

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

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

ORDER ON REHEARING

(Issued and Effective December 15, 2006)

TABLE OF CONTENTS

INTRODUCTION..... 1  
     Procedural History..... 2  
         Public Statement Hearings..... 2  
         Evidentiary Proceedings and the August 23 Order..... 3  
         Petitions for Rehearing and Recent Comments..... 3  
     Request for Oral Argument..... 5  
         NYSEG’s Petition..... 5  
         Parties’ Responses..... 7  
         Determination..... 7  
 ISSUES RAISED FOR REHEARING OR CLARIFICATION..... 8  
     Health Care Benefits Inflation..... 8  
     Pension and OPEB Discount Rate..... 11  
     Hydroelectric Expense..... 13  
     Productivity and Merger Savings..... 15  
     Integrated Back Office Project and Work Management System... 17  
     Capital Structure..... 19  
         NYSEG’s Rehearing Petition..... 19  
         Parties’ Responses..... 21  
         Discussion..... 25  
     Return on Equity..... 26  
         NYSEG’s Rehearing Petition..... 26  
         Parties’ Responses..... 28  
         Discussion..... 30  
     “Hedged Portfolio” As The Residential Default Rate..... 32  
         PULP’s Petition for Rehearing..... 32  
         Parties’ Responses..... 32  
         Discussion..... 34  
     Prudence of One-Month Forward Contracts..... 35  
         Direct Energy’s Petition for Clarification..... 35  
         Parties’ Responses..... 36  
         Discussion..... 36  
     Forecast of the NBC for Fixed Price Service..... 37  
         Direct Energy Petition on Rehearing..... 37  
         Parties’ Responses..... 37  
         Discussion..... 38  
     Notice of Intent to Offer a Fixed Price in 2008..... 40  
         NEM Petition for Rehearing..... 40  
         Parties’ Response..... 40  
         Discussion..... 40  
     Commodity Options for Demand-Metered Customers..... 40  
         Constellation NewEnergy Petition for Clarification..... 41  
         Direct Energy Petition for Rehearing..... 41  
         Parties’ Responses..... 41  
         Discussion..... 42  
     Phase-In of Merchant Function Charges..... 44  
         MI Petition for Rehearing..... 44  
         SCMC/RESA Petition for Rehearing..... 45

|   |    |
|---|----|
| Parties' Responses.....                             | 45 |
| Discussion.....                                     | 48 |
| Merchant Function Charges and the EOSA Option.....  | 49 |
| SCMC/RESA Petition for Clarification.....           | 49 |
| Parties' Responses.....                             | 49 |
| Discussion.....                                     | 49 |
| Generic Policy Regarding Incentives or Profits..... | 49 |
| NEM Petition.....                                   | 50 |
| Parties' Responses.....                             | 50 |
| Discussion.....                                     | 51 |
| State Action Immunity.....                          | 51 |
| Direct Energy Petition on Rehearing.....            | 51 |
| NEM Petition on Rehearing.....                      | 51 |
| Parties' Responses.....                             | 52 |
| Discussion.....                                     | 52 |
| Effect of ESCO Referral Order.....                  | 52 |
| NFG Petition for Clarification.....                 | 53 |
| Parties' Responses.....                             | 53 |
| Discussion.....                                     | 54 |
| ORDERING CLAUSES.....                               | 55 |

STATE OF NEW YORK  
PUBLIC SERVICE COMMISSION

At a session of the Public Service  
Commission held in the City of  
New York on December 13, 2006

COMMISSIONERS PRESENT:

Patricia L. Acampora, Chairwoman  
Maureen F. Harris, recused  
Robert E. Curry, Jr.  
Cheryl A. Buley

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

ORDER ON REHEARING

(Issued and Effective December 15, 2006)

BY THE COMMISSION:

INTRODUCTION

In this order, we address petitions for rehearing and/or clarification filed by seven parties to this proceeding -- New York State Electric & Gas Corporation (NYSEG or the company); Multiple Intervenors; Direct Energy Services, LLC (Direct Energy), National Energy Marketers Association (NEM); Constellation NewEnergy, Inc. (Constellation); Public Utility Law Project of New York, Inc. (PULP); and the Small Customer Marketer Coalition and the Retail Energy Supply Association, jointly (SCMC/RESA) -- and one non-party, National Fuel Gas Distribution Corporation (NFG). These parties seek modification or clarification of our Order Adopting Recommended Decision With Modifications issued August 23, 2006

in this proceeding (the Order).<sup>1</sup> As discussed below, we (1) reaffirm without change our prior decisions regarding the delivery rate and revenue requirement issues raised by NYSEG, the "hedged portfolio" default commodity rate for residential customers, the forecasting of the nonbypassable charge for the fixed price option, the commodity options available to large demand-metered commercial and industrial customers, the phase-in of merchant function charges, and the requirement that NYSEG file an ESCO Referral Plan; (2) modify the Order to set a date by which NYSEG must give notice of its intent to offer fixed price commodity service in 2008; (3) clarify the Order to state that EOSA customers will not pay a merchant function charge; and (4) decline to make declarations regarding the prudence of hedging via one-month forward contracts, PSC policy in setting profit incentives, or State Action Immunity.

#### Procedural History

In September 2005, this case began with the tariff leaves and the rate proposals NYSEG filed to increase delivery rates; to establish a multi-year rate plan; to provide customer refunds from the Asset Sale Gain Account; and to continue the Company's commodity options and retail access programs. NYSEG made its proposals anticipating the conclusion of the current rate plan which ends this month.

#### Public Statement Hearings

In May 2006, three public statement hearings were held in Binghamton, Hornell and North Greenbush. The statements received at the hearings largely confirmed and reiterated the views expressed in the correspondence we received by electronic, voice and regular mail.

In sum, customers in the NYSEG services areas favor lower and stable electric rates and predictable energy prices, for which they can plan accordingly. Customers also want reliable electric service without unnecessary service

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<sup>1</sup> Case 05-E-1222, Order Adopting Recommended Decision with Modifications (issued August 23, 2006).

interruptions or lengthy outages. Elderly customers, and those on fixed and low incomes, request that their needs be adequately considered in the rates we establish.

The Commission has also heard from retired electric system workers and representatives for the current workers. They have encouraged us to provide NYSEG the resources it requires to serve the public well and to keep the electric system in good working order. Further, we heard from elected government officials and local community leaders who support actions that ensure safe and reliable electric service and provide just and reasonable rates. They favor alternatives to traditional energy service and customers having the ability to choose between the fixed and variable rate options that NYSEG and the growing number of competitive energy service providers provide.

#### Evidentiary Proceedings and the August 23 Order

This rate case has gone through a lengthy hearing process. Evidentiary hearings began on March 22 and ran without interruption to April 5, 2006. The last hearing was held on April 12, 2006. Thereafter, the active parties provided an initial round of briefs to the presiding officers who issued their recommended decision on June 9, 2006.<sup>2</sup> Thereafter, the parties submitted briefs on exceptions and reply briefs on June 29 and July 14, 2006, respectively.

The Commission issued the Order on August 23, 2006 and decided that NYSEG had not presented a sufficient basis to increase delivery rates as requested. Instead, we determined that electric delivery rates in 2007 should be reduced by \$36.2 million. The Order did not establish a multi-year rate plan. The Order continued, albeit with modifications, the commodity options and the retail access programs that NYSEG administers and required as well that NYSEG develop and file a plan for an ESCO Referral Program. It also required NYSEG to refund to customers \$77.1 million from the Asset Sale Gain Account.

#### Petitions for Rehearing and Recent Comments

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<sup>2</sup> Case 05-E-1222, Recommended Decision (issued June 9, 2006).

Within the allotted time allowed by statute and regulation,<sup>3</sup> we received petitions seeking rehearing or clarification of various matters addressed in the Order. Under our rules, such petitions were due by September 22, 2006, with replies due 15 days thereafter. NYSEG and Multiple Intervenors filed their petitions for rehearing on September 7, 2006; SCMC/RESA filed their petition for rehearing on September 19, 2006; and the remaining petitions were filed September 22, 2006.

As a consequence of the different filing dates, parties could not respond to all the petitions in a single document. On September 22, 2006, we received NYSEG's response to Multiple Intervenors and SCMC/RESA; Staff's response to NYSEG and Multiple Intervenors; the response of the New York State Consumer Protection Board (CPB) to NYSEG; Direct Energy's response to NYSEG; and Multiple Intervenors' response to NYSEG. On October 12, 2006 (pursuant to an extension of time granted all parties by the Secretary), we received a second round of responses: NYSEG responded to the petitions of Direct Energy, NEM, Constellation, PULP and NFG; Staff responded to PULP, Constellation, Direct Energy, NEM, SCMC/RESA and NFG; CPB responded to Direct Energy; SCMC/RESA responded to PULP; and Direct Energy responded to PULP and NFG. Where necessary to avoid confusion, we have referred to parties' "First Response" and "Second Response" in discussing them below.

Also after the Order, we received approximately 45 letters and 115 e-mails in reaction to our decision and to NYSEG's petition for rehearing. About 40 of them sent by individuals, businesses, chambers of commerce and not-for-profit organizations (including 14 that were identically worded) expressed concerns that a rate decrease could jeopardize safety or reliability by interfering with NYSEG's ability to maintain its infrastructure. Other reasons noted for reversing the rate decrease were threats to customer service or employment levels, or that an increase would be fair in view of generally rising price.

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<sup>3</sup> Public Service Law (PSL) §22; 16 NYCRR 3.7.

Over 100 of the letters and e-mails urged us to maintain the rate decrease, stating that current rates are too high. Several writers expressed the view that high utility rates were hurting the upstate New York economy. A few correspondents expressed outrage at what they perceived as "threats" by NYSEG to reduce service quality or reliability. We also received one petition with 31 signatures of residential customers concerned with rate levels, cost increases and billing problems.

### Request for Oral Argument

#### NYSEG's Petition

Pursuant to 16 NYCRR 3.8, NYSEG has requested oral argument on five matters. They are NYSEG's equity ratio; return on equity; the pension and OPEB discount rate; hydroelectric generation expenses; productivity and other cost disallowances.<sup>4</sup> According to the Company, the record on these matters has not been fully and properly considered. It contends that our evaluation of the facts and evidence has been compromised by senior advisors who did not make all the facts known to us. NYSEG believes that we would benefit from hearing its information at an oral argument where it would tell us of the potential detriments to ratepayers if the Order is not altered.

NYSEG specifically alleges that the resolution of the five matters contain errors of law and fact. According to the Company, the Order compromises safe service and the reliable operation of the electric distribution system. NYSEG claims that it has been denied recovery of its prudently incurred costs and granted a confiscatory rate of return.

