BEFORE THE STATE OF NEW JERSEY
BOARD OF PUBLIC UTILITIES
OFFICE OF ADMINISTRATIVE LAW

I/M/O THE PETITION OF JERSEY	)	
CENTRAL POWER AND LIGHT	)	DOCKET NOS. ER02080506, ER02080507,
COMPANY FOR APPROVAL OF AN	)	AND ER02070417
INCREASE IN BASE TARIFF RATES,	)	OAL DOCKET NO. PUC 07894-02, 07984-02,
DEFERRED BALANCES FILING AND	)	AND 07983-02
2002 CED FILING		

INITIAL BRIEF OF
THE NEW JERSEY DIVISION OF THE RATEPAYER ADVOCATE
Volume 2

SEEMA M. SINGH, ESQ.
RATEPAYER ADVOCATE

Division of the Ratepayer Advocate
31 Clinton Street, 11th Floor
P. O. Box 46005
Newark, New Jersey 07101
(973) 648-2690 - Phone
(973) 624-1047 - Fax
http://www.rpa.state.nj.us
njratepayer@rpa.state.nj.us

Dated: May 7, 2003

On the Brief:
Ami Morita, Esq., Deputy Ratepayer Advocate
Judith B Appel, Esq., Asst. Deputy Ratepayer Advocate
Kurt S. Lewandowski, Esq., Asst. Deputy Ratepayer Advocate
Elaine A. Kaufmann, Esq., Asst. Deputy Ratepayer Advocate
Ava-Marie Madeam, Esq., Asst. Deputy Ratepayer Advocate
Diane Schulze, Esq., Asst. Deputy Ratepayer Advocate

Joshua Seidemann, Esq. Asst. Deputy Ratepayer Advocate

VI. BASIC GENERATION SERVICE PRUDENCE ("BGS") REVIEW: THE COMPANY'S BGS COSTS WERE NOT INCURRED PRUDENTLY AND THEREFORE ARE NOT RECOVERABLE

A. Standard of Prudence Review: Only Prudently Incurred Costs May Be Recovered from the Ratepayers

1. The Company Bears the Burden of Proof in Demonstrating That Costs Were Incurred Prudently

Section 48:3-57(d)-(e) of the Electric Discount and Energy Competition Act ("EDECA") provides for the recovery of BGS deferred balances that are "reasonable and prudently incurred." In the instant proceeding, full recovery of the proposed deferred balance would have an unprecedented impact on the rates paid by the customers of the Company. The promise of EDECA was to lower rates and to provide better service to energy consumers in New Jersey through competition. Just four years after the start of restructuring, New Jersey ratepayers are faced with little choice in competitive suppliers of electricity and a deferred balance of the four electric utilities of over one billion dollars. In sum, if the proposed deferred balance costs are fully recovered by the utilities, then the corresponding rate increase will have a significant negative impact on New Jersey's economy and the State's energy consumers.

The Board has broad and sweeping powers over all aspects of public utilities that are subject to its jurisdiction. *See N.J.S.A.* 48:2-13; *Township of Deptford v. Woodbury Town Sewerage Corporation*, 54 *N.J.* 418 (1969); *In re Public Service Electric and Gas Company*, 35 *N.J.* 358, 371 (1961). The Board is the regulatory agency with jurisdiction and control over electric public utilities, including the jurisdiction to set rates. *N.J.S.A.* 48:2-21. It is established law in New Jersey that a public utility is required by statute to show that an increase in rates is just and reasonable. *Id.* The statute provides, "the burden of proof to show [that] the increase, change or alteration is just and reasonable shall be upon the public utility making the same." *N.J.S.A.* 48:2-21(d). New Jersey precedent supports the premise that the burden of proving reasonableness of costs lies with the Company. *See, i.e., In the Matter of the Petition of Public Service Electric and Gas Company for an Increase in Rates and In the Matter of the Petition of Public Service Electric and Gas Company for an Increase in Rates – Hope Creek Proceeding*, BPU Docket No. ER85121163, OAL Docket No. PUC 0231-86 (April 6, 1987). ("*Hope Creek Order*"). ("[i]t is uncontroverted that Public Service had the burden of proving the reasonableness of its expenditures for Hope Creek as only reasonable costs can be included in rate base and permitted to earn a return"); and *Public Service Coordinated Transport v. State*, 5 *N.J.* 196, 222 (1950). The same standard is applicable to the instant proceeding: the only costs that may be included in JCP&L's recovery are those that were incurred prudently, and in order to recover those costs, JCP&L must demonstrate that it acted prudently.

In evaluating whether the Company met its burden to prove that it acted reasonably and prudently during the transition period, the Board must evaluate the managerial conduct in light of the circumstances, information, and options in existence at the time management decisions were made. Quoting the New York Public Service Commission, the Board in the *Hope Creek Order* stated:

> [t]he Company's conduct should be judged by asking whether the conduct was reasonable at the time, under the circumstances considering that the company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people could have performed the tasks that confronted the Company. *Hope Creek Order* at 65, 66.

The *Hope Creek Order* further clarifies the Board's standard of review when determining prudence:

> [t]he Company, as discussed earlier in this Order, had the burden of proof with respect to the reasonableness of the costs that were expended in building the plant. In order to meet that burden with respect to the various enhancements, the Company had to show the reasons why each of the enhancements were installed and the benefits to be derived from their installation. An integral part of the benefits associated with the enhancement is a justification of the costs.
> *Id.* at 89.

Accordingly, the instant deferred balance prudence review must apply the standards set forth in the *Hope Creek Order* and determine: (1) whether the Company's actions during the transition period were reasonable given the specific circumstances at the time decisions were made; and (2) whether the Company has demonstrated sufficiently the reasons why each BGS cost was incurred, and the benefits derived by the Company's actions. Moreover, the Board must review (3) whether the Company mitigated risk sufficiently.

Consistent with the holding in the *Hope Creek Order*, EDECA and the *JCP&L Final Order* specifically stated that only "reasonable and prudently incurred costs" claimed by an electric public utility to provide BGS may be recovered. *N.J.S.A*. 48:3-57(e) and *JCP&L Final Order* at 104. In a post-restructured electric industry environment, the forecast prudence review should act to encourage utilities to control costs. The promise of a future regulatory review takes the place of the competitive marketplace controls. In other words, management decisions must be restrained by the prudence standard in order to prevent regulated companies from inefficiently allocating resources.[1] The Board articulated this standard in the *JCP&L Final Order* when it recognized the possibility of run-up deferral balances, and noted that the Company is required to "endeavor to mitigate such risk." The Board stated:

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[1] *See Democratic Central Committee v. Washington Metropolitan Area Transit System, Inc*., 485 F.2d 886, 907 (D.C. Cir. 1973), *cert. denied*, 415 U.S. 935 (1974), *see, also, General Telephone Co. of Upstate New York, Inc. v. Lundy,* 17 N.Y.2d 373, 377, 218 N.E.2d 274, 277 (1966) (noting that a regulator may prevent unreasonable costs for materials from being passed on to ratepayers).

> by virtue of the price cap mechanism, a run-up in market prices above those pre-supposed in establishing the BGS rates could result in an under-recovery of NUG stranded costs, which in turn could lead to a buildup in the Deferred Balance. Accordingly, it is in the public interest for GPU to pursue the mechanisms identified in paragraph 7 of the Stipulation to hedge against purchases of power for BGS in the open market. *JCP&L Final Order* at 96.

As demonstrated herein, the Company made imprudent decisions in its BGS procurement policies and decisions under the standards set forth in the *Hope Creek Order* and the *JCP&L Final Order*. Ultimately, the Board must determine whether the proposed recovery of the deferred balance is in the public interest.

2. The Company Has Failed to Provide Sufficient Evidence to Support its Claim BGS Costs Were Prudently Incurred

The *Hope Creek Order* establishes the need for a vigorous prudence review. A thorough prudence inquiry is fact-intensive and should focus on whether the utility management acted in a manner consistent with the performance of other similarly situated utilities.[2] The imposition of a prudence standard is a frequent and ordinary occurrence in utility decisions. "Prudence" is a standard that evolves to match the factual circumstances to which it is to be applied. Prudence requirements provide incentives for efficient managerial behavior.[3] The governmental regulations essentially substitute for market forces.[4] It is therefore incumbent on the utility to provide the information necessary for regulators to thoroughly understand the business decision

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[2] *See Arizona Public Service Comm.*, 21 F.E.R.C. para. 63,007 (1982) (initial decision), *aff'd in relevant part*, 23 F.E.R.C. para. 61,419 (1983).

[3] *See El Paso Natural Gas Co. v. FPC*, 281 *F.2d* 567, 573 (5th Cir.), *cert. denied*, 366 *U.S.* 912 (1960).

[4] *See Midwestern Gas Transmission Co. v. FPC*, 388 *F.2d* 444 (7th Cir.), *cert. denied*, 392 *U.S.* 928 (1968).

made by the utility to make the determination of prudence. As described below, JCP&L failed to provide evidence to support the conclusion that it controlled its BGS procurement costs prudently.[5]

Evaluating the reasonableness of management decisions is primary in determining whether a utility has acted prudently. The Michigan Public Service Commission denied recovery of construction expenditures for a gas distribution plant because of poor management techniques that caused unreliable cost estimates, improper and unnecessary expenditures designed to overcome delays, numerous and unnecessary design changes, poor relations with the contractor, and inadequate quality control. *Consumers Power Company*, 14 *P.U.R.4th* 1 (Mich. Pub. Serv. Comm'n 1976), *remanded on other grounds*, 78 *Mich. App.* 581, 261 *N.W.2d* 10 (1977). In the instant proceeding, the Company has failed to demonstrate adequately that the design, selection, or implementation of its constantly changing procurement strategies were prudent. The most apparent flaw in this respect is the lack of adequate documentation that would describe the Company's implementation, and subsequent abandonment, of models. The Company not only made imprudent decisions but failed to document adequately its BGS procurement policies and decisions.

[5] The benchmark for determining whether utility management has acted prudently is similar to the standard of care analysis in common-law negligence, but with the caveat that the standard of care required of utility management is greater than that of other private sector management. *See, e.g., Virginia Electric Power Co.,* 11 F.E.R.C. para. 63,028 at p.65,189 (initial decision), *aff'd in relevant part,* 15 FERC para. 61,052 (1981). The fact-intensive prudence inquiry focuses on whether the utility management acted in a manner consistent with the performance of other similarly situated utilities. *Arizona Public Service Comm. supra.*

B. Development and Implementation of Supply Process: the Company Failed to Demonstrate That it Met Either Generic or Fact-specific Standards That Would Permit Recovery of its BGS Deferred Balances

1. The Company's Undocumented and Haphazard Approach to BGS Procurement Was Imprudent

The BGS supply for the transition period cost over $3 billion, which is comparable to the cost of a nuclear power plant. One would expect a high level of scrutiny for this magnitude of expenditures. *R-59*, p. 10:20-21. Further, BGS procurement in the restructured environment of EDECA occurred as JCP&L divested the bulk of its generation resources and became much more dependent on the open market. Consequently, the Company's purchases were from a restructured, competitive marketplace. *R-59,* p. 10:2-8. This new paradigm was more complex than the regulated market that preceded it, and accordingly called for a high level of care, including the comprehensive maintenance of documentation for subsequent internal and regulatory review.

In addition to the fact-intensive prudence inquiry that focuses on findings of fact unique to each utility and each plant, various generic factors are relevant in determining whether management has acted prudently. Your Honor and the Board must determine not only whether the actions that the Company took were prudent, but also whether there were actions that the Company should have taken in light of the EDECA structure and the mandate that only prudently-incurred costs may be recovered. Notwithstanding inherent uncertainties in spot and forward markets purchasing, the Company did have a certain degree of control over its actions. Prudent planning is recognized not only from the outcome of decisions made in accordance with those plans, but should also be judged on the basis of whether the plan is, in and of itself, prudent in its design, selection, and implementation. Accordingly, Your Honor and the Board must examine for prudence both the design and selection of the various strategies selected by the Company, and the implementation of those strategies.

The Company claims to have employed the required level of expertise, yet evidence in the record indicates the opposite. *JC-14 Rebuttal,* p. 8-10. Cite Ratepayer Advocate witness Paul Chernick noted that (a) the Company shifted purchasing strategies often, and (b) failed to maintain documentation that would permit adequate review and control of the purchasing process. For example, the Company touts the fact that it made "quantum improvements" to the models during the 36 month BGS period. *JC-19 Rebuttal* , p. 5:19, 20. Yet, this fact calls into question even further the sufficiency of any of the three methods at their inception, if each of the three models introduced in just four years required such modifications. The shifting strategies, flawed implementations and inadequate documentation that typify the Company's procurement strategy support the conclusion that the Company's purchasing personnel lacked the pre-requisite level of knowledge to operate effectively in the restructured environment. The Ratepayer Advocate will demonstrate below that neither the design nor the implementation of the BGS procurement strategies utilized by the Company was prudent.

a. The Company Shifted Strategies Frequently in a Comparatively Short Period of Time.

The Company used and discarded various purchasing models, described below, in rapid succession. The ever-changing nature of the underlying strategies (underscored by the rapid rejection of them) raises significant questions as to the viability of any of the strategies at their respective inception. In just four years the Company embarked on three different strategies, indicating insufficient experience or expertise in either the selection or implementation of the models.

From August 1999 through January 2001, the Company utilized the X-method. From February 2001 through October 2001, the Company utilized the HOST model. The X-method and HOST model utilized what was termed "Dollar Cost Averaging" ("DCA") as the target fill strategy. Subsequently, from November 2001 onward, the Company utilized the Lock and Load procurement acceleration strategy, which incorporates a both a target-setting process and a fill trajectory. The Rebuttal Testimonies submitted by Company witnesses Messrs. Charles A. Mascari and Dean W. Stathis confirm Ratepayer Advocate witness Mr. Chernick's testimony that, in sum, the Company's actual forward purchases under these strategies did not match what the Company claimed was its procurement strategy. In testimony, and in discovery, the Company tells a story of changing strategies and models which the Company never fully followed.

The purchasing model employed by a major utility such as JCP&L, which serves over one million ratepayers, should not be selected by a "trial and error" method. The rapid change from one purchasing method to another suggests inexperience on the part of the Company. It must be noted that the utility ratepayers rely on the expertise of the Company and its personnel, and pay monthly bills for the provision of reliable service at just and reasonable rates. JCP&L should have employed personnel better equipped to make purchasing decisions, in order to serve customers in accordance with the Company's statutory charge.

b. The Company Failed to Implement Even the Most Basic Review and Control Measures

As described by Ratepayer Advocate witness Paul Chernick, while there was novelty to the nature of the new utility paradigm, the concept of documenting new courses is a known and logical practice. Accordingly, there are basic and rudimentary steps that the Company should have taken as it entered the new marketplace.

As described by Mr. Chernick, the Company should have developed, early in the process, a strategy that included documented procedures for: (1) "the percentage of each generation service that should be purchased in the forward contract market (as opposed to daily spot markets);" (2) "the desired timing of the contract purchases (a week ahead, a month ahead, a year ahead);" (3) "the form of contracts (for example, fixed prices versus prices tied to gas prices);" (4) "the extent to which price risk should be hedged with options;" and, (5) "how the above guidelines should vary with current spot and contract prices, volatility, and other factors." *R-59*, p. 13:20-14:9.

As described by Mr. Chernick,

> Documentation is important for three different reasons. First, clear documentation is important for control of the process. The Company needed to make decisions on a daily basis for acquisition of a number of different generation products (capacity, ancillary services, peak-period energy, off-peak energy, and other energy shapes), for various time periods (hourly, daily, annual, and various intermediate durations) and for physical products, financial transactions, and options. Many of these decisions would need to be made very quickly, with little opportunity for review or supervision, and by different people on different days. In order to maintain control over the process, JCP&L would require clear policies in place to guide staff and to retain a clear trail recording the decisions made by staff to ensure that they were following the guidelines. *R-59*, p. 11:22-12:6.

Mr. Chernick also explains that documentation is necessary in order to determine whether the Company's strategy was in fact meeting the Company's goals. Mr. Chernick states that one would expect the Company to have monitored its performance as to how its purchase costs compared to spot prices and forward prices for day-ahead, month-ahead, and other term commitments. Historical results would also be useful in evaluating potential new strategies for timing purchases. The Company should have monitored whether it was exercising the options it bought (and if not, whether the risk reduction was worth the price), whether the total costs of the options exceeded the cost of generation services they provided, and whether it was purchasing more or less power in the spot market than it had planned. *R-59*, p. 12:7-20. Further, the Company should have maintained a high level of documentation because it knew when EDECA was enacted in February 1999 that only reasonable and prudently incurred costs would be recoverable. Prudent management would retain documentation for subsequent regulatory review. *R-59*, p. 12:21-13:2.

