New York Power Authority

Staff Analysis of Public Comments and Recommendations

Rate Modification Plan

Appendix A

April 2003

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Part I: Introduction

A. Review of January 2003 Trustee Action

At their meeting of January 28, 2003, the Trustees authorized notice of a proposal to adjust the hydroelectric rates for rural & domestic ("R&D") or preference customers. (For the purposes of this report, the term R&D and preference are used interchangeably). The proposed rate plan was prepared by the Authority staff and explained in its January 2003 Report on Hydroelectric Production Rates, Rate Modification Plan (hereinafter, "Rate Modification Plan"). The proposed plan consisted of new base rates for five periods. Consistent with the Trustees' resolution of December 18, 2001, the rate for the first period would have been retroactive from that date to April 30, 2003 based on a cost-of-service test year from October 1, 2001 to September 30, 2002. This initial period was to have a reduced energy rate of $4.59/MW-hour, and result in a refund of approximately $4.4 million. For this period, the demand charge would have remained at $1/kW-month.

The Rate Modification Plan proposed a rate design change in which the proposed rate increases for the 2003-2006 rate years would be recovered through increases to the demand charge rather than through the energy charge. The energy charge was to remain at $4.92/MW-hour throughout the rate plan. As the Rate Modification Plan explained, the rate design change reflected the fact that cost of power produced at the Authority's Niagara and St. Lawrence-FDR hydroelectric projects ("Hydro Projects") is comprised of fixed costs, which do not vary with the amount of energy produced.

To set the rates for the four future rate periods, Staff used projected calendar year data. The Rate Modification Plan proposed the following rates:

12-Month Period Commencing	Demand Rate $/kW-month	Energy Rate $/MW-hour	Effective Rate (based on 70% load factor customer) $/MW-hour	% Increase
5/1/2003	1.45	4.92	7.76	13
5/1/2004	1.71	4.92	8.27	7
5/1/2005	2.10	4.92	9.02	9
5/1/2006	2.39	4.92	9.59	6

The Rate Modification Plan included a cost-of-service study which set out the calculations supporting the proposed rates and explained the additional costs of production of hydroelectricity at the Hydro Projects. These costs include: (1) the Authority's capital costs including upgrades and life extension and modernization costs at both Hydro Projects; (2) the Authority's costs related to Federal Energy Regulatory Commission ("FERC") relicensing for the Hydro Projects; (3) Operation and maintenance ("O&M") costs for the Hydro Projects; (4) the Hydro Projects' share of the Authority-wide switch to accrual accounting for post-employment benefits other than pensions ("PBOPs"); and (5) indirect overhead costs.

B. Public Comment Period

Written notice and a copy of the Rate Modification Plan were mailed to all affected customers on or about January 28, 2003. The written notice also stated that any person who so desired could contact the Authority to receive additional documentation concerning the rate proposal. The Authority published a news release on January 31, 2003 which described the proposed rate action. Notice of the proposed action was published in the New York State Register on February 19, 2003. Also on February 19th, the State Register published a notice that a Public Forum would be held on March 18, 2003 for the purpose of obtaining the views of interested persons.

Subsequent to the Trustees action on January 28, 2003, Authority staff met on numerous occasions with affected customers and customer organizations for the purpose of answering questions about the proposed rate revisions. The Authority staff held meetings with the following parties: the Municipal Electric Utilities Association ("MEUA"), which represents 46 municipal utility systems in New York State; representatives from the rural electric cooperative systems of Delaware County, Oneida-Madison, Otsego and Steuben ("Coop Systems"); the City of Jamestown Board of Public Utilities ("Jamestown"). The Authority staff also had teleconferences with representatives of four of the seven neighboring states, namely Massachusetts, New Jersey, Ohio and Pennsylvania ("Neighboring States"), and with New York State Electric & Gas Corporation ("NYSEG").

Interested parties submitted numerous data requests concerning the Rate Modification Plan. Staff responded to 32 data requests from MEUA, 10 from the Coop Systems, 57 from Jamestown, 20 from the Neighboring States and 20 from NYSEG. Many of these data requests had multiple subparts, so these numbers somewhat understate the amount of material staff provided. Many data requests sought the workpapers in support of the calculations of the Authority staff and the Authority's consultants. Such materials were provided to the parties.

On March 18, 2003, the Public Forum was held in Syracuse. The Forum was conducted in accordance with the terms of the Policy and Procedures – Public Forums on Rate Proposals adopted by the Authority's Trustees in November 1990. Such policy and procedure provides for the holding of public forums on all Authority production and transmission rate increase proposals of two percent or more.

A panel of Authority representatives was available at the Public Forum to explain the basis for the proposed rate revisions and to listen to issues raised by concerned members of the public. Excluding Authority representatives, a total of 15 persons attended the Public Forum. Spoken comments presented at the Forum were transcribed and included as part of the record in this proceeding. Speakers included representatives from MEUA, Jamestown and the Neighboring States, all of whom expressed their appreciation to Authority staff for their cooperation and timely responses to data requests. A transcript of the Public Forum was made available for a fee payable to the court reporting company.[1]

The Authority had invited parties to submit written comments at the Public Forum. The only such comments received were (1) Statement of Kevin R. Brocks on Behalf of MEUA ("MEUA Statement") and (2) the Preliminary Comments of the Neighboring States ("Preliminary NS Comments"). Authority representatives announced at the Forum that written comments would also be accepted and considered as part of the record if received by April 7, 2003.[2]

The written comments that were subsequently submitted are listed below:

- Letter of Power for Economic Prosperity Group, April 3, 2003 ("PEP Letter").
- Letter of City of Jamestown Board of Public Utilities, April 7, 2003 ("Jamestown Letter").
- Comments of Neighboring States of Massachusetts, New Jersey, Ohio and Pennsylvania, April 7, 2003 ("NS Comments").[3]
- Letter of New York State Electric & Gas Corporation, April 7, 2003 ("NYSEG Letter").

All of the public comments received were evaluated by Authority staff. A detailed description of the issues raised and the proposed disposition of each make up the body of this report.

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1 References herein to the transcript are designated as "Tr. [page #]:[line # - line #]."

2 The April 7th deadline was in accordance with the 45-day comment period required by the New York State Administrative Procedure Act.

3 The Neighboring States state that their April 7th Comments supersede the Preliminary NS Comments. (NS Comments at 1 n.1). For this reason, the Authority staff will not address the Preliminary NS Comments, though they are included in the record of these proceedings.

C. Summary of Proposed Final Rates

Based on the information received from the parties through in-person meetings, teleconferences, the Public Forum and the filed written comments, the Authority staff proposes the following rates. They are modified only slightly from those contained in the Rate Modification Plan.

12-Month Period Commencing	Demand Rate $/kW-month	Energy Rate $/MW-hour	Effective Rate (based on 70% load factor customer) $/MW-hour	% Increase
5/1/2003	1.45	4.92	7.76	13
5/1/2004	1.71	4.92	8.27	7
5/1/2005	2.09	4.92	9.01	9
5/1/2006	2.38	4.92	9.58	6

These rates reflect a 1 cent/kW-month reduction in the demand rate for the 2005 and 2006 rate years. In addition, the Authority f recommends that the energy rate for the retroactive rate period (December 18, 2001 through April 30, 2003) be lowered to $4.58/MW-hour from the originally proposed $4.59/MW-hour. Staff estimates that this lowered energy charge will produce a $4.5 million refund for the retroactive period. Authority staff's final production cost of service which reflects these changes is included at the end of this report as Exhibit 1. The final rates' impact by customer class is unchanged from impacts shown in the Rate Modification Plan, Exh. NYPA-4.

