DEFERRED BALANCES TASK FORCE

Statement of Jersey Central Power & Light Company

This statement is submitted on behalf of Jersey Central Power & Light Company (JCP&L) at the request of the Deferred Balances Task Force (Task Force). The Task Force has been charged by Governor James E. McGreevey, in his July 31, 2002 Executive Order, among other things, to address the reasons why the State's electric utilities have accumulated deferred balances and to assess the merits of securitizing deferred balances, as provided for in Senate Bill 869, which is pending the Governor's approval.

The deferred balances are accumulating on the utilities' financial books as a consequence of the interplay among certain provisions of the Electric Discount and Energy Competition Act (EDECA). EDECA was enacted into law in 1999 to restructure the electric and gas utility industries to allow for competition in certain parts of the business – the supply of the electricity or gas commodity – while continuing regulation over other aspects of the business, such as delivery. As part of the restructuring, the utilities were authorized to recover so-called stranded costs, which, very generally, were costs incurred in the regulated environment that might no longer be recoverable in a deregulated environment. Among many responses to restructuring, JCP&L, with the approval of the Board of Public Utilities (BPU), sold its generating stations in an attempt to foster the development of competitive markets and used the net above-book value proceeds to reduce its stranded costs that would otherwise be recoverable from customers under EDECA.

In addition to restructuring the utility industry and addressing stranded costs, EDECA also mandated significant rate reductions, while capping those reduced rates for four years. As a result, certain utilities were unable to recover all of their costs under these capped rates on a current basis, particularly (1) costs related to power purchases under BPU-approved long-term contracts with non-utility generators (NUGs), and (2) the costs of power purchased in the unregulated wholesale market to meet basic generation service (BGS) obligations imposed by EDECA. In JCP&L's case, much of the power needed to meet its BGS obligations has been procured in these wholesale markets because, as noted, JCP&L has sold its generating stations. Rather than forcing a write-off of these under-recovered NUG and BGS costs, which would have impaired the utilities' financial integrity, the BPU, as required by EDECA, has authorized the utilities to defer these costs on their books for future recovery.

In order to help ensure the financial integrity of the utilities and provide some additional cost savings to customers, EDECA also allowed for the recovery of stranded costs through the issuance of transition bonds. These transition, or securitization, bonds are simply one form of asset-backed securities that have been common financing tools for a wide range of industries and assets for many years. Indeed, billions of dollars of asset-backed securities are sold every year. Securitization provides two major benefits. First, securitization will help to preserve and enhance the utilities' credit standing, thereby facilitating the utilities' access to the credit markets to raise needed capital on reasonable terms. Second, securitization can also produce cost savings, in the form of lower interest rates, that can be passed on to customers. Senate Bill 869 is designed to clarify the authority of the BPU to allow the utilities to recover these deferred costs through securitization.

These deferred costs represent real and substantial dollars that the utilities have spent, primarily to purchase power, but have not been able to recover in their rates as a result of restructuring under EDECA. Therefore, without securitization, the utilities will have to continue to finance these deferred costs, as well as future costs of this nature, through other means, such as the issuance of traditional utility debt in the form of first mortgage bonds or other long-term securities. By incurring this incremental debt, that would not have been incurred in the old regulated environment (where such costs would have been recovered on a current basis), the utilities' balance sheets will become distorted with excessive debt. This high debt load, or leverage, as it is commonly referred to in the financial community, will adversely impact the utilities' credit quality and may well cause the credit rating agencies to downgrade the utilities' debt. Such a result would, at a minimum, increase the utilities' cost of capital, which must be recovered from customers. It could even impede the utility's overall access to the capital markets, making it difficult to raise needed capital to finance infrastructure investments that are necessary to improve reliability and accommodate customer growth. Securitization bonds, on the other hand, are backed by a dedicated, non-bypassable customer charge, so that the bonds are non-recourse to the utilities. Therefore, even though the securitization debt will appear on the utilities' balance sheets, the credit rating agencies ignore the debt in their credit analysis, so it should not adversely impact credit quality and ratings.

Moreover, JCP&L's mortgage indenture and charter documents, as do those of most utilities, limit the amount of first mortgage bonds and unsecured indebtedness that JCP&L is permitted to issue. Therefore, if JCP&L continues to use up this borrowing capacity in financing these real obligations, whether or not they are deferred for accounting purposes, its financial flexibility could be hampered going forward, which could adversely impact its ability to finance requisite investments in its electric system.