In addition to claiming that its operations will suffer, NYSEG states that its financial condition has been rendered a blow. According to the Company, the financial community considers the Order to be harsh, adverse and below expectations. NYSEG points specifically to the negative outlook

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<sup>4</sup> Each of these matters is fully addressed below in the same sequence as presented and considered in the presiding officers' June 9 Recommended Decision and the Order.

statements rendered by three bond rating agencies, Standard & Poor's, Fitch, and Moody's. Thus, the Company believes that its ability to attract capital has been impeded. It claims that delivery rates should not be reduced by \$36.2 million in 2007 if the Company is expected to continue to provide high levels of electric service reliability,

According to NYSEG, the Order is internally inconsistent. The Company acknowledges that the Order provided sufficient revenues to cover some costs that will be incurred to maintain system reliability. However, NYSEG claims it was denied recovery of other equally important costs, and revenues, that are also needed to ensure reliable customer service. Overall, the Company asserts that the impact of the Order is adverse to system operations, employee relations and customers. If the Order stands, NYSEG states that it will have to reduce its workforce by hundreds of positions. Arguing against such reductions, NYSEG notes that it previously reduced delivery rates and that the Company has not received a delivery rate increase in ten years.

NYSEG also seeks oral argument to address the advisory staff presentation made at the open session on August 23, 2006. According to NYSEG, its on-going differences with the Department of Public Service may have adversely affected the resolution of the five matters for which it has sought rehearing. In this regard, the Company believes it should not be punished for achieving high earnings on commodity sales made in the past.

Concerning its multi-year rate proposal, NYSEG states that the Commission should have considered the advantages the proposal sought to provide. The Company faults DPS Staff for extreme litigation in this case and for only presenting on the record its position for a one-year result. NYSEG faults the Staff for not entering into meaningful negotiations to develop a multi-year rate plan acceptable to both parties.

Finally, in support of its request for an oral argument, NYSEG has provided affidavits that purport to contain new facts and circumstances. The affidavits also present the Company's refutation of points made by advisory staff in the presentation on August 23, 2006.

Parties' Responses

No party has endorsed or supported NYSEG's request for an oral argument. All of the parties who responded to the Company's motion urge us to deny the request. First, they note that oral argument is not the norm in Commission proceedings and the standard only permits such argument in the unusual case where an issue was not adequately developed in testimony and written pleadings.<sup>5</sup> They also argue that the proper time for an oral argument is long since past and NYSEG's request is untimely, coming, as it does, with the Company's petition for rehearing.<sup>6</sup>

Determination

We find no need to conduct an oral argument in this case at this time. The record on the five matters raised by NYSEG is ample and we find that each of the matters has been adequately developed. At the evidentiary hearings held in this case, NYSEG had an unfettered opportunity to submit all of its testimony and arguments. NYSEG also was afforded a full opportunity to cross-examine the witnesses who opposed the Company's positions. Moreover, NYSEG responded at length in two rounds of briefs to the counterarguments presented by the parties who opposed the Company's presentation. Given the substantial record before us, we are not persuaded that NYSEG had an inadequate opportunity to develop the record in this rate proceeding. The evidence is to the contrary.

As to the allegation that the senior staff has advised us poorly and interfered with our evaluation of the record, we reject this contention for several reasons. First, we have not simply relied on the advisory staff for our knowledge. We have evaluated the record for ourselves and have reached an informed judgment on each contested issue from the information the parties submitted. That said, we also find that the Commission was properly aided by the advisory staff. The assistance we received

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<sup>5</sup> 16 NYCRR 3.8(a).

<sup>6</sup> 16 NYCRR 3.8(b).

in no way hindered us, interfered with our careful consideration of the record, or detracted from the quality of the decisions we reached in the Order. To the extent that any of the points made by the advisory staff during the August 23 open session warrant our consideration here, NYSEG has presented its contrary views in the section of its rehearing petition addressing the equity ratio and equity return matters and we have considered the points it has made.

We therefore deny NYSEG's motion for oral argument. Further, we exclude from the record the affidavits the Company has proffered. Those affidavits rely on a variety of extra-record material, such as analysts' criticisms of the Commission decision and listings of the results of other utility commissions for other utilities. As explained below, this material is irrelevant to our decision and does not meet the factual standards for rehearing; either a showing of an error of fact or new circumstances. The record in this matter has been closed and NYSEG's rehearing petition has not shown a basis for reopening it. Allowing this material to remain in the record would be unfair to other parties that were not allowed to challenge it through cross-examination or testimony.

#### ISSUES RAISED FOR REHEARING OR CLARIFICATION

##### Health Care Benefits Inflator

NYSEG's petition for rehearing urges us not to adhere blindly to the 20-year-old policy that governs the use of a general inflation factor for health care costs and other cost categories. The Company claims the policy is outdated and the facts presented here warrant a different approach and outcome. NYSEG asserts that its health care costs in 2007 are expected to be \$2.5 million greater than the ratemaking allowance for this item provided by the general inflation factor. The Company believes it is unrealistic to expect expense savings in other cost categories to offset the higher amount of health care benefits.

In opposition to the established policy, NYSEG asserts that health care costs have substantially and consistently exceeded the general inflation rate for many years and it expects this trend to continue in the future. The Company notes that medical benefit costs are a large portion of the costs that are adjusted using the general inflation factor. It therefore believes that they warrant independent consideration. NYSEG's medical benefits amount to 13% of costs to which the general inflation factor is applied. The medical benefit costs included in the GDP index used to measure inflation amount to only 0.3%. Given this disparity, NYSEG claims that the medical benefit costs should be excluded from the "pool of dollars" to which the general inflation factor is applied.

Finally, NYSEG acknowledges that the Commission recently rejected an affiliated company's, Rochester Gas and Electric Corporation's, comparable ratemaking proposal.<sup>7</sup> In the case involving RG&E, the Commission observed that the company had presented no evidence suggesting that the amount of medical insurance costs included in the inflation pool was inadequately represented by the general inflation factor. NYSEG claims that it has provided such evidence in this case and has shown that a separate medical inflator is necessary.

In response, DPS Staff states that NYSEG merely reiterates its previous position and provides no new information or logic for the Commission to consider. Staff rejects the notion that any particular cost item should be singled out for special treatment. Rather than develop differing rates of escalation for each cost item, Staff supports the application of a broad measure of general inflation to a large group of expenses to avoid unnecessary complication and chaotic results.

Staff also disagrees with NYSEG's suggestion that the Company has no ability to control the amount of medical benefit costs it incurs. Staff lists several means available to the

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<sup>7</sup> Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation - Electric and Gas Rates, Order Adopting Recommend Decision with Modifications (issued March 7, 2003) pp. 23-24.

Company to manage and reduce such costs, including the level of deductibles and co-payments, possible benefit changes, participation rates, and other means.

According to Multiple Intervenors, NYSEG's rehearing request primarily reflects the Company's unwillingness to accept the Commission's long-standing policy on this matter. It notes that this practice has been re-examined periodically and the Commission has repeatedly decided to use it.

Multiple Intervenors supports the aggregation of a large number of expenses and the use of a general inflation index stating that there is no reason to believe that all the expense items will rise with the inflation rate. It also states that NYSEG should not be allowed to "cherry-pick" a single item that exceeds the inflation rate. Rather than focus on any single expense item, Multiple Intervenors states that the Company should instead consider the entire group of expenses, as a whole. Addressing the recent case involving RG&E, Multiple Intervenors states that NYSEG's evidence in this case is no better than was RG&E's, because the Company has only considered a single expense and not the entire pool of costs.

We have considered the record evidence concerning the conventional approach that is used to apply a general inflation factor to a group of costs that includes medical benefits. We have not ignored NYSEG's testimony, evidence or arguments nor are we blindly wedded to the established policy.

We find that in an uninterrupted series of rate proceedings, the Commission heard and considered the utility company arguments that continued to question the wisdom of applying the general inflation factor to medical benefit costs. In these cases, the Commission has periodically re-affirmed that this ratemaking practice makes good sense and is fair.

In this instance, NYSEG has focused on the amount of medical benefit expenses being inflated and the amount of medical benefit costs included in the development of the GNP index used to measure inflation. The disparity that the Company notes does not dissuade us from adhering to the standard approach. The disparity is not new nor is it out of line with the prior

application of this approach. Moreover, no single cost item should be excluded or "cherry picked" from the group of expenses that are inflated using a general factor. We continue to believe that this approach is well designed to provide the Company a necessary incentive to manage health benefit costs in the context of a wide range of other costs that the Company incurs. Accordingly, NYSEG's request that we modify our decision regarding the health benefits inflator is denied.

#### Pension and OPEB Discount Rate

The presiding officers used a 5.75% discount rate for rate year pension and other post employment benefits (OPEB) expense amounts. They recommended that we consider the financial conditions pending at the time of our decision to update the discount rate in keeping with the current conditions. In its brief on exceptions, DPS Staff recommended that we use a 6.25% discount rate, given the bond yields it observed, and we adopted Staff's proposal.

In its petition for rehearing, NYSEG states that bond yields at the time of the Order were about 40 basis points lower than those reported by DPS Staff. The Company therefore insists, on rehearing, that we use the same 5.75% discount rate that the presiding examiners had used. In support of its position, NYSEG notes that the Commission did not change the discount rate that was used in the recently decided Central Hudson Gas & Electric Company rate proceeding. In the alternative, NYSEG proposes to defer a discount rate change for pension income and OPEB expense symmetrically around 5.75%. The Company states that this approach is currently in use for its gas operations and it could also be used for the electric department.

In response, DPS Staff states that it was not possible to use mid-August bond yields for the discount rate the Commission applied in its Order. Of necessity, the market data for the update was obtained in advance, and Staff stands by the 6.25% discount rate that was current when it provided its brief opposing exceptions. CPB states that, as long as we are

consistent in our approach, it should not matter which date is used for updating all the items that fluctuate over time.

Staff notes that we made other updates for general inflation and fuel prices using June 2006 data; however, NYSEG has not petitioned us to rehear or adjust any of them. In a similar vein, CPB notes that we updated NYSEG's allowed rate of return on equity to the Company's advantage. Rather than make any selective and one-sided updates now, Staff and CPB urge us to deny NYSEG's petition.

As to the recent Central Hudson rate determination, Staff observes that the decision there concerned the actual, 2006 discount rate, not a rate year forecast like the matter presented here. Staff asserts that the decision has no application here because the Central Hudson case involved a multi-year rate plan and deferral accounting for pension and OPEB expenses. In the Central Hudson context, updates have no rate advantages or disadvantages. Staff also observes that the update in the Central Hudson case concerned only \$1 million, an amount significantly lower than the \$5 million difference presented here.

Finally, Staff states that NYSEG's request for a deferral of the pension income and OPEB expense symmetrically around 5.75% is too late, coming after the close of the record and without any support. According to Staff, were we to entertain NYSEG's new proposal at this stage of the proceeding, we would promote chaos and encourage the parties to rate proceedings to game the process.

We find that the updates made subsequent to the presiding officers' recommended decision were consistently timed and executed. The updates were not made, either individually or collectively, to advantage or disadvantage any particular party and no one item should now be updated on its own. A convenient date was selected--in this case the June date on which the parties provided their briefs on exceptions--and those results were used.<sup>8</sup> Updates cannot be executed as late as the date of

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<sup>8</sup> We note that the 1977 Statement of Policy on Test Periods in Major Rate Proceedings establishes the date of the parties'

the open meeting. To do so would interfere with the issuance of our decision within the time interval provided by the Public Service Law for major rate proceedings. For all these reasons, NYSEG's rehearing petition on this matter is denied.