The Authority staff also recommends that the Rate Stabilization Reserve ("RSR") bandwidth remain at +/-$25 million. The staff had originally proposed a +/-$15 million bandwidth. The justifications supporting the Authority staff's rate proposal with these changes are explained in detail in the pages that follow.

Part II: Public Comments, Staff Analysis and Recommendations

A. Issue: Cost-Based Adjustment to Production Rates Reflecting the Removal of Ancillary Services Costs and Requests to Provide Revenue Credits

Public Comments:

The Neighboring States claim that the Authority's proposed rates are illegal and inconsistent with recognized industry practice because they fail to properly account for the revenues the Authority receives from its sales of ancillary services to the New York Independent System Operator ("NYISO"). (NS Comments at 5-6, 9).[4] The Neighboring States insist that the Authority should, instead of removing from its rates the cost of producing those ancillary services, set its rates by crediting all revenues derived from the sale of ancillary services. (NS Comments at 6-9). The Neighboring States further claim that because of the Authority's proposal, they must now "secure their share of the required ancillary services from the NYISO." (NS Comments at 6).

NYSEG also claims that customers should receive full credit in the rates for these ancillary services revenues or that such revenues should be credited to the RSR. (NYSEG Letter at 3).

The Neighboring States claim they should also receive credit for the Authority's hydroelectric revenues derived from sales to the NYISO. (NS Comments at 10-11). Such revenues are those derived from other Hydro Projects' sales at rates different from the preference rates at issue here.

[4] For the purposes of this proceeding the Authority is applying the cost-based Hydro Projects rate to the Neighboring States. However, the Authority does not concede that the Neighboring States are legally entitled to cost-based rates.

The Neighboring States request that the Authority explain why its reported ancillary services revenue for the Test Year in one data response does not match the dollar amount that appears in its Financial Report. (NS Comments at 7-8). Finally, both the Neighboring States and NYSEG point out that the Authority inadvertently omitted to deduct the O&M component of Black Start Service and Voltage Control Service from its removal of ancillary services costs in its cost-of-service. (NS Comments at 10; NYSEG Letter at 3).

Staff Analysis:

1. <u>Rate Adjustment Related to O&M for Voltage Control and Black Start Services</u>

The Authority recognizes that an adjustment to the proposed rate is necessary to incorporate the cost-based credit for O&M related to Voltage Control and Black Start services, as pointed out by the Neighboring States, NYSEG and informally by other parties. This omission in the Rate Modification Plan was inadvertent and will be corrected. Making this adjustment would reduce the demand charge by a penny in the 2005 and 2006 rate years. The resulting demand charges are $2.09/kW-month and $2.38/kW-month, respectively. In addition, this adjustment reduces the energy rate by a penny for the retroactive rate period (December 18, 2001 to April 30, 2003) to $4.58/MW-hour. This adjustment has no effect on the rates for the 2003 and 2004 rate years.

2. <u>Ancillary Services: Cost versus Revenue Credits</u>

The Neighboring States and NYSEG both propose that the Authority provide a credit which is based on revenues the Authority receives from the sales of ancillary services, rather than the costs incurred to produce such services. As shown below, these parties raise no arguments to undercut the reasonableness and validity of the cost-based credit. In fact, they do not cite any statutory, judicial or regulatory support for their insistence that the Authority must adopt revenue crediting.

a. In Light of the Restructured Market in New York State, the Authority's Cost-Based Credit for the Production of Ancillary Services is Reasonable

All parties recognize that ancillary services are handled differently than before in this restructured electricity market. Since the NYISO became the central market operator for New York State in November 1999, it has not permitted the sale of ancillary services directly to any customer. Indeed, prior to the startup of the NYISO there was no market of any kind for ancillary services in New York. Rather, these services were provided by utilities to their customers on a bundled, undifferentiated basis. Thus, the Authority did not cause these changes; the NYISO did. Contrary to the Neighboring States' claims, it is the NYISO's market structure that requires all customers to "secure their share" of ancillary services, because self-provision of ancillary services (*i.e.* the direct provision of such services by a load-serving entity for its own customers) is not yet permitted by the NYISO.[5] In fact, since December 2000, the Neighboring States have had to "secure their share" of NYISO required ancillary services by reimbursing the Authority for purchases of such ancillary services it makes on the Neighboring States' behalf.[6]

As a result of the change in market structure, no party would quarrel with the notion that the Authority should adjust its hydroelectric cost of service in some manner. The only issue is how to reflect the new market order. As shown below, it is reasonable and appropriate that such costs be removed from the Authority's proposed production cost of service. The results are significant: without these costs, the hydroelectric cost of service has been reduced by $10-12 million for each

[5] If and when self-provision is permitted by the NYISO, the Authority staff has committed to review this issue to determine whether it would be appropriate to supply or sell ancillary services directly to customers. Rate Modification Plan at 13.

[6] For the first 13½ months of NYISO operations, the Authority actually absorbed all NYISO costs (including ancillary services) associated with service to the Neighboring States. This is described further in the response to the Neighboring States' refund argument, *infra,* at page 15.

year over the life of the proposed rate plan. *See* Rate Modification Plan, Exh. NYPA-1, page 2 of 2, line 13.[7]

b. Use of Cost Credits is Authorized Under the Rate Making Principles Set Forth in the *Auer* Cases

In the absence of any federal or state statutory directives regarding this issue, and there are none, it is the *Auer* cases which provide a roadmap to the Authority for setting its preference rate. Those principles focus on setting this rate based on the Authority's costs of producing power, not on the revenues generated by its power sales.

(i) Neither Federal nor State Statutes Compel Revenue Crediting

The Neighboring States' assertion that the Niagara Redevelopment Act, 18 U.S.C. § 836(b)(2) (2000) ("NRA"), requires the adoption of revenue crediting is utterly baseless. (NS Comments at 4). The NRA contains no such command. In fact, the courts have construed the NRA's "lowest rates reasonably possible" language as a goal to be achieved by resale of power to end users, not an absolute standard by which the Authority's wholesale rates must abide.

In *Power Auth. of State of New York v. FERC,* 743 F.2d 93 (2nd Cir. 1984), the court reviewed the language of the NRA that at least fifty percent of the Niagara Project power be "for the benefit of the people as consumers, particularly rural and domestic [*i.e.* R&D] consumers, to whom such power shall be made available at the lowest rates reasonably possible . . . ." 18 U.S.C. § 836(b)(2). The court concluded that this was "precatory language," and that it expressed a "Congressional

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[7] The Neighboring States claim that there is an inconsistency in the number representing the Authority's annual revenues from the sale of ancillary services. (NS Comments at 8). While the issue is irrelevant given the appropriateness of using cost rather than revenue credits, the numbers are readily explained. Gross ancillary services revenues from the Projects are $32,695,512, while net revenues stated in the Authority's Financial Reports in 2002 are $14,019,000. The difference is attributable to payments made by the Authority under agreements with the Niagara Mohawk Power Corporation and NYSEG for ancillary services costs for the Authority's industrial and economic development power customers.

expectation, not a mandate." 743 F.2d at 104. In other words, Congress was setting a goal, not a precise standard with respect to rates.