In this proceeding, JCP&L must show that its BGS costs were incurred prudently. During the course of this proceeding, JCP&L was repeatedly late in providing information in response to discovery requests (*R-59*, p. PLC-3), and Ratepayer Advocate review of that information, when it was finally received, revealed that the Company could produce little documented justification for its actions. *R-59*, p. 31:1-32:2 In discovery, the Company did not clarify the basis for its procurement decisions. To the contrary, the limited data that JCP&L provided on discovery were inconsistent with the assertions made in the testimony. *R-59*, p. 6:12-17. The Company's discovery responses failed to provide necessary information on the development of the inputs to its models, the outputs of those models, or what actions were taken in response to the model results. R-59, p. 31:1-32:2

For example, Company witness Dean W. Stathis testified that the Company conducted morning meetings at which "current regional, national, and international energy market conditions (weather generation, generation outages, transmission outages, natural gas and oil markets) and their impact on short- and long-range energy prices" were discussed, along with PJM-related information. According to Mr. Stathis, these meetings developed volume targets, discussed products, and established price ranges. *JC-15 Direct*, p. 7:1-9. Yet, as described by Ratepayer Advocate witness Mr. Chernick,

> when asked for "full and complete copies of all documents including workpapers, studies, analyses, meeting minutes, PJM load forecasts, and PJM price forecasts from mathematical models used at each morning meeting for short term supply planning," all that JCP&L could provide was a pile of 10-day graphs of load and weather forecasts, some with JCP&L's hourly energy supply on the same graph, and a smaller number of 10-day forecasts for the day-ahead energy price on the Western Hub. There were no analyses of energy market conditions, generation outages, transmission outages, real-time PJM pricing, congestion within PJM, volume targets, types of products or price ranges. *R-59*, p. 20:19-21:4.

The Company's poor documentation process is further evidenced by the response to RAR-BGS-124, *R-82* in which the Company states that "[w]ritten notes and price quotations from these discussions [analyzing volatility in PJM capacity auctions and other capacity markets] and resultant views were not kept." The Company also stated in response to RAR-BGS-66, *R-80* that "[n]o operational reason existed to record such [broker] quotes in a historic database and JCP&L did not do so." Repeatedly, the Company has failed to provide adequate documentation of its processes.

The paucity of Company documentation regarding BGS procurement decisions makes it impossible for the Board to find that JCP&L was prudent in selecting objectives, establishing techniques and procedures for implementing those objectives, and executing the actions selected in the planning process. The lack of internal retrospective reports and analyses of JCP&L's decisions also directly raises questions about prudence, since frequent reports would be necessary to evaluate performance in the new EDECA environment. *R-59*, p. 7:1-7.

Both legally and logically, this lack of information demonstrates inadequate documentation procedures. No finding of prudent management can be made when the Company fails to provide an adequately documented description of the actual day-to-day processes and activities of the Company's management; the Company is in the best position to present facts demonstrating the efficiency of its management.[6]

2. The Company's Procurement Strategies Were Contrary to Cost Control Principles or Disregarded by Management

a. The Inherent Flaws of the X-Method Were Exacerbated by its Inconsistent Application

The first model the Company used to purchase electricity was a modified X-method. The X-method, according to the Company, was intended to mitigate JCP&L's exposure to volume and price risk. *S-38* at VII-14. The X-method utilized a full strategy referred to as dollar cost averaging ("DCA"). According to the Brattle Group, a private consulting firm retained by the Company to assist them in procurement, DCA is a rigorously defined approach, calculated as follows: set a fixed hedge percentage of projected load, and during each of the 12 months preceding a delivery month, purchase a "near equal" amount of forward MW on the bilateral market. *R-51*(3) at 5. By contrast, Company witness Charles A. Mascari uses the term "DCA" to describe a "process of small purchases each month over the procurement planning horizon rather than a single large purchase." *R-52.* "Fixed hedge percentage" as used by the Brattle Group to define DCA, however, may not equal the "small purchases" described by Mr. Mascari. When purchases for over one million customers are concerned, these distinctions can be critical. At the end of the day neither approach was used by the

[6] The proposition that the Company's case is weakened by its failure to produced adequate evidence is consistent with the "adverse inference rule," which provides that when a party has within his control relevant evidence that he fails to produce, that failure gives rise to an inference that the evidence is unfavorable to him. *International Union (UAW) v. NLRB,* 459 *F.2d* 1329, 1336 (D.C. Cir. 1972). The adverse inference rule has been adopted specifically by FERC and its predecessor agency, the FPC, *see, e.g., New England Power Co.*, 27 F.E.R.C. 65,168, and should similarly be adopted by Your Honor and the Board. The rule is articulated in *Alabama Power Co. v. F.P.C.*, 511 *F.2d* 383 (D.C. Cir. 1974), wherein the court stated: "It is a familiar rule of evidence that a party having control of information bearing upon a disputed issue may be given the burden of bringing it forward and suffering an adverse inference from failure to do so." *See* McCormick, Evidence sec. 337 at 787 (2d ed. 1972).

Company. In addition to the confusion in the use of the term "DCA" (and JCP&L's apparent lack of clear communication with its own consultants), the Company's (1) goals in the use of the X-model; and (2) implementation of the model were flawed. Therefore, the Company failed to show prudence in the use of its X-model.

(i) The Company's Stated Goal in the Use of the X-Method was Flawed Because it Did Not Seek to Minimize Costs

The stated purpose, or the "goal," of the Company's use of the X-method was flawed. The ultimate goal of the Company, according to Mr. Mascari, was to minimize the potential variation in earnings, specifically, the difference between market energy and capacity ("MEC") revenues and BGS costs (*JC-14 Direct* at 10:1). In other words, the Company's only stated goal seems to be maintaining predictability of costs. While predictability should have been one of the goals the Company strived for post EDECA, it should not have been the only goal, exclusive of other important factors, such as obtaining lowest possible cost.

First and foremost principle in utility regulation is the utility's obligation to ratepayers to provide safe and adequate service at the lowest available cost.[7] A secondary, but nonetheless important concern is avoiding rate shock and preserving price stability. *R-76*, p. 7 Therefore cost predictability should not be the only stated goals of a utility. As Ratepayer Advocate witness Mr. Chernick correctly pointed out, JCP&L's insistence on focusing on only one of these two goals, to "reducing variability," was inappropriate. *R-59* at 26:14, 15.

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[7] *See Midwestern Gas Transmission Co.*, 36 *F.P.C.* 61, 70 (1961) (noting that utilities must use all reasonably available cost saving tools).

Regardless of the results of the approach taken by JCP&L, the Company's primary objective should have been to minimize BGS costs[8], with a secondary goal of minimizing the *variation* in earnings from month to month. The danger of the Company's fixation with minimizing earnings variation is the real possibility of increasing the *total level* of expected costs over the course of a year. As Mr. Chernick stated in his testimony, "[i]n some months, the BGS costs were below the MEC revenues, so minimizing the differences would actually have required the Company to increase BGS costs." *R-59* at 26. JCP&L's strict strategy of seeking to reduce only the variation between monthly MEC revenues and costs is therefore flawed.

There is question as to whether the Company endeavored to control costs. Company witness Frank C. Graves argues that it would not have been possible for the Company to minimize costs, even if it had wanted to do so. *JC-19* at 18:6-13. Mr. Graves's testimony was premised, at least in part, on the theory that the Company could never expect to reduce costs by buying either forward or spot, and could endeavor only to buy "fairly-priced" power. The notion of "beat[ing] the market" or "tim[ing]" the market, according to Mr. Graves, has no bearing in this sort of a situation. *JC-19* at 18-20, 22-23. Therefore, according to Mr. Graves, the Company had no real opportunity to eliminate or reduce the differential between wholesale market prices and the capped BGS rate that JCP&L was permitted to charge customers. It appears from Mr. Graves's testimony that not only did the Company not endeavor to contain expected costs, but that the Company believed that it is impossible to contain expected costs. In so arguing, however, Mr. Graves disagrees with his client and contradicts the HOST model assumptions and results, a model also used by the Company during the transition period and which is discussed fully below. According to its own modeling, the Company's efforts to

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[8] In fact, at the evidentiary hearing, one of the auditors incorrectly stated that "minimizing the deferred balance" was the Company's goal. T75:L1, (April 28, 2003)

reduce its earnings risk increases the expected cost of power purchases. *See, i.e., R-56*(3) (upper-right quadrant of seventh non-numbered page), emphasizing that this assumption was "rooted firmly in financial theory and practice." The HOST model documentation and HOST model assume that hedging increases expected cost. Indeed, the Company's own process document states that the HOST output results present a range of "portfolio targets [that] represent an efficient tradeoff between expected costs and the variance of costs." *JC-50*-(2) at 7. It is not surprising that the Company accumulated such a large deferred balance in light of the Company's belief that controlling costs is virtually impossible.

(ii) The X-Method was Applied in a Manner Inconsistent with its Initially Stated Approach

The Company claims to have spread its purchases over time in order to avoid disrupting the market, and causing price spikes. *JC-14 Direct*, p. 21. But, the Company failed to follow this approach, even according to the Company's self-set and vague definition. Exhibits *R-57* and *JC-51* provide target hedges and target fills data, and reveal that for the delivery months September through December 2000, the Company did not purchase any energy, even though the targets had not been reached. On January 17, 2000, for the delivery month of August 2000, the Company faced a 2,400 MW shortfall. Operating on the Company's "spread small purchases over time" approach, that would call for 600 MW per month in order to compensate for that shortfall through July 2000. On March 31, 2000, however, the Company purchased 1,050 MW. R-59, p. 23. Then, over just five days in April 2000, the Company purchased 1,350 MW, leaving only 100 MW to be purchased in June. *R-59*, p. 22-23. These deviations from the Company's self-prescribed policy are hardly indicative of "small purchases spread over time."

The Company's purchases, then, were far from "small" and "spread over time." As described below, the Company was never precluded from purchasing large amounts of energy. The Company may have felt constrained from making large purchases on the broker market, but apparently purchased on the bilateral market without reservation. This certainly raises the question as to why the DCA process was promoted, since according to the Company's practice, it could always buy large quantities on the bilateral market. Further, the data provided by the Company does not "break out" bilateral from broker purchases. *R-57(1).* Without these markers, there is no way to evaluate the effect of DCA on the Company's purchasing strategy.

The Company believed that large purchases on the broker market would create "panic buying rumors," *JC-14 Rebuttal*, p. 21:10, but had no such reservations about the bilateral market; the Company apparently believed that those large purchases would go unnoticed. The anonymity of bilateral purchases was explained by the use of silent third-parties who conducted business on behalf of the Company. T.78:L25-79:L6 (3/4/03). Yet, none of these parties has been identified, leaving an incomplete picture of how the Company was operating. The Company bragged about the secretive nature of these transactions, noting that, "in our case there is no equivalent to an SEC filing requirement, nobody knows unless we tell them." T80:L23-25 (3/4/03). Although the Company cites discretion as a method by which to avoid affecting the market, the anonymity of these sales similarly shields the Company and its purchasing practices from scrutiny.

b. The HOST Model was Run Using Risk Tolerances that Expert Consultants Had Advised the Company Against, and Without Clear Directions as to Target Levels

The Company moved to the HOST model because its ability to deal explicitly with Company risk tolerance represented an improvement over the X-model. *JC-14 Direct*, p. 22:15. It was established at the evidentiary hearings that the HOST model outputs present a range of portfolios for different Risk Tolerance values. T42:L24-43:L7 (3/5/03). When the Company selects a single risk tolerance value, the HOST model produces the optimal hedge target mix of forwards and options for that risk tolerance value. The lower the selected risk tolerance value, the more hedging, and the higher the expected costs. When the Company selects a risk tolerance value, it makes a decision about the expected costs to the ratepayer. And, according to the HOST model output, a higher risk tolerance results in higher expected earnings. T43:L24-44:L3 (3/5/03). Therefore, the Company decision-maker could face a menu of possibilities, a choice among which would reflect Company's tradeoff between earnings risk and expected cost.

Yet, despite the range of risk tolerance available to the Company that should have permitted the Company to blunt the effect of BGS costs, the Company ignored the advice of its professional consultants and selected risk tolerances on the basis of surveys that, essentially, asked managers to assess how much they would gamble to win a hypothetical lottery:

> (Graves) My understanding is that there were some surveys conducted of the five key members, I guess, in which they were individually asked to react to various so-called lotteries which are in effect bets where someone comes up to you and says, "If I were to offer you a deal where you could win twenty dollars with a fifty percent chance or lose ten dollars with a fifty percent chance," the expected value of that would be five dollars. . . .
>
> By asking a series of such questions you can get a measure of the tolerance for that end of the risk of each individual in that fashion, and a parameter called risk tolerance was estimated that described the point at which they would generally be willing to participate in those kinds of risk equation. . . . in effect it captures how much more nervous they become as more moneys [sic] are at stake. T.38:L1-10, 39:L1-11 (3/5/03).

This internally focused approach seems to contradict directly the observation of the Company's consultants, the Brattle Group, which reported that GPU was exploring risk management policies that would consider "ideally, internal cost-risk tradeoffs consistent with NJ BPU views about ratepayer preferences." *R-*

51(2), p. 17. Further, in addition to being unable to present a reasoned basis for selection of risk tolerances, the Company was also unable to identify who had ultimate responsibility for deciding the risk tolerance, allowing only that "it was a process of surveying five people and comparing and approving their results and having them agree on a representative value, but I don't know who ultimately approved it." T39:L12-19 (3/5/03). Quite simply, this vagueness is troubling, and is hardly indicative of a prudent decision making process.

Apparently, the tolerances were approximately zero: when asked whether the minimization tendencies sought by the Company "represent[ed] a risk tolerance of zero," the Company responded, "it would be a very conservative strategy with a risk tolerance approaching zero." T84:L21-85:L9 (3/4/03). The Company attempted to justify this position by explaining that there is no "present value advantage even if you can project a future expected cost that is lower because you are bearing more risk." T45:L23-25 (3/5/03). Yet, this position ignores the reality that had the Company accepted increased risk, it would have ultimately lowered its BGS costs. According to the Company, management based its decisions on hypothetical, fictitious lotteries, rather than the professional advice tendered by specialists in the field. The Ratepayer Advocate is not championing the cause of unnecessary risk, but certainly some degree more than "zero" of a willingness to cut costs should have been demonstrated by the Company.

Mr. Stathis stated in Rebuttal Testimony that HOST model supply targets were "relegated to minimum target benchmarks," *JC-15 Rebuttal*, p. 3:14, 15, but was unable to identify any place in the HOST model documentation where it states that the HOST model results should be relegated to minimum targets. T12:L12 (3/5/03). Additionally, the Company provided only procedural rules for the use of the Host model (*JC-50*), rather than the requested descriptions of "all computations and data" (*JC-50*-(d)) used to set targets. Nor was

Mr. Stathis able to identify whether Lock & Load targets have been greater than HOST targets T12:L15 (3/5/03). And, according to Mr. Stathis, the Company did not have in place clear and documented policies as to what should occur when PJM volume fell below the trigger prices T13:L7 (3/5/03).

The Company's failure to explain adequately its departure from both industry practice and the course of action recommended by professional consultants is fatal to the Company's assertion that it incurred costs prudently.

c. The Company's Flawed Implementation of the Models Only Exacerbated the Inherent Flaws in their Application to BGS Procurement.

The Company's institutional guidance and explanation of direction as to the series of models that it employed is unclear, at best. According to *JC-15 Rebuttal*, p. 3, lines 21-23:

> In order to reconcile the growing post-Merger gap between lower long-term targets and forecasted short-term BGS requirements, JCP&L targeted, for a given month, *the average daily on-peak load forecasts for its accelerated purchases for that month* (emphasis added).

But again, according to *R-55*, once a PJM forward price fell into the "trigger range:"

> Acceleration of purchases was now a possibility but not automatic. Rather, a decision to accelerate was based on an *evaluation* of JCP&L average daily on-peak load targets, committed supply on hand to meet the target, PJM forward market fundamental and technical factors and current depth of the PJM forward market (emphasis added).

Even the Company's accounts of its purchasing strategies vary. The HOST model was not mentioned in the initial testimony of Messrs. Stathis and Mascari; Mr. Mascari reported on the X-model and DCA, and Mr. Stathis described the acceleration of forward purchases after the merger. The HOST model was first mentioned in discovery as the basis for targets in the period February 2001 through June 2002. *R-57*. Then, in

Rebuttal Testimony, Mr. Stathis testified that due to price declines in 2001, the Company rejected the HOST model apparently because it did not like the falling targets and replaced it with the Lock & Load Strategy. *JC-15 Rebuttal*, p. 2:5-19.

Mr. Stathis states:

> JCP&L had in place a procurement strategy that was based upon triggering additional purchases above and beyond minimum targeted levels when forward prices dropped to the level of JCP&L's estimates of the marginal cost of production and thus were unlikely to fall much lower. *JC-15 Rebuttal*, p. 2:4-7.

The Lock and Load Strategy, however, was first mentioned in this proceeding in the Company's *rebuttal testimony*. *Id.* The late-arrival of this information is further evidence of the haphazard manner in which the Company apparently selected, implemented, and recorded its BGS procurement processes.

d. Company Witnesses Did Not Adequately Review Model Inputs, Which are Crucial to the Determination of Whether the Model Was Effective.