Aside from these very important credit quality issues, securitization can reduce the utilities' costs, which savings can be passed on to customers. The financial markets tend to rate securitization bonds more highly than traditional utility debt offerings, primarily because of the special protective provisions addressing securitization that were included in EDECA to create an irrevocable, dedicated stream of revenue to service the bonds. For example, the securitization bonds issued by both JCP&L and Public Service Electric and Gas Company were rated triple A by the rating agencies. As a result, securitization can usually be undertaken at lower interest rates than traditional utility debt and the resulting lower financing costs can be passed on to customers.

Securitization is a tool that was envisioned as a key element of EDECA and was critical to preserving the utilities' financial integrity. Securitization bonds are not obligations of the State and do not affect the State's credit rating. JCP&L believes that securitization remains as important today as it was when restructuring was just introduced.

JCP&L notes that it has previously supplied most of these thoughts to the legislative committees considering Senate Bill 869 and in testimony submitted in connection with its recently-filed rate petitions.

1. **Did your company take a position on EDECA, and specifically on the issues relating to deferred balances, before the Act was passed?**

Response: Yes, JCP&L (then operating as GPU Energy) did take a generally supportive position of EDECA, including the benefits of securitization of each utility's stranded costs, but coupled its support with a warning that "mandating unrealistic rate reductions will undermine the long-term benefits of a free competitive market", particularly if such rates are inadequate to cover costs over which the utility has no control, such as "government-mandated non-utility generation charges, the taxes we collect for government and the cost of mandated societal benefit programs". See Ard Testimony at 2, 5.

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Attached are copies of (1) testimony submitted by Elizabeth Ard, GPU Energy's Vice President of Regulatory and Government Affairs, which was delivered on November 12, 1998 to the Senate Economic Growth, Agriculture and Tourism Committee, and on November 20, 1998 to the Assembly Policy Oversight Committee (referenced herein as "Ard Testimony"); (2) letter dated October 9, 1997 from Julie Strout, GPU Energy's Manager-Legislative Initiatives, to various legislative and administrative staff personnel of the Office of Legislative Services, scheduling a briefing on October 27, 1997 regarding the subject of securitization; (3) letter dated November 1, 1997 from Kevin Lynott of GPU Energy to James DiEleuterio, Treasurer of New Jersey, confirming a meeting on November 12, 1997 with the Treasurer's staff to discuss securitization, and (4) the slide presentation by Terrance G. Howson, GPU Energy's Vice President and Treasurer, on the subject of Asset Backed Securitization of Stranded Costs, which was presented at both the October 27 and November 12, 1997 meetings mentioned above.

In addition, on numerous other occasions during the period that the bill which eventually became EDECA was pending before the Legislature, JCP&L repeatedly raised concerns to the Board and to legislative personnel about the risk of capping retail rates when Basic Generation Service ("BGS") supply was going to be procured from an essentially deregulated wholesale marketplace, such that the capped retail rates would be inadequate to cover the potential costs of meeting JCP&L's BGS obligations. JCP&L repeatedly argued that it was inappropriate to cap utility rates insofar as they related to costs over which the utility had no control. In particular, JCP&L urged that EDECA allow for rates to fluctuate in order to reflect the potential changes in the wholesale cost of energy and capacity needed to meet its BGS obligations. Such a provision would have mitigated the build-up of the deferred balances, albeit with the trade-off of introducing some uncertainty into utility rates.

Even before EDECA was proposed (much less enacted), JCP&L was concerned about its ability to recover its stranded, above-market NUG costs on a full and timely basis as required by law under PURPA and by applicable Board Orders. Indeed, in its original unbundled rates and stranded costs filings with the Board in July 1997 (Docket Nos. EO97070458 and EO97070459), JCP&L had proposed that the above-market costs of NUG production be recovered annually in a separate, non-bypassable NUG Transition Charge ("NTC"), similar to the prior Levelized Energy Adjustment Clause ("LEAC"), which would be subject to annual true-up and adjustment in order to keep pace with changing market prices and NUG charges. However, the EDECA mandate for reduced and capped rates throughout the four-year Transition Period precluded the Board from accepting JCP&L's NTC proposal, thus resulting in the buildup of the significant MTC Deferred Balances of unrecovered above-market NUG costs.

MTC for NUGs ??

2. **When EDECA was passed, did your company anticipate accruing significant deferred balances? Why or why not? If this assessment changed please describe when and why.**

Response: As noted in the Ard Testimony (see attached to No. 1, above), GPU Energy was concerned from the outset that unrealistic and sustained rate reductions under EDECA "will doom competition to failure and threaten reliable electric delivery service", and "will undermine the long-term benefits of a free competitive market" (id., at 2), making it difficult or impossible for a utility to recover "charges that we can't control and on which we make no profit", including "government-mandated non-utility generating [NUG] charges . . . and the cost of mandated societal benefit programs" (id., at 5). These are precisely the sources of the build-up of JCP&L's deferred balance which consists of over-market NUG charges, BGS costs in excess of the capped BGS "shopping credit" rates and other costs which could not be recovered under the reduced and capped rates imposed under EDECA.