Hydroelectric Expense

In this case, we accepted and adopted CPB's review of hydroelectric expenses.<sup>9</sup> Consequently, we provided NYSEG a rate allowance for these costs that is consistent with the costs the Company incurred in 2004--an amount that exceeded the recent, four-year average for these expenses. We also allowed NYSEG one-fourth of the amount it claimed for additional maintenance to satisfy federal mandates that affect hydroelectric power production. In its petition for rehearing, NYSEG asserts that the entire amount it requested is essential for public safety and the protection of the hydroelectric facilities. The Company urges us to consider carefully the documents and facts it proffered in response to CPB's discovery which, according to NYSEG, fully support the amount it requested for the rate year.

NYSEG points to the support that exists in New York for renewable energy sources, including the retail renewable portfolio standard. The Company considers any disallowance of hydroelectric costs to be inconsistent with the desirable production of this source of low-priced energy. If it is required to defer the scheduled maintenance of the hydroelectric units, NYSEG asserts that the units' reliability, and their

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initial briefs on exceptions as the latest opportunity for them to submit easily verifiable known changes in cost rates. 17 NY PSC 25-R, 28-R.

<sup>9</sup> In its petition for rehearing, NYSEG claims that the record contains no evidence that CPB audited and investigated the Company's hydroelectric expense information by conducting any site visits or by interviewing any of its personnel. Nonetheless, the record is clear that CPB offered testimony containing its position on the hydroelectric expenses based upon its review of the NYSEG rate case filing and answers to certain information requests posed to the Company.

service lives, will be adversely affected and customers will risk unforced outages and increased costs.

In response, CPB states that this issue was adequately examined on the record and does not require a rehearing. CPB criticizes the Company for not squarely addressing facts and for resorting to dire warnings to obtain the amount it requested. To clarify this matter, CPB states that NYSEG has, by our action, received the full amount that was requested for hydroelectric plant maintenance. The issue here concerns a 215% increase in the amount NYSEG sought for hydroelectric plant operations--an increase, according to CPB, that was never explained by the Company. Absent any explanation for this cost increase, CPB continues to believe that the Company should be held to the 2004 expenditure level.

During this proceeding, Staff took no position on the adjustment presented by CPB. However, Staff now responds to NYSEG's rehearing petition by disagreeing with the Company's characterization of the record. Staff notes that NYSEG provided six responses to the discovery requests posed by Staff and CPB. Staff states that three of the responses provided no information. The other three supported the use of a six-year average for outside services expenses and a \$616,000 allowance for 22 historic projects. Staff criticizes NYSEG for not removing any completed projects from the historic base year before it projected the amount of expenses for the rate year. Staff also believes the Company's forecast may double-count outside services expenses, given the use of a normalized, six-year average.

In sum, Staff states that NYSEG did not provide adequate justification for the historic hydroelectric expenses it claimed and the Company did not comply with the normalization requirements of the 1977 Forecast Test Year Policy Statement. Staff therefore supports the CPB analysis and the adjustments the Commission made.

On the basis of the additional arguments we have considered here, we find that the adjustment made to the amount of hydroelectric expenses claimed by NYSEG was proper. CPB proposed and supported a rational approach that is commonly used

to arrive at a representative amount of expenses for the rate year when the annual amount, in a given year, may vary by large degrees. DPS Staff's review of this matter has confirmed that NYSEG's rate case presentation was insufficient to warrant any greater expense allowance. Therefore, we decline to modify our prior decision. To avoid a similar occurrence in NYSEG's next rate case, we are directing the Company to provide an expert witness and testimony detailing its full support for the amount it seeks to include in rates for hydroelectric expense. Should the Company fail to provide adequate testimony on this matter, we may continue to use a multiple year average for this expense item.

#### Productivity and Merger Savings

The Order adopted the presiding officers' recommendation to apply a 3% productivity factor to NYSEG to account for the merger-related efficiencies and project-specific cost savings that are expected to occur during the rate year. In its rehearing petition, NYSEG claims that the 3% productivity factor is erroneous and not supported by any critical analysis or substantive evidence. According to the Company, it has demonstrated \$40 million of merger-related savings in the upcoming year and it should not have to provide any additional productivity above the amount routinely applied in rate proceedings. NYSEG states that it has provided all the stand-alone, merger-related cost savings customers are entitled to and there are no other efficiency effects from integration projects and activities to be reflected in rates. NYSEG states that, if the 3% productivity adjustment stands, there will be a workforce reduction and a degradation of service.

NYSEG also states that the Order double counts, and artificially increases, the expected merger savings by excluding from rates certain management incentive compensation payments. NYSEG believes that the incentive payments excluded from its operation and maintenance expenses should be recognized as dollar-for-dollar reductions to the productivity savings amount.

In response to this argument, Staff states that there is no record evidence supporting the Company's assertion that rate year productivity is linked, in any way, to the incentive compensation that NYSEG pays to its executives and managers. Absent any such demonstration on the record, Staff states that no double count can either be presumed or inferred.

As to the 3% productivity factor used in this case, Staff states that there is ample evidence supporting this amount and more. According to Staff, the 3% factor is modest and at the lower end of the productivity range developed by it and CPB. Both parties believe that NYSEG can easily exceed the 3% productivity factor with the savings and efficiencies the Company and its parent, Energy East, plan to pursue.

Staff also doubts that NYSEG will incur any layoffs due to the Commission's treatment of labor expenses and productivity. Staff points out that full ratemaking allowances have been provided for the established workforce, the prevailing meter-reading program, the customer care system and the employees returning to their routine jobs from the implementation of this system, and for additional apprentices. Staff calculates that \$1.5 million more than the amount required for the Company's current work force has been built into rates. Thus, it concludes that NYSEG's workforce reduction claims misrepresent the true facts and are belied by the Commission's expectations for additional productivity and expected savings.

CPB states that the Company's rehearing petition is a rehash of NYSEG's position in the briefs it filed. CPB considers the evidence supporting 3% productivity to be overwhelming, given the additional efficiency available for NYSEG to achieve.

We find no basis to grant NYSEG a rehearing on this issue. There has been no error of fact or law shown nor any changed circumstances to warrant a departure from the decision contained in the Order. There is no evidence that the productivity adjustment "double counts" any of the adjustments made to exclude excessive executive and management incentive compensation from the just and reasonable rates we have established. Nor do we see any justification for NYSEG's

assertion that the amount of productivity factored into the rates set for 2007 should, of its own accord, trigger any adverse work force reductions or any deterioration of service quality. The petition for rehearing of this matter is denied.

Integrated Back Office Project and Work Management System

NYSEG objects to the exclusion of the Integrated Back Office Project and Work Management System costs from rates. The Order determined that these items were fully covered in the rates set for the period ending in December 2006. Under the terms of the existing rate plan, NYSEG was not allowed to carry forward and recover them in the rates established for 2007 and thereafter. In its rehearing petition, NYSEG points to a provision of the Commission's 2002 order adopting the existing rate plan which states:

[T]he Joint Proposal implies that a portion of the costs to achieve the merger savings may be capitalized and recovered over more than a five-year period.<sup>10</sup>

From this provision, NYSEG believes it can continue to recover Integrated Back Office Project and Work Management System expenses and capital costs. The Company states that only the depreciated costs for the projects (not the total capitalized costs) were treated as annual expenses through 2006. According to the Company, the disallowance of the undepreciated costs is wrong because the capitalized costs were properly charged to capital accounts and they are scheduled to be depreciated over a period exceeding the term of the rate plan.

In support of its position, NYSEG states that it has been capitalizing internally-developed software costs since 1999. It states that this practice is consistent with the Federal Energy Regulatory Commission's (FERC's) uniform system of

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<sup>10</sup> Cases 01-E-0359 and 01-M-0404, New York State Electric & Gas Corporation - Electric Rates and Merger Proposal, Order Adopting Provisions of Joint Proposal With Modifications (issued February 27, 2002) (the 2002 rate order).

accounts which, according to the Company, is the accounting system that the New York Commission also uses. Thus, NYSEG claims we have made an error of law, and we should permit it to defer the software costs for these projects for their inclusion in rates beyond 2006.

Staff responds that the Company's reference to the 2002 rate order is selective and misleading. Staff quotes language from the same paragraph of the 2002 rate order as that relied upon by the Company which states that the parties intended that all merger costs be recovered by the end of 2006. Given the level of earnings NYSEG achieved during the rate plan, Staff sees no reason for NYSEG to refuse to expense the software costs as the rate plan required. Staff also states that NYSEG required, but did not request or obtain, Commission authorization to capitalize any internally-developed software costs. Consequently, it considers the Company's reference to the FERC accounting requirements, and any of its similarities to the accounting system used in New York, as irrelevant to the rate plan requirements that applied to NYSEG.<sup>11</sup>

We find no error of law or fact, nor any changed circumstances, to warrant a rehearing of this issue. NYSEG misconstrues the current rate plan that operates through the end of this year. The relevant paragraph of the 2002 rate order shows that we contemplated that all merger costs be recovered by the end of 2006. That rate plan has provided the Company a full and adequate opportunity to recover its merger-related costs and the internally developed software costs in particular. Both portions of the software costs--the capitalized and the amortized portions--were covered by the rate plan requirement. NYSEG has no Commission-approved accounting in place that permits it to

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<sup>11</sup> Staff observes that 16 NYCRR 165.1(c) states that the system of accounts does not determine our ratemaking practices. Staff also notes that, as recently as a December 29, 1998 Notice of Proposed Rulemaking, the Commission clearly indicated that its use of any FERC system of accounts does not supersede the specific accounting required by the Commission's actions in rate plans, policy statements and on particular accounting petitions.

extend the recovery of these expenses beyond the term of the current rate plan. Moreover, these items require no such treatment either at the earnings levels achieved under the current rate plan or to comply with the rate plan's provisions.

### Capital Structure

#### NYSEG's Rehearing Petition

We rejected the presiding officers' recommendation to use NYSEG's stand-alone equity ratio to set the Company's revenue requirements and delivery rates for 2007. Instead, we adopted DPS Staff's proposal to use the Energy East consolidated capital structure for the equity ratio needed for ratemaking purposes. Thus, we rejected the 48.3% stand-alone equity ratio NYSEG had presented and instead applied the 41.6% equity ratio suggested by the Staff approach.

In its rehearing petition, NYSEG claims the difference is about \$122 million of capital that should earn the allowed return for equity and not the rate applied to debt. According to NYSEG, our use of the Energy East consolidated capital structure deprives it of about \$9.5 million in revenue requirements--an amount it considers to be confiscatory.

NYSEG claims that our rate determination is incorrect as a matter of law and fact. The Company believes we misinterpreted the requirements of the 2002 rate order, which also authorized Energy East and RG&E to merge. According to the Company, the merger-related provisions of the 2002 rate order live beyond the rate plan that ends in December 2006. It states that the merger provisions require us to use the NYSEG stand-alone equity capital for setting the 2007 revenue requirements and delivery rates.

The Company points specifically to language in the joint proposal submitted in the prior case that addressed the merger transaction and purports to resolve all such issues. It states that "[t]he cost of such business transaction [i.e., the merger] shall not be 'pushed down' below the New RGS level, and the goodwill created in this transaction shall not appear on the

books of either RG&E or NYSEG".<sup>12</sup> NYSEG asserts that this provision protects customers from paying the purchase price above book value that Energy East incurred and it resolves all merger-related issues pertaining to capital structure and rate base. From this, NYSEG claims that the 2002 rate order resolved, for all time, the portion of NYSEG's capital structure related to the merger and it left no room for the Commission to revisit this matter in a subsequent rate proceeding.