The only federal court that has considered the NRA's language in the context of a challenge to the R&D rate found that the statute provided little guidance to assess the rate's legality. In *Delaware County Elec. Coop., Inc. v. Power Auth. of the State of N.Y.,* 82 Civ. 7256, 1985 U.S. Dist. LEXIS 18981 (S.D.N.Y. June 12, 1985), the judge determined that the statute leaves the court with "little guidance to examine the propriety of the electric rates challenged in this case." *Id.,* slip op. at 9. The judge declined to assert jurisdiction and dismissed the case.[8]

The applicable state statute, N.Y. Public Authorities Law §1005(5) (McKinney 1994 & Supp. 2003) ("PAL"), also contains no directives helpful to the Neighboring States. Aside from its precatory language which, like the NRA, refers to the "lowest possible rates," to the extent the PAL discusses rates, its focus is on costs, not revenues. The statute refers to contract "prices representing cost of generation, plus capital and operating charges," and it requires the Authority's contracts for sale of power to provide, *inter alia*, for the payment of project "expenses" and "interest." There is most assuredly no specific mention of ancillary or other services provided by the Hydro Projects or how they were to be treated for rate making purposes.

In the last analysis, it is the *Auer* decisions which have guided the Authority's rate setting since 1981. In *Auer v. Dyson,* 110 Misc. 2d 943 (Sup. Ct. Oswego Co. 1981) ("*Auer I*"), certain R&D consumers sought a judgment declaring the Authority's general purpose bond resolution violative of its state statutory obligation

[8] Nor has the FERC issued any such orders. In fact, FERC has repeatedly held that it has no jurisdiction under the NRA or the Federal Power Act to regulate the Authority's rates and this interpretation has been upheld on appeal. *New York Power Authority,* 98 FERC ¶ 61,033 at 61,096 (2002); *Villages of Andover v. Power Auth. of State of New York,* 64 FERC ¶ 61,066, at 61,611, *reh'g denied,* 64 FERC ¶ 61,358 (1993), *aff'd sub nom. Village of Bergen v. FERC,* 33 F.3d 1385, 1389-91 (D.C. Cir. 1994); *Municipal Elec. Utils. Ass'n of N.Y. State,* 9 FERC ¶ 61,128 at 61,254 n.5 (1979), *reh'g denied,* 10 FERC ¶ 61,001 (1980). Contrary to the Neighboring States' contentions (NS Comments at 7), nothing in *State of Vermont Public Service Board v. Power Authority,* 55 FPC 1109 (1976), provides any guidance on ratemaking or revenue credits.

to charge those R&D customers the "lowest possible rates." PAL § 1005(5).[9] *Auer I,* 110 Misc. 2d at 951. The *Auer I* plaintiffs claimed that they would be charged a rate higher than permitted under the statute because the bond resolution pledged revenues from the hydro projects to the payment of bonds issued for other Authority projects. The court declared that the bond resolution, including the pledge of all revenues, did not violate existing law. *Id.,* 110 Misc. 2d at 944, 953.

The *Auer I* court first addressed the statutory rate provision. It found that the Authority has "broad discretion . . . to determine the components of its costs" and it does not have to guarantee any specific rate. *Id.* at 948. With respect to the rural and domestic customers, the court provided additional guidance on what constitutes the "lowest possible rate":

> There is no limitation or guideline for determining "lowest possible rate" other than the responsibility of the authority to seek contracts of sale to industry as a secondary purpose "to secure a sufficiently high load factor and revenue returns" to permit the accomplishment of that purpose. *An interpretation that would permit the lowest possible rate to be less than cost would be absurd,* and it must be presumed that the Legislature never intended such a result. (McKinney's Cons Laws of NY, Book 1, Statutes, § 146.)

110 Misc. 2d at 949 (footnote omitted; emphasis added).

The *Auer I* court went on to resolve any potential conflict between this rate provision and the pledge of all hydro revenues found in the bond resolution. Once the cost-based rate has been set, the Authority has fulfilled its statutory obligations and can retain and pledge "excess revenues" garnered from the Hydro Projects. As the *Auer I* court stated:

> Once there is evidence that the lowest possible rate within [the statutory] limitation has been established, PASNY will have fulfilled its obligation. If there are still excess revenues, there is no statutory prohibition which would prevent the transfer of such revenues to the general fund.

[9] The *Auer I* plaintiffs also contended that the Authority violated the NRA's "lowest rates reasonably possible" standard, but the court treated the two standards synonymously.

110 Misc. 2d at 949.

In *Auer v. Dyson,* 125 Misc. 2d 274 (Sup. Ct. Oneida Co. 1984), *aff'd for reasons stated below,* 112 A.D.2d 803 (4th Dep't 1985) ("*Auer II*"), these essential principles were revisited and reaffirmed. First, it recognized that once the cost-based rate was set, "if there was excessive revenue, it could be added to the general fund and used for legally permissible purposes." *Auer II,* 125 Misc. 2d at 276. Second, *Auer II* stressed the importance of retaining those excess revenues to maintain the validity of its bond resolutions. If, the court said, those revenues were used instead to reduce the preference rate below cost,

> [s]uch a result would violate the revenue pledge and cause a default under the terms of the bonds since in no case could the hydro revenues be used for the bondholders.

125 Misc. 2d at 277.[10]

Following the second *Auer* case, the parties agreed on the *Auer* Settlement[11] which states, among other things, that preference rates "shall be defined as cost[,]" ¶ 2; that "[s]uch cost shall be determined by the Authority's trustees in the exercise of their broad discretion consistent with Justice Tenney's Order and Judgment dated April 2, 1982 in *Auer I*[,]" ¶ 3; and that "[o]nce the lowest possible rate . . . has been established excess revenues . . . may be added to the general fund of the Authority." ¶ 10 (internal quotations omitted). Those settlement principles were incorporated into an Order and Judgment signed by Justice Tenney and filed in

[10] *Auer II* and subsequent state court rate litigation dealt with challenges to specific costs which, the ratepayers claimed, should not have been included in the preference power cost of service. *Auer II*, 125 Misc. 2d at 277-78 (challenge to debt service for cancelled nuclear plants); *Village of Bergen v. Power Auth. of State of New York,* 249 A.D.2d 902, 903-04 (4th Dep't 1998), *appeal denied,* 97 N.Y.2d 606 (2001) (challenge to allocation of indirect overhead costs by use of a capacity, rather than labor, ratio).

[11] March 5, 1986 Settlement Agreement settling *Auer v. Dyson*, No. 81-24 (Sup. Ct. Oswego Co.), *Auer v. Power Authority*, Index No. 11999-84 (Sup. Ct. N.Y. Co.) and *Delaware County Electric Cooperative, Inc. v. Power Authority*, 82 Civ. 7256 (S.D.N.Y.) ("*Auer* Settlement").

court on January 10, 1986.[12] Since that time, the Authority has set its preference power rate in accordance with that *Auer* Settlement and Judgment.

