that presumption is false. The Companies cannot finance more through pollution control notes. Furthermore, any new debt would be priced at the current market price and not at the average cost of the embedded debt with or without the pollution control notes. This fact was recognized by the Staff and the Commission in the last NYSEG Electric rate case and that is why the imputed debt in that case was priced at 6.54%.

I. <u>Advanced Meter Infrastructure ("AMI") Calculations</u>

1. <u>Significance of AMI</u>

Q. How does Mr. Benedict characterize the importance of the Automated Metering Initiative?

A. Mr. Benedict states on page 27 of his testimony:

> …the companies AMI filings are a major new initiative pending before the Commission. These AMI proposals will have <u>significant impacts on the rates customers pay</u> and will represent a commitment of hundreds of millions of utility funds. It would be unwise to ignore this issue as the Commission will surely be examining the adequacy of the companies' rates in this proceeding. (<u>Emphasis added</u>)

Q. Do you believe that this case is the proper forum in which to determine the financial outcome of such a major initiative?

A. No. As Mr. Benedict stated, the Commission already has proceedings in progress to review the NYSEG and RG&E AMI initiatives. Those proceedings will determine how and when AMI will be implemented and what vehicle will be used to recover costs from, and flow benefits to, customers.

2. Staff Proposes No AMI Surcharge and Does Not Provide for AMI in Rates

Q. Given that Mr. Benedict stated that "it would be unwise to ignore this issue… in this proceeding", how did Staff provide for AMI rate recovery in this case?

A. It didn't. Mr. Benedict simply stated at page 29 of his testimony:

The surcharge proposals appear unjustified. First, the net costs of AMI are immaterial, if you consider the deprecation impact discussed below. Also, both NYSEG gas and RG&E's current rate plans have provisions that address the costs of mandates, such as AMI.

Then he proceeded to create AMI revenue requirements that he purports are insignificant and therefore should not be recovered through a surcharge.

Q. Since Staff is recommending against a surcharge for AMI, did it provide for AMI in its revenue requirement calculations (Exhibits ___(JB-2) & ___(RHP-2))?

A. No. With the exception of not removing depreciation on the existing meters, which it claims will cease at the time AMI is implemented, leaving the revenues that are supporting the existing meters to offset part of the cost of depreciation on the new AMI facilities, Staff made no adjustments to include AMI in its revenue requirement calculations. However, as explained below, rate recovery of the existing meter investments, whether through continued depreciation or future depreciation rates is imperative for the Company. NARUC's AMI Resolution recommends that commissions consider providing for the timely cost recovery of prudently incurred AMI expenditures, "including accelerated recovery of investment in existing meter infrastructure." Mr. Benedict's proposal to simply retire the existing meter investment and address the undepreciated value in a future depreciation proceeding does not provide timely recovery, as recommended by NARUC.

Q. What reasons did Mr. Benedict give in his testimony in this proceeding for concluding that the Commission should not authorize NYSEG and RG&E to implement a surcharge to recoup incremental AMI costs?

A. Starting at page 26 of his testimony, Mr. Benedict argued that NYSEG and RG&E should not be allowed to implement a surcharge to recoup incremental AMI costs for the following three reasons:

1. the accuracy of estimated costs and savings is questionable,
2. the use of a surcharge to collect a financially immaterial amount is unjustified and directly conflicts with existing provisions in the company’s current rate plans which were already designed to accommodate these types of program costs, and

3. the reconciliation provisions of the surcharge proposal do not allow for accountability, in that there is no mechanism for review of the companies' performance in managing AM1 program costs.

3. <u>Staff Concern About Accuracy of AMI Cost Estimates</u>

Q. Please address Staff's first concern about the accuracy of estimated costs and savings.

A. The filings that NYSEG and RG&E currently have before the Commission include **<u>estimates</u>** of the surcharge rates based on (a) estimates of the net costs and (b) estimates of the timing of the implementation of the project. These are only estimates. These estimates will be refined after the responses that have been received to the Requests for Proposal ("RFP") are reviewed and again after the Commission has issued an Order that will enable the project to be implemented. The actual surcharge rates will be based on actual capital costs and will be reconciled at the end of each year. Indeed, accuracy of the estimates of net costs and the timing of the implementation are two key reasons why the Companies have proposed that net AMI costs, at least in the early stages, be recovered through a surcharge instead of base rates and that the revenues received be reconciled with actual costs and adjusted accordingly.

4. Staff Claim of Immaterial AMI Net Costs

Q. Please explain how Staff determined that the cost of AMI to be immaterial and, therefore, should not be recovered through a surcharge.

A. As described, starting on page 29 of his testimony, and as shown on Exhibits ___(JB-5) and ___(JB-6), Mr. Benedict made five adjustments to reduce the estimated 2009 AMI revenue requirements from the amounts presented in the NYSEG and RG&E AMI filings to $3.5 million and $3.2 million, respectively:

A) Mr. Benedict reduced the depreciation on the new AMI facilities by the amount of depreciation currently being accrued on the existing meters that he claims will cease at the time AMI is deployed.