In its rehearing petition, NYSEG also challenges the Order's finding that the use of a parent company's (Energy East's) consolidated capital structure is the standard practice the Commission has applied to utility holding companies in other regulated industries and in fully litigated proceedings. The Company reasons that, if this regulatory principle has a rational basis, its application should be the same in both litigated and settled rate proceedings. NYSEG also asserts that the Commission has departed from the consolidated capital structure approach in cases involving RG&E, Central Hudson Gas & Electric Corporation, and the St. Lawrence Gas Company.

NYSEG insists that a 41.6% equity ratio is far below the electric industry average that is expected to be between 47% and 50% in 2006 and subsequent years. NYSEG considers its 49% stand-alone equity ratio to be consistent with the capitalization ratios of the companies included in Staff's proxy group. NYSEG therefore believes that the stand-alone equity ratio, and the practice followed in the cases involving RG&E, Central Hudson and St. Lawrence, should be applied here.

The Company also claims that we were incorrectly advised about the equity ratio supported by the existing rate plan. NYSEG and DPS Staff differ as to the capital structure inherent in the existing rate plan. According to DPS Staff, the rate plan is premised on a 42.5% equity ratio. According to NYSEG, the plan supports a 45% equity ratio. While both parties recommended Commission adoption of the current rate plan, they

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<sup>12</sup> Cases 01-E-0359 and 01-M-0404, supra, 2002 rate order, Joint Proposal, Section III, Merger Transactions.

apparently never reached a perfect understanding of the capital structure underlying the rate plan.

Further, NYSEG asserts that a low common equity ratio combined with a low equity return cannot provide it a fair return comparable to those allowed other companies. NYSEG states that its allowed return does not afford investors confidence in the Company's financial integrity as demonstrated by the negative outlook announcements following the Order.

Addressing the debt-financing strategy Energy East used to acquire RG&E and the goodwill it purchased, NYSEG states that the Commission knew about and accepted the use of such financing when it determined that the merger was in the public interest. NYSEG also points to the savings to ratepayers received as a result of the merger which it estimates to be over \$40 million annually.

Finally, in response to the Order's reference to the "ring fencing" that could be used to support the use the subsidiary company's stand-alone capital structure, NYSEG states that it is prepared to adopt ring-fencing provisions if it will permit the use of the Company's stand-alone capital structure for ratemaking purposes.

#### Parties' Responses

##### DPS Staff

Staff remains opposed to the use of NYSEG's stand-alone capital structure for setting the 2007 revenue requirements and delivery rates primarily because the rating agencies determine NYSEG's costs on the basis of the consolidated financial strength of Energy East. Staff states that the debt leveraging Energy East has used denies NYSEG the "A" bond rating it could otherwise obtain. In these circumstances, Staff believes ratepayers should not pay for "A" bond rating parameters without obtaining the benefits of the higher rating. Addressing the acquisition strategy Energy East used to acquire RG&E, Staff states that the rating agencies look to the consolidated company, Energy East, for the determinations they render.

Turning to the rate proceedings and decisions involving other utility companies, Staff points out that, since the Energy East acquisition, RG&E has been put on notice that its capital structure will be calculated on a consolidated basis if it does not become structurally separate from Energy East.<sup>13</sup>

As to Central Hudson, Staff points out that its parent has more equity than the utility company and the parent company has invested its equity funds in unregulated subsidiaries. Central Hudson recognizes the fact that its consolidated capital structure is not reasonable for the purpose of developing its regulated rate of return when it uses its stand-alone capital structure for ratemaking purposes. Staff notes that Central Hudson's bond rating is not constrained by the rating agencies in stark contrast to NYSEG's constrained ratings due to the debt leveraging Energy East has used for its acquisitions and mergers.

Addressing the St. Lawrence Gas Company, Staff observes that the approach for this company has varied due to the company's unique circumstances. Nonetheless, St. Lawrence Gas is a subsidiary of a Canadian firm and the Canadian government restricts the parent company's ability to refinance its high debt costs. Consequently, in this instance, it is proper to use the St. Lawrence Gas Company's stand-alone capital structure.

In response to NYSEG's assertion that the capital structure provisions of the 2002 rate order continue beyond December 2006, Staff states that the order neither addresses nor controls the capital structure methodology the Commission uses for ratemaking purposes subsequent to the current rate plan. Staff also states that the equity ratio supported by the existing rates is unclear and it provides little, if any, guidance for the ratemaking actions after 2006.

Concerning the electric industry's average equity ratio and the equity ratios of the companies in the proxy group, Staff states that Energy East and NYSEG do not have the same equity ratios. On this score, they are not comparable to those holding

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<sup>13</sup> Cases 02-E-0198 and 02-G-0199, Rochester Gas and Electric Corporation - Rates, Order Adopting Recommended Decision with Modifications (issued March 7, 2003) p. 63.

companies and utility subsidiaries that have similar equity ratios. Thus, Staff considers the Company's reference to the so-called comparable companies to be an "apples to oranges" comparison.

As to the rating agencies' and investment advisory firms' views about the Order, Staff insists that the Commission decision should not change because of the negative ratings. Staff points to NYSEG's last five years of substantial earnings and notes that the rates set for 2007 cannot sustain past earnings and remain just and reasonable for ratepayers.

In response to NYSEG's assertion that the Order impairs the Company's ability to raise capital, Staff points out that NYSEG's bond rating remains at investment grade. It observes that there is no evidence showing that a downgrading from a BBB+/Baa1 to a BBB/Baa2 would impair NYSEG's ability to raise capital. Moreover, Staff points to a Standard & Poor's report which states that Energy East's capital spending program is expected to be financed with internally generated funds.

Finally, Staff has reviewed the ring-fencing provisions offered by NYSEG. According to Staff, such provisions must be considered with assurances from the credit rating agencies that they will recognize NYSEG's creditworthiness separate and apart from Energy East's. Absent such assurances, Staff does not believe the provisions offered by NYSEG suffice. Staff suggests that NYSEG present its ring-fencing provisions either with its enhanced bond ratings or with rating agency statements that the ring-fencing provisions are effective for the intended purpose in the next rate case, rather than making a last-ditch attempt to obtain its preferred capital structure in a petition for rehearing.

#### Multiple Intervenors

Like Staff, Multiple Intervenors notes that NYSEG has made no showing that the credit rating agencies would recognize its creditworthiness separate and apart from Energy East's with the ring-fencing provisions it has proposed. Also, contrary to NYSEG's claim that the 2002 rate order determined a portion of

the capital structure for 2007 and beyond, Multiple Intervenors states that the Commission is obliged to set just and reasonable rates that uses a proper capital structure for ratemaking purposes. Given that NYSEG's credit rating is tied to Energy East's, Multiple Intervenors considers it appropriate to use the consolidated capital structure. Multiple Intervenors also notes that the \$100 million Energy East provided to NYSEG for corporate improvements was funded through debt financing. Multiple Intervenors states that this debt weakens the consolidated capital structure and it should not receive an equity return allowance from NYSEG ratepayers.

Multiple Intervenors also disagrees with NYSEG's view of the 2002 rate order. It states that the parties entered into a single joint proposal that was submitted to the Commission. According to Multiple Intervenors, the joint proposal cannot be considered two separate and distinct proposals. It also states that the 2002 rate order did not establish any precedent for future rate proceedings beyond the term of the current rate plan.

Addressing NYSEG's efforts to show that the use of consolidated capital structures has been inconsistent, Multiple Intervenors states that the results in settled rate proceedings need not be based on any rigid formula, or particular methodology, when the parties submit an uncontested proposal to serve the public interest. In this case, however, where all the issues concerning NYSEG's rates were litigated, Multiple Intervenors supports the Commission's adherence to the ratemaking principles customarily used, including those for determining an appropriate equity ratio.

#### CPB

CPB considers the arguments contained in NYSEG's rehearing petition to be the same as those presented in the Company's briefs. Noting that the parties previously responded to the Company's arguments, CPB states that there is nothing new and the rehearing request should be denied. CPB also points to substantial evidence of record for using the Energy East capital structure for ratemaking purposes in 2007.

Discussion

Other than the ring-fencing provisions NYSEG has offered, we find that the Company's petition has not presented any changed circumstances to warrant a rehearing of this issue. As to the ring-fencing provisions, DPS Staff and Multiple Intervenors properly note that, for us to find any such provisions adequate, we require clear assurance from the major rating agencies that the ring-fencing provisions would produce different ratings for Energy East and NYSEG based on their respective capital structures. In any event, the Company's presentation on ring-fencing does not point to an error of fact justifying rehearing. The Company attempts to respond to our willingness to re-evaluate NYSEG's capital structure once it showed a full insulation from Energy East through "ring-fencing." Staff correctly observes that our intent was that such a presentation would be made in conjunction with the next rate case.

As to the alleged errors of law and fact claimed by NYSEG, we find that the 2002 rate order does not support the Company's position here. Our ratemaking and delivery rate determinations for 2007 depend entirely on the record made in this case. Our actions were not pre-determined by the decision allowing Energy East and RG&E to merge, nor do the terms of the multi-year rate plan that ends this December control the ratemaking for 2007 and thereafter. The new rates we have set for 2007 are based exclusively on the merits of the filings and submissions provided in this case and no other. This approach complies fully with the applicable requirements.

As to any confusion about the facts supporting the current rate plan, and the capital structure results reflected in the current plan, we find that the parties' competing and inconclusive views about the amount of equity capital reflected in the current rates are immaterial and irrelevant to our rate actions for 2007. We have determined, and we remain confident, given the current financial conditions applicable to Energy East and NYSEG, that the rates for 2007 should be established using

the consolidated capital structure and not the stand-alone capital structure. It is also perplexing that NYSEG considers the issue settled for all time, when at the same time it acknowledges the different views of parties to the joint proposal. Accordingly, the Company's rehearing petition on this matter is denied.

### Return on Equity

#### NYSEG's Rehearing Petition

The Order adopted the presiding officers' recommendation to set NYSEG's allowed return on equity using the average of the rate of return calculations provided by the DPS Staff and the Consumer Protection Board witnesses who testified in this proceeding. The presiding officers adopted this approach because these parties kept, as well as is possible, to the tenets of the Generic Financing Case approach that has been the Commission's standard and consistently used approach.<sup>14</sup> Our update of the parties' calculations produced the 9.55% allowed return on equity that was used in the Order. NYSEG's petition for rehearing claims that this allowed return on equity is confiscatory, insufficient as a matter of law, and unreasonable.<sup>15</sup>

NYSEG challenges the allowed return, pointing to the information discussed at the August 23, 2006 open session. When asked by a Commissioner to explain why the NYSEG allowed equity return differs from various equity returns allowed to other utility companies in other states, the Director of the Office of Accounting and Finance provided his response to the inquiry.

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<sup>14</sup> Case 91-M-0509, Proceeding on Motion of the Commission to Consider Financial Regulatory Policies of New York Utilities, Recommended Decision (July 19, 1994).

<sup>15</sup> NYSEG also claims that the updated calculations producing the 9.55% allowed equity return should have been provided in the August 23 order. However, the update did not depart from the calculations of record as provided by DPS Staff and CPB. Consequently, there was no need to detail the update as the Company suggests.