Given the teachings of *Auer*, there is nothing unreasonable nor irrational about using cost-based credits for ancillary services. Because the Authority can no longer sell these services to its preference customers, the costs connected with the production of such services should no longer be charged to them and were accordingly removed from their cost of service. That is precisely what *Auer* would require. On the other hand, to do as the Neighboring States propose would ignore production costs and emphasize revenues received, thereby yielding a rate below cost and using revenues in a manner inconsistent with the Authority's obligations to its bondholders.

There is no difference between the Neighboring States' request to credit ancillary services sales to the R&D rate and its request to credit all revenues from other Hydro Project sales. (NS Comments at 10-11).[13] A similar claim was unsuccessfully raised by some of the same out-of-state customers in the Authority's last hydro rate proceeding in 1992. In that case, the out-of-state customers sought credits for revenues garnered from industrial sales made at the Hydro Projects. These customers claimed that the *Auer* Settlement principles violated the "lowest possible rate" mandate of the NRA and the PAL. The Authority's 1992 Final Staff Report rejected this argument for the same reasons described above: the Authority must not set the rate below cost. That requirement is found in the *Auer* decisions and *Auer* Judgment and is fully binding on the Authority, notwithstanding any claim

[12] January 10, 1986 Order and Judgment in *Auer v. Dyson* (Sup. Ct. Oswego Co.) ("*Auer* Judgment").

[13] The Neighboring States conflate the issue of sales into the NYISO, hydro curtailments and the amounts of energy they receive under their contracts. (NS Comments at 11 & n.6). Curtailments, which are allowed in these customers' contracts, are not related to the NYISO sales. Rather, they are related to low water flows. The sales into the NYISO neither affect the total amount of energy available from the Hydro Projects nor alter the amount of capacity at the Projects that is available to meet the contractual entitlements of R&D customers. The Neighboring States' fixation on the Authority's $66,668,000 in test-year sales from the Hydro Projects is similarly misplaced. (NS Comments at 10). That figure represents gross revenues, and is not offset by the power purchases from the NYISO made at the Hydro Projects.

by the Neighboring States that they are no longer bound by the *Auer* Settlement. (NS Comments at 14).[14]

In short, the Authority staff finds the Neighboring States' and NYSEG's request for revenue credits for ancillary services sales or for any other Hydro Project sales both unreasonable and inconsistent with the *Auer* principles. Because revenue credits are not required to set the rate in the first instance, the Authority need not, as NYSEG contends (NYSEG Letter at 3), include such credits in the RSR.

c. <u>The Authority does not Discriminate Against the Neighboring States</u>

There is no merit to the Neighboring States' claim that the Authority discriminates because some in-state preference customers may be receiving ancillary services without paying for them. (NS Comments at 7). First, no discrimination exists with respect to the preference rate which is the subject of this proceeding. The Authority is currently offering the same R&D rate for power and energy to preference customers whether in-state or out-of-state. (It is also incorrect to claim that such customers receive ancillary services from the Authority because, as the Authority has already explained, it cannot sell such services under the NYISO market rules.) Second, any financial assistance that the Authority provides to other customers for ancillary services stems from unique contractual relationships not present in the case of sales to Neighboring States. For example, the Authority voluntarily paid certain ancillary services costs for its in-state full requirements municipal and rural cooperative customers. These payments were made in the context of the Authority's full service contracts with these customers that cover both hydro and non-hydro power sales. The Authority was under no obligation to incur such costs and is certainly not required to assume such responsibility for the Neighboring States or other in-state customers. Any difference in treatment is thus *not* based on in-state or out-of-state status.

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[14] Because NYSEG's current preference power contract incorporates the *Auer* Settlement principles, NYSEG cannot and (appropriately) does not make any such claim.

d. The Size of the Authority's Proposed Refund is Appropriate

The Neighboring States' request to enlarge their refund for the retroactive rate period (December 18, 2001-April 30, 2003) is baseless. They observe that there is no mention in the Rate Modification Plan of how the hydropower customers were or will be credited for the Authority's ancillary services sales to the NYISO from startup in November 1999 until December 18, 2001, the effective date of newly proposed rates. (NS Comments at 9). As explained in detail above, no revenue credits are justified whether for the retroactive period or for future rate years. In any event, for the first 13½ months of NYISO operation through December 2000, to the benefit of the Neighboring States, the Authority absorbed *all* NYISO costs associated with service to them, including Schedule 1, marginal losses and NTAC,[15] for which the Authority receives *no* corresponding NYISO revenues. In short, there is no reason for the Authority to augment the proposed refund.

Recommendation:

The cost-based credit proposed by the Authority staff is fair and reasonable. The Authority is not required to use ancillary services revenues or any other excess revenues from the Hydro Projects to reduce the R&D rates below cost. To do so would be inconsistent with the *Auer* decisions and the resulting *Auer* Settlement and Judgment. The Trustees should reject these requests by the Neighboring States and NYSEG and approve, as specified above, the modification of the cost of service to exclude O&M for Voltage Control and Black Start services.

[15] NYPA Transmission Adjustment Charge.

B. Issue: Capital Cost Issues

Public Comments:

The Neighboring States make several arguments concerning the capital cost recovery methods employed by the Authority. While they state they are not now challenging the continued use of the *Auer* TOC method through the end of their current power contracts on October 31, 2003, they suggest that the issues they raise on this subject should be the basis of negotiations on new power contracts. They claim that the Trended Original Cost ("TOC") methodology used by the Authority under the terms of the *Auer* Settlement and Judgment is inconsistent with the methods employed by regulators and results in the collection of revenues in excess of costs. (NS Comments at 14-15). The Neighboring States make a general attack on the inflation compensation component of the Authority's capital cost and state that the equity in the Hydro Projects is customer contributed capital as to which the Authority is entitled to no return. (NS Comments at 14-17). Lastly, they suggest that the TOC inflation compensation revenues and not new equity be used to fund new investments in the Hydro Projects, and that there be an accounting for the use of the revenues collected from the hydro customers. (NS Comments 18-19).

Staff Analysis:

Authority staff notes that no party questions the reasonableness of adopting a "hybrid" capital cost recovery approach. As Dr. Larry Kolbe's Report in the Rate Modification Plan explained, the Original Cost ("OC") methodology is appropriate for the recovery of the Authority's new, debt-financed capital investments, while a different TOC-type methodology should be used to recover its existing, equity-financed capital investments. The Neighboring States only challenge certain aspects of the TOC methodology as applied by the Authority.

1. The New York Power Authority Owns the Equity in its Hydro Assets on Behalf of the People of the State of New York

There is no basis for the Neighboring States' remarkable claim that the Authority is not entitled to a return on its equity in the Hydro Projects. That claim seems to be based solely on the following argument:

> The Authority only has two sources of capital—debt and collections from ratepayers above its out-of-pocket costs. The Authority does not sell stock to raise equity capital and has no stockholders. It does not receive equity infusions from any third parties. Therefore, it does not have to earn a return on equity capital nor pay out any stock dividends. Its only source of what it calls "equity" capital is its ratepayers.

(NS Comments at 16). This amounts to a claim that the customers and not the Authority own the equity in the Hydro Projects. To the contrary, the legal owner of the hydroelectric projects always was and is the Authority, a corporate municipal instrumentality of the State of New York, PAL §1002, and the Authority is entitled to a return on its investment.