In Rebuttal Testimony, Mr. Graves stated that in his opinion, the Company used "successful, prudent decision-making," *JC-19* at 41:2, and on cross-examination confirmed that his assessment was based upon his review of the X-method and HOST models. T57:L24, 25 (3/5/03). Yet, Mr. Graves's assessment is limited in that, as he explained on cross-examination, his assessment of the models was based upon his opinion of the Company's *selection* of the X and HOST models, T58:L6-12 (3/5/03), but not a thorough investigation into the inputs. Mr. Graves acknowledged that the reasonableness of input values speak to the success of the models, stating that, "if you put in bad data you can get spurious recommendations, no doubt about that." T58-23-59:L2 (3/5/03). Mr. Graves acknowledged that he reviewed those values that Company used in those models only "[f]rom time to time," T58:L15-19 (3/5/03), and with regard to a question of whether he “reviewed the variation of those input values,” Mr. Graves responded “No.” T58:L20-22 (3/5/03). Without adequate review of the inputs to the models, any opinion as to appropriateness of the models is flawed. The models are only as good as the input. Mr. Graves testified with authority only as to the models themselves, and was unable to testify as to the reasonableness of the inputs and their variations. The Company has not presented adequate proof as to the effectiveness or appropriateness of its selected models, and the Your Honor and the Board therefore cannot count their implementation as prudent.

3. The Company Failed to Utilize Financial and Weather Hedging Properly to Mitigate the Risk of Sharp Electric Price Increases.

It is a long-established regulatory principle in New Jersey that utility service must be provided at “just and reasonable” rates. *N.J.S.A.* 48:2-21. This standard presupposes diligent management. A utility is entitled only to those rates which will allow it to conduct its operations "under efficient and economical operation ...." *Public Service Coordinated Transport v. State*, 5 *N.J.* 197, 225 (1950). As the New Jersey Supreme Court has stated, “Good company management is required; honest stewardship is demanded; diligence is expected; careful, even hard, bargaining in the marketplace and at the negotiation table is prerequisite.” *In re Board's Investigation of Telephone Companies*, 66 *N.J.* 476, 495 (1975).

Consequent to the restructuring of the electric industry and JCP&L’s decision to sell most of its generation assets, the Company was compelled to purchase electricity in the open market. Since the spot market, by its nature, risks price spikes, a prudent utility would seek to balance the risk of spot purchasing by taking steps intended to provide a measure of stability in energy purchase expenditures. One method of managing risk is the utilization of various hedging tools. Other industries that rely heavily on commodities typically rely on hedging to reduce the risk of price run-ups. Only the utility industry, with its guaranteed "pass-through" costs, has lagged behind.

Financial and weather hedging provides a method for the Company to protect itself against adverse effects of cost variances. Yet, the Company did not take advantage of these available tools. The Auditors report that the use of "financial options as a hedge against BGS procurement costs" was "widely utilized in the electric utility industry . . . and the Company was late in incorporating their use as part of its BGS procurement program." *S-38* at VII-53. The Auditors also noted that even when the Company followed the lead of its industry peers and used financial instruments, that usage amounted to only 0.05% of the Company's total BGS expenditures. *Id.*

The Company's imprudence can also be discerned from its failure to adopt multiple recommendations intended to utilize weather hedging. As described by the Auditors, "[t]he Company was aware of, but did not avail itself of weather hedges that may have provided some additional volume protection during the summer of 2001." *S-38* at VII-54. Risk Oversight Committee ("ROC") meetings minutes reveal that Anood Kapoor of GPU requested authorization to use weather derivatives as hedges as early as December 1999. *S-38* at VII-55. Subsequently, in an April 2001 presentation, Dr. Kapoor again advised GPU to examine the suitability of weather derivatives as procurement hedges. *R-56(1)*, p. 43, entitled, "HOST: All You Want to Know, and Some More." The Company, however, failed to heed this advice. The Ratepayer Advocate does not propose that the Company should have followed every recommendation presented to it, but significant questions as to the Company's prudence surface when management ignores repeated advice. In sum, the Company failed to adhere to common current industry practice, and disregarded specifically recommendations presented to it on multiple occasions.

C. Pennsylvania vs. New Jersey Supply Costs: New Jersey BGS Deferrals Are Dramatically Higher Than Those Incurred in Pennsylvania, Indicating Imprudence on the Part of New Jersey Management.

Among the significant differences between New Jersey and Pennsylvania is that Pennsylvania utilities operated without the assurances provided by future recovery of deferred balances. Accordingly, the Pennsylvania utilities had greater incentive to control costs, since management errors and imprudence could not be recovered from the ratepayers, but would instead be reflected in shareholders profits. *R-59*,p. 7:25-8:9, 66 Pa. Cons. Stat. 2804 (1998).[9] By contrast, EDECA provided the utilities with a comfort-zone that prudently incurred costs would be recovered. The Ratepayer Advocate submits that this allowance removed any incentive that the Company had to control costs in New Jersey. The evidence is striking, the New Jersey Company essentially paid $239 million more than its Pennsylvania affiliates. *R-59*., p. 8:14-15, and PLC-2.

The New Jersey Company almost always paid more per MWh for purchases than its Pennsylvania affiliate companies did in the same month. *R-59* at Schedule PLC-2. (This computation excludes the costs of the NUG contracts and the transitional PPAs, which vary between utilities.) As described by Ratepayer Advocate witness Mr. Chernick, the average price that PennElec and MetEd paid for non-NUG, non–transitional-PPA power (weighting the two companies equally) was about 12% less than the price that JCP&L paid. At the prices paid by the Pennsylvania utilities, the Company's $1.92-billion bill for non-NUG, non–transitional-PPA power through July 2002 would have been $239 million less.

[9] *See also Joint Application for Approval of the Merger of GPU, Inc. with FirstEnergy Corp.; Petition of Metropolitan Edison Company and Pennsylvania Electric Company, as Supplemented, for Relief Under their Approved Restructuring Plan and Electricity Customer Choice and Competition Act: Opinion and Order*, Pennsylvania Public Utility Commission Dockets No. A-110300F0095, A-110400F0040, P-00001860, P-00001861, at 15 (June 14, 2001).

The Company attempts to justify the difference with several insufficient explanations. As described by Mr. Chernick, *R-59*, p. 9, the Company argues that JCP&L's costs per MWh of BGS supply would be greater than those of its Pennsylvania affiliates because:

1. the Company has "higher peak requirements" than the other companies;

2. the "overall average cost of JCP&L's NUGs is significantly higher;"

3. "Shopping levels have been significantly higher in PennElec and MetEd than in JCP&L…thus reducing their power supply requirements compared to JCP&L;"

4. "Congestion costs [affect] JCP&L significantly more than" the other utilities, and:

5. "JCP&L tends to have a higher load response due to extremely hot weather…due to the greater penetration of air conditioning."

None of these arguments, however, provide a justifiable explanation for the differences in the costs of market purchases.

The Company's claim that it has "higher peak requirements" than other companies fails to provide any reasoned justification for the high New Jersey supply costs. As explained by Ratepayer Advocate witness Mr. Chernick, while the Company does tend to have a lower load factor than the Pennsylvania affiliates, and a slightly higher percentage of energy used in the peak period, the Company failed to offer any quantitative computation to demonstrate that these differences in load shape could explain the differential in prices. *R-59*, p. 9:18-21. The Company's statement regarding "higher peak requirements" is a generic description devoid of hard data that would tend to support its position. As set forth above, the Company bears the burden of proof in this proceeding, and therefore must be able to substantiate with verifiable data its claims regarding any alleged effect of the differences in peak requirements.

The Company's reference to NUG costs is also misleading. The Ratepayer Advocate comparison that determined the $239 million difference *excludes* NUG costs. *R-59*, p. 9:22-23. Therefore, any NUG-related costs that the Company may cite do not affect the Ratepayer Advocate conclusions; the NUG costs do not explain the differentials. Indeed, if these "significantly higher" NUG costs were included, the disparity would be even more striking.

The Company's next argument that shopping levels have been significantly higher in PennElec and MetEd than in JCP&L is functionally unsound. As Ratepayer Advocate witness Mr. Chernick correctly points out higher shopping levels in Pennsylvania would tend to draw off customers with better load shapes, thereby *increasing* the unit cost of power supply. Contrary to the Company's position, this would tend to lead to a comparatively *lower* New Jersey cost. *R-59* at 10:1-2. Arguably, if New Jersey had reached the shopping levels achieved in Pennsylvania, JCP&L's residential customers would be looking at even higher prices.

The Company's claim that "[c]ongestion costs [affect] JCP&L significantly more than" the other utilities is another example of the Company's anecdotal, rather than quantitative, evidence. Mr. Chernick noted that the Company itself did not quantify the differences that could cause higher congestion costs than the in New Jersey. *R-59*, p. 10:3-4. The Company's general proposition fails to include any data that enable Your Honor or the Board to either conduct or review a quantitative analysis to determine whether, in fact, congestion costs have any bearing on the Company's costs. Accordingly, no competent analysis of the effect of the alleged differences can be undertaken, and the supposed effect cannot be determined.

Lastly, Mr. Chernick found that the Company's claim that "JCP&L tends to have a higher load response due to extremely hot weather…due to the greater penetration of air conditioning" is unsupported. The differentials are not driven by the summer air-condition load: in the summer months, JCP&L's power-supply costs per MWh have been relatively close to those of the Pennsylvania utilities. *R-59*, p. 10:5-9. In fact, the divergences tend to be greater in the *fall and winter*, rather than in the summer, as shown at *R-59*, PLC-2.

The Pennsylvania data provides a valuable benchmark to use when evaluating whether the steps taken by JCP&L were prudent. The result, quite simply, speaks for itself. At the prices paid by the Pennsylvania utilities, the Company's $1.92-billion bill for non-NUG, non–transitional-PPA power through July 2002 would have been $239 million less. If the New Jersey Company had achieved the reasonable procurement success of its Pennsylvania affiliate, the New Jersey company's deferred balance would be $239 million less. The Company has not adequately explained this difference. Accordingly, Your Honor and the Board should utilize the Pennsylvania experience as a benchmark against which to measure JCP&L's performance, and to find that the New Jersey BGS costs were not incurred prudently.

The comparison of New Jersey to out-of-state performances is especially important in light of the fact that three New Jersey utilities (Rockland Electric/RECO, Atlantic/ACE, and JCP&L) have merged with out-of-state utilities in the past few years. As evidenced by the JCP&L experience, New Jersey ratepayers appear to have suffered while their peers in Pennsylvania appear to have not been as adversely affected by energy markets. The interests of New Jersey ratepayers must be protected. Only continued vigorous oversight of the utility activities will ensure that New Jersey ratepayers are treated fairly.

D. NUG Mitigation Effort

Because the Company Has Made No Significant Mitigation of NUG Contract Costs since 1997, Your Honor and the Board Should Not Allow the Company to Collect Interest from Ratepayers on This Portion of the Deferred Balance.

1. The Company Failed to Demonstrate That It Took All Reasonable Measures To Mitigate Its Stranded Costs Associated With Its NUG PPAs

JCP&L, throughout the transition period, was a party to a number of NUG contracts. Indeed, in this filing, the Company has projected over $1.0 billion in above market NUG Purchase Power Agreement costs. *JC-13*, Sch. SDM-1A (12+0).

In the JCP&L restructuring Order, the Board found that "recovery of above-market costs associated with NUG contracts, as well as costs associated with NUG contract buyout payments via the MTC is consistent with *N.J.S.A.* 48:3-61(a)(3)." *Final Order* at p. 97. The Board reminded the Company, first in the *Summary Order* on May 24, 1999, and subsequently repeated in the *Final Order*, that it had "an ongoing obligation to take all reasonable measures to mitigate the stranded costs associated with the NUG utility Purchase Power Agreements," and should use "its best efforts to pursue beneficial buyouts, buydowns or restructuring of NUG PPAs." *Id*. at 98.

Since the date of that Summary Order, the Company has not managed to successfully complete one buydown or buyout of any of its NUG contracts. This despite the efforts of "three analysts, a lead manager, a director, and a Vice President, as well as in-house and outside counsel." *S-39*,VIII-4. In fact, the only buyouts/buydowns that the Company did manage to finalize were before the Summary Order.

According to the Audit Report, prior to restructuring, the Company was reasonably aggressive in pursuing opportunities to reduce its NUG commitments. A chronological listing shows:

1994 - American Refined Fuel contract buyout in BPU Docket no. EC92040516
1995 - Fuel contract restructuring with New Jersey Natural Energy Corporation
1996 - Freehold Cogen[10] buyout
Newark Box - approved by BPU in Docket No. EM8604395
Dupont/Parlin- approved by BPU in Docket No. EM86121245
1997 - Crown Vista buyout in BPU Docket No.ER95120633.
Milford restructuring- approved by the Board in Docket No. EM97100738 and EM87060431.
Monmouth- reduction was approved in Docket No. EM95040167

Since 1997, little progress has been made in reducing costs associated with NUG contracts. In March 2001 the Company apparently negotiated an "interim operating agreement" with Parlin and Newark Box that resulted in approximately $6.3 million in savings through the third quarter of 2002. *S-38*,VIII-5. This "interim operating agreement" allowed JCP&L to resell natural gas rather than use it to make electricity. Beyond this agreement, there has been no mitigation of NUG costs since 1997.

As shown below, the Company remains a party to several NUG contracts that are costing ratepayers hundreds of millions of dollars in above-market costs, with negotiations either stalled or "on-going".

[10] The Board in the Final Order allowed the recovery "without interest, of the unrecovered balance at August 1, 1999 of Freehold Cogen buyout costs (as defined in Docket No. ER95120633) in the amount of approximately $106 million ("Freehold Buyout Cost"). Final Order , p. 105. The Board noted however that "[n]othing herein alters the current interim nature of Freehold Cogen Buyout Costs recovery, pending the Board's final decision in Docket No. ER95120633." The Docket on this agreement is still open.

Project	Projected Above Mkt Costs - 2000-2003	Status
South River	$250,000,000	Negotiations on-going
Lakewood	$114,000,000[11]	Negotiations on-going
Bayonne	$184,000,000	Closing delayed
Newark Boxwood	$ 59,000,000	Negotiations on-going
Parlin	$ 52,000,000	Negotiations on-going
Marcal	$ 43,000,000	Negotiations stalled
Milford	$ 12,000,000	Status of negotiations, if any, since 1997 restructure unclear
Camden	$ 22,000,000	No contacts since 1998
Gloucester	$ 17,000,000	No contacts since 1998
Kenilworth	$ 9,000,000	No contacts since 1998
Warren	$ 6,000,000	Negotiations on-going
Manchester	$ 2,000,000	Negotiations stopped in 1999
Monmouth	$ 1,000,000	No talks since 1997 restructure

[*S-38*, VIII, p. 5-6.][12]

While the Company claims that its re-negotiation efforts are picking up, ratepayers have yet to see any significant savings in over five years of "ongoing negotiation." The three most expensive NUG contracts are supposedly entering a phase of renewed negotiations. The South River contract has projected through the transition period above-market NUG costs of more than $250,000,000. According to the auditors, "the framework of a proposed agreement was reviewed with BPU staff on May 14, 2002." *S-38* at VIII, p. 7. And yet, a year later, there is no evidence of a signed agreement. Similarly, the Lakewood contract, with projected above-market costs of $114,000,000, has been the subject of a possible restructuring "since early 2002." *Id.*

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[11] The Auditor's report exhibit VIII-2 places this contract at $250,000,000 above Market NUG. However, the cited source states that Lakewood is $114,000,000 above market.

[12] According to the Auditor's report, the projected numbers are as of the "commencement of the Deferred Balance proceeding." The updated testimony of Susan D. Marano's Cummulative Forecast Through Jul-03, shows a significantly higher number for "NUG Purchase Power Agreements above market" of $1,015,705,149. *JC-13, Sch.SDM-1A, Dec 02 Update*, p.1

The Bayonne plant has projected above-market costs of $184,000,000. And, in early 2001, JCP&L "began serious negotiations" with the Bayonne plant's current owner and "reached agreement in February 2002." *S-38,* VIII*, p. 7*. This restructuring agreement has been approved by the BPU but apparently, for some reason, the closing has been delayed. *Id.* At the time the Audit report was written, "BWG had not determined the cause of the delay." *S-38* VIII*, p. 13*. The Auditors also noted that the "[m]erger with FirstEnergy caused minor delays in negotiations with Bayonne, Lakewood, and South River." *Id*.

An additional indication of the Company's less than aggressive mitigation strategy is JCP&L's rejection of Reliant Energy's proposal to restructure JCP&L's NUG portfolio. *S-38*, VIII-15. At about the time of the merger, Reliant Energy contacted JCP&L with an offer to restructure its NUG portfolio for a share in the resultant savings. *Id*. JCP&L first put off Reliant by responding that the proposal would have to be approved by FirstEnergy. *Id.* Reliant provided to the JCP&L ROC a written overview of the proposal with a subsequent meeting in person to review the proposal. JCP&L subsequently rejected the offer "on the basis that the savings were speculative, and the approach was inconsistent with its NUG mitigation strategy." *Id*. The audit report noted that "[t]he audit timetable has not provided adequate time to examine the merits of the proposal and JCP&L's reasons for rejecting it." *Id*.

The Auditor's report concluded that the BPU might want to disallow some amount of the over market NUG costs associated with the smaller NUG contracts because the Company "has been less than aggressive in its pursuit of mitigation opportunities for its smaller contracts." *S-38*, VIII-13, VIII-16. In disallowing recovery of certain NUG costs, the Auditors recommend that the Board use the Company's 10% benchmark "of a reasonable savings target for NUG contract restructurings." *Id.*

The Company has not provided sufficient evidence that it took seriously the obligation to mitigate its NUG contract costs. Indeed, the total lack of any appreciable ratepayer savings achieved during the transition period indicates the opposite. The Company's "best efforts" were not good enough. Accordingly, because the Company achieved no significant mitigation of NUG contract costs since 1997, the Ratepayer Advocate respectfully requests that Your Honor and the Board not allow the Company to collect interest from ratepayers on this portion of the deferred balance. The Company's shareholders should bear some responsibility for JCP&L's management failure to mitigate NUG costs. Your Honor and the Board should adjust the Company's accrued interest by $59,463,586. See attached Schedule 2.