According to NYSEG, the ensuing discussion of extra record information during the open meeting contravened its due process rights.

NYSEG has surveyed for itself the allowed equity returns in other states and it disagrees with the Accounting and Finance Director's observations. The Company believes that the allowed returns in other states are higher than the Director indicated. In its rehearing petition, NYSEG specifically challenges and responds to five of the Director's observations concerning a rate decision rendered by the Arkansas Public Service Commission; average allowed equity returns, equity ratios and bond ratings; and the allowed equity returns in settled rate proceedings.

NYSEG also challenges the allowed return for "narrow insularity" and for rigorously adhering to the Generic Financing Case methodology. According to the Company, the equity returns it has observed for other utility companies with comparable risks (and with whom NYSEG should have a commensurate return) proves that the 9.55% for NYSEG is atypically low and confiscatory. Similarly, NYSEG points to the companies in Staff's proxy group and states that their allowed returns and equity capitalization ratios are far below the average it considers to be representative for the utility industry. According to NYSEG, its allowed return on equity should be at least 115 basis points higher to avoid a confiscatory result and to provide a return commensurate with investments having corresponding risks.

Assuming that we continue to use the Energy East consolidated capital structure, NYSEG claims that the allowed equity return must be adjusted upwards to account for all the risk associated with the debt financing contained in the capital structure. NYSEG asserts that a "Hamada Adjustment" is required to reflect the use of the lower amount of common equity.<sup>16</sup> The

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<sup>16</sup> NYSEG's rehearing petition introduces, for the first time in this proceeding, the use of a "Hamada Adjustment". It pertains to the use of the Capital Asset Pricing Model and, according to the Company, it takes the unlevered beta of a proxy group to relever the unlevered beta for NYSEG at the common equity ratio that is used in this case. The

Company points to the use of this adjustment in two rate proceedings, one involving the Long Island Water Corporation and another involving RG&E. According to NYSEG, the use of the Energy East equity ratio requires a 75 basis point adjustment. At the 41.6% equity ratio level the Commission has used, the Company does not believe that its bond ratings and financial risks are sufficiently similar to the proxy groups to avoid the use of the "Hamada Adjustment."

### Parties' Responses

#### Staff

Staff states that NYSEG's criticism of the cost of equity set in this case lacks merit. It observes that the methodology employed by the Commission is one that it has long used to determine the cost of equity for utility companies. Staff doubts that a 9.55% equity return allowance can be considered confiscatory, noting that Central Hudson recently received a 9.6% allowed return and these results are consistent in the circumstances applicable to each company. Staff also asserts that NYSEG has not specifically quantified the level at which an allowed return becomes confiscatory.

Responding to NYSEG's observations about the equity returns allowed in other states, Staff states that it has counted 24 cost-of-equity recommendations provided by state regulatory staffs, and seven commission decisions, below 10%. Thus, Staff does not consider the rate of return recommendations and decisions in New York as being out of line with those in other states. Nonetheless, Staff states that the regulatory approaches used in other states are likely to differ, which makes any such comparisons not particularly useful.

Staff notes that NYSEG can calculate the Commission's 9.55% allowed equity return for itself using the testimony and exhibits the DPS and CPB witnesses provided on the record. Staff also defends the Director of the Office of Accounting & Finance

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difference in the relevered beta and the original levered beta is calculated and it is applied to the expected market risk premium to increase the allowed equity return.

and denies that his comments infringed on the Company's rights. Staff states that the Director's anecdotal comments in response to a Commissioner's inquiry do not detract from the Commission's written decision rendered exclusively on the evidence of record.

As to NYSEG's proposed Hamada Adjustment, Staff states that it is typically used to reflect financial risk differences. In this instance, however, Staff notes that the average bond ratings for its proxy group and NYSEG are the same, BBB+. Therefore, it sees no need for any adjustment here. In fact, Staff believes that NYSEG's business profile is less risky than the proxy group's and it offsets any potentially higher financial risks the Company may face.

In general, Staff believes NYSEG's proposed cost of equity is out of touch with the conditions prevailing in today's financial markets. Staff notes that long-term interest rates are near a historic low, supporting the equity returns the Commission has recently applied to NYSEG, Central Hudson and various other jurisdictional companies. In sum, Staff sees no reason to depart from the results produced from a rigorous application of the Discounted Cash Flow and Capital Asset Pricing Models.

#### Multiple Intervenors

Addressing NYSEG's criticisms of the statements made by the Director of the Office of Accounting & Finance at the open session, Multiple Intervenors states that they are irrelevant here. It points out that the rate decision is not related to any of the Director's comments because it is tied directly to the Generic Financing methodology detailed on the record.

Concerning the equity returns allowed in other states, Multiple Intervenors states that the results in other jurisdictions do not demonstrate that the decision in this case is confiscatory. Multiple Intervenors believes that our adherence to the longstanding method used in New York satisfies the applicable legal standards. It notes that similar criticisms have been made in other rate proceedings and the Commission has consistently rejected such attempts to rely on authorized returns in other states. Instead, Multiple Intervenors supports a

comparison of NYSEG's allowed rate of return with the returns the Commission has allowed other utility companies. It considers the results in all the recently decided cases to be rational and in keeping with the applicable legal standards.

Finally, addressing the proposed Hamada Adjustment, Multiple Intervenors notes that the record in this case lacks evidence as to the relevance, applicability, justification or calculation of any such adjustment. Nor is Multiple Intervenors aware of any instance in which the Commission has addressed the merits of this adjustment in an electric utility company's rate proceeding. From its knowledge of the proxy group Staff employed in this case, Multiple Intervenors states that the proxy group's and NYSEG's comparable bond ratings render a utility-specific adjustment, like the Hamada Adjustment, unnecessary.

#### CPB

In support of the Commission's decision, CPB points to the rate of return allowed to Central Hudson. According to CPB, NYSEG's 9.55% allowed return compares well with the 9.6% equity return Central Hudson was permitted. It notes that Central Hudson's return is for three years and contains a multi-year premium. Given that NYSEG's allowed return applies only to the 2007 delivery rates (and not to the three-year period applicable to Central Hudson), CPB considers NYSEG's allowed return to be higher.

CPB observes that the Commission's adherence to the Generic Financing methodology has functioned well in the many years it has been used. It believes that approach remains reasonable and reliable for ratemaking purposes.

#### Discussion

We have considered NYSEG's petition for rehearing, and the parties' responses, and we find no basis for departing from the 9.55% cost of equity capital set on the basis of the evidentiary record. First, we note that the rate of return decision rendered in this case is fully reflected in the written decision issued on August 23, 2006. Our decision is based on the

parties' testimony, evidence and arguments. The discussion at the open session does not constitute the Commission's findings or its decisional rationale and does not supplement the record before the Commission. Consequently, much of NYSEG's rehearing petition is extraneous to the process that was used here to decide the issue.

Moreover, the development of a rate of return on equity for NYSEG, including application of the Generic Financing framework to NYSEG, where appropriate, has been fully documented on the record. That approach supports the 9.55% cost of equity we found to be reasonable and supported when we rendered our decision. The update of the methodology based on the Generic Financing framework at the time of the briefs on exception provided NYSEG the benefit of a higher allowed return, and the update was executed consistent with the methods presented by DPS Staff and CPB on the record.

The New York Commission has never set any allowed returns for jurisdictional utility companies on the basis of any allowed returns set by regulatory bodies elsewhere. Such allowed returns may reflect stale data, other regulatory regimes and different weighting of evidence presented in other records. In every case, the record before the Commission provides the best efforts to ascertain the applicable financial market conditions and requirements for the cost of equity capital analysis that we require.<sup>17</sup> Contrary to NYSEG's claim, we have not rigorously and insularly adhered to a rigid Generic Financing calculation, but properly given NYSEG a return commensurate with the risks that it faces based on the general framework of the General Financing methodology as informed by the record before us. As discussed in the original opinion, we appropriately adjusted the Generic Financing methodology to reflect the most appropriate growth rates and a more inclusive proxy group for the Discounted Cash Flow Model, and updated data for the Capital Asset Pricing Model. We did use the weighting of the Discounted Cash Flow and Capital

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<sup>17</sup> That record does not, among other things, support the "Hamada adjustment" that NYSEG now seeks.

Asset Pricing Models, a portion of the Generic Financing methodology that we continue to favor. NYSEG has not shown why we should not continue to follow a general approach, which as allowed us to maintain a reasonable level of consistency for all utilities in New York State for many years. As a result, we find no basis for departing from that approach now.

"Hedged Portfolio" As The Residential Default Rate

PULP's Petition for Rehearing

In its petition, PULP asserts that the Commission erred in eliminating fixed price service as the default option for residential customers and substituting in its place the "hedged portfolio" default rate. According to PULP, the Order establishes the validity of the fixed price option as a just and reasonable rate. Moreover, our revisions to the current fixed price offer, notably the lowering of the retail conversion factor, have properly corrected the deficiencies that were criticized by the other parties in the case. However, according to PULP, in making that fixed price offer an option that must be elected by customers, we have "denied access" to fixed price service for vulnerable customers.<sup>18</sup>

In contrast to fixed price service, PULP asserts, the hedged portfolio default rate that we have ordered is not a just and reasonable rate set in accordance with Public Service Law §72. PULP asserts that the default rate ordered here lacks history or analysis or sufficient standards, methodologies, formulas or caps to satisfy our rate-setting obligations under §72. According to PULP, the Order improperly delegates the ratemaking task to NYSEG, in violation of the Commission's duty to set rates.

Parties' Responses

In response, both Staff and SCMC/RESA assert that the Order does, indeed, contain sufficient standards and direction to

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<sup>18</sup> PULP Petition for Rehearing at 6.

NYSEG such that it complies with PSL §72. SCMC/RESA point out that we have charged NYSEG with balancing the objectives of low price, secure supply, and rate stability, standards sufficient to meet statutory requirements. Moreover, SCMC/RESA note, default customers are automatically protected by the legacy hedges in the non-bypassable charge, which provide hedging for 60% of NYSEG's load, a level the Commission has previously opined to be adequate. SCMC/RESA assert that customers are further protected from volatility because they are charged monthly, based upon the average load shape of the residential class; therefore, customers are significantly insulated from the impact of the spot market. According to Staff, the hedged portfolio described in its testimony and adopted in the Order is a partially hedged portfolio, which will have volatility characteristics somewhere between those of a fully hedged portfolio and the spot market. Therefore, Staff finds no merit in PULP's contention that this portfolio performance must be proven.

Both SCMC/RESA and Direct Energy support the move to make fixed price service an opt-in option. Direct Energy states that the Commission recognized the inconsistency between the continuation of a utility fixed price option and the establishment of a vibrant competitive market. Therefore, according to Direct Energy, the option of an opt-in fixed price service is only an interim step toward the proper end state, in which such service is provided exclusively by ESCOs. According to Direct Energy, PULP's petition ignores the careful balance struck by the Order between promoting competition and protecting retail customers.

For their part, SCMC/RESA dispute PULP's claim that the regime established in the Order will prevent customers from obtaining the protection of fixed price service. They note that NYSEG will conduct extensive outreach regarding the options available to customers, and they assert that the capability of customers to exercise choice is far greater than the bleak picture painted by PULP. In any event, SCMC/RESA note, historical data show that customers were not better off under the

current fixed price option; instead, customers generally paid more than those on the variable rate plan.