During the negotiations that led to the Stipulation of Settlement in JCP&L's restructuring proceedings, JCP&L noted on several occasions that increases in the market price of energy and capacity -- increases that were possible, but not anticipated at the time -- could lead to the accrual of significant deferred amounts on its books. For that reason, JCP&L proposed, and the parties to the Stipulation agreed, to securitize such deferred amounts so as to limit the rate impact for customers and to ensure JCP&L's financial integrity. The Board's 1999 Summary Order approving the Stipulation did not change this aspect of the Stipulation.

(Quote)

Of course, the magnitude of the deferred balance has been exacerbated beyond anyone's imagination by the complete failure of competitive market forces to hold down energy prices to the levels previously anticipated, thus requiring more and more of the Company's capped revenues to be applied to its growing costs of providing BGS to non-shopping customers and thereby creating an increasing revenue shortfall in the recovery of above-market NUG costs.

3. **Please provide, in a matrix, the positive/negative of purchase power costs (i.e., deferred costs) for each month since deregulation commenced up to the present time.**

Response: Schedule SDM-1B to the prefiled testimony of Susan D. Marano (Exhibit JC-13) sets forth the month-by-month and cumulative annual totals of all Deferred Market Transition Charge ("MTC") revenues, expenses and related credits for the transition period from August 1, 1999 through May 30, 2002. Schedule SDM-1A shows JCP&L's forecasted amounts through July 31, 2003. Included in these schedules is an accounting for the specific revenues and expenses for purchase power required to provide BGS.

Additional copies of Schedules SDM-1A and 1B are attached hereto for convenience.

4. **Why deferred balances were accrued:**

   a. **To what degree did the provisions of EDECA contribute to the accumulation of deferred balances? Would any specific changes in EDECA have decreased the scope of the deferred balance problem?**

   Response: In a nutshell, and as JCP&L had earlier warned, the mandate of unrealistic and sustained (capped) rate reductions under EDECA, coupled with the failure to emerge of a competitive energy market which would produce the hoped-for reductions in wholesale energy costs, contributed significantly to the accumulation of deferred balances reflecting the unrecovered amounts of BGS costs in excess of JCP&L's applicable "shopping credits", as well as the above-market NUG purchased power costs which could not be recovered under the EDECA capped rates. Certain changes in EDECA, such as the setting of BGS shopping rates on a current market-cost basis, or some provision for a safety valve to adjust rates in the interim, as JCP&L had previously suggested, could have alleviated the deferred balance problem.

   warned of
   wanted change

   b. **To what degree was utility management responsible for the accumulation of deferred balances?**

   Response: As noted, the primary driver of JCP&L's deferred balance are the above-market costs incurred under mandated NUG power purchase agreements which were approved by the Board pursuant to PURPA, and over which JCP&L has essentially no control. Nonetheless, JCP&L's management has consistently ~~worked diligently~~ to mitigate the stranded, above-market costs of those mandated NUG power purchase agreements. JCP&L has also worked diligently to minimize and control the potential volatility of BGS purchased power costs. <u>See</u> Filippone Testimony (Exhibit JC-3); Mascari Testimony (Exhibit JC-14); Stathis Testimony (Exhibit JC-15); Non-Utility Generation Mitigation Report, and excerpts from Mascari's testimony on NUG mitigation in JCP&L's stranded costs proceeding and Board Order thereon. Accordingly, JCP&L does not believe that its management is in any way responsible for the accumulation of the deferred balance.

   what @ renegotiation

   c. **How did unanticipated external factors (e.g. changes in the electricity market) contribute to deferred balances?**

   Response: Changes in the competitive electricity market have certainly played a role in contributing to the deferred balances. Because of the apparent failure of a truly competitive energy market to emerge under EDECA, two things have happened: (i) despite an initial enthusiasm for shopping, nearly all shopping customers have returned to BGS because third-party suppliers of energy could not effectively compete with the fixed BGS charges (or "shopping credits") that were mandated under EDECA, and (ii) the increased costs of electric energy and capacity supply needed to provide BGS to virtually all retail customers has overwhelmed the ability of the EDECA-capped retail rate structure to provide timely and adequate revenues to offset BGS, NUG and other costs.