B) He imputed estimated savings that might materialize if uncollectibles and theft of service can be reduced as a result of AMI.

C) He imputed a 38% common equity cap instead of the 41.6% cap that was imputed in the most recent NYSEG Electric rate Order and the 45% equity cap that was provided for in the currently-effective and Commission-approved NYSEG Gas and RG&E Electric & Gas Rate Plans.

D) He reduced the Return on Equity from the returns allowed in the most recently-approved NYSEG & RG&E Rate Decisions and Rate Plans to 9.0% in this case.

E) He reduced the cost of the imputed debt from the 6.54% rate, approved in the last NYSEG Rate Decision, to the embedded cost of the actual debt.

(Imputed debt is the amount of artificial debt that is added to the capital structure supporting Rate Base as a result of Staff's reduction in common equity below the actual equity levels at each company that results from the 38% equity cap.)

Using the resulting reduced revenue requirements, Mr. Benedict deducted taxes and then divided the net-of-tax balance by the Common Equity that is <u>currently</u> supporting Rate Base (41.6% NYSEG Electric and 45% for the three other departments, as noted above) to arrive at the basis points which he purports to be immaterial. Based on this calculation, as noted at page 31 of his testimony, Mr. Benedict claims that the earnings impact from AMI would only reduce RG&E's Electric and Gas earnings by 23 and 49 basis points, respectively. He does not state the basis points for NYSEG, however using the same math, the earnings impact from AMI would be 17 and 38 basis points for NYSEG Electric and Gas, respectively. It should be noted that, even though he used the 38% equity cap proposed by Staff in this case to calculate his claimed AMI revenue requirement shortfalls, Mr. Benedict did not divide by the common equity that would be left after Staff's PBA imputations and after the imputed 38% common equity ratio.

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Q. Performing the same calculation, but using the common equity that would be left after Staff's PBA imputations and Staff's imputed 38% common equity cap, by how many basis points would earnings be reduced based on Mr. Benedict's calculated AMI revenue requirements?

A. NYSEG Electric & Gas earnings would be reduced by 21 basis points and 57 basis points, respectively. RG&E Electric & Gas earnings would be reduced by 38 basis points and 72 basis points, respectively.

Q. What level of earnings impact does the Commission consider materials?

A. Section 48.1 of the Public Service Law states that 0.05 percent of common equity is considered material. That is 5 basis points.

5. <u>Staff Concern About Reconciliation Method</u>

Q. Please comment on Staff's concern that the reconciliation provisions of the surcharge proposal presented in the Companies' AMI filings do not allow for accountability, in that there is no mechanism for review of the companies' performance in managing AMI program costs.

A. This is a concern that should be addressed in the AMI proceedings. Accountability is a factor that needs to be addressed in most reconciliation processes and the Staff and the Companies usually work together to develop procedures that are satisfactory to both parties. There is no reason that same process cannot take place in the AMI proceedings. However, to categorically claim in this case that an AMI surcharge should not be provided for in another proceeding would be unfair and inappropriate.

6. <u>Uncollectibles and Theft of Service</u>

Q. At page 28 of his testimony, Mr. Benedict states that one of Staff's concerns about the accuracy of the AMI net cost estimates is that the potential cost savings associated with better control of theft of service and uncollectible accounts that had been identified as potential cost savings in the Companies' February filing had been eliminated in the Companies' updated May filing. Can you please explain the significance of those potential savings and why they were removed?

A. Yes. In February, the Companies indicated that an AMI system would virtually eliminate estimated bills and, as a result, fewer disputed bills and associated write-offs could be expected. As the Companies prepared for the May filing, it became clear that it would be difficult to reasonably estimate the amount of any potential savings that might result from fewer disputed bills and that the amount would probably not be material. In February, it was also thought that the AMI system could assist companies in more accurately identifying when the consumption of customers in arrears reached the point where a shutoff was appropriate. Quicker shutoffs could mean that less energy would be provided "for free", thereby leading to a resultant reduction in revenue requirements. Subsequently, it was determined that the existing processes should be as effective at identifying when arrears get to the point that service should be disconnected and therefore this potential savings attributable to AMI was removed. As a side note, if AMI were able to provide information that led to earlier shut-offs, an initial spike in shut-offs could be expected to lead to greater initial write-offs which were also not included in the AMI forecast. Similarly, with respect to theft of service, it is difficult to determine with any degree of accuracy how much might actually be saved as a result of AMI; however it is not expected to be material.

Q. To the extent that AMI does enable the Companies to reduce uncollectibles and/or theft of service, how will such savings benefit customers?

A. The portion of such savings that relate to commodity will be flowed through to customers via the MFC and the NBC and be reflected in the POR discount rate. Delivery savings, while not expected to be material, will be reflected in future revenue requirements.