The Neighboring States never explain, let alone cite any supporting facts or any economic or legal authority, how the mere payment of their electricity bills magically translates into ownership of the project generating that electricity. It is true that the Authority does not issue stock. It is true that its existing equity consists of what a private firm would call "retained earnings," which represents money received from selling services to customers over the years. It is *not* true, as the Neighboring States suggest, that all revenues the Authority receives above out-of-pocket expenses is somehow owned by the customers who purchased the power. These revenues are not customer-supplied capital, much less assets owned by the customers, particularly out-of-state state customers who were most certainly not the primary intended beneficiaries of the Authority's generation assets.

Those revenues or earnings, whether considered capital or equity, are owned by the Authority as a fiduciary for the people of New York, who in 1931 chartered

NYPA as a public corporation to develop hydroelectricity for the benefit of the state. The Authority was and is free to use such revenues for any lawful corporate purpose, including reinvestment of the revenues to improve or expand the hydroelectric facilities. *See Auer II*, 125 Misc. 2d at 276.

The Hydro Projects were first constructed in the late 1950s and early 1960s with revenue bonds issued by the Authority. The bonds were neither guaranteed nor supported by the State. It was the Authority, not the State itself, which provided the only credit support for the bonds through its sales of power and energy. The power contracts did not require the customers to pay if power was not delivered. In short, the real risk associated with the projects was borne by the bondholders, not the customers. Nothing in this risk/reward equation suggests that the customers ever had rights to the equity that the projects generated.

By analogy, suppose a private developer financed a new auto plant using 100 percent debt secured only by the revenues from car sales and the credit of the developer. That developer is entitled to and does receive the new plant's earnings over its debt service costs. These earnings are the required reward for bearing the risk that even if something goes wrong with the plant, the developer still has the obligation to service the debt. If, like the Authority, the developer chooses to leave those earnings in the project to accumulate over time, they become retained earnings. Those retained earnings are the developer's equity. The buyers of the cars produced from the plant do not end up owning it just because it initially was financed 100 percent with debt. They get a car for their money, not a car plus part ownership of the plant.

The Authority's accumulated equity in its hydro investments is the same. The Authority's assets and revenues backed the debt used initially to build the hydro facilities. The Authority's customers receive electricity for their money. That is all they are entitled to under the law and their power contracts. The purchase of power does not entitle them to an equity stake in the assets used to provide those services, any more than a car buyer is entitled to part-ownership of a 100 percent debt-financed auto plant.

The Authority owns the equity in its hydro assets for the benefit of the people of the State, who created the Authority. This equity is not "customer contributed capital," and it would be inappropriate, and fundamentally unfair, to treat it as such.

2. <u>The Neighboring States Are Not Entitled to an Accounting for Equity Which They Do Not Own</u>

Based on the flawed assumption that the Neighboring States somehow own the Authority's revenues and assets, they go on to assert their right to inquire "how the capital contributed" by them has been or will be used by the Authority. (NS Comments at 18-19). As explained above, the customers of the Niagara and St. Lawrence-FDR projects did not contribute equity to the Authority. The bargain rates they paid bought a service. The rates did not buy part-ownership of the assets used to provide the service. Since customer-supplied equity equals zero, no accounting is required.

3. <u>Baseless Critiques of the Authority's TOC Methodology</u>

While the Neighboring States insist that they are not "now challenging" the TOC method, they do not accept that method and go on to say why, in their view, it may not be "appropriate" for future rate setting. (NS Comments at 15). Each of these criticisms is wide of the mark for, as explained below, use of the TOC method captures legitimate costs of producing the power purchased by the Neighboring States.

a. <u>TOC is an Economically Sound Method of Recovering Capital Costs</u>

The Neighboring States' challenge to TOC focuses on the absence of supporting "regulatory precedent" in the area of "cost-based wholesale electricity rates." (NS Comments at 14-15). The fact that TOC is a recently developed methodology does not mean that it is economically unjustified. In fact, in the 1980s, when FERC took a completely fresh look at regulating oil pipelines, it adopted a form of TOC in lieu of the old utility style OC method. *Williams Pipe Line Co.*, 31 FERC ¶ 61,377 (1985). Versions of TOC have also been recently employed in the United Kingdom and Australia, as those countries attempt to regulate industries which have just been privatized. *See, e.g.*, Australian Competition and Consumer Commission's "Draft Statement of Principles for the Regulation of Electricity Transmission Revenues," May 1999, www.accc.gov.au/electric/regulation.html. Equally important, the Authority's right to employ the TOC methodology (including an inflation component) is not only found in the *Auer* Settlement but also in the *Auer* Judgment decreed in that litigation which embodied the *Auer* Settlement.[16] That Judgment has guided the Authority's rate setting actions and accorded sizeable benefits to all preference customers, including the Neighboring States, over the years. In effect, then, the Neighboring States now hope to reaffirm that part of the *Auer* Judgment which favors them and disavow that portion which does not.

b. <u>The Authority's Cost of Equity Properly Includes an Inflation Component</u>

The Neighboring States suggest that, notwithstanding the teachings of *Auer*, the inflation portion of the Authority's TOC methodology "is not a component of the Authority's cost of capital." (NS Comments at 15). They are wrong.

The use of an inflation factor to recover capital costs is appropriate in all respects. It is a basic fact of financial economics that equity has a cost. No one would accept the risk of an equity investment without an expectation of a return adequate to justify that risk, and that expected rate of return is the cost of equity. Debt holders, too, require interest as compensation for supplying funds. Interest rates include compensation for the pure time value of money, the risk of default, and the inflationary effect on the purchasing power of the bond's promised interest payments and principal. Similarly, the cost of equity includes compensation for the

[16] *See* note 12 and accompanying text, *supra*.

impact of inflation as well as for the pure time value of money and for the other risks to which equity is exposed. The Authority's cost-based rates therefore appropriately embrace the cost of equity, including inflation compensation.

The inflation compensation in the *Auer* TOC approach thus covers a part of the cost of the equity provided by the Authority. It does not, as the Neighboring States insist, represent additional customer-contributed capital. What is more, the inflation component covers just a fraction of the Authority's full cost of equity. As a result of the *Auer* Judgment, the Authority does not charge its customers a "real" rate of return (*i.e.*, the cost of equity over and above compensation for inflation) on its equity that other utilities, whether regulated or not, collect from their customers.

Contrary to the Neighboring State's assertion, but for *Auer*, the Authority could have validly included in its cost of service a real rate of return. In New York there are no laws barring public entities from charging a real rate of return. In fact, Article 9 §1(f) of the New York State Constitution guarantees municipal power systems (such as the Authority's in-state preference customers) a fair return on their investment (*i.e.*, the equity in the system) over and above the costs of operation and maintenance and necessary and proper reserves; the customers of the systems must pay rates sufficient to provide the return. Federal courts have also acknowledged the propriety of a public power entity collecting a rate of return from its customers. While the City of Vernon, California is a non-jurisdictional public power utility like the Authority, its transmission revenue requirement was examined by the FERC in the context of its participation in the California Independent System Operator. Upon review of FERC's decision, the Court of Appeals, while remanding the case to FERC to determine the level of return, made clear that the City was entitled to a return:

> Regarding costs, "it has come to be well established that electrical rates should be based on the costs or providing service to the utility's customers, plus a just and fair return on equity." *Alabama Elec. Coop., Inc. v. FERC*, 684 F.2d 20, 27 (D.C. Cir. 1982).