2. The Company Failed to Manage Its Existing Portfolio To Minimize BGS Costs.

As explained by Ratepayer Advocate witness Mr. Chernick, "[a]t the beginning of competition in 1999, the Company had a large number of NUG contracts, two utility contracts, the Transitional Power Purchase Agreements ("PPA") from the Three Mile Island ("TMI") sale, and various company-owned generation resources contributing to the BGS supply." *R-59* at 13:7-10. Mr. Chernick noted that at time of the termination of the utility contracts in 1999, most of the utility generation had been sold, and a capacity-only transitional PPA had been added in connection with the generation sale. At that time, integration of the NUG resources into the Company's BGS portfolio, including scheduling, dispatch, and renegotiation of the contracts, would have the effect of decreasing BGS costs. Further, as noted by Mr. Chernick, the Company also should have determined when it had excess generation services from long- and short-term purchases and from owned resources to resell into the market, and determined *how* to dispose of that excess. *R-59* at 13:10-17. There is no evidence in the record, however, to support the proposition that any of these measures were enacted.

The Auditors note that the Transition Purchase Power Agreements associated with the Company's divestiture of its generation assets "exposed JCP&L and its BGS customers, to market price volatility." *S-38*, 1-6. For example, the Auditors characterized the Company's actions as "naive" with regard to the sale of the fossil units to Sithe in 1998 without including some provision for the retention of access to the divested plant energy through parting contracts. BWG noted: "[w]e question the wisdom of not including provisions for retaining access to the divested fossil plant energy through the parting contracts offered as part of the sale in 1998" but concluded that it would be "hindsight critique" to fault the Company for its failure to include potential hedges that could have decreased the Company's susceptibility to market uncertainties. The report then concluded that no one "will ever know how much providing some optionality (sic) would have cost, because it does not appear to have been asked for at the time of the fossil unit action." *Id.* Lack of exploration of these tools to minimize costs is just another example of the Company's imprudent management of its BGS costs.

3. Your Honor and The Board Should Adjust the Company's Deferred Balance by the Amount the Company Has Over-Collected in both Interest and the Freehold Buyout.

The auditors also noted that JCP&L is collecting a 14.64% rate of return on its generation assets through BGS revenues. The Auditiors note that no Board Order allowed the collection of such a high rate of return and that JCP&L is relying on a Board Order for another utility which, in fact specifies a lower rate of return than the rate being collected by JCP&L. *S-38*, V-3.

The auditors did not specify which other utility the Company is relying upon. However, presumably, the Company is relying on the Atlantic order in which the Board allowed ACE to recover 13% on its fossil generation. The Company's reliance on this Order is misplaced. First, if the Board order is the Atlantic order, Atlantic is only receiving a hefty 13% rate of return on its to be divested generation, not the egregious 14.64%

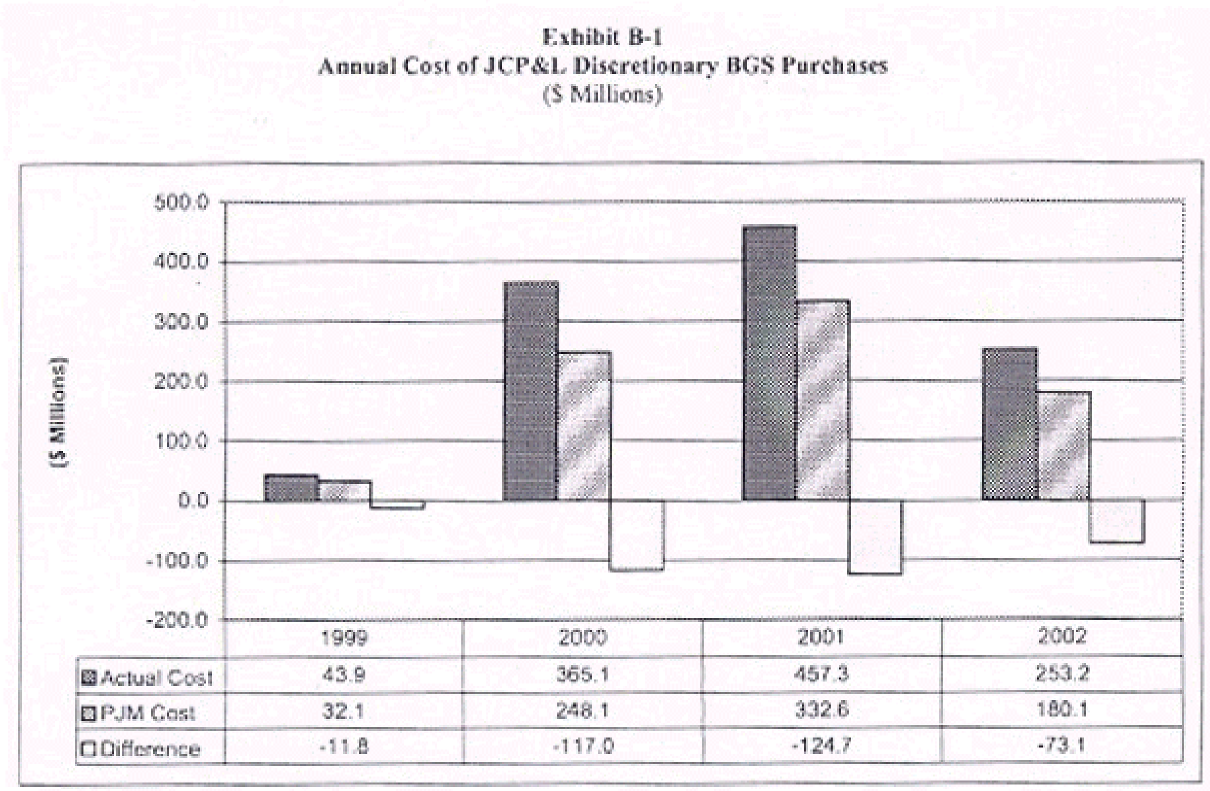
being accumulated by JCP&L. Moreover, the very high return the Board ordered for ACE was premised on the anticipated divestiture of these assets. And, in fact, the Board has recently determined that 13% is no longer an appropriate return on these assets. *I/M/O Atlantic City Electric Company's Rate Unbundling, Stranded Costs and Restructuring Filing*, Order Setting Interim Rates, Docket Nos. EO97070455, EO97070456, and EO97070457 (April 21, 2003). In fact, the Board is now considering the use of the short term debt rate. *Id*. at 4. Accordingly, the Board should take the earliest opportunity to investigate this extraordinary interest being recovered by the Company, without Board authorization, and to take any steps necessary to return any interest over-recovery to ratepayers.

As a final note, the Company has collected through the MTC, and prior to that through the DSF, buyout costs associated with the Freehold Cogen project. This matter was recalled pursuant to Secretary Izzo's letter dated March 25, 2003 and is currently pending before the Board. (BPU Docket No. ER95120633) Accordingly, all costs collected by the Company for the Freehold buyout should be disallowed until the Board has made a final determination regarding that agreement.

E. Relevance of Post-hoc Comparison: the Company Has Failed to Demonstrate Either Through Performance or Contemporaneous Documentation That it Performed in a Prudent Manner.

1. EDECA Contemplated a Post Hoc Retrospective Review.

The Board recognized the necessity of a *post hoc* analysis when it requested that the Auditors prepare "an aggregate comparison of the cost of JCP&L's discretionary BGS purchases during the first three years of the transition period with the cost if those purchases had been made at the existing PJM market prices." *S-38* at B-1. Exhibit B-1 of the Audit Report, reproduced below, is telling: the Company *always* paid higher than PJM prices, for a total difference of $327 million, more than 29% of its total $1.119 billion BGS expenditures.



Source: S-38 at Appendix B-1.

The annual discrepancies ballooned to $117 and $124 million in 2000 and 2001. The Ratepayer Advocate submits that the evidence presented in this case regarding the Company's inappropriate selection and implementation of procurement strategies is confirmed by the dismal performance revealed by the Board-ordered *post hoc* review. The chart that is reproduced above speaks for itself. No meaningful analysis of the Company's performance would be available without a *post hoc* comparative analysis of the Company to its industry peers or, more specifically, the prices at which its peers purchased BGS supplies. The Board's analysis is entirely consistent with the Ratepayer Advocate position, set forth above, that comparison to similarly-situated utilities provides a benchmark that is not only valuable, but absolutely essential to a thorough prudence review.

The very nature of EDECA and the statute's structure to compensate utilities for costs that were reasonably and prudently incurred calls for a retrospective review of a company's performance. Any argument to the contrary flies in the face of the intent of the Act. As described above, the review does not presuppose that any Company is prophetic in the sense that it could, or should, have anticipated every circumstance and occurrence that would affect its purchasing and other activities. But, as established above, the review can, and should, recognize comparable benchmarks against which the Company's performance can be evaluated.

2. The Company's Testimony Ignores Its Specialist's Advice to Enact Performance Metrics.

Even the Company's consultants urged the establishment of benchmarks for retrospective analysis and review. Initially, Mr. Graves testified that an *ex post* review of Company performance cannot be executed efficiently in the BGS deferrals environment. Specifically, Mr. Graves testified that "looking at actual market outcomes after the fact says little about the effectiveness of a particular power procurement strategy." *JC-19* p. 5:14-16. Yet, on cross-examination, Mr. Graves stated that a company's performance can be evaluated after the fact on various bases,

> such as the quality of procedures and policies they [the Company] used to guide their decisions, whether those were consistent with best practices in the industry and whether they updated and modified the inputs to those on a regular basis, and they considered whether those same models were sufficient to formulate their decisions or needed to be overridden and supplanted by other information. This is the type of review that can and should be done. T8 51:15-25 (3/5/03).[13]

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[13] Case law is consistent with Mr. Graves's recognition of the need for review and comparison, including the comparison to other industry participants. For example, in addressing an allegation that a transit company had the highest operating costs among major urban transit companies, the court indicated that standards of efficiency are therefore in question. *Democratic Central Committee v. Washington Metropolitan Area Transit System, Inc*., 485 *F.2d* 886, 907 (D.C. Cir. 1973), *cert. denied*, 415 *U.S*. 935 (1974). Similarly, in *Trans World Airlines. Inc. v. CAB*, 386 *F.2d* 648, 657-58 (D.C. Cir. 1961), *cert. denied*, 390 *U.S*. 944 (1968), the D.C. Circuit explained that the prudent limit on an airline's selling expenses is determined by comparison with the comparable expenditures of other airlines.

When compared against similarly situated and corporate-related utilities in Pennsylvania, JCP&L incurred costs that were, on average, 13% higher than its Pennsylvania affiliates. As described in Section D, above, the Company's attempts to justify this disparity on the basis of regional differences fail for either a lack of quantitative data upon which such a comparison could be made or inherent logical infirmities.

Further, benchmarks against external players are not the only barometer that can be utilized. Internally-generated benchmarks can, and should, be used, as well.[14] The Company should have periodically reviewed the performance of the guidelines by (1) comparing the costs of the guideline recommendations to the costs under other approaches, and (2) reviewing staff compliance with those guidelines, and the reasonableness of any departure from the guidelines (including whether those deviations indicated a need to change an underlying guideline). *R-59*, p. 15:13-19. Indeed, the Brattle Group, professional consultants hired by the Company, one of whose principals later testified on behalf of the Company in the instant proceeding, recommended that the Company establish a metric against which to measure performance. But, no such metric was established. The Company left itself with no way to measure its performance, and apparently relied upon future recovery of its deferred BGS balances as a way to make up for its losses.

Company witness Mr. Graves testified that there is no appropriate basis for evaluating performance after-the-fact, stating that "[l]ooking at actual market outcomes after-the-fact says little about the effectiveness of a particular power procurement strategy." JC-19, p. 5:14-16. Yet, Mr. Graves provided on cross-examination a description of a rational basic procurement metric whose utilization would evince a systematic and thoughtful approach to BGS procurement.

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[14] *See, also, Florida Power Corp.*v. Cresse, 413 *So.2d* 1187, 1189 (1982) (fact that national data bank information indicated that other companies did not maintain a complete inventory of spare parts did not excuse a utility which failed to order spare parts while knowing of history of pump failure).

> Q: [Referring to *R-51*(4)] Now, does this describe also a basic procurement metric to be used for a post-op review, an after the fact review?
>
> (Mr. Graves) Yes, subject to some clarification that occurs later I think where they discuss how to measure risk.
>
> The idea is that there is a possible metric that you could have agreed upon before the process started for reviewing the process after the fact. It is not the only one, but it is a possible one.
>
> Q: Looking at page 4 [of that same attachment,] does this recommend that as [sic] a comparison metric can be used as a tool in determining prudence?
>
> A: Yes, in a certain way. What it is saying is that if you could agree with the Commission that the kind of risk exposure that would have occurred under this strategy of procurement would have been acceptable before the fact, then you could compare after the fact results to this and see if you did or did not do as well as this strategy, but it is only an acceptable measure subject to that *a priori* agreement because that becomes prudent in the context of that *a priori* discussion about what kinds or [sic] risk as I mentioned you understand is going to be borne and is acceptable.
>
> And having had that discussion you could revise the approach. You can say, well, we had no idea it was going to be so risky, and you tighten it up, we can discuss something.
>
> Then you define if it was prudent. T54:L12-55:L18 (3/5/03).

Additional evidence confirms that the Brattle Group was of the opinion that *ex post* comparisons were valid and useful for several purposes. In December 2000, the Brattle Group submitted to GPU a diagram of an overall approach to risk management, from the development of a hedging strategy to *ex post* comparisons. *R-51*(5) at 4. The Brattle Group recommended DCA with 100% hedging as the benchmark for *ex post* evaluations because it is simple and transparent. *R-51*(5), p. 3 ("A transparent, feasible strategy should be identified as a metric for evaluating realized, actual performance -- herein called "Dollar Cost Averaging" (DCA);" *R-51*(3), p. 3.

The Brattle Group even proposed *ex post* comparison to metric for use in *incentive bonuses*. In a September 2000 presentation, the Brattle Group recommended that "GPUE incentive bonuses could be tied to success of these deviations from pure DCA strategy," *R-51*(3), p. 16, and that "[p]erformance evaluations should re-center on the *ex post* cost of the benchmarking strategy and avoid judging price forecasting skills." *R-51*(3), p. 17.

The instances of recommendations to utilize a metric for *ex post* review are legion and the fact that the Company had received professional advice to create and utilize metrics for *ex post* review further supports the determination that the Company acted imprudently when it ignored those recommendations. Quite simply, the Brattle Group proposed that *ex post* comparisons to a metric be used as a tool in the determination of prudence. The Company was told that "the goal of the project is to develop a Procurement Metric that describes the reasonable and prudent cost and level of risk for acquiring BGS/POLR supply." *R-51*(4), p. 4. The presentation went on to state that "the Metric can be used for two primary purposes: (1) as a tool for GPUE to determine prudence for the first year of BGS, (2) as a tool going forward." *R-51*(4), p. 6. The presentation concluded by stating that:

> BGS procurement should be benchmarked with a very basic, easy-to-explain, highly-hedged, operationally-feasible metric. The DCA metric is such a benchmark and can be used to show the prudence of the actual cost of GPUE's procurement strategy. . . . Performance evaluations should re-center on the *ex post* cost of the benchmarking strategy and avoid "Monday morning quarterbacking" on price forecasting skills and highly speculative strategies. *R-51*(4), p. 36.

Oddly, the Company now presents a principal in that firm to testify that *ex post* reviews are not helpful. JCP&L is not prophetic in the sense that it could have foreseen future and spot market prices, and the

Ratepayer Advocate similarly cannot divine what would have occurred had the Company taken a different path. But, the Company received lots of expert advice, advise about hedging, about risk management, about establishing a benchmark to measure performance, that it seemingly just disregarded. Furthermore, the Company did not sufficiently document its processes to allow for proper regulatory review. It variously selected models, and then superseded them without clear policies that dictated as to when the models should be ignored. Accordingly, the Company has not demonstrated that it incurred massive BGS deferral balances prudently, and must therefore be denied the opportunity to collect these amounts from ratepayers.

F. The Audit Report Shows a Series of Unsupported Conclusions That Lack Evidence of Comprehensive Independent Analysis.

1. The Report Evinces a Lack of Independent Analysis by Presenting as its Conclusions and Analyses Direct Quotes from Company-Provided Material.

As described below, the Audit Report lacks demonstrative evidence that it is the product of thorough and independent analysis. The Audit Report is riddled with instances in which key conclusions, definitions, and explanations are verbatim copies of material provided by the Company in either testimony or discovery responses. The appearance is one of wholesale adoption by the Auditors of the Company's representations without any independent analysis of those positions by the Auditors. As such, the Audit Report is as only as strong as the Company's representations, and is weakened further in that it cannot demonstrate adequately that in fact investigated or otherwise plumbed beyond the surface of the Company's actions.

The Auditors explain that a "prudence audit" involves:

> (Mr. Laros): . . . looking at the organization, policies, procedures, methodologies, experience of the people, quality of the resources that they apply.
>
> You are looking at the alternatives that were available, what people are doing based on what could happen or what should happen at that time. T40:L1-7 (4/28/03).