Finally, NYSEG states that it "reluctantly declines" to support PULP's position on rehearing, even though it "fully appreciates" PULP's concerns, because NYSEG cannot afford to make the fixed price option the default.<sup>19</sup> Given the structure of the fixed price option and what it characterizes as the unreasonably low retail conversion factor, NYSEG asserts that it could not withstand the increased risk that it would assume if large numbers of its residential customers were to default to the fixed price option.

#### Discussion

We reject PULP's contention that the hedged portfolio default rate is untested and unproven or that it lacks history or sufficient standards to satisfy our rate-setting obligations under PSL §72. On the contrary, the flow-through of a utility's costs in managing its supply portfolio, including costs of fuel and of purchased power, with oversight and review by Department Staff and by us, is a long-standing practice here. As PULP acknowledges, our employment of fuel adjustment charges, whereby utilities passed through both fuel and purchased power costs, has been explicitly upheld by the courts as proper ratemaking. Mechanisms allowing the flow-through of purchased power, including not merely spot market purchases but also hedged contracts purchased at the utility's discretion, are already in place at many New York electric companies, including Consolidated Edison, Orange & Rockland, Niagara Mohawk, and Central Hudson.<sup>20</sup> Indeed, the supply costs at Niagara Mohawk passed through to most residential customers have been structured this way since 2002.<sup>21</sup>

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<sup>19</sup> NYSEG Second Response at 10.

<sup>20</sup> Some of these utilities flow hedging costs through a commodity charge and some through a delivery charge; the distinction is not material to this point.

<sup>21</sup> See Case 01-M-0075 - Niagara Mohawk Power Corp. & National Grid USA - Merger, Opinion No. 01-6, Opinion and Order Authorizing Merger and Adopting Rate Plan (December 3, 2001), approving October 11, 2001 Joint Proposal, which includes

The NYSEG default rate is thus a continuation of a widespread practice that has worked well, not a new, untested venture as PULP asserts.

We will indeed closely monitor NYSEG's performance in providing for default customers under the standard we have established to manage volatility, achieve reasonable prices, and secure an adequate supply for default customers. As is amply clear from the record in this proceeding, the hedged default proposed by Staff that we adopted in the Order is the same type of commodity service in place at other New York utilities, such as Central Hudson and Orange and Rockland. As it does with those utilities, Staff will review NYSEG's commodity rates, both to insure that NYSEG has correctly flowed through the costs it incurs and to monitor the reasonableness of those costs. As noted, our oversight and remedies in monitoring this rate are similar to the oversight we have exercised over fuel adjustment charges in the past. Moreover, we will be exploring generically whether additional guidance can be provided to all electric utilities engaged in this effort,<sup>22</sup> just as we have developed guidelines for the supply portfolio management practices of gas utilities. Under these circumstances, PULP's claim that we have shirked our statutory duty is unfounded.

We further agree with the concept that affording customers a choice of alternatives, which include the alternative of completely fixed price service, is an appropriate means of providing volatility protection at this time. There is no basis to PULP's claim that the wide array of choices afforded under the Order will "deny access" to any customer for any service available in the market.

#### Prudence of One-Month Forward Contracts

#### Direct Energy's Petition for Clarification

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recovery of the costs of new hedges under section 1.3.4, p. 46.

<sup>22</sup> This effort is under way in Case 06-M-1017.

In its petition, Direct Energy asks the Commission to declare that NYSEG can prudently replace its expiring commodity hedges with one-month forward agreements pending further action in Case 06-M-1017, the proceeding that is examining utility electric supply portfolio management generically. According to Direct Energy, the testimony of its expert witnesses in this case establishes that such contracts would provide volatility protection without disrupting the competitive market. Therefore, Direct Energy advocates that we earmark such hedging activity as a "safe harbor" pending the outcome of Case 06-M-1017. In the interim, Direct Energy asserts, NYSEG's experience in using such contracts will benefit the record in Case 06-M-1017.<sup>23</sup>

#### Parties' Responses

In response, CPB asserts that the clarification requested by Direct Energy would be a "significant change in portfolio management policies previously articulated by the Commission."<sup>24</sup> CPB asserts that the Commission should not make any decision regarding portfolio management policies pending the thorough evaluation of the topic by all parties in Case 06-M-1017. Similarly, Staff asserts that there is no need at this time to pre-approve any specific type of hedging. Rather, it advises the Commission to await the results of the generic inquiry.

#### Discussion

We agree that the best course is to allow these issues to be the subject of more thorough airing in the context of Case 06-M-1017. Given the pendency of that proceeding, there is no reason for us to make a pre-determination of prudent hedging

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<sup>23</sup> We note that, in its petition for rehearing, NEM also states that the practice of meeting the needs of POLR commodity-related costs with short-term hedges, such as monthly hedges, better serves Commission policy.

<sup>24</sup> CPB Second Response at 1, citing Case 00-M-0504, Retail Energy Markets Policy Statement at 32-34.

practices at this stage of this proceeding. Therefore Direct Energy's request is denied.

Forecast of the NBC for Fixed Price Service

Direct Energy Petition on Rehearing

In its petition for rehearing, Direct Energy challenges that part of the Order establishing the mechanics by which NYSEG will offer fixed price service. According to Direct Energy, the Commission made a mistake in requiring NYSEG to forecast the non-bypassable charge for its fixed price option to arrive at an "all-in" fixed price, while other customers, including customers of ESCOs, will pay a variable non-bypassable charge. Direct Energy asserts that, in so providing, the Order represents a departure from our prior stated policy of promoting competitive markets. Direct Energy further asserts that few ESCOs will be able to forecast the non-bypassable charge and will therefore be discouraged from offering fixed price service. In Direct Energy's view, the damage from this provision will be compounded by the 80/20 sharing of gains and losses between shareholders and customers.

The fact that the variable non-bypassable charge will be shown each month on the bills of fixed price customers is irrelevant, Direct Energy asserts, because customers will select their commodity service during the open enrollment period, long before they ever see such bills. Moreover, Direct Energy asserts, showing the variable non-bypassable charge on the bills does not ameliorate the anti-competitive effects of the all-in fixed price, since that price leaves customers in precisely the same financial position they would occupy if they received a fixed non-bypassable charge and a fixed commodity charge. Direct Energy asserts that we provided no explanation why this action was required to meet any other policy objective and, therefore, our action is arbitrary, capricious, and unlawful.

Parties' Responses

In response, NYSEG asserts that the Commission provided a "full and thorough" explanation of its decision regarding the forecasting and fixing of the fixed price rate, including the non-bypassable charge, for fixed price customers.<sup>25</sup> NYSEG reviews the discussion at pages 42-43 of the Order in which we discussed and rejected the alternative of offering a fixed non-bypassable charge to all customers and instead required NYSEG to describe and present its fixed price option as a bottom-line fixed price.

Staff asserts that Direct Energy has not pointed to any error of law or fact or raised any issue not already considered on the record in this proceeding. Moreover, according to Staff, Direct Energy has misconstrued the Order as allowing NYSEG to fix the non-bypassable charge in its fixed price rate. In fact, Staff asserts, NYSEG, in forecasting the non-bypassable charge to set its all-in fixed charge, will be making a forecast that reflects a variable non-bypassable charge. According to Staff, Direct Energy's complaint that ESCOs would have difficulty forecasting the non-bypassable charge to offer all-in fixed price service is the same complaint previously considered and rejected by the Commission as discussed in the Order.

#### Discussion

The issues surrounding the availability of a fixed or variable non-bypassable charge for various classes of customers were hotly contested and thoroughly aired in this proceeding. They were addressed at length in the Recommended Decision issued by the Administrative Law Judges and were considered again by us in the exceptions process, during which Direct Energy and other parties submitted two rounds of briefs. We have thus considered a host of competing policy objectives in arriving at the scheme reflected in the Order.

Under the balance struck in the Order, the same variable non-bypassable charge will appear each month on the bills of all customers. This presentation represents a departure

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<sup>25</sup> NYSEG Second Response at 2.

from the current fixed price offering, which NYSEG currently describes as a combination of a fixed commodity rate and a fixed non-bypassable charge. The record in this proceeding makes clear that the current description of each charge as separately "fixed" is somewhat of a fiction, since the two charges tend to vary inversely to each other, such that each serves as a partial hedge of the other. Consequently, we concluded in the Order that NYSEG should describe its fixed price option only as a "bottom line" fixed price rather than the combination of two fixed sub-parts. Nevertheless, as a practical matter, to arrive at its fixed offer initially, NYSEG will need to make forecasts of each component. Our Order merely noted this mechanical detail to provide some implementation guidance to the Company.

In responding to PULP's Petition for Rehearing in this case, Direct Energy asserts, "PULP's rehearing request totally ignores the careful balance that the Commission struck in the Order between promoting competition and protecting retail customers in markets where NYSEG's existing FPO has effectively foreclosed the development of competitive markets for retail commodity supply."<sup>26</sup> From this statement, we conclude that Direct Energy is not, on rehearing, challenging the existence of the fixed price service allowed under the Order. Given the existence of a fixed price option, it is necessary for NYSEG, at the outset of the one-year offering period, to arrive at the fixed rate. Direct Energy's rehearing petition fails to identify any alternative other than the one set forth in the Order which would allow NYSEG to set the rate for its fixed price. Consequently, Direct Energy's request on this ground is denied.

Similarly, the Order and the Recommended Decision adopted by the Order together fully address the complaint that ESCOs may have difficulty in forecasting the non-bypassable charge. This issue was resolved by the finding that the forecasting difficulties faced by ESCOs are identical to those faced by NYSEG. Direct Energy's petition merely repeats its

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<sup>26</sup> Direct Energy Second Response at 4.

prior positions without adding anything new to the debate. Therefore, this issue does not merit further consideration here.

Notice of Intent to Offer a Fixed Price in 2008

NEM Petition for Rehearing

NEM seeks clarification regarding NYSEG's offer of a fixed price option in 2008. It notes that we did not set forth a date by which NYEG must notify us of its decision to offer a fixed price option in 2008. According to NEM, if NYSEG does not provide sufficient lead time, marketers will be disadvantaged in formulating future offers. Therefore, NEM requests that we establish a deadline by which NYSEG should provide notice of its decision.

Parties' Response

Staff responds to NEM by supporting the request. Staff recommends that the Commission direct NYSEG to provide notice to the Commission, consumers, and interested parties of its intent to offer a fixed price option for commodity service in 2008 by no later than September 1, 2007.

Discussion

NEM's request has merit. We will adopt Staff's recommendation, in part, by requiring NYSEG to notify this Commission and the active parties in this proceeding by no later than September 1, 2007 of its decision regarding the offering of fixed price commodity service in 2008. Such notice should be filed with the Secretary and served on active parties. Simultaneously, NYSEG should issue a press release announcing its decision. Thereafter, NYSEG should work with our Outreach and Education staff to notify customers of their choices for commodity service in a manner similar to the Voice Your Choice campaign conducted in the fall of 2006.