Pacific Gas & Elec. Co. v. FERC, 306 F.3d 1112, 1120 (D.C. Cir. 2002).

c. <u>The TOC Method Does Not Result in an Overcollection of Capital Costs</u>

In this instance the Neighboring States speculate that "it is possible" that the inflation component of TOC allows the Authority to collect more monies ("extra capital") than necessary to replace its production facilities. They suggest this might amount to a form of prepayment for future service or facilities that will be used for future service. (NS Comments 17-18).

This speculation is misplaced. First, the Authority uses a construction cost index, not an index of general inflation, to calculate the inflation component of its TOC methodology. Second, the TOC approach is designed to return the original investment on an inflation-adjusted basis and not, as the Neighboring States assume, to replace the production capacity as originally built.

d. <u>The Relationship Between the Authority's Capital Cost Recovery Methods and the Negotiation of New Power Contracts</u>

The Neighboring States state that while they are forbearing from attacking the *Auer* Settlement and the use of the *Auer* TOC methods, such matters should be considered as part of the contract re-negotiations with the Authority and they request that the Authority acknowledge this. (NS Comments at 15, 19). This is not the proper forum to address the Neighboring States' desired agenda for contract negotiations. However, as noted in the above section addressing the treatment of ancillary services revenues, *supra*, the Authority must set cost-based rates for the Hydro Projects in a manner consistent with the *Auer* decisions and Judgment, by which it is legally bound. Thus, if cost-based rates are to be a subject of such future negotiations, the Neighboring States must know that the Authority is not free to set cost-based Hydro Project rates in any other manner other than that prescribed in that Judgment.

Recommendation:

It is recommended that the Capital Cost Recovery methods as explained by Dr. Kolbe and as employed by the Authority for more than 20 years be ratified and the modifications recommended by the Neighboring States be rejected.

C. Issue: Rate Design

Public Comments:

Several parties commented on the change in rate design. As explained in the Authority's Rate Modification Plan, the rate structure has not changed from the inception of the Hydro Projects–all increases have been recovered through the energy rate. MEUA states that, "A change…as currently presented may not be appropriate. A modification may be needed to mitigate the impact of a rate increase." (MEUA Statement at 2). More critical of the rate design change is NYSEG. NYSEG agrees with the Authority that fixed costs should be recovered through fixed rates, but claims that, "we could not determine from the information that was available…what the actual charges would be on a pure fixed–variable rate design." (NYSEG Letter at 2). They continue, "Additionally, the New York State Public Service Commission has generally permitted utilities only to move towards recovery of fixed costs in the fixed component of rates." *Id*. NYSEG then recommends that, "[t]o be more equitable and minimize the impact on all customers," the Authority allocate the cost increases equally between the demand and energy charges. *Id*. Submitting comments in favor of the Authority's proposal to recover the cost increases in the demand charge were Jamestown and the Power for Economic Prosperity Group ("PEP"), representing replacement power and expansion power customers. (Jamestown Letter at 1-2; PEP Letter at 1-2).

Staff Analysis:

NYSEG claims it could not determine what costs are truly fixed and variable to calculate a cost-based rate design. Page 20 of the Rate Modification Plan discusses the basic principles of cost classification into the demand/energy rate components. Generally speaking, fuel costs, purchased power and some O&M costs are allocable to the energy component. Since the Niagara/St. Lawrence facilities source of fuel is water, there are no fuel costs and purchased power costs are not part of the revenue requirement. It is not necessary to do an intensive study to conclude that the cost structure of the Hydro Projects is largely fixed and most costs should be classified as demand-related.

Over time, as costs rise, particularly the capital costs relating to the upgrades and modernization, it is no longer appropriate to recover these incremental costs through the energy rate. In consideration of NYSEG's well-founded and reasonable concerns about minimizing adverse customer impacts, the staff did not propose a one-step approach to purely demand-based rates, but struck a middle course. The compromise was to maintain the current energy rate of $4.92/MW-hour and allocate costs in excess of the $4.92/MW-hour to the demand charge. Staff believes this approach moves the rate design to more accurately reflect the cost structure while minimizing rate volatility. The Rate Modification Plan shows that the costs recovered through the energy rates are $99.6 million/year for the 2003-2006 period. Exh. NYPA-1, page 2 of 2, line 18. In 2003 and 2006, the total cost of service is projected to be $151.7 million and $185.8 million, respectively (line 14). Even with this modest shift in rate design, the energy rates will still recover the majority, 66% and 54%, of total costs for the 2003 and 2006 period.

Recommendation:

Staff acknowledges that there are two competing rate making goals. One is that the rate design should be reflective of the cost structure. In general, hydroelectric productions costs are largely fixed. The other principle is mitigation of adverse customer impacts. The proposed rate design moves modestly towards the proper classification of costs while minimizing customer impacts. The proposed rate design should be approved.

D. Issue: Post-retirement Benefits Other than Pensions

Public Comments:

The Neighboring States make a number of criticisms of the Authority's plan to begin accruing for Post-retirement Benefits Other than Pensions ("PBOPs") obligations and reflect such accrual in the R&D rates. First, they recommend that the implementation of any accrual be deferred until such time as the Government Accounting Standards Board ("GASB") officially acts to require this method. If the Authority proceeds with inclusion of accrual costs in the R&D rates, they recommend that the Authority extend the amortization period from 20 years to 30 years. (NS Comments at 12-13). Jamestown also expressed this concern about the amortization period at the Public Forum (Tr. 25:12-21), but did not file any written comments on this issue.

The Neighboring States also request that the Authority make periodic adjustments to the transition obligation (*i.e.*, the amount of deferred PBOPs expenses being recovered) to take into account changes to factors that were used in the original actuarial study. (NS Comments at 13). They request that the Authority perform quadrennial updates to the transition obligation and establish a formal process for customer review and input on any adjustments made. (NS Comments at 13; Tr. 30:24-25 -- 31:1-11).

Staff Analysis:

The Authority staff notes that no party questions the prudence of adopting accrual accounting for PBOPs costs. As explained in the Rate Modification Plan, it is a sound methodology that has passed muster in the federal courts, the FERC and the New York State Public Service Commission ("PSC"). The comments instead focus on the propriety of implementing the methodology now, and the length of the amortization period.

The Authority staff does not find the request to delay the implementation of the accrual method convincing. As explained in the Rate Modification Plan, prompt implementation of the accrual method is appropriate since the deferral would only increase the total PBOPs costs that need to be recovered. Rate Modification Plan at 16. For accounting purposes, the Authority has already adopted the accrual method for PBOPs obligations for calendar year 2002. The rate treatment for PBOPs costs should be the same as the accounting treatment to the extent possible, unless there is a compelling reason not to do so. No party has articulated a compelling reason to delay putting these costs in rates. Moreover, GASB has taken additional steps to solidify its position favoring adoption of accrual accounting for PBOPs by its issuance of the February 14, 2003 "Exposure Draft."[17] The Exposure Draft sets forth the proposed standard for accrual accounting, with comments due on April 30, 2003. Similar to previous GASB recommendations, the Exposure Draft encourages early implementation of accrual accounting. Exposure Draft at ¶33. Absent any good reason to delay the inclusion of PBOPs accrual costs in the preference rate, the Authority staff rejects the Neighboring States' arguments.