These external factors were recognized at the outset of EDECA as a potential threat to the realization of EDECA's goals. However, contrary to JCP&L's urgings, EDECA itself provided no flexibility or safety value to adapt to unanticipated changes in the marketplace, thus leaving no real alternative but to build up the deferred balances of unrecovered costs.

d. Why do utilities have such vastly different deferred balances, even on a per customer basis?

Response: Different utilities have had different profiles of generation resources, NUG contracts and other stranded costs that may have impacted the build up of deferred balances. For example, PSE&G was permitted to transfer its generation assets to an affiliate, and at essentially the same time was authorized to securitize some $2.5 billion of stranded costs related to those assets (and to amortize some $568.7 million of excess depreciation reserves to fund a significant portion of its required rate reductions). Since PSE&G had few NUG commitments and its generation affiliate was willing to provide BGS service to PSE&G's customers at the shopping credit rates, PSE&G had no significant exposure to the build up of a deferred balance of unrecoverable BGS or NUG costs.

different authorizations of securitized costs

JCP&L, on the other hand, sold the bulk of its generation assets to third parties in Board-approved transactions, and used the net proceeds to benefit customers ~~by significantly~~ reducing its generation-related stranded costs without the need for generation-related stranded cost recovery through securitization or otherwise (other than its net investment in the Oyster Creek ~~nuclear generating~~ station). However, JCP&L remained saddled with its Board-mandated NUG contracts, representing ~~nearly 20%~~ of its generation requirements, the over-market costs of which could not be recovered on a full and timely basis under the EDECA-capped rates, particularly given the ensuing escalation in market energy prices and the return of shopping customers to BGS, which consumed an increasing proportion of JCP&L's EDECA-capped revenues.

why

NUG per %

5. **Prudency Review/Mitigation:**

   a. **Explain the process your company utilized for purchasing power in wholesale markets. Specifically, please describe:**
      i. **the sources of power purchases**
      ii. **the methods by which prices were bid and/or negotiated**
      iii. **the types of agreements entered into (e.g. short- or long-term contracts, hedge agreements, etc.)**
      iv. **identify the sources of the power by quantity and price.**

   b. **Describe all efforts to mitigate or reduce your purchased power costs and deferred balances, particularly at periods of peak demand, and including but not limited to the following mitigation techniques:**
      i. **negotiating and/or bidding techniques**
      ii. **the search for alternative supply sources**
      iii. **attempts at demand side management, particularly at periods of peak demand**
      iv. **attempts to renegotiate non-utility generation contracts that were above market rates**

   c. **What new or expanded efforts will your company undertake in Year 4 of deregulation (August 1, 2002 – July 31, 2003) to mitigate the accumulation of deferred balances?**

Response: (a) i, ii, iii and iv; (b) i and ii – The attached prefiled testimony of Charles A. Mascari (Exhibit JC-14) and Dean Stathis (Exhibit JC-15), which were filed with the Board on August 1, 2002 in support of JCP&L's 2002 Deferred Balances Filing (BPU Docket No. ER02080507), sets forth in considerable detail the sources of JCP&L's power purchases, procurement strategy, pricing methods, and types of agreements entered into in the procurement of wholesale energy and capacity supplies to meet its BGS obligations.

(b) iii – JCP&L's continuing efforts to encourage and obtain demand-side management by its customers, particularly at periods of peak demand, include JCP&L's efforts to implement a Voluntary Load Reduction ("VLR") program, the maintenance and aggressive utilization of the Residential Appliance Cycling program which has produced significant PJM capacity credits, and the development of Comprehensive Resource Analysis ("CRA") programs.

results?

The VLR program offered monetary incentives to customers who voluntarily reduced their load during times of peak load and/or cost or during system emergencies. In the Residential Appliance Cycling program, JCP&L used radio-activated relays to selectively cycle individual residential air conditioning equipment, in order to optimize system load and shift energy off-peak. The Residential Appliance Cycling program has produced significant PJM capacity credits. In addition, JCP&L's active participation in, and funding of, CRA programs, which encourage the installation of more efficient equipment in both retrofit and new construction projects, educate consumers on the benefits of energy efficient technologies and provide incentives for renewable energy technologies, has contributed to its peak load reduction.