7. <u>Depreciation of Existing Meters</u>

Q. Please identify the annual amount that NYSEG and RG&E are currently depreciating existing meters?

A. Based on the amounts shown on Exhibits __ (JB-5) and ___(JB-6), NYSEG is depreciating existing meters at the annual rate of approximately $3.9 million and RG&E is depreciating at the annual rate of approximately $2.1 million.

Q. Do you agree with Mr. Benedict's proposal that depreciation on the existing meters should cease when AMI is implemented and that the revenues that are currently supporting that depreciation can then be used to offset part of the cost of the depreciation on the new AMI facilities?

A. No. Staff's retirement approach, while generally consistent with normal retirement accounting, does not provide for the timely and accelerated recovery of the existing meter investment as recommended by NARUC and preferred by the Companies. As Mr. Benedict testified, the cost of depreciating the existing meters is currently in rates. AMI represents a significant technology change in our industry and properly providing for the recovery of historical meter investment is important. From a ratemaking point of view and financial integrity point of view, it is most appropriate to continue depreciating, or amortizing, the existing meters at the current rate and to continue to recover that cost through rates as it is today. At the time that NYSEG and RG&E filed their AMI proposals with the Commission, it was indicated that the Companies and Staff would work together in those proceedings to determine how the remaining cost of the existing meters would continue to be recovered through rates. When the Companies filed their AMI revenue requirements, they did not forecast ceasing depreciation of the existing meters (as Staff has done in this case) because the Companies believe that those existing assets should continue to be depreciated or amortized and recovered through rates at, at least, the existing level. In fact, NARUC recommends that commissions consider an accelerated recovery of the existing investment.

8. Cost Recovery Provided for Under Existing Rate Plans

Q. As noted earlier, Mr. Benedict stated that both NYSEG gas and RG&E's current rate plans have provisions that address the costs of mandates, such as AMI. Does his testimony indicate that the NYSEG Gas and RG&E AMI shortfalls would be deferrable or otherwise offset based on the provisions of the current rate plans?

A. That is not clear, given Staff's proposed changes in the deferral thresholds.

Q. Did Mr. Benedict indicate if the NYSEG Electric Rate Order includes any such recovery provisions and, if not, how he proposed that NYSEG Electric would recover its AMI revenue requirement shortfall if a surcharge is not provided and the cost is not included in base rates?

A. No. Mr. Benedict was silent on the issue.

Q. Referring to page 33 of his testimony, Mr. Benedict makes several suggestions that the Commission might want to consider relating to recovery of net AMI costs. Do you want to comment on those statements?

A. Yes. First Mr. Benedict suggests that the Commission might want to require the Companies to "proceed with AMI deployment without additional recovery assurances from the Commission" "since both companies are over earning at current rate levels". Mr. Benedict fails to point out that it is Staff's proposed PBA imputations, changes in common equity cap and changes in the sharing provisions that would throw the Companies into excess earnings positions. He also does not point out that if rates are reduced based on the revenue requirements that he and

Mr. Haslinger present on Exhibits ___(JB-2) and ___(RPH-2), there would be no earnings sharing to absorb AMI. Mr. Benedict further suggests that "another [way] would be to assume that the cost of deployment would be absorbed by the utilities, which then can constitute a positive benefit of the acquisition". He goes on to say that "given the downward revisions to the net cost of AMI deployment and other possible adjustments (such as slippage), it should be valued at a zero cost and therefore be given little weight in the decision for approval. These statements should be disregarded. The Companies have presented the AMI proposals pursuant to Commission direction. These programs are key steps in achieving the Governor's "15 by 15" clean energy strategy. No attempt should be made here or elsewhere to force the Companies to absorb the cost.

9. **<u>Summary of AMI</u>**

Q. Please summarize the Companies' Position.

A. The Commission has separate proceedings where the NYSEG and RG&E AMI proposals are being considered. No action should be taken in this proceeding that would in any way inhibit, pre-determine how the Commission will equitably provide for rate recovery of prudently incurred AMI costs or otherwise jeopardize the AMI program.

VI. CONCLUSION

Q. Do you have anything further to add?

A. Yes. For the reasons stated above, the Commission should reject Staff's recommendation to transform this Section 70 proceeding, regarding whether the Proposed Transaction is in the public interest, into an investigation of Staff's proposal to impose hundreds of millions of dollars worth of asset write-offs, company-financed reserve increases, rate reductions and earnings sharing. Staff's proposals are beyond the proper scope of this case and would contravene the existing rate plans and orders authorized by the Commission for NYSEG and RG&E. In light of Staff's testimony, NYSEG and RG&E have been compelled to respond to the Staff's punitive proposals, but we urge the Commission not to delay this proceeding by consideration of Staff's many rate issues. As explained in detail in this testimony, Staff's proposals are without merit and should be dismissed or, at the very least, deferred for consideration in an appropriate rate proceeding.

Q. Does that conclude your testimony?

A. Yes.