The Authority staff does not believe that extending the amortization period from 20 to 30 years is appropriate. For accounting purposes the Authority has already adopted a 20-year amortization, and as stated, there is no compelling reason for rate treatment to differ from accounting treatment. As the Authority staff previously explained, a 20-year amortization period was endorsed by FERC and the PSC. The recent GASB Exposure Draft sets out a 10-year minimum and 30-year maximum amortization period. *Id.* at ¶ 11(f). It is self-evident that 20 years is reasonable.

Finally, the Authority staff agrees that periodic updates to the transition obligation are reasonable. The GASB Exposure Draft recommends an actuarial review no

[17] Exposure Draft, Proposed Statement of the Governmental Accounting Standards Board, Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (February 14, 2003) ("Exposure Draft").

less than biennially. *Id.* at ¶ 10. Thus, under the proposed standard, the Authority would be obligated to make such adjustments at a greater frequency than the quadrennial review requested by the Neighboring States. Any changes to the transition obligation that result will be reported in the Authority's financial reports, which are available to the public.

Recommendation:

The Authority staff recommends that PBOP accrual costs be included in the R&D rates beginning with the 2003 rate year. The staff further recommends that the 20-year amortization period be retained and that the transition obligation be reviewed periodically, consistent with the final standard adopted by GASB.

E. Issue: Benefits of Niagara and St. Lawrence-FDR Upgrades

Public Comments:

The Neighboring States claim that the preference customers are not receiving the benefits of the increased capacity that these upgrades would produce. They recommend that the capital costs of the upgrades be capitalized during the entire upgrade process and that those costs only be included in the R&D rates to the extent that additional capacity is made available to the R&D customers. They contend that if no additional capacity is allocated to the preference customers, then either the costs associated with the upgrades be excluded from the R&D rates or the revenues from additional capacity sales be included as a revenue credit. (NS Comments at 19-21).

Staff Analysis:

The Neighboring States' statement that they receive no benefits from the upgrade work at the Hydro Projects overlooks the real benefits that all R&D customers receive from the upgrades. In fact, they enjoy increased reliability of operation and lower costs of maintenance. The generation, transformation and control equipment at the Hydro Projects was approximately thirty-four years old at the start of the upgrade process and some of the plant equipment will be over fifty-years old by the time work on the last unit is begun. All of this equipment is based on 1950s' design and manufacturing technology for which spare parts are increasingly hard to find or expensive to custom manufacture. With the use of twenty-first century design and manufacturing technology, increased efficiency and longevity of operation is also achieved.

The upgrade process at the Hydro Projects is done on a unit-by-unit basis with each unit outage taking less than a year. Upon completion of the outage, the upgraded unit is placed back into service. The increased reliability and efficiency becomes immediately available to all Hydro Project customers. As part of the upgrade process, new stainless steel turbine runners and transformers are being installed. After about forty years of operations, turbine runners become increasingly subject to fatigue, cracking and failure, while heat damage causes insulation in transformers to deteriorate. Replacing the current forty-year old turbine runners with new runners eliminates the risk of catastrophic failure and using stainless steel greatly reduces cavitation damage. Less damage reduces down time and maintenance costs during periodic inspections and overhauls. Advanced design will also increase the efficiency of the turbines allowing a few additional megawatts to be produced. Likewise, new improved transformers eliminate the risk of insulation failure while further reducing transformation losses. New control and auxiliary equipment will provide additional flexibility of operation and reduced labor cost through automated operation and remote monitoring.

The Authority staff sees no merit in the Neighboring States' proposal to capitalize the costs until the entire upgrade process is completed. Once an upgraded unit is placed back in service, all customers begin to immediately benefit from the increased reliability and reduced maintenance costs. To date, the capital cost of upgraded units that have been completed has been included in the annual hydroelectric cost of service and computation of the Rate Stabilization Reserve ("RSR"). Likewise, all sales of energy, including any additional energy from the more efficient newer units, are included in the cost of service. To the extent that additional energy is generated through increased efficiencies, the benefits of such increased generation will be flowed through the RSR to the customers.

The Authority will perform studies of the increased capacity that may be available from the Hydro Projects when the upgrades are completed. To the extent that the increased efficiency produces additional firm capacity, that additional capacity would be made available to preference customers in accordance with the NRA and the Niagara Project license. In the meantime, if there are short-term sales of capacity (*e.g.* for a capability period via the NYISO's capacity auction) above the base level of capacity sales used in the hydroelectric cost-of-service study (*see* Rate Modification Plan, Exh. NYPA-1, page 2 of 2, line 15) the Authority staff proposes that such sales be credited to the RSR. This crediting will be done in addition to the usual RSR credits the Authority makes for energy sales made from the Hydro Projects above the base level reflected in the cost of service. *See id.*, line 20.

Recommendation:

The Authority staff recommends that the capital costs of the Niagara and St. Lawrence-FDR upgrades continue to be rolled into the R&D rates. The staff further recommends that the Authority perform studies of the increased firm capacity that may be available from the Hydro Projects when the upgrades are completed.

F. Issue: Commitment to Control Hydroelectric Project Costs

Public Comments:

MEUA expressed concerns about cost control at the Hydro Projects, noting that

> it is clear that just like the MEUA systems, NYPA has a public duty to control the cost of providing that power. Whether it is in relicensing the Niagara Project or instituting new rates, we have an obligation to control costs. NYPA and MEUA are partners in that duty.

(MEUA Statement at 1). No other party commented on this issue.

Staff Analysis:

As a public entity, the Authority strives to control its costs by balancing the need to maintain and upgrade its generating and transmission projects with the provision of power to its preference customers at the lowest possible rate. The Authority and its customers have a mutual interest in cost containment.

With respect to any financial obligations in connection with the relicensing of the Niagara and St. Lawrence projects, the Authority's goal is a balanced approach that takes full account of its obligations to its bondholders and its concerns for the environment and the local communities, but also recognizes the significance of low-cost Niagara Project power to its customers.

Recommendation:

The Authority agrees with the position expressed by MEUA. The Authority should continue its efforts to control costs, wherever possible, while also maintaining and upgrading its generating and transmission assets. This will ensure that the Authority reliably and efficiently provides low cost power to its preference customers.

G. Issue: Rate Stabilization Reserve Deadband

Public Comments:

The Neighboring States and Jamestown recommend that the Authority maintain the current RSR deadband of +/- $25 million, within which no credit or surcharge would be applied, and not reduce it to +/-$15 million as proposed in the Rate Modification Plan. These parties raise concerns that the narrower deadband would expose them to rate volatility. Current low water flow conditions, which may not return to normal any time soon, contribute to this concern. (NS Comments at 21; Jamestown Letter at 2; Tr. 24:2-18). The Neighboring States also request that the RSR calculation be made available to customers for their review. (NS Comments at 22).

Staff Analysis:

The Authority staff finds merit in the comments on the size of the bandwidth due to current low flow conditions.

The RSR was established in 1987 with a range of +/- $25 million. It was designed to capture over or under recovery of costs that arise from the difference between the billed charges and the actual costs of production which vary with water flow conditions. The effect of the RSR is to dampen the effect of an under or over recovery that would otherwise need to be reflected in rate adjustments. The RSR balances are recorded in April of each year when the Authority staff calculates its annual Hydro Cost of Service.