The Ratepayer Advocate submits that an adequate audit would include an independent investigation and verification of the Company's statements regarding relevant issues. This independent verification would be demonstrated by the Auditors' statements and explanations of relevant material, including interviews with personnel, review of Company documents, and integration of relevant material from the record in this proceeding. Additionally, an adequate audit would utilize external benchmarks as yardsticks against which the subject company's performance could be compared. Yet, in many instances, the Auditors simply reproduced (sometimes with insufficient, sometimes without any, attribution) Company testimony and discovery responses without any independent explanation as to the reasons why the Auditors adopted those positions. The Auditors attempted to explain at the evidentiary hearings:

> (Mr. Laros) The material in here is felt by me to be a valid description of the factual information we were provided to present as verified through interview notes or interviews or other discovery.
>
> And I didn't feel it was necessary to recraft what I thought were apt descriptions of various matters. T33:8-15 (4/28/03).

The Auditors' approach creates a situation in which it is virtually impossible to discern the value-added analyses of the Auditors.

For example, page VII-1 of the Report provides a background of the environment in which JCP&L operated, the circumstances surrounding its selection and implementation of models, its purchases, regulatory issues, and other data and circumstances allegedly analyzed by the Auditors. Presumably, the section is based upon the auditors' review and interpretation of relevant data, including the Company's testimony in this case, the Company's responses to discovery requests, Company records, data, and information. Yet, astoundingly, what the Auditors refer to as their "opinion," *see S-38* at Cover Letter Accompanying Report, is actually a direct, and non-attributed quote, from the Company's pre-filed testimony, specifically, *JC-14*, *Direct*. The Audit Report states,

> For each month, JCP&L developed projected peak loads for JCP&L customers under normal weather, mild weather and severe weather conditions based upon historical usage data. JCP&L then developed an estimate for BGS requirements based on trends in customer shopping experienced in Pennsylvania and other states that introduced retail competition prior to New Jersey. *S-38* at VII-13.

Identically, Exhibit *JC-14*, the Direct Testimony of Charles Mascari, states at page 8, lines 14-19:

> For each month, JCP&L developed projected peak loads for JCP&L customers under normal weather, mild weather and severe weather conditions based upon historical usage data. JCP&L then developed an estimate for BGS requirements based on trends in customer shopping experienced in Pennsylvania and other states that introduced retail competition prior to New Jersey. *Exhibit JC-14*, p. 8:14-19.

Astoundingly, the Audit Report does not even provide a footnote or other citation to the Company's pre-filed testimony. Indeed, on its face, there is nothing in the relevant section of the Audit Report that would alert the reader to the fact that this information is a direct, non-attributed quote from the Company's testimony. A similar instance of non-attribution occurs at page I-7 of the Audit Report, which states:

> Once the fill targets were established, JCP&L was an active buyer in the marketplace so that over time, but prior to entering any given month, the portfolio of committed supplies approximated the established fill target for that month. JCP&L procured electric energy on the wholesale market over time in order to avoid very large volume purchases that it felt could drive wholesale prices even higher than already being experienced in the less than fully-mature marketplace. *S-38* at I-7.

This section is once again nearly identical to the Direct Testimony of Charles A. Mascari:

> Once the supply targets were established, JCP&L was an active buyer in the marketplace so that over time, but prior to entering any given month, the portfolio of committed supplies approximated the established supply target for that month.

> JCP&L purposely procured electric energy on the wholesale market over time (analogous to the "dollar cost averaging" approach employed for stock purchases), avoiding very large volume purchases that could drive the wholesale price even higher in this less than fully-mature marketplace for electric energy and capacity. *JC-14* at 11:21-12:7.

Direct quotes of Company material without the use of quotation marks is misleading and inappropriate. The Audit Report, in substantial parts, is simply a restatement of the Company's testimony and discovery responses.

The trend continues on the page VII-14 of the Audit Report when the subject of load forecasting is discussed. The Audit Report states:

> Shopping experience in other states (i.e., Vermont, California, Pennsylvania) was considered. Information came from general literature such as news reports and Internet searches. No specific studies or statistical analyses were undertaken. Final assumptions were based on judgment after reviewing available information. *S-38* at VII-14.

Identically, the Company states in its response to RAR-BGS-90 (*R-79*) that:

> Shopping experience in other states (i.e., Vermont, California, Pennsylvania) was considered. Information came from general literature such as news reports and Internet searches. No specific studies or statistical analyses were undertaken. Final assumptions were based on judgment after reviewing available information. *R-79.*

Although in this instance the Company provides a footnote, there is no indication that this material is a direct, unadulterated quote of the Company's response to a discovery request. The Audit Report presents the Company's exact response in a manner that would lead the reader to believe that the statement represents the Auditors' independent conclusion with regard to the matter.[15]

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[15] On the same page, the Auditors incorporate the Company's response to Discovery Request RAR-BGS-89. Notwithstanding the addition of an introductory phrase, "[d]uring the transition," the text of the Audit Report repeats the paragraph-length language of RAR-BGS-89 *word for word*.

Other examples of this sort of mimicry are legion: the Company's statements at the bottom of that page track the language of the Company's response to Discovery Response RAR-BGS-51 (*R-57)*. While footnotes are provided, the often identical verbatim language is not presented as a direct quote from the Company material, but as the Auditors' independent findings.

Most egregious is the Auditors' wholesale incorporation of Company language in the Audit Report's "Findings and Conclusions" section. For example, the Auditors support Point 13 of the "Findings and Conclusions" section by stating:

> JCP&L reviewed short- and long-term PJM capacity prices and corresponding market trends on a daily basis. This review process included an informal canvassing of not only the broker market for real-time pricing and market intelligence on selected capacity products but also discussions with potential counter-parties on capacity products, prices and forward views. According to JCP&L, particular attention was placed on the various PJM auctions and both the range and trend of clearing prices. *S-38* at VII-49.

By way of comparison, the Company stated in response to RAR-BGS-124 (*R-82*):

> JCP&L reviewed short- and long-term PJM capacity prices and corresponding market trends on a daily basis. This review process included an informal canvassing of not only the broker market for real-time pricing and market intelligence on selected capacity products but also discussion with potential counter parties on capacity products, prices and forward views. Written notes and price quotations from these discussions and resultant views were not kept.
>
> Particular attention was placed on the various PJM auctions and both the range and trend of clearing prices. *R-82*.

In fact, the only difference between the two statements is the Company's acknowledgment that it did not retain any "written notes and price quotations" from the discussions. Nowhere in the Auditors' statement is there any information that indicates that they did anything more than simply adopt wholesale the Company's statements.

The trend continues when the Auditors conclude:

> It was JCP&L's intent to transact a majority of its short-term energy needs in the day-ahead market unless identifiable trends or market conditions caused JCP&L to bid a limited portion of its load in the real-time market. In choosing between day-ahead and real-time product types for these limited situations, JCP&L would typically consider market trends of how specific real-time and day-ahead LMP points have been trading over different planning horizons – daily, weekly, high-demand hours, etc. *S-38* at VII-49.

By way of comparison, the Company's response to RAR-BGS-122 (*R-81*) states:

> While it was JCP&L's intent (and actual experience) to transact a majority of its short-term energy needs in the day-ahead market, there may have been identifiable trends or conditions that would have caused JCP&L to bid a limited portion of its load in the real-time market. In choosing between day-ahead and real-time product types for these limited situations, JCP&L would typically consider market trends of how specific real-time and day-ahead LMP points have been trading over different planning horizons – daily, weekly, high-demand hours, etc. *R-81*.

Once again, the Audit Report does not evince evidence of independent analysis of the Company's actions. At its best, the Auditors appear to have approved the processes that the Company claims to have undertaken. Yet, as described above, the Company did not retain adequate documentation of its processes. Therefore, the Audit Report, which similarly does not provide information that probes beneath the Company's assertions, lacks value in the portions where it seems to only playback to the audience what the Company represented.

2. The Auditors Were Unable to Demonstrate that the Information that it Reviewed was Current, Complete, and Accurate.

The Auditors revealed on cross-examination that an apparent lack of records did not affect their ability to audit the Company. In a discovery response, the Company described various reviews that it conducted, but concluded that "[w]ritten notes and price quotations from these discussions and resultant views were not kept." *R-82.* A greater portion of that discovery response, as described above, was adopted wholesale by the Auditors and presented as "proof" of their Finding and Conclusion 13. When asked how the Company arrived at its conclusion if "[w]ritten notes and price quotations" had never been retained by the Company, the Auditors responded as follows:

> (Mr. Laros): We didn't care that they didn't have a record of it, electronically. I mean that portion of the response was not relevant to the conclusion that we reached, which was that they appropriately monitored it.
>
> Q: How did you verify that they appropriately monitored it without any documentation?
>
> A: I don't look at [sic] piece of paper for every finding and conclusion . . . I did look at samples of reports that [sic] the provided that people had either in the interviews or attached to the data responses.
>
> So I certainly felt that I was comfortable that the information that was being presented was valid but I did not then do a further search to look at the data bases supporting the maintenance of market information of anything like that. T38:22-39:23 (4/28/03).

As further borne out by the Auditors' discovery responses, the Auditors were unable to demonstrate that their review included information that was current, complete, and accurate. In response to several discovery requests, the Auditors provided information via electronic "Adobe" files. Adobe files utilize Portable Document Format (PDF), a universal file format that preserves the fonts, images, graphics, and layout of any source document, regardless of the application and platform used to create it.[16] In other words, an Adobe file will present an exact replica of the original image. In many of the critical hedge reports provided in Adobe format to the Ratepayer Advocate, *see, e.g., R-86* and *R-87*, entire bands of data, often comprising nearly half the data on any given page, were either entirely illegible or so heavily shaded as to be functionally illegible. When asked whether these illegible documents were relied upon by the Auditors, the witness responded,

> (Mr. Laros) I can't say, no, these are copies of copies. I may have a more original copy in my copy. T56:16-19 (4/28/03).

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[16] *See* http://www.adobe.com/products/acrobat/adobepdf.html, last visited April 27, 2003.

Either way, there is a gaping hole in the ability of the Ratepayer Advocate, and indeed any party to this proceeding, to judge the adequacy of the Auditors' review because and the independence of its conclusions.

G. Summary

The Company, which bears the burden of proof in this proceeding, has not demonstrated that it incurred its BGS costs prudently. Therefore, the Ratepayer Advocate recommends that the Court deny recovery of $239 million of the deferred balances as well as the $ 59,463,586 in interest collected on the Company's NUG above market costs. Furthermore, any costs collected by the Company associated with the Freehold buyout should be set aside until that separately docketed matter has been finally decided. Also regarding the Freehold Buyout, it appears from Susan Marano's Schedule SDM-4 that the Company may be including the Freehold Buyout balance in their interest calculation. This is in violation of the Board's *Final Order* and should be adjusted by the Company. Finally, Your Honor and the Board should disallow the Company's self-authorized collection of a 14.64% return on its generation assets through BGS revenues.

VII. DEMAND SIDE MANAGEMENT

The Company's request for "lost revenues" pursuant to the Company's energy efficience programs has been addressed in the Revenue section of this brief.

VIII. CONSUMER EDUCATION

A. Consumer Education Program ("CEP") Costs Incurred by JCP&L Are Not Recoverable Through the Societal Benefits Charge Because the Company Has Failed To Establish That The Costs Were Reasonably and Prudently Incurred.

1. Background of the CEP

By Order dated September 22, 1998[17], the New Jersey Board of Public Utilities (ABoard@) established a consumer education program to educate consumers on the impending changes that would result from deregulation of the electric and gas markets pursuant to EDECA. EDECA required the Board to establish a multi-lingual electric and gas consumer education program, with the goal of educating residential, small business, and special needs consumers concerning restructuring of the electric power and gas industries. *N.J.S.A.* 48:3-85(d).

The Board in its May 20, 1999 Order created the Utility Education Committee (AUEC@) which represented the interests of the electric and gas utilities, and the Energy Education Council (AEEC@), which represented the interests of consumers.[18] The Board gave the UEC responsibility for developing and implementing the statewide consumer education program. The EEC was given a minor "consulting" role, but the ultimate decision-making power was left with the UEC. By Order dated August 11, 1999, the Board retained the Center for Research & Public Policy of Hartford, Connecticut ("Center") to advise the Board and to research the level of consumer awareness of energy deregulation and restructuring. The Center was required

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[17] *I/M/O the Energy Master Plan Phase II Proceeding to Investigate the Future Structure of the Electric Power Industry,* BPU Docket No. EX94120585Y, Order on Consumer Education, (Sept. 22, 1998). ("September 22, 1998 Order@).

[18] The Ratepayer Advocate was a participating member of the EEC.

to present its findings on the effectiveness of the statewide CEP and also make recommendations for improvements to the Board.

By Order dated October 15, 1999, the Board adopted performance standards and benchmarks that were called "Measures of Success," which were subject to review and refinement as necessary to assess the success of the CEP. These actions were consistent with *N.J.S.A.* 48:3-85(d), which requires the Board to "promulgate standards for the recovery of consumer education program costs from customers which *include* reasonable measures and criteria to judge the success of the program enhancing customer understanding of retail choice." (*emphasis added*). Subsequently, the June 23, 2000 Order established filing procedures for utilities that were planning to file for CEP cost recovery. The Board relied on their previous ruling in the restructuring proceedings, which stated that CEP costs would be recovered through the societal benefits charge ("SBC"). The CEP cost recovery filings would be accompanied by public notice and a public hearing in compliance with *N.J.S.A.* 48:2-32.2 and *N.J.S.A*. 48:2-32.4. The Board further recognized that evidentiary hearings would be needed to assess the reasonableness and prudence of the cost levels incurred to achieve the Board approved Measures of Success. *June 23, 2000 Order* at 3.

Since the implementation of the CEP, the electric and gas utilities have been deferring costs for both the statewide and local CEP campaigns. Winning Strategies, the UEC=s consultant, billed the utilities for the statewide program based on its determination as to the appropriate allocation between electric and gas utilities generally, and then, by utility, based on the utilities' number of customers. *Id.* Each utility paid for its own local campaign.

2 The Company Did Not Demonstrate Compliance With the "Reasonable and Prudent" Standard For Years 1, 2, and 3.

The Company in its Base Rate and Deferred Balance filing is seeking recovery in one year of $5.5 million CED costs through an SBC CED charge of .0294 cents per kWh. *JC-3,* p.23. The Company is seeking recovery of Year 1 costs which were the subject of a Board filing in August 2000. The 2000 docket is still open. *JC-3,* p. 23. The Company has also filed for a declaratory judgment ruling[19] permitting recovery, with interest, of CEP costs in Years 2 and 3. This filing has been consolidated with the Base Rate case and the Deferred Balance filing. The Company has requested recovery of these costs without making the requisite showing that the costs were reasonably and prudently incurred.

In its Declaratory Ruling filing before the Board, JCP&L seeks:

- Costs plus interest incurred from April 1, 2000 through March 31, 2001 ("Year 2") in the amount of $2,511,772. *PH-6* at paras. 3, 24.
- Costs plus interest incurred from April 1, 2001 through March 31, 2002 ("Year 3") in the amount of $1,223,070. *Id*.
- Projected "extension" costs plus interest incurred from April 1, 2002 through December 31, 2002 in the amount of $53,000. *Id*. at paras. 3, 26.

The Company is also seeking a BPU determination that the projected CEP related costs are "presumptively prudent." The Company claims that a recovery for CEP costs is presumed prudent if the utility achieves the Board determined measures of success. *Id.* at para 10 (citing the June 25th Order). The determination that a Company's CEP costs are reasonable and prudently incurred does not rest on the attainment of the Measures of Success or performance standards for a particular year, or even on the recommendations of an auditor's report. Even if the Measures of Success are achieved, there must be a showing that all costs incurred were reasonable and prudent. The Board in the above cited *June 25, 1999 Order* stated that it would look to "the extent these [expenditures] represent prudently incurred expenses." More recently, in the *June 23, 2000*

[19] *PH-6; I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition - Jersey Central Power & Light Company's Verified Petition for Declaratory Ruling,* BPU Docket No. ER02070417. ("*2002 CED Filing*").

Order the Board stated that "[t]he reasonableness and prudence of the cost levels incurred to achieve the Board approved measures of success will need to be assessed in reviewing the SBC filings." Only then will the utilities be permitted to recover the CEP costs in a manner consistent with EDECA. Accordingly, the Company's recovery of costs is dependent on the Board's determination of prudence. This important step cannot be circumvented. Simply stated, the fact that the Measures of Success were attained does not by itself indicate that the Company's CEP expenses in achieving that target were reasonable and prudently incurred. It merely indicates that minimum benchmark levels were achieved for the performance standards established by the Board to measure the success of the CEP. The Company may also not rely on the "pre-approval" process as proof of prudence. Pursuant to the *August 9, 1999 Order*, the UEC, (of which JCP&L was a member) presented its proposed consumer education materials to the Board and the EEC before dissemination, plus a factual presentation to the Board of the UEC's budgets and expenses for each year of the CEP prior to implementation. *PH-6*, para. 11. The "preapproval" and "presentment of budgets" by the UEC to the Board is not equivalent to an automatic finding of prudence by the board for each utility requesting CEP recovery. The *August 9, 1999 Order*, which established the pre-approval procedure, gave no indication that the Board's approval of the content of the consumer education material was also an approval of the costs that would be incurred. Even if the Board approved the content of the consumer education material, the prudence of the costs associated with producing these materials presented by the utilities was not considered by the Board at that time. Therefore, the UE's "presentment of budgets" to the Board cannot be considered an "automatic" finding of reasonableness and prudence for each utility's statewide CEP costs.