Commodity Options for Demand-Metered Customers

Constellation NewEnergy Petition for Clarification

In its petition, Constellation seeks clarification as to whether the fixed price option is available to demand-metered commercial and industrial customers. According to Constellation, the Order "clearly indicates that NYSEG's fixed price portfolio management service should **not** be available as a default service to larger commercial and industrial customers."<sup>27</sup> Constellation continues, "The Commission analysis here indicates that only non-demand metered and residential customers are eligible for the fixed price commodity service as a default service."<sup>28</sup> According to Constellation, the Order is ambiguous regarding the availability of fixed price service for large, demand-metered commercial and industrial customers.

Direct Energy Petition for Rehearing

In its petition, Direct Energy urges the Commission to reverse its decision to permit the offering by NYSEG of fixed price service for large commercial and industrial customers. According to Direct Energy, the Commission has sufficiently justified its decision to retain the fixed price option for residential customers. However, according to Direct Energy, there is no similar expressed rationale for continuing the fixed price option for large commercial and industrial customers. Our decision is especially odd, according to Direct Energy, in light of our finding that these customers are sufficiently sophisticated that the default service afforded them need not be hedged by NYSEG.

Parties' Responses

Both NYSEG and Staff respond to Constellation that there is no ambiguity in the Order regarding the availability of fixed price service. These parties assert the Order is clear in stating that fixed price service is an option that may be

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<sup>27</sup> Constellation Petition at 2, citing Order at 45-46 (emphasis in original).

<sup>28</sup> Id.

selected by large, demand-metered commercial and industrial customers other than those with demand greater than one megawatt, who are required to take hourly metered service.

In response to Direct Energy, the Company asserts that there was ample record evidence that large commercial and industrial customers desire the fixed price option for the same reasons as residential customers. Therefore, NYSEG opposes Direct Energy's petition on this ground. Staff, on the other hand, is somewhat supportive of the Direct Energy petition. According to Staff, it was a rational Commission policy decision to find that large, demand-metered commercial and industrial customers do not need hedging protection in their default rate. Consequently, Staff avers, "It does seem anomalous then to allow these same customers to opt for the FPO."<sup>29</sup> According to Staff, the Commission should either make the default and optional offerings for commercial and industrial customers the same as those for residential customers or it should restrict the large commercial and industrial customers from the option of fixed price service.

#### Discussion

Constellation NewEnergy's confusion in interpreting the Order stems from its equating of the term "hedged portfolio service," which we use throughout the Order to describe the default service to be provided to residential customers, with the term "fixed price service," which is available as an option to be affirmatively selected by residential customers. When the two terms are treated as synonyms, as occurs in Constellation's petition, confusion does indeed result. When the terms are used to describe two very different kinds of service, as they are consistently used in the Order, there should be no confusion as to our meaning. As both Staff and NYSEG correctly describe, the Order provides that large, demand-metered commercial and industrial customers (other than those with demand over one megawatt) will continue to have the option to elect fixed price

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<sup>29</sup> Staff Second Response at 4.

service from NYSEG, as they have for the past four years. If they make no election, they will default to a rate based upon the pass through of the spot market price, as hedged by the non-bypassable charge, as they do under the current rate plan. Consequently, the Order preserves the status quo as to the options available to these large commercial and industrial customers.

As we noted in the Order, there is a "relative dearth" of discussion on the record regarding the appropriateness of NYSEG's continuing to offer the fixed price option to large commercial and industrial customers.<sup>30</sup> Although Constellation states in its petition for clarification that robust competition exists between ESCOs seeking to provide fixed-priced service to demand-metered customers, the competitiveness of the market for demand-metered customers was not the subject of sufficient testimony or exhibits subject to cross-examination for us to reach a conclusion in this case. Parties devoted little attention to the issue. Given this lack of a record to support any change, it seems most prudent to us to preserve the status quo.

Moreover, there is no need for the consistency that Staff describes. NYSEG's offering of optional fixed price service in this case is based largely upon the state of competition in the market and the ability of a competitive marketplace to provide fixed priced service at a just and reasonable rate if NYSEG were to withdraw the service. In contrast, our decision regarding the type of default service to be afforded to a particular class of customers is based upon the needs of that particular customer class. Given the relative sophistication of business customers of sufficient size to warrant demand metering, we have deemed it appropriate that they experience potentially greater exposure to the spot market than residential customers. Such "inconsistency" is entirely justified by the different characteristics of these service classifications.

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<sup>30</sup> Order at 45, referenced in NYSEG's Second Response at 4.

Phase-In of Merchant Function Charges

MI Petition for Rehearing

In its petition for rehearing, Multiple Intervenors asserts that the Commission committed an error of fact that, if not remedied, will result in unintended consequences. Specifically, MI asserts that the Commission's decision to adopt a phased-in approach to move from retail access back-out credits to cost-based merchant function charges (MFCs) is frustrated by the provisions of the Order which convert the back-out credits to MFCs at the beginning of the transition period instead of at the end. MI, in its petition, walks through what it believes to be the impact on delivery-only customers and on full-service customers. Under the scenarios painted by MI, the delivery-only customer experiences the full impact of the change from back-out credits to MFCs on January 1, 2007 without the benefit of the phase-in contemplated by the Commission. On the other hand, under MI's scenario, the supply customer would see an unanticipated increase in its total delivery charges on January 1, 2007, which would then gradually decline until January 2008. According to MI, "this approach makes no sense."<sup>31</sup> As an alternative, MI proposes that the retail access back-out credit be reduced on a phased schedule and that, at the end of this phase-in period, the back-out credit be converted to a merchant function charge.

Separately, MI also asserts that the Order is not sufficiently clear that delivery rates need to be reduced so that the transformation of back-out credits into merchant function charges will be revenue neutral to NYSEG and its customers. Specifically, MI asks us to clarify that NYSEG's delivery rates should be reduced by the sum of the amount previously paid annually to customers in the form of retail access credits and by the amount projected to be recovered annually from commodity customers through the MFC. Moreover, MI asserts that the phase-

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<sup>31</sup> MI Petition for Rehearing at 7.

in will result in actual revenue to NYSEG that will be less than what is imputed in NYSEG's revenue requirement and that the shortfall should be recovered through the lost revenue recovery mechanism. MI asserts, however, that the delivery rate reduction associated with the "end state" of the phase-in must be implemented at the start of the rate year, so that delivery rates do not require any subsequent change to effectuate the Order.

SCMC/RESA Petition for Rehearing

The Small Customer Marketer Coalition and the Retail Energy Supply Association also seek rehearing regarding the phase-in of the change from the retail access back-out credits to merchant function charges. According to SCMC/RESA, the Commission erred by failing to allow some period of time following the establishment of new rates in which customers would experience no change whatsoever relating to the conversion of the back-out credit to MFCs. There is a need for stability in back-out credits in the instant case, SCMC/RESA argue, due to the controversy over the structure of a retail access program, the continuation of fixed price service, and the nature of default service. SCMC/RESA assert that "the competitive environment in NYSEG for 2007 remains shrouded in a veil of doubt, confusion and uncertainty."<sup>32</sup> Given this situation, SCMC/RESA believe that it behooves the Commission to minimize the number of material changes that will be implemented in the 2007 timeframe. Consequently, SCMC/RESA urge the Commission to structure a phase-in that does not make any change in the retail access back-out credit until January of 2008. According to SCMC/RESA, such a schedule for the transition from back-out credits to MFCs was recently approved for both Consolidated Edison and National Grid. SCMC/RESA advocate that a similar schedule be followed here.

Parties' Responses

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<sup>32</sup> SCMC/RESA Petition for Rehearing at 5.

In responding to Multiple Intervenors, NYSEG asserts that the adverse impacts cited by MI "do not exist."<sup>33</sup> According to the Company, the phase-in structured by the Order provides the same economic price signal and impacts upon a customer's decision to choose an ESCO for supply service as would the structure advocated by MI. According to NYSEG, to grant MI's request, the Commission would need to increase the delivery revenue requirement to reverse the inclusion of revenue from retail access credits already reflected and to reset delivery rates in 2008. According to NYSEG, such steps would be administratively burdensome and would delay the goal of achieving a cost-based, unbundled MFC.

NYSEG responds to MI's request for clarification by asserting that the Order is already clear in specifying the adjustments advocated by MI. According to NYSEG, the record in this proceeding establishes that the revenue requirement has been adjusted to reflect the elimination of retail access back-out credits and that delivery rates and MFCs have been designed so as to be revenue neutral. Finally, NYSEG acknowledges that, during the initial transition period, NYSEG will return additional MFC over-collections through a concurrent reduction in the non-bypassable charge. According to the Company, this approach provides a systematic method for returning the excess MFC revenues to customers and addresses the concerns raised by MI.

NYSEG responds to SCMC/RESA by urging the Commission to reject SCMC/RESA's arguments. First, NYSEG argues that the reliance on approaches at other utilities is misplaced, since the resolution at other utilities is based upon facts and circumstances unique in those cases and not necessarily appropriate here. Moreover, the Company argues that the bill impacts associated with retail access credits or avoidance of the MFC are essentially the same and are minor in relation to the total electric rates that customers will pay.

In its response to MI, Staff disagrees that the Commission made an error of fact. However, Staff asserts that

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<sup>33</sup> NYSEG First Response at 4.

the phase-in issue could benefit from additional clarification. According to Staff, the Commission should make clear that NYSEG's lost revenue recovery calculation, included in the non-bypassable charge to all customers, will true-up the entire difference between the phase-in MFCs and the final MFCs such that the effect sought by MI will be accomplished. According to Staff, this approach is reflected in NYSEG's compliance tariff. Staff asserts that, as reflected in those tariff amendments, the NBC for all customers will decrease on January 1, 2007 to reflect the over-collection of MFC revenues. Thereafter, the NBC will increase in a phased fashion to offset the corresponding phase-in of the MFCs. In this way, Staff asserts, delivery-only customers will gradually pay more, while the all-in rates (delivery charges plus adjustments flowed through the NBC) of supply customers will be unaffected by the phase-in.

In responding to SCMC/RESA, Staff asserts that those parties fail to demonstrate any error of fact or law made by the Commission. Staff notes that the two other cases to which SCMC/RESA refer were based upon joint proposals providing that the issues resolved therein not be deemed precedents to be cited in other proceedings. Moreover, according to Staff, neither case reflected a full unbundling of merchant function charges such as occurred in this case. In addition, Staff asserts, rates in both cases were established for a multi-year period, allowing for more flexibility and an extended phase-in period than a one-year case can provide. Staff further asserts that, in this case, the Commission had full knowledge of the interplay between the MFC phase-in and NYSEG's commodity offerings, including the open enrollment period for the fixed price option, when we made our determination. According to Staff, the SCMC/RESA petition adds nothing new to the record in this regard. However, if the Commission is disposed to consider SCMC/RESA's request, Staff asserts it could support an additional extension of the phase-in, such that the current levels of 4 and 2 mills for small and large customers, respectively, could be maintained for six months before beginning the phase-down of MFCs. According to Staff,

such an extension would represent a reasonable balancing of the issues raised here.