(b)iv – JCP&L's efforts to mitigate or otherwise renegotiate its over-market NUG contracts are summarized in Mr. Filippone's testimony (Exhibit JC-3), at 11-12. Also attached is the most recent quarterly report (2dQ 2002) by JCP&L to the Board on its ongoing and cumulative NUG mitigation efforts, as well as Mr. Mascari's testimony from JCP&L's stranded costs proceeding describing JCP&L's extensive pre-1997 efforts to mitigate NUG stranded costs, which led the Board to conclude in its Final Order dated March 7, 2001 (at 111), that JCP&L "has taken reasonable measures to date on mitigation of stranded costs". Also attached is a copy of the Board's Order dated May 16, 2002 in Docket No. EM02030152, approving JCP&L's proposed restructuring of the Cogen Technologies New Jersey Venture ("Bayonne") NUG contract which, when consummated, will result in an up-front restructuring credit of approximately $27 million to be applied directly to the MTC Deferred Balance.

(c) – JCP&L will continue to pursue all opportunities to mitigate the financial effects of the NUG PPAs that JCP&L was mandated to enter into by previous administrations. In the past year, JCP&L has reached agreement with one major NUG owner to restructure its contract; that restructuring has been approved by the Board. The nominal result of that restructuring on the deferred balances is a reduction of $27 million, although the final result depends upon the timing of the owner's replacement financing. JCP&L is currently in extensive discussions to restructure its contract with the joint owners of another major NUG project. These negotiations are proving to be extremely complex due to the financial and structural arrangements the owners have with their financial backers, but substantial progress continues to be made in an intensive effort by both JCP&L and the owners. The availability of securitization could potentially form the basis for wringing benefits out of these discussions. JCP&L has also renewed discussions with a third NUG owner, and those discussions have the potential to bear additional fruit in the form of deferred balance and ongoing cost mitigation, particularly if securitization is available. Other mitigation activity deals with ongoing NUG contract administration to assure that the lowest cost alternatives under the contracts are being employed. JCP&L has devoted to NUG mitigation the full-time or part-time efforts of five senior-level company staff with significant senior management involvement and support.

In addition to its continuing efforts to mitigate or otherwise renegotiate its overmarket NUG contracts, as summarized above, JCP&L proposed (together with the other New Jersey electric utilities) and participated in the successful State-wide BGS auction process, as approved by the Board. This auction process has resulted in JCP&L's entire Year 4 BGS load being supplied by the winning bidders at fixed wholesale prices which approximate JCP&L's Year 4 retail shopping credit rates, subject to adjustments for transformer and line losses and revenue taxes. However, JCP&L remains vulnerable to the further accumulation of above-market NUG costs. All of the foregoing have been taken into consideration in the projections reflected in the attached Deferred Balances Report to the Board at June 30, 2002, as well as in Schedules SDM-1A and 1B which were attached hereto in response to Question No. 3.

6. **Are there specific remedies that your company supports to address the issue of deferred balances? Does your company support the securitization of deferred balances as allowed for by S-869?**

Response: JCP&L's recommendations for remedies that address the issue of its MTC Deferred Balance, including support for the securitization thereof under EDECA as well as under S-869, are set forth in the excerpts from Mr. Filippone's testimony (Exhibit JC-3), which are submitted herewith.

In his testimony, Mr. Filippone clearly supports securitization of the MTC Deferred Balance as a "win-win" outcome for all parties, including customers and investors alike, under all the circumstances which he previously described. Mr. Filippone also discusses an alternative to securitization, namely, a limited amortization period such as four years, which would protect the Company's financial integrity, but would result in higher carrying costs and much more significant rate increases to customers in the short term. JCP&L strongly believes that securitization, as allowed both under EDECA (for NUG stranded cost balances) and by S-869 for all deferred balances, is clearly in the best interests of all concerned.

7. **Does your company have a position on the process by which deferred balances should be investigated and heard by the Board of Public Utilities?**

Response: JCP&L has submitted the testimony of Mr. Filippone (Exhibit JC-3), Ms. Marano (Exhibit JC-13), Mr. Mascari (Exhibit JC-14) and Mr. Stathis (Exhibit JC-15), which fully demonstrate and support the reasonableness and prudency of JCP&L's electric energy and capacity procurement strategies and related costs and their proper accounting and ratemaking treatment, as well as the source of JCP&L's deferred balance, its mitigation efforts and its proposed recovery methodology through securitization in order to protect and minimize the impact thereof on its customers. JCP&L fully expects that, in the context of JCP&L's 2002 Deferred Balances Filing and, ultimately, its 2002 Rates Filing, the Board will hear, investigate and review the process by which the deferred balances occurred and the appropriateness of JCP&L's proposed methodology for recovery thereof. As part of this process and pursuant to the provisions of the Board's Final Order dated March 7, 2001 (at 112-113), the Board has initiated a review by outside auditors of the deferred balances of each of the electric utilities.