From the inception of the CEP, the Board contemplated the manner in which utilities would be able to recover reasonably incurred expenses associated with carrying out the objectives of the CEP. In the *June 25,* *1999 Order*[20], the Board began to lay the foundation for CEP cost recovery. The Board ordered that any electric or gas public utility that had incurred expenses related to the CEP would be able to defer those expenses, to be recovered at a later date, according to a two-part test. First, the CEP expenses must meet the standards for measures of success to be developed by

the Board, and, second, the CEP expenses must have been prudently incurred, a determination also to be made by the Board. *June 25, 1999 Order* at 2.

Again in April 2002[21], the Board restated the position taken in its October 15, 1999 and June 23, 2000 Orders allowing utilities to recover their CEP costs through the SBC. The Board repeated that in order for utilities to recover CEP expenses, the utility must file with the Board and be subject to public and evidentiary hearings. The Board decided to proceed in this manner because ACEP cost recovery through the SBC will result in an increase to the SBC now or at the time the deferral ceases and recovery commences in the case of electric utilities.@ *April 8, 2002 Order* at 3. After establishing that public hearings would be held regarding CEP cost recovery through the SBC, the Board reiterated its position that, “[t]he reasonableness and prudence of the cost levels incurred to achieve the Board approved measures of success will need to be assessed in reviewing the SBC filings.” *Id*.

Prudence requirements are imposed on a public utility’s ability to recover costs in order to encourage efficient managerial behavior. According to New Jersey law and Board precedent, the utility must prove that all costs incurred were reasonable and prudent before these costs can be collected from ratepayers. *N.J.S.A.* 48:2-2(d)*, Hope Creek Order*. The Board in *Hope Creek* disallowed recovery of specific costs because the company had not established that the costs were reasonably incurred. The Board noted:

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[20] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket NO. EX99040242, Decision and Order, (June 25, 1999). (A*June 25, 1999 Order*@).

[21] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket NO. EX99040242, Order of Extension, (April 8, 2002). (“*April 8, 2002 Order*”).

> Having clearly reserved its right to scrutinize the reasonableness of the costs incurred in the construction of Hope Creek, it is important to delineate the standard employed by the Board during its review. It is uncontroverted that Public Service had the burden of proving the reasonableness of its expenditures for Hope Creek as only reasonable costs can be included in rate base and permitted to earn a return. (*citation omitted*)
> *Id*. at 65.

The Board expounded upon the criteria used to determine whether a utility's costs were prudently incurred when it stated:

> The Company's conduct should be judged by asking whether the conduct was reasonable at the time, under the circumstances considering that the Company had to solve its problem prospectively rather than in reliance on hindsight. In effect, our responsibility is to determine how reasonable people could have performed the tasks that confronted the Company.

Id. at 66.

The Board repeated this sentiment in its discussion of construction enhancements when it stated:

> The Company, as discussed earlier in this Order, had the burden of proof with respect to the reasonableness of the costs that were expended in building the plant. In order to meet that burden with respect to the various enhancements, the Company had to show the reasons why each of the enhancements were installed and the benefits to be derived from their installation. An integral part of the benefits associated with the enhancement is a justification of the costs. The Board is not convinced that the Company has met its burden of proving that the following enhancements are both reasonable and necessary and therefore <u>FINDS</u> that their costs should be disallowed for rate making . . . *Id*. at 89.

In the *Hope Creek Order*, the Board set forth the two-part standard of review for a prudence determination. The standard provides that before a cost can be recovered in rates, each Company must: 1) show that the Company's actions meet the reasonable person standard given the specific circumstances at the time decisions were made; and 2) show the reasons why each cost was incurred and the benefit to ratepayers by the Company's actions. In effect, the prudence review determines whether the Company performed its task in a manner that was reasonable at the time, and allows regulators to prevent unreasonable costs from being passed on to ratepayers.

The Measures of Success relied on so extensively by the utilities were only a benchmarking tool, used to measure the level of awareness energy customers achieved through the education program. They were never intended to replace the prudence standard. In this proceeding, Your Honor and the Board must ascertain whether the costs expended to achieve the task were prudently incurred. In order for JCP&L to show that it prudently incurred these expenses, the Company must meet the two-part prudence test as stated in the *Hope Creek Order.*

Throughout the consumer education proceedings there has been no Board scrutiny of CEP costs. The Company presented no testimony in this proceeding demonstrating that they satisfied the *Hope Creek* prudence standard. Rather it simply asserts monetary amounts with no explanation of the prudence or reasonableness of these amounts. The Company may not recover CEP costs until it has shown compliance with the prudence standard. As stated previously, the utility bears the burden of proving that their costs are reasonable and prudently incurred, and in this case, the Company has failed to present any evidence in order to meet its burden.

B. Even Under The Company's Erroneous Position That Achieving Measures of Success Is Synonymous With Prudence, The Failure of the Statewide CEP to Satisfy the Measures of Success Established by the Board in Years 2 and 3 Should Preclude Cost Recovery.

Even if Your Honor and the Board were to determine that the achievement of the Measures of Success was equivalent to prudence, the fact that the statewide CEP failed to achieve its objectives for Year 2 and Year 3 should necessarily preclude the recovery of costs incurred by the Company in those two years.

The Board hired the Center to conduct research on the level of awareness of gas and electric consumers regarding energy deregulation and restructuring. In order to evaluate consumer awareness in different areas, the Center developed performance standards and benchmarks referred to as Measures of Success. The Year 1 Measures of Success were accepted by the Board by Order dated October 15, 1999[22] and focused mainly on increasing consumer awareness of deregulation and choice of alternate energy suppliers.[23] However, Year 1 Measures of Success were changed in Year 2 and Year 3 to reflect later developments in the energy market.

Year 2 of the consumer education program failed to raise the awareness of gas and electric consumers of competition and the ability to switch to alternate energy suppliers, which was vital to the success of the program. The Ratepayer Advocate expressed its concerns to the Board in a letter dated January 11, 2001, which stated that the continued focus on deregulation in Year 2 was inappropriate given the high awareness levels achieved in Year 1, and recommended that the CEP should instead focus on the benefits of deregulation such as increased competition and a choice of energy suppliers. *See* Exhibit A attached hereto. The data compiled by the Center for Year 2 of the CEP indicated that consumers were still very much in the dark about alternate suppliers and their pricing plans as well as information on the mechanics of making a switch.[24] Equally

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[22] *I/M/O the Consumer Education Program on Electric Rate Discounts and Energy Competition*, BPU Docket No. EX99040242, Decision and Order, (Oct. 13, 1999).

[23] The Year 1 Measures of Success were as follows:
A. **Awareness** - awareness of deregulation across all market segments of at least 70%. This would include the General Consumer Market (GCM), Hispanic Consumer Market (HCM), African-American Consumer Market (AACM), Small Business, Low Income, Seniors and the Disabled.
B. **Knowledge** - at least a 50% correct knowledge level of deregulation facts across the four-core markets: GCM, HCM, AACM, and Business.
C. **Selection Process Awareness** - at least a 30% Avery of somewhat aware@ level for the supplier selection process.
D. **Decision Making** - at least a 30% level of making a conscious decision to switch, not to switch or not to decide.
E. **Call Center Satisfaction** - at least 80% satisfaction level among consumers utilizing the NJ Energy Choice call center.
F. **Response to Recommendations** - CEP campaign officials are to respond to any recommendations made in the Center=s reports which are endorsed, accepted and forwarded by the Board in memo form only.

[24] The Fifth Report submitted to the Board by the Center showed a 10% decline in the number of consumers who were very or somewhat aware of the process to follow in selecting an energy supplier. In addition, the Fifth Report also revealed that 55.4% of consumers were still waiting for more information in order to make a decision to switch to a energy supplier. Fifth Report at 8.

problematic was consumer ignorance of the term Aprice-to-compare@ and how this information could be used to shop around for a new supplier.[25] Therefore, it came as no surprise when the Center revealed in its Sixth Report to the Board that the switching activities of consumers in Year 2 did not meet its benchmark target for residential markets. Switching statistics continued to show a steady decline in Year 3, as shown in the Center's Seventh Report.[26] Presumably, if more consumers were provided with information giving them the necessary tools to research their switching options, make a decision, and initiate a change in energy providers, then residential switching numbers would have increased**,** not decreased, in Years 2 and Year 3.

In Year 3, because of sharp increases in energy prices, the Ratepayer Advocate recommended that the statewide component of the CEP should be re-directed to address concerns related to high energy costs. *See* Exhibit B (February 15, 2001 letter to Board). This would include providing information to consumers about the reason for high energy costs, advising consumers of ways to manage their energy usage and energy bills, and increasing awareness of financial assistance for which consumers may be eligible. Although Year 3 of the statewide CEP did include Measures of Success related to consumer awareness of energy conservation and efficiency, as well as the availability of financial assistance,[27] these Measures of Success were very general and not detailed or specific enough to be truly effective in ensuring that consumers had the necessary information to

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[25] The Center in its Sixth Report to the Board acknowledged the need to provide consumers with the necessary information so that they may make a switch and recommended that Aconsumers need to be taught by both utilities and the CEP how to find and just what their price-to-compare is. This may be a very large barrier to participation. Nearly 100% of consumers don=t know what or how to find what they pay per-kilowatt hour or per-therm.@ See Center=s Sixth Report at 12**.**

[26] The Seventh Report revealed declining levels of switching activities among consumers. For example, 96.9% of all respondents could not name or estimate the amount they pay per kilowatt hour which serves as a barrier to shopping. Approximately 60% of respondents were still not familiar with the term price-to-compare and how to use this information in making a decision to switch. Also, only 6.6% of respondents had actively shopped around for a new energy supplier. See Seventh Report at 8.

[27] The specific measures were general consumer awareness that: (1) A[l]ocal utilities have energy conservation and efficiency programs;@ and (2) A[f]inancial assistance programs are available to help low income households pay their energy bills. See Seventh Report at 33.

respond to high energy costs. These shortcomings became very obvious when the Center's Seventh Report to the Board revealed that the CEP fell short of Year 3 goals in the areas of awareness of conservation/efficiency and financial assistance.

In conclusion, the statistics from both Year 2 and Year 3 demonstrate that the statewide CEP failed to increase awareness among gas and electric customers in the critical areas of competition, switching to alternate energy suppliers, energy conservation and efficiency, and the availability of financial assistance to eligible consumers. The apparent foible in the statewide CEP was its continued focus on the message of deregulation in Year 2 and Year 3 when there were issues of greater concern worthy of consumers' attention. Therefore, it is improper to allow utilities to recover statewide CEP costs for Year 2 and Year 3, when the statewide CEP failed to achieve its Measures of Success in the aforementioned areas. It follows that if ratepayers did not benefit from the CEP during Year 2 and Year 3, utilities should not be permitted to recover from ratepayers costs associated with a failed program.

IX. REMEDIATION ADJUSTMENT CLAUSE ("RAC")

In the 1980's the State of New Jersey mandated that the State's utilities remediate the sites of all former manufactured gas plants. The New Jersey Department of Environmental Protection ("NJDEP") regulated the environmental aspects of the clean-up, and the Board of Public Utilities ("BPU" or the "Board") regulated the financial and economic recovery aspects of the clean-up.

In JCP&L's 1984 base rate filing, the Company first sought recovery of expenses associated with coal tar clean-up ("MGP remediation"). *In the Matter of the Petition of Jersey Central Power & Light for Approval of an Amendment of its Tariff and to Provide Increased Base Tariff Rates and Changes for Electric and Other Tariff Changes,* BPU Docket No. 841-55 (Order dated February 11, 1985) ("1985 Base Rate Order"). In its Order in that proceeding the Board authorized the Company to collect a base rate allowance of $308,000 for coal tar clean-up expenditures. *Id.* at 4.

In the Company's next base rate case in 1985, the Board authorized JCP&L to include $2.530 million in its base rates as an allowance for on-going MGP remediation activities. *In the Matter of Petition of Jersey Central Power & Light for Approval of an Amendment of Its Tariff to Provide for an Increase in Rates and Charges for Electric Service,* Docket No. ER8507698 (Order dated June 24, 1986) *("1986 Base Rate Order*"). *Id.* at 6.

In JCP&L's base rate filing in 1991, the Board again addressed the MGP cost recovery issue. *IMO Petition of Jersey Central Power & Light Company for Approval of Increased Base Tariff Rates and Charges for Electric Service and Other Tariff Revisions,* Docket No. ER91121820J (Order dated June 15 1993) *("1993 Base Rate Order").* As a result of the $2.530 million rate allowance authorized in the 1985 base rate case, the Company had accumulated a $6.700 million over-recovery of MGP costs. Accordingly, the Board suspended the recovery of the $2.530 million in base rates and left the docket open to address prospective MGP related policy and recovery issues. *Id* at 10.

In 1994 the Board issued an Order establishing MGP rate-making treatment for JCP&L. *IMO Petition of Jersey Central Power & Light Company for Approval of an Increase in Electric Rates and For Changes in the Tariffs For Electric Service – Manufactured Gas Plant Remediation Costs*, Docket No.ER91121820J (Order dated December 16, 1994) (*"1994 MGP Order*"). In that Order the Board authorized essentially the same RAC ratemaking treatment for JCP&L as it had previously authorized for Public Service Electric & Gas Company ("PSE&G") in Docket No. ER91111698J. *Id.* at 5-7. In the Order the Board reaffirmed its suspension of the $2.530 million base rate allowance and provided that:

> Effective and concurrent with the next LEAC rate change occurring after the elimination of the credit balance resulting from the over-recovery of previously-allowed remediation costs, JCP&L is authorized to amortize prudently-incurred manufactured gas plant remediation costs ... including carrying costs ... through a Remediation Adjustment Clause established for that purpose.

[*1994 MGP Order* at 7]

The authorized carrying cost rate was set at "the then-current rate on seven-year debt for a single 'A' rated combination gas and electric utility of 6.25%." *Id.*

And finally, in its Decision and Order in Docket No. ER95120634, dated July 30, 1997, the Board adopted a stipulation establishing the specific RAC recovery mechanism to be used in future filings, and set the Company's RAC factor at zero. *IMO The Motion of Jersey Central Power & Light Company (D/B/A GPU Energy) for Approval to Amend its Tariff for Electric Service to Adopt and Implement a Manufactured Gas Plant Remediation Adjustment Clause*, Docket No. ER95120634 (Order dated July

30, 1997) (*"1997 RAC Order").* The Board set the RAC factor at zero because it judged the December 31, 1995 unrecovered RAC expenditure of $310,103 to be insignificant. *Id.* at 6.

Regarding the current filing, the Company has stated that the purpose of the filing was "to provide . . . the opportunity to conduct a full advance review of the reasonableness and prudence of all actual and projected MGP costs and expenditures, net of related insurance recoveries, incurred and to be incurred by JCP&L from January 1, 1996 through July 31, 2003." *IMO Verified Petition of Jersey Central Power & Light Company for Review and Approval of Costs Incurred for Environmental Remediation of Manufactured Gas Plant Sites and for an Increase the Remediation Adjustment Clause of its Filed Tariff in Connection Therewith*, Docket No. ER02030173 (Verified Petition filed March 13, 2002), par.8 *("2002 RAC Filing).* "Related insurance recoveries" was also to be reviewed. *JC-1* at 1.

The Company has requested that its RAC factor be based on expenditures through July 31, 2003. *JC-1* at 3. Since it made its filing, it has provided quarterly updates which contained summary data for 2002. The Company has made expenditures of $31.596 million through December 31, 2002. *JC-1, Attachment 4, (12+0)* To this amount is added $8.205 million of estimated expenditures for the subsequent period through July 31, 2003. *Id.* When these actual and projected amounts are reduced for previous rate recoveries of $16.877 million and net insurance recoveries of $30.618 million, the Company claims recoverable MGP expenses of $10.099 million. *Id.*

In its initial filing, the Company requested a $0.0001 per kWh RAC factor that was derived based on forecasted 2002 kWh sales by applicable rate classifications. *RA-6* at 18. This amount included accrued interest on the net expenditure balance at the rate of 6.25%. *Id.* Using the initial filed estimates, the recoverable MGP expenses were $12.750 million (vs. the December 2002 update of $10.099 million). *Id.* Removing the net accrued interest through August 2003, the recoverable amount was reduced to $11.866

million. *Id*. This amount divided by estimated 2002 sales and adjusted for New Jersey Sales and Use Tax ("NJSUT") derived the $0.0001 per kWh proposed rate. *Id*.

As a result of the Ratepayer Advocate's review in this matter, the Ratepayer Advocate submits that the Company improperly handled certain issues and that the Board and Your Honor should reject JCP&L's proposed treatment of them. The issues in dispute are (1)Insurance recoveries; (2) Legal expenses; (3) Interim accrual rate; (4) Carryover of prior expense balances; (5) Disallowance of forecasted expenses and rates; and (6) Mandated annual filings.