Discussion

No modification of the Order is necessary to achieve the phase-in of the change from retail access back-out credits to MFCs we intended. Multiple Intervenors' petition has been helpful in eliciting a fuller description of the means by which the Company's tariffs will comply with both the letter and the spirit of the Order. As Staff's response explains, the full effect of the phase-in will be accomplished by the combination of changes to delivery rates, merchant function charges, and the lost revenue recovery mechanism included in the non-bypassable charge. When the effect of these three charges is considered, delivery-only customers will see an increase in rates that will increase step-wise every six months, as envisioned in our Order. Similarly, supply customers will be largely unaffected by the phase-in mechanism. Of course, all customers will feel the effect of the overall change, in that the amount of the revenue previously associated with back-out credits that has been included in revenue requirement is greater than the amount imputed for merchant function charges. As NYSEG points out, no further clarification of these revenue adjustments is necessary, since they were fully indicated on the record in this proceeding and duly reflected in NYSEG's compliance tariff.

We reject SCMC/RESA's request that the impact of the change from back-out credits to merchant function charges be delayed beyond January 1, 2007. Those parties sought a phase-in of the change to ameliorate any adverse impacts from too abrupt a change. Merely pushing out the date by which the change begins does little to change the level of impact of the rate change on the day it occurs. While we were receptive to parties' requests for a phase-in, we see no basis for an outright delay in implementation of a change that otherwise promotes the goals of transparent, cost-based rates that better serve the development of a competitive market. Consequently, SCMC/RESA's request in this regard is denied.

Merchant Function Charges and the EOSA Option

SCMC/RESA Petition for Clarification

SCMC/RESA seek clarification of a statement in the Order, in which we describe the so-called EOSA option as based upon the fixed price option, with the spot market price plus one mill backed out of the rate. Because we did not explicitly state that the Merchant Function Charge, included in the fixed price option, would be deducted from the EOSA rate, SCMC/RESA seeks clarification that this is the case.

Parties' Responses

Staff agrees that the Commission intended the result that SCMC/RESA seeks on clarification. According to Staff, NYSEG's tariff filed in compliance with the Order provides for the result desired by SCMC/RESA, thereby rendering SCMC/RESA's request moot. NYSEG similarly agrees that EOSA customers should not pay the Merchant Function Charge. It, too, points to its tariff filing, which makes clear that the MFC will be applicable only to customers taking supply service from NYSEG. According to NYSEG, "No Commission clarification is necessary because NYSEG agrees with such statement [desired by SCMC/RESA] and will implement the EOSA option accordingly."<sup>34</sup>

Discussion

All parties properly agree that we did, indeed, intend that a party taking service under the EOSA option would not pay the Merchant Function Charge. That charge is applicable only to customers taking supply service from NYSEG. Because the interpretation reflected in NYSEG's compliance tariff is correct, we will not require changes in that regard before making that tariff provision permanent.

Generic Policy Regarding Incentives or Profits

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<sup>34</sup> NYSEG First Response at 3.

NEM Petition

NEM also seeks clarification from the Commission as to how and on what activities a utility should be awarded higher returns and bonus profits. According to NEM, this Commission should not provide incentives to the utilities it regulates to enter or remain in competitive markets. NEM asserts that the risks that NYSEG faces in offering the fixed price service are unclear and should be more clearly defined. The Commission should undertake this clarification, NEM asserts, to specify the risks that a State-regulated monopoly must take in Order to earn profits in excess of a regulated rate of return. According to NEM, the Commission should articulate a policy that it will only provide incentives of profits and higher returns on capital that a utility reallocates from competitive activities to infrastructure investments and reliability upgrades. In contrast, if a utility engages in a competitive activity, NEM argues, the utility should do so through an affiliate, and shareholder capital, not ratepayer funds, should be at risk. NEM expresses concerns that this case, which assertedly awards NYSEG bonus profits for engaging in competitive activity, should be clearly noted as unique and not a state-wide expression of policy.

Parties' Responses

In response, NYSEG asserts, "NEM misapprehends the manner in which NYSEG's or any regulated utility's commodity rate of return is established by the Commission. NYSEG's commodity rates are not set to allow to it to recover more than its return, but are set to provide an *opportunity* for NYSEG to realize earnings commensurate with the risk it bears for providing commodity service."<sup>35</sup> NYSEG asserts that offering a fixed price commodity product carries more risk than a regulated return is designed to capture. According to the Company, those risks include deviations from expected price, quantity, volume, and

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<sup>35</sup> NYSEG Second Response at 8.

load shape, as well as the risks associated with the non-bypassable charge. NYSEG chronicles the discussion of these risks on the record, which it asserts forms an ample basis for the decision in the Order.

In its response, Staff states that the Commission's decision regarding an appropriate level of return for the fixed price option was what the Commission felt necessary based upon the record in this case. There is no need, Staff asserts, to expand the Commission's decision here into general policy regarding utilities generally. Moreover, according to Staff, the Commission has already expressed those general policies in the Retail Markets Policy Statement, and it is abundantly clear that the Order applies only to NYSEG.

#### Discussion

NEM has mischaracterized the intent and effect of the Order. Moreover, it offers no basis on which we should appropriately make a broad declaration of policy regarding hypothetical situations that may arise in the future. Its petition in this regard is denied.

#### State Action Immunity

##### Direct Energy Petition on Rehearing

Direct Energy's petition also seeks clarification by the Commission that the Order does not extend State Action Immunity to NYSEG for any voluntary action taken by NYSEG to preserve or expand its current dominant position in markets for retail commodity supply. Direct Energy asserts that it is concerned by our discussion of outreach and education in the Order, in which we described NYSEG's commodity and delivery options as required by and regulated by this Commission. Direct Energy apparently fears that NYSEG might rely upon our statement to engage in assertedly anti-competitive conduct under the protection of the State Action Doctrine.

##### NEM Petition on Rehearing

NEM makes a related request in its petition for clarification, requesting the Commission to declare when a market is "officially competitive" and further that, when a market is competitive, the State Action Doctrine would not apply to the services offered by a utility in that market. According to NEM, the Commission should ensure that a monopoly cannot protect its market share by blocking market entry or undermining competition, only to return the next year claiming the market is still not workably competitive.

### Parties' Responses

NYSEG opposes the requests of both NEM and Direct Energy, stating that there is no record evidence that NYSEG is currently or has in the past engaged in anti-competitive conduct. Moreover, NYSEG argues, it would have the right to invoke the State Action Doctrine under the test set forth in California Retail Liquor Dealers Assn. v. Midcal Aluminum, 445 U.S. 97 (1980), in the event a party were to allege that NYSEG had engaged in such conduct. NYSEG states that Direct Energy made such an argument in Case 05-M-0858.<sup>36</sup>

Staff responds to Direct Energy and NEM by also asserting that no clarification is warranted here. According to Staff, the Order is not a general statement of policy but rather the application of specific evidence to issues raised by NYSEG's request for rate relief.

### Discussion

We decline to make the "clarification" requested by Direct Energy and NEM. The Order, as it currently stands, makes no express declaration regarding the scope or applicability of the State Action Doctrine. We see no merit in speculating regarding the hypothetical situations presented in the petitions.

### Effect of ESCO Referral Order

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<sup>36</sup> See Case 05-M-0858, Order Denying Clarification and Rehearing, (September 20, 2006) at page 8.

NFG Petition for Clarification

National Fuel Gas Distribution Corporation, which was not a party to this proceeding, petitions for clarification of the statement made in the Order that "The institution of an ESCO referral program was required under our state-wide guidelines for such programs as set forth in our Order of September 22, 2005 [sic] in Case 05-M-0858."<sup>37</sup> According to NFG, "If it was NYSEG's prior commitment that formed the basis for the Commission's decision to direct NYSEG to institute an ESCO referral program, Distribution takes no position on the Commission's authority to mandate an ESCO referral program based on NYSEG's failure to honor a prior commitment to pursue such a program. On the other hand, if the basis for such a directive was a belief that the December 22 Order required the implementation of such programs, Distribution maintains that the December 22 Order contains no such mandate."<sup>38</sup>

According to NFG, those utilities that have implemented ESCO referral programs have done so voluntarily. NFG asserts that its own decision to implement such a program was not a concession of the Commission's authority to mandate such programs. Therefore, it requests the Commission to state on rehearing that ESCO referral programs are voluntary.

Parties' Responses

In its response, NYSEG states that it supports NFG's position, which NYSEG characterizes as asserting that "an ESCO referral program is a voluntary program and that the Commission cannot require NYSEG or another utility to institute an ESCO referral program."<sup>39</sup>

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<sup>37</sup> NYSEG Order at 109, quoted in NFG Petition for Clarification at 3, referring to the ESCO Referral Order of December 22, 2005.

<sup>38</sup> NFG Petition at 4.

<sup>39</sup> NYSEG Second Response at 11.

For its response, Staff recites the procedural history of NYSEG's particular ESCO referral program, mentioning in particular NYSEG's letter of January 20, 2006 in which NYSEG notified us of its intent to initiate collaborative discussions regarding an ESCO referral program in the context of this rate case. According to Staff, the Company has not actually initiated such a collaborative, prompting the Recommended Decision proposal that NYSEG be ordered to file a plan. Staff asserts that our directive to the Company in the Order to file an ESCO referral program plan responds to the RD and to NYSEG's failure to comply with the ESCO Referral Order. According to Staff, no clarification is therefore necessary, and NFG's petition should be denied.

Direct Energy also responded to NFG's petition. According to Direct Energy, NFG has fundamentally misread the ESCO Referral Order. Direct Energy interprets the ESCO Referral Order as making the provisions of a state-wide ESCO referral program mandatory. According to Direct Energy, it is inherent in the fundamental concept of a uniform state-wide program that the program be mandatory, since a purely voluntary approach could not achieve the state-wide uniformity desired by the Commission. Moreover, Direct Energy asserts, the ESCO Referral Order clearly establishes our authority to mandate ESCO referral programs. According to Direct Energy, the discussion in the ESCO Referral Order regarding the application of State Action Immunity for certain voluntary conduct is intended to shield ESCOs and other non-utility participants in such programs from antitrust claims that might be asserted by opponents of such programs. Direct Energy reads NFG's petition as a collateral attack on the ESCO Referral Order which should be denied as procedurally improper and untimely.

#### Discussion

The clarification NFG seeks is based upon an overly narrow reading of the ESCO Referral Order. NFG is correct that, by its own terms, the ESCO Referral Order did not directly order utilities to institute ESCO referral programs. Rather, we

anticipated that such programs would be developed either in separate, utility-specific collaborative proceedings initiated in response to the ESCO Referral Order or in the context of utility-specific rate cases, such as this one. NFG is mistaken when it confuses the procedural choice we made in the ESCO Referral Order with a concession of lack of authority to mandate such programs. In this case, despite NYSEG's commitment to collaborate on an ESCO referral program, any such collaborative efforts failed. Consequently, we have ordered NYSEG to file an ESCO referral plan for our consideration.

The Commission Orders:

1. Except to the extent granted by this order, the parties' petitions for rehearing and clarification of the August 23, 2006 Order are denied.

2. On or before September 1, 2007, New York State Electric & Gas Corporation will file with the Secretary and serve on all active parties to this proceeding a notice indicating whether it intends to offer fixed price commodity service in 2008. NYSEG will take further steps to notify the public generally and customers in particular consistent with the discussion in this order.

3. This proceeding is continued.

By the Commission,

(SIGNED)

JACLYN A. BRILLING  
Secretary