A. Insurance Litigation Proceeds and Expenses

1. JCP&L Inappropriately Diverted $2 Million of MGP Insurance Litigation Recoveries From the JCP&L MGP Account to Itself and to Other GPU Affiliates, and Credited These Funds to Income. The Company Should Be Required to Credit the JCP&L MGP Account With This $2 Million.

In 1994, the Company filed complaints against 16 insurance companies seeking reimbursement for MGP remediation costs under JCP&L's liability coverage in policies spanning several years. *JC-1* at 4. In or around 1999, the Company entered into five settlements that covered all 16 carriers. *Id*. In his Direct Testimony, Company witness Colin Sweeney explained the settlements:

> These actions led to reaching successful settlements with all carriers resulting in recoveries totaling $36,100,000. The incremental expenses associated with the recovery actions through December 31, 2001 totaled $5,481,563. The total insurance recoveries, net of expenses, through December 31, 2001 is $30,618,437.

[*JC-1* at 4]

Mr. Sweeney's testimony regarding the amount of insurance recoveries was inaccurate. The amount of insurance recovery was actually $38.1 million. *RA-6* at 11. Two million dollars had been diverted to GPU affiliates and had been credited to income in each case. *RA-6* at 13. The Company had resisted providing the requested settlement documents on the ground of confidentiality. Ultimately, after a significant delay, the Company finally provided the documents in its Response to Discovery Request RAR-21 pursuant to a confidentiality agreement. *RA-6* at 11**.** Those documents revealed that the actual proceeds from the settlements were $38.100 million and not $36.100 million sworn to by Mr. Sweeney. *Id.* The Company then admitted that $2 million of the insurance recoveries had been diverted to other GPU affiliates and to JCP&L non-MGP accounts and credited to income:

> Since two of the insurance settlements also covered the resolution and release of coverage claims for other potential environmental risks of JCP&L and its affiliates which were not related to JCP&L's former MGP plants (e.g., coverage for potential environmental claims against MetEd and Penelec in Pennsylvania, as well as for non-MGP environmental claims against JCP&L), it was determined that **of the aggregate settlement proceeds of $38.1 million, $2 million was properly allocable to such other risks and the balance of $36.1 million was credited to JCP&L's MGP deferred balance.**

[*JC-21* at 1; emphasis added]

The Ratepayer Advocate disagrees with the Company's treatment of the $2 million. By letter dated November 27, 2002, counsel for JCP&L provided internal memos concerning two specific settlements. *R-4.* These settlements were with Carrier A for $5 million and with Carrier B for $0.5 million.[28] *Id.* at 1-2. According to the letter, these carriers would not settle JCP&L's claims unless they obtained a "full environmental" release from JCP&L and its affiliates and parent. *Id.* at 1. Such a release would preclude any future claims against the carriers for any actual or potential environmental claims by Penelec, MetEd or GPU. *Id.*

[28] At the evidentiary hearings the carriers were identified off the record. To maintain confidentiality the parties agreed to refer to the companies as Carrier A and Carrier B.

There appears to be little justification for the allocation of insurance proceeds for "potential environmental risks of JCP&L and its affiliates." *Id*. For one thing, at least some of the insurance policies, which were the basis for the complaints, were solely in the name of JCP&L. T55:L23-T56:L4; T57:L7-9; T59:L6 (1/15/03). Other policies, specifically those "concerning the more recent periods" were maintained by GPU, and the other GPU operating companies, Jersey Central, Metropolitan Edison and Penelec, were additional insured parties. T54:L8-12 (1/15/03). In his Rebuttal Testimony Mr. Sweeney testified that the premiums were appropriately allocated to and paid by the covered insureds. *JC-1 Rebuttal*, p. 3. However, when cross-examined on the allocation, Mr. Sweeney admitted that he did not know how the allocation was determined. T59:24 (1/15/03). His testimony was based on unsubstantiated discussions with someone from the Risk Management division, "who confirmed that that was the case." T69:L2-9 (1/15/03). Mr. Sweeney identified the individual from Risk Management as Tom McDonald, but admitted that Mr. McDonald had not submitted any discovery or certifications in this proceeding. T60:L10-16 (1/15/03). The Company has presented no evidence that Company affiliates were allocated any share of the costs of the policies in dispute, no evidence that they ever paid premiums on such policies, or were participants in the various suits. Indeed, the sole plaintiff in the Complaint filed against the 16 insurance carriers was Jersey Central Power & Light. *Exhibit 22*.

The affiliates did not participate, nor did they pay for any of the associated litigation expenses. *RA-6* , p. 12. Moreover, it makes little sense to compensate JCP&L for potential non-MGP environmental claims that have yet to materialize. Indeed, if the Company were to receive such money, those proceeds should properly be placed in an escrow account, earning interest, and kept available to pay future claims.[29] *RA-6*, p. 12. As for MetEd and Penelec in Pennsylvania, one must assume that they have their own insurance policies to cover

[29] If the settlement amount is allowed to disappear into net income then JCP&L ratepayers are exposed to future income claims with no insurance proceeds to help defers potential clean-up costs. The Company collects from the insurance company and then from ratepayers.

their potential environmental claims. *Id*. They should not be given a windfall in the form of extraordinary income.

Despite claims that the $2 million amount reflects "the fair value of the non-MGP claims," the supporting documentation shows no appropriate justification. *R-4* at 1. First, there are no other non-MGP claims. *Id.;JC-1 Rebuttal*, Attachment 15 at 3. Second, with respect to settlement with the Carrier A, the Company's own environmental counsel stated that:

> Carrier A likely would be responsible for a small portion of any covered damages arising from a future environmental claim, so that **JCP&L did not give up meaningful rights in agreeing to the broad release.** . . . In other words, JCP&L can take some comfort from the fact that it has learned of no new, significant environmental claim in many years. Indeed, the MGP claims are the only ones to date to 'trigger' insurance coverage.

[*R-4;JC-1* Rebuttal Attachment 15 at 3-4; emphasis added.]

Third, the Company acknowledges that recovery for any claims by MetEd and Penelec in Pennsylvania would be problematical given Pennsylvania Court decisions that apply a "sudden and accidental" requirement that is typically not met by environmental claims which relate to hazardous waste discharges over extended periods of time. *R-4; JC-1 Rebuttal*, Attachment 15 at 4; *JC-1 Rebuttal*, Attachment 14. Counsel notes in his letter that:

> Pennsylvania courts strictly enforce the pollution exclusion in the Carrier A policies, so that there is no Carrier A exposure to environmental claims in that State, and the release gives up nothing with respect to such claims.

[*R-4;JC-1* Rebuttal Attachment 15 & 14]

Regarding the Carrier B "full environmental release," the same counsel stated that: "JCP&L gave up very little, if any, of the coverage that should be available in the event of a future environmental claim." *R-4;JC-1 Rebuttal*, Attachment 15 at 2. He further stated that; "...Carrier B's financial situation is such that it likely will not be around much longer to pay any future environmental claims. . . ." The full environmental release was thus considered by the Company to have only marginal value.

The allocation of proceeds to non-MGP claims is not economically justified, nor is it reasonable. GPU, MetEd, and Penelec did not pay any portion of the litigation cost, they made no insurance claims under the policies at issue, and yet they have benefitted by depriving New Jersey ratepayers of $2 million in MGP cost offsets. *RA-6* at 14. To allow the GPU companies and First Energy Corp. to profit from insurance policies and litigation efforts paid solely by New Jersey ratepayers would be unconscionable. *Id.* Your Honor and the Board should disallow the Company's allocation of $2.0 million of insurance proceeds to JCP&L and its affiliates and reduce recoverable MGP expenses by the same amount.

2. JCP&L Has Failed to Provide Sufficient Documentation for the Board to Approve the Company's Claimed $5.482 Million in Legal Fees.

a. Selection of Counsel

JCP&L incurred $5.423 million in expenses associated with its MGP insurance litigation. *RA-6,* Sched. RWL-1 p. 1of 2. As part of its review of this filing the Ratepayer Advocate attempted to examine the Company's legal expenses relating to the MGP insurance litigation. In Request RAR-61 the Company was asked to address the Company's hiring of law firms for the MGP insurance litigation. *RA-16.* Specifically, the request sought "details of the selection process, any bidding or rate negotiations associated with the firm's selection, the nature of the authorization for retention, and any documentation related to the selection process." *Id.* The request also sought details concerning "the relevant environmental insurance litigation experience of the firm and the individuals assigned to the engagement" for the law firm of Berlack, Israels & Liberman. *Id.* Although Berlack, Israels & Liberman accounted for $3.465 million of the $5.423 million of total litigation expenses, or about two-thirds of the total cost, the Company's response to this request provided neither documentation on the selection process nor information concerning Berlack, Israels & Liberman's relevant environmental insurance litigation experience. *RA-6*, Schedule RWL-1, p. 1.

Colin Sweeney, the Company witness who provided the only evidence on this issue, was unqualified to do so. Mr. Sweeney is a supervisor in handling remediation, and has no responsibilities regarding legal matters. *JC-1* at 1; T50:L22-T51:L2 (1/15/03). He admitted that he "was not aware of specific settlements or proceeds associated with other cases," and that he had no knowledge of environmental settlements other than what he had heard in discussions. T71:L9-17 (1/15/03). Nevertheless, he alleged that Berlack, Israels & Liberman's $3.5 million in legal fees plus additional fees to a second firm were a "bargain". *JC-1 Rebuttal* at 7, line 2; T73:L22-T74:L10 (1/15/03).

This witness was not directly involved with the procurement of outside environmental counsel nor was he in any way responsible for their procurement; nevertheless, he was the witness the Company chose to testify about the Company's procurement procedures. T52:L24; T53:L2; T80:L15 (1/15/03). He did not know the procedure in effect prior to 1996, nor did he participate in the process of selecting outside counsel. T77:L3; T77:L24; T81:L15 (1/15/03). This witness clearly was not competent to testify to the engagement of environmental counsel for the MGP litigation. His testimony thereon should be disregarded.

b. Reasonableness of Litigation Expenses

There has been inadequate documentation concerning the selection, rates and relevant experience of a firm that charged ratepayers almost $3.5 million. *RA-6* at 15. Under the RAC recovery mechanism the Company serves as a virtual agent for ratepayers. Since ratepayers ultimately pay the bill, they are entitled to receive documentation sufficient to determine whether the remediation activities and related costs are reasonable. *Id*. The Company's caviler attitude and inadequate response concerning a material component of

MGP expenditures should not be tolerated. The Ratepayer Advocate therefore recommends that the Board deny the Company recovery of these unsubstantiated costs.

JCP&L charged various internal expenses, including some overheads, to litigation activities. In addition to the outside legal and expert fees, some expenses charged to RAC litigation were associated with "persons assigned to the Remediation Group in support of the successful insurance recovery actions." *RA-15.* The Company asserts that these assigned persons worked on activities such as "support in data production efforts; responding to discovery requests; providing support to the Company's expert witnesses; and participating in depositions and other discovery." *Id.* Many, if not all, of these charges were already embedded in base rates, were not incremental, and should not have been charged to MGP litigation. *RA-3; RA-4*. The resulting double recovery is contrary to established regulatory principles: The Company cannot treat the RAC recovery as an automatic recovery mechanism and also include expenses that are recovered in base rates.

B. Community Relations

JCP&L has a community relations department within the Company; however, the Company retained an outside firm to provide public relations services for certain MGP sites. T99:L18; T91:L9-24 (1/15/03). JCP&L has stated that the goal of its Community Relations program is "to keep community stakeholders fully informed of the MGP investigation and remedial activities and to gain acceptance of JCP&L's efforts. . . ." *RA-24.* The Company also claims that "maintaining credible and positive working relationships within the communities where MGP sites are located is an integral component of JCP&L's MGP program." *Id.*

Although a community relations program may be useful, it is questionable whether the retention of an outside public relations firm was necessary. JCP&L charged expenses to the MGP program that should more properly have been charged to the Company's public relations department. *RA-6* at 24. For the period from 1996 to 2001, JCP&L charged $0.725 million to the MGP program, much of which included corporate image enhancement, lobbying, and general public relations. *RA-6*, Schedule RWL-3, p.1[30]; T125:L20-21 (1/15/03). Expenses for Company public relations personnel were already in base rates; utilizing this staff for MGP community relations would not have cost ratepayers additional money. *Id.* at 24.

In *RA-6*, Schedule RWL-3, p. 2, community relations costs are shown on a site by site basis. The schedule demonstrates that there is no direct relationship between the level of MGP expenditures and the cost of the community relations effort. *Id.* For example, the Long Branch and Wildwood sites, both of which were shared with other utilities, incurred about $2 million of MGP expenses, but had comparatively low community relations costs. *RA-6* at 24. In contrast, sites that were solely the responsibility of JCP&L, on average, incurred about $30,000 for such activities on each site. *Id.*

While there is a need to keep communities informed about MGP remediation activities, such communication could be addressed by press releases and on-going contact with appropriate local officials. *Id.* at 25. JCP&L's public relations activities went well beyond such efforts, and were not NJDEP-mandated, necessary, nor reasonable. *Id.* The Company has failed to meet its burden of proving prudence; consequently, all community relations costs should be disallowed. *Id.*

C. Internal MGP Costs

Ratepayer Advocate witness Mr. LeLash provided a schedule that sets out internal JCP&L expenses charged to MGP activities annually for the period 1996 through 2001. *RA-6*, Schedule RWL-4, p.1. As shown in that schedule, the largest cost was for payroll, in the sum of $1.854 million, and payroll-related or "adder" amounts totaling $340,000. *Id.*

In its explanation of these charges, the Company stated: "employees in the Environmental Affairs Department ["EAD"] who are dedicated to the MGP remediation effort and incremental to the normal

[30] JCP&L shared the costs of the community relations program, which totaled $1.115 million, with New Jersey Natural Gas Company or Elizabethtown Gas Company. The allocation of costs was 60% to JCP&L and 40% to New Jersey Natural or Elizabethtown.

operations of the Company, are charged to the MGP specific work orders established for this purpose." *RA-18*. With reference to payroll related expenses, the Company further stated that:

> . . . the Company believes that payroll overheads related to the employees specifically dedicated to the MPG remediation effort are legitimate incremental MGP expenses to be recovered through the RAC. Likewise, M&S overheads . . . are incremental to the normal non-MGP operations of the Company.

[*Id.*]

JCP&L inappropriately charged payroll and overhead expenses to the RAC recovery account. The Company, under its accounting for MGP expenses, deferred such costs for recovery through the RAC mechanism. T83:L6-T85:L15 (1/15/03). Many, if not all, of these internal charges were included in the Company's prior test year. T86:L15-T88:L17 (1/15/03). Although Mr. Sweeney testified that he did not know if payroll overhead or fringes were passed through in base rates, a review of the record demonstrates that such costs indeed were in base rates. T127:L22-24 (1/15/03); T88:L15-17 (1/15/03).

According to the Company, the payroll overhead cost allocation rates are blended average rates for the years 1996 through 2001, and reflect both bargaining and non-bargaining components. *RA-4*. The Company's response also provides allocation factors by year ranging from 26.6% up to 36.8%. *Id.*; *RA-6* at 26. Mr. LeLash presents the data for the payroll overheads by year for both the EAD expenses and the MGP deferrals. *RA-6*, Schedule RWL-3, p. 2. Not only do those overhead percentages not match those provided in the Company's response, but the EAD and the MGP deferrals differ dramatically. *Id.* Moreover, in 1996, the MGP payroll overhead was more than five times that charged to other environmental matters even though the MGP payroll was about sixty percent less. *Id.* On the basis of this data, it would appear that the MGP deferrals were assigned higher overhead rates in several years. *Id.* at 27.

As noted above, JCP&L entered into agreements with either New Jersey Natural Gas or Elizabethtown Gas Company to share the remediation costs of certain MGP sites. Under the sharing agreements with each of these companies, no internal expenses such as payroll or overhead charges were included as MGP expenditures, under the prevailing 60%-40% allocation mechanism. *RA-6* at 27. In addition, no other New Jersey utilities, which have RAC recovery mechanisms, charge internal expenses in their RAC recovery claims. *Id.* This practice of excluding such charges is true for both on-going and incremental categories of internal expenses. *Id.*

JCP&L attempts to justify seeking recovery of payroll and overhead through the RAC by claiming that such costs were deferred in its last base rate case, and, therefore, they are not being recovered within base rates. *RA-6* at 27. In the test year the Company deferred a total of $172,749 for MGP activities. *RA-6*, Schedule RWL-4, page 3, revised**.** These deferred expenses did not include any amount for payroll overheads or fringe benefits. *RA-5*. In contrast, in the Company's test year cost of service, the Company claimed $891,050 for environmental expenses. *Id.* At a minimum, the fact that no payroll overheads were included within the test year cost of service indicates that $340,000 plus any such payroll overheads in 2002 should be excluded from the Company's claimed MGP expenses. *RA-6* at 28.

Ratepayer Advocate witness Mr. LeLash has determined that in 2001 JCP&L over-recovered environmental costs by $0.477 million. *RA-4,* Schedule RWL-4, page 3, revised. In that year the Company recovered $0.891 million for environmental costs in base rates (the amount included in the test year cost of service) and $0.388 million through MGP credit offsets, for a total recovery of $1.279 million, resulting in the over-recovery of $0.477m. *Id.* For the entire recovery period from 1996-2001, the Company over-recovered internal costs by a total of $1.728 million. *Id.*

JCP&L should not be allowed to defer environmental costs, be they payroll, fringe, or overheads, if such costs have already been recovered through base rates. *Id.* at 29. Using 2001 again as an example, the combined other environmental and MGP related costs were $0.802 million, while the recovery in base rates was $0.891 million. *Id.* In such a case, no costs should be deferred to the MGP accounts. *Id.* To allow a deferral in these circumstances would allow JCP&L to double-recover the $0.477 million amount described above. *Id.* In effect, the Company is seeking to profit from its NJDEP mandated remediation activities at the expense of its ratepayers.

The Ratepayer Advocate therefore recommends that Your Honor and the Board disallow $1.728 million for the over-recovery from 1996 through 2001, plus any over- recovery in 2002 as being inappropriate and unreasonable. *Id.*

D. Inclusion of Projected 2003 Costs in Proposed RAC Factor

Board policy permits RAC recovery only on actual expenditures. The Company should be required to recalculate its expenses based on a period ending September 30, 2002.

In its *JCP&L Manufactured Gas Plant Order*, Docket No. ER91121820J (Order dated Dec. 16, 1994) ("1991 JCP&L MGP Order"), the Board established an MGP methodology for JCP&L. The Board found that JCP&L should be permitted the same ratemaking treatment afforded to PSE&G in Docket No. ER91111698J (Order Dated May 14, 1993). *1991 JCP&L MGP Order* at 6. In the Order the Board established the following methodology for JCP&L:

> JCP&L will file its annual Remediation Adjustment Clause as a separately docketed matter simultaneously with with its annual Levelized Energy Adjustment Clause (LEAC) filing. The RAC filing, to commence after the overrecovered balance of remediation costs is exhausted, will include <u>actual expenditures for a selected eleven month period of each year with estimates for the twelfth month. The RAC filing will be updated for the twelfth month actuals by the twentieth of the first month of the following eleven month period</u>. Documentation supporting the twelfth month actuals will be made available to the parties by the twentieth of the first month of the following eleven month period.

[*Id.]*

The Company has requested that its RAC factor be based on expenditures through July 31, 2003. However, as noted above, the Board Order requires that the RAC be filed with 11 months of actual data and one month of estimated data. *Id.* The actual costs of the estimated month are to be filed by the 20th day of the following month. *Id.* This would allow the 12th month's actuals to be included in that year's RAC review.

Contrary to Board Orders, JCP&L failed to file annual RAC reviews, resulting in the current filing's containing data from January 1, 1996. *JC-1* at 3.

Company data indicate that the Company spent $28.682 million through September 30, 2002. *RA-6* at 18. To this amount it added $14.858 million of estimated expenditures for the period from October 1, 2002 through July 31, 2003. *Id.* When these expenditure amounts are reduced for previous rate recoveries of $16.877 million and net insurance recoveries of $30.618 million, the Company claimed $13.387 million in recoverable expenses in its September quarterly update. Id.

Your Honor and the Board should not include data through December 2002 in this filing. The Company filed its "12 & 0" report on February 28, 2003. Briefs in this matter are due on May 2, 2003. It is impossible for Mr. LeLash to review the Company's expenses from October 1, 2002 through December 31, 2002 in such a short time frame. Consequently, the Company's recovery should be limited to those expenses incurred only through September 30, 2002.

Based on JCP&L's net RAC expenditures through September 30, 2002, the Company has an over-recovery of $2.796 million. Expenditures incurred on and after October 1, 2002 can and should be reviewed in the Company's next RAC filing; therefore, no RAC factor needs be implemented at this time. *RA-6* at 19. Additionally, the Company has stated that it plans to make annual RAC filings in April of each year with effective dates of August 1. *RA-6* at 20. JCP&L should be required to time its annual filings so that all expenses for which recovery is sought will be actual well before the effective date of the new RAC factor. *Id.* at 20. For example, if the Company were to file in April, then recoverable expenses should be based on actual data through March of each given year. *Id.* Thus, the Company should be required to file its first annual RAC filing in April 2004, with a review of expenditures for the October 2002 through March 2003 period.

In addition, the Company improperly calculated its beginning balance as of January 1996. *RA-6* at 22. The Company has claimed a $1.714 million opening balance that is in conflict with the Board's determination in Docket No. ER95120634. As shown on the Company's Exhibit JC-2, the total recoverable amount determined by the Board at the end of 1995 was $310,103. *JC-2*. To this amount, it is necessary to add the

$798,030 amount for the expenses related to insurance recovery in order to derive an opening balance of $1,108,133, not $1,714,000. *Id.*

For its opening balance and subsequent calculations the Company failed to reflect the accrued interest balance. In order to calculate its monthly interest accurately, the Company should reflect both accrued interest and the deferred tax balance on a monthly basis. *Id.* However, given the Company's existing methodology of calculating deferred taxes on a quarterly basis, it would be reasonable to net accrued interest into the cumulative balance on a calendar basis. *Id.* Accordingly, the Company should be required to recalculate its overall interest amount with the prior year's interest accrual rolled into the deferred balance as of December 31 of each year. *Id.*

E. Summary of RAC Adjustments

The Ratepayer Advocate recommends four RAC adjustments. *RA-6,* Sched. RWL-5 Rev. The first adjustment removes 100% of the community relations program costs from the MGP expense accounts. The second adjustment removes the deferred environmental expenses that have already been recovered through base rates. *Id.* The third adjustment removes the unsubstantiated litigation expenses and the fourth eliminates the Company's $2 million credit of proceeds to various GPU entities. *Id.* In total, these adjustments would lower the Company's recoverable MGP expense amount by $7.953 million. Id. The following sets forth the Ratepayer Advocate's recommended adjustments:

Recommended RAC Adjustments ($000's)

	Company	Adjustment	Recommended
Community Relations Costs	$ 725	$ (725)	$ -0-
Internal Environmental Costs	7,721	(1,728)	5,993
Insurance Litigation Costs	5,423	(3.500)	1,923
Insurance Offset	2,000	(2,000)	-0-
MGP Expense Offset	$10,446	$(7,953)	$5,993

SOURCE: Exhibit RA-6, Schedule RWL-5, Revised.

F. Conclusion

For the foregoing reasons, the RPA recommends that Your Honor and the Board accept the Ratepayer Advocate's proposed RAC adjustments.

X. OTHER SBC DEFERRED BALANCES

A. Nuclear Decommissioning ("NDC")

The Company has proposed a reduction in the overall level of annual decommissioning recovery by $5.6 million. *JC-3*, p. 28.

B. Universal Service Fund ("USF")

At the time of filing, the Company proposed that rather than estimate its USF charge for the purpose of this proceeding, it would defer recovery of these costs until after the Company receives the Board's Order in the pending USF proceeding.

The Board on March 20, 2003, approved the establishment of a permanent USF to begin July 1st of this year. *I/M/O the Establishment of a Universal Service Fund*, Docket No. EX00020091 (Agenda dated March 20, 2003, Item 2C). Implementation of the USF awaits final Board Order.

C. Uncollectible Revenue ("UNC")

The Company has proposed to continue the UNC charge at its current level. *JC-3*, p. 28.

XI. APPROPRIATE INTERIM DEFERRAL RECOVERY

IN ORDER TO MITIGATE RATE SHOCK, JCP&L'S PROPOSED DEFERRED BALANCE RECOVERY PROPOSALS SHOULD BE REJECTED, AND THE TEN-YEAR RECOVERY PROPOSAL RECOMMENDED BY MR. ROTHSCHILD SHOULD BE ADOPTED.

At its agenda meeting on March 20, 2003, the Board recalled several issues related to the securitization and amortization of deferred balances. The Board's action was memorialized in a letter dated March 25, 2003 from Board Secretary Kristi Izzo ("Secretary's Letter"). The Secretary's Letter recalled "the issue of how much of the prudently incurred deferred balances should be securitized and how much should be amortized, what is the appropriate length of the amortization and the interest rate." Secretary's Letter, p. 1. The Secretary's Letter also recalled the issue of "whether all or part of the prudently incurred deferred balances are legally eligible for securitization under EDECA." *Id*. However, the Secretary's Letter also provided that "[t]o the extent that the parties have offered opinions on the setting of transitional amortization and interest rates in their cases, those portions of their briefs will be reserved to the Board and decided by the Board as part of their final rate Order." *Id*., p. 2.

The Ratepayer Advocate and the Company addressed several of the issues recalled by the Board in testimony filed in the instant proceeding. *R-49, R-50, JC-3, JC-5*. Although the issues raised therein are not among the issues before Your Honor, having been recalled by the Board, so as not to prejudice its position the Ratepayer Advocate will address the issues raised in testimony herein below. The Ratepayer Advocate also wishes to reserve its right to supplement its testimony and briefs in any future proceedings on these issues before the Board.

The Company proposed three alternatives for recovery of its deferred balances. First, recovery over four year period at the seven-year rate. Second, securitization over a fifteen-year period.[31] Finally, if the Board were to reject its amortization and securitization proposals, the Company proposes to recover its deferred balance over an unspecified time at its overall cost of capital. As set forth in the testimony of its witness, Mr. James Rothschild, and discussed more fully below, the Ratepayer Advocate recommends a ten-year amortization period for the Company's deferred balance, with interest fixed at the seven-year treasury rate shown in the Federal Reserve Statistical Release on or closest to August 1, plus 60 basis points ("seven-year rate"). *R-49*; p. 5.

A. The Amortization Period Should Extend to 10-Years

Amortization of the deferred balance over a four-year period, as proposed by JCP&L, would result in an unreasonable rate increase for its ratepayers. Mr. Rothschild examined the Company's amortization proposal. For purposes of illustration, Mr. Rothschild performed numerous calculations using the Company's deferred balance estimate of $683,983,000. *R-49*, p. 7. Mr. Rothschild found that the Company's four-year amortization proposal would result in an increase in rates of approximately 9 percent. *Id*. While the percentage increase attributable to the Company's deferred balance amortization proposal is significant in itself, it is especially burdensome when considered in the context of the Company's other proposals. Mr. Rothschild noted that the rate increase attributable to amortization would be especially burdensome to ratepayers since it comes at a time concurrent with a credit elimination and a potential increase in the Company's composite MTC factor, resulting in a proposed increase of 14.3 percent. *Id*.

Mr. Rothschild concluded that extending the amortization period from four-years to 10-years produced a steep drop in rates.[32] *Id*, pp. 8-9. Mr. Rothschild found that using a 10-year amortization period instead of a

[31] On February 14, 2003, JCP&L filed a securitization petition with the Board. *See I/M/O JCP&L*, BPU Dkt. No. EF03020133.

[32] While amortization of the balance over a period longer than 10-years is possible, Mr. Rothschild found that the rate impact of extending the amortization period beyond ten years was more gradual. *R-49*, pp. 10-12.

four-year period would significantly lower the annual charge to recover the deferred energy balance, from 0.9272 cents per kWh to 0.4183 cents per kWh. *Id.*. Clearly, the 10-year amortization period recommended by Mr. Rothschild results in significant savings for JCP&L's ratepayers vis-à-vis the Company's four-year amortization proposal.

The Ratepayer Advocate respectfully submits that the rate increase mitigation offered by a longer recovery period outweighs the Company's stated concerns about the impact of a longer recovery period on the Company's ability to borrow more money. *JC-5 Rebuttal*, p. 10. Although the Company raised a concern about the impact of a longer recovery period on its financial integrity, Mr. Rothschild found that the Company did not present any analytical evidence of a financial integrity problem caused by its deferred balance. *R-50*, p. 8. In fact, Mr. Rothschild found that the Company's most recent pre-tax coverage ratio of 4.54 compares favorably to other electric utilities in New Jersey, and that a ratio of 4.54 is "very comfortable, especially since this ratio already includes much of the deferred balance financing." *R-49*, p.18.

Moreover, as Mr. Rothschild noted, during the recovery period the Company will have positive cash flow related to the deferred balance, in contrast to the Transition Period when the deferred balance was increasing in amount. *RA-50*, p. 9. The Company fails to consider the impact of a positive cash flow stemming from the recovery of the deferral through rates in the post-transition period. Under both the four-year and 10-year recovery proposals, the Company would have positive cash flow related to the deferred balance, all else equal. In fact, in response to a discovery request, Company witness Thomas C. Navin acknowledged that as cash flow increase, other things equal, the Company's ability to service its debt will improve. *Id.*, p. 7. As further noted by Mr. Rothschild, the shift from a negative cash flow during the Transition Period to a post-transition period positive cash flow would cause an improvement in the Company's financial integrity. *Id.*, p. 8.

Thus, while the improvement for the Company might be greater under a four-year amortization rather than a 10-year amortization, there would be an improvement nonetheless. *Id.*

In summary, the Company's claim that its financial integrity would be harmed by a longer recovery period is unsupported in the record. Unlike the Transition Period when borrowing related to the deferred balance was increasing, in the post-transition recovery period the outstanding deferred balance will shrink in size, with a shift in the Company's cash flow from negative to positive. Here, as discussed above, any claimed negative impacts on the Company's credit ratings and financial integrity should be eased in the recovery period by the shrinking deferred balance and positive cash flow. Moreover, the rate increase mitigation offered by a longer amortization period clearly outweigh any unsupported claims of adverse impacts on the Company's financial integrity.

B. The Accrual Interest Rate Should be the Seven-Year Rate, Fixed at the Beginning of the Recovery Period

Mr. Rothschild recommends that the deferred amount should accrue at a rate equivalent to the seven-year rate, that is, the interest rate on seven year constant maturity treasuries, plus sixty basis points. *R-49*, p.10. Mr. Rothschild further recommends that the rate should be set initially at the time the recovery rate is established by the Board. *Id*. In contrast, the Company proposes to adjust the seven-year rate annually throughout the its proposed four-year recovery period, or use its overall cost of capital if amortized over a longer recovery period.

Mr. Rothschild's fixed interest rate recommendation reflects the nature of the deferred balance. During the Transition Period the deferred balance was growing, resulting in negative cash flow and the need for financing to offset the negative cash flow. In contrast, during the recovery period, the deferred balance will decline over time, with a positive cash flow stemming from its recovery through rates. Mr. Rothschild rightly noted that since the full amount of the deferred balance would have already been financed before the recovery period a fixed interest rate should be used, set at the beginning of the recovery period. *R-49*, p. 9

Furthermore, using a fixed interest rate would have additional, practical advantages. Mr. Rothschild noted that a fixed interest rate would "have the additional advantages of 1) not having to change the recovery rate annually; and 2) making the non-securitization more directly comparable to the securitization case, because of securitization financing is used, that financing must be accomplished at a fixed rate." *Id*.

Mr. Rothschild also found that the Company's overall cost of capital would be the most expensive alternative to finance the deferred energy balance. *R-49*, p. 8. Significantly, Mr. Rothschild found that the Company's proffered cost of capital excludes short term debt. T41:L4-8 (3/4/03). Mr. Rothschild noted that financing the deferred balance over a ten-year period would include short-term debt. T42:L-11 (3/4/03). Furthermore, Mr. Rothschild noted that the Company did not provide any analysis to support its claim that it would need to earn its overall cost of capital on the deferred balances to avoid financial integrity problems. *R-49*, p. 8. In short, there us no basis to conclude that use of an interest rate of less than the Company's overall cost of capital would present financial integrity problems for the Company if the amortization period were extended beyond four years.

C. The Amount Upon Which the Interest Accrual is Based Should be Adjusted to Reflect Tax Savings

Mr. Rothschild found that JCP&L's claimed deferred balance is comprised of expenses which the Company could deduct from its federal and state income taxes. *R-49*, pp. 15-16. Hence, the deductibility of the deferral-related expenses caused a reduction in the Company's current tax liability. The related reduction in the Company's current tax liability works as a offset to the deferred balance, reducing the amount which needs to finance. Mr. Rothschild estimated that out of a total claimed deferred energy balance of $683,983,000, JCP&L only needed to finance $404,576,000 of that amount. *Id.* The deductibility of expenses comprising the deferred energy balance reduced the Company's tax liability and, in turn, decreased the amount of the deferred balance which the Company needed to finance. *Id.* Since JCP&L incurs no interest expense on the portion of the total deferral balance financed by an income tax deferral ($279,407,000) and, therefore, that portion of the total deferred balance should be excluded from the amount upon which the interest accrual calculation is made. As recommended by Mr. Rothschild, the Company should only be permitted to earn a return on that portion of the its deferred balance which it had to finance. *Id*.

Although the Company avoids grossing-up the recovery period interest for income taxes, Mr. Rothschild found that it erred by assigning an interest carrying charge on he recovery of the deferred tax balance. *Id*., p. 16. Mr. Rothschild adjusted the Company's figures to correct this error and found that his changes lower the deferred balance recovery from 0.3495 cents to 0.297 cents per kWh, all else equal. *Id*., p. 16, Sch. JAR-2.

D. JCP&L Should not be Permitted to Include a Tax Gross-Up in Its Interest Expense Recovery Revenue

Finally, the revenue associated with the recovery of the interest on the deferred balance should not be subject to an income tax gross-up, as set forth in the testimony of Mr. Rothschild. Mr. Rothschild considered the tax treatment of the deferral-related expenses in the context of the post-Transition Period recovery of the deferred balance. Since the interest expense incurred each year in the recovery period and associated recovery revenue cancel each other out, Mr. Rothschild concluded that it would be improper to add an income tax gross-up to the interest expense recovery revenue. *R-49*, pp. 15-16.

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