Authority staff had initially recommended that the range be reduced from +/- $25 million to +/-$15 million for the 2003-06 rate years since the proposed rate design would collect more of the hydro R&D costs through the demand charge and therefore reduce the variability in future over/under recoveries. While staff believes that the narrower deadband with the proposed rate design would not lead to more frequent rate changes, retention of the current deadband will not materially affect the Authority's financial position. In addition, there is some merit to the contention that because low hydrologic flows continue to be forecasted, narrowing the RSR deadband would put the customers at risk of a surcharge. This could be the case despite a revised rate design that is less sensitive to swings in hydrologic flows.

With respect to the Neighboring States' request for information regarding the RSR calculations, the annual Hydro Cost of Service is and will continue to be made available to customers upon request.

Recommendation:

Staff recommends that the current deadband range of +/-$25 million be retained.

H. Issue: Miscellaneous Capital Cost-Related Issues

NYSEG raises two separate but related concerns on capital costs which are discussed in subsections 1 and 2 below.

1. <u>Capital Costs at St. Lawrence-FDR Project</u>

Public Comments:

The first issue relates to a data request regarding an O&M increase of $11.7 million between the test year and 2003 as shown in the Rate Modification Plan, Exh. NYPA-1, page 1 of 2, line 1. In response to the data request, Authority staff provided a table that identifies four components of the increase. The largest two were payroll and benefits ($4.4 million) and maintenance ($5.0 million). The text supporting the table reads, "With respect to the St. Lawrence Project, the on-site hydro production expenses increased due to more personnel assigned to the Life Extension and Modernization." NYSEG comments that, "The inclusion of expenditures for capital projects in current rates is contrary to generally accepted accounting principles as they are applied to the electric utility industry." (NYSEG Letter at 2).

Staff Analysis:

NYPA agrees with NYSEG's statement regarding the treatment of capital-related expenses. Indeed, the Authority's treatment of labor expenses relating to the St. Lawrence modernization is consistent with this approach. The labor costs relating to the upgrades are indeed capitalized. The confusion stems from the data response which mistakenly described these O&M costs as capital-related. A more accurate response should have made clear that these O&M costs could be expensed. An improved data response would have said that the on-site hydro expenses increased "due to increased personnel and benefits stemming from wage and benefit escalations, in addition to increased maintenance tasks unrelated to the modernization."

Recommendation:

The issue is resolved due to the above clarification showing that labor expenses at the St. Lawrence Project which were not related to modernization of the project, were properly included as O&M costs.

2. <u>Principal Payments of White Plains Office Debt</u>

Public Comments:

The second issue raised by NYSEG is its criticism of the inclusion of the principal payments on the debt for the White Plains office building in the hydro cost of service. It notes that because of the repayment schedule for the debt principal, the cost of service for the White Plains office is higher in the short-term than it would be otherwise and represents " . . . an inequitable allocation of benefits to future customers at the expense of current customers." (NYSEG Letter at 3). NYSEG further argues that including such debt principal payments in the cost of service is contrary to "standard regulatory ratemaking principles" which would dictate that costs be recovered over the longer service life of the asset rather than over the period of debt repayments. (NYSEG Letter at 3).

Staff Analysis:

The White Plains Headquarters was purchased in 1991 and a portion of the investment is debt-financed. The portion that is equity-financed is recovered via TOC. For the portion financed by debt, the Authority has elected to recover in rates the principal portion of the debt instead of depreciation. The debt has been refinanced twice over the years to take advantage of favorable interest rates and the current debt balance has a maturity date of 2008. The weighted average interest rate for the current debt is 4.9%.

By including the debt payments in the cost of service, the revenue requirement is identical to the expenses the Authority incurs in owning the building. The stream of debt payments occurs from 1991-2008, or 18 years, represents a real cash expense for the Authority, and therefore, should be reflected in the cost-based rates.

It is true that the Authority's capital recovery approach for its White Plains Headquarters is in some ways non-standard as compared to the cost-of-service treatment for an investor-owned utility. However, the preference rate customers benefit from this methodology. First, unlike an investor-owned utility, the Authority does not include a profit component in its capital costs. As already explained, the Authority uses a TOC method which does not charge a real return to ratepayers. In addition, the Authority's cost of debt is very low compared to a typical investor-owned utility. Second, the Authority's approach differs from the method suggested by NYSEG by changing only the timing of the recovery of the capital costs. On a net present value basis, the costs recovered would be the same, whether it is recovered over a shorter period or a longer period.

Recommendation:

Because the refinancing of the White Plains office debt reduced the Authority's total costs, and recovery of principal payments is only a timing issue, Authority staff recommends the continued recovery of these debt payments in the R&D rates, as proposed.

I. Issue: Review and Comment Period for Proposed Rate Plan

Public Comments:

MEUA and Jamestown expressed concerns over the time allotted for review of the Authority's proposal. MEUA commented that there was not much time to review this matter which "put intense time pressure on our outside analysts." They also noted that due to "NYPA Staff's cooperation, we are getting all the information we requested and will be able to respond." (MEUA Statement at 2). While also acknowledging the cooperation of the Authority staff in responding to data requests, Jamestown stated at the Public Forum that "there has not been enough time from the announcement of the proposed increase to the May 1 implementation date to fully develop our analysis at this time." (Tr. 19:19-25 -- 20:1-9). Jamestown requested that the rates be delayed or implemented on an interim basis, and that the Authority allow more time the next time it raises rates. (Tr. 20:9-18). Jamestown did not reiterate this concern in its written comments.

In their written comments, the Neighboring States requested that the Authority distribute to all parties the comments it received and allow 10 business days for reply comments. (NS Comments at 3).

Staff Analysis:

Staff believes that there was sufficient time for the public to consider the proposed rates.

As noted earlier in Part I, the Authority promptly sent copies to its customers of its proposal immediately following the January 28, 2003 Trustee action, filed all appropriate notices in the State Register, made itself available to meet or teleconference with all customers to discuss the proposal, and responded to detailed data requests from Jamestown, MEUA, the Coop Systems, NYSEG and representatives of the Neighboring States.

While Staff understands that the parties faced many complex issues in this proceeding, there has probably never been a time where parties in a rate proceeding have felt that sufficient time has been allowed. Parties always feel that more time is needed. The time provided for customer review in this proceeding was adequate, as evidenced by the volume of data requests made and answered, and by the detailed comments received. It bears noting that the time frame for this rate proposal closely mirrors that of the last rate action in 1992. At that time, the Authority's Trustees considered the proposed action to revise hydroelectric preference rates at their January meeting. Final action to approve the rate revision took place at the April meeting.

Likewise, it was not necessary or appropriate to grant the Neighboring States' request to receive and respond to others parties' comments. First, the Authority followed the statutory requirement to allow a 45-day comment period which extended from February 19, 2003 (the day the proposed rates were noticed in the State Register) to April 7, 2003. As noted, all affected customers were sent a copy of the Report on or about January 28, 2003, which afforded the Neighboring States a review period well in excess of 45 days. Second, there is no state law requirement to entertain reply, or in this case, supplemental, comments. *See* N.Y. State Administrative Procedures Act § 202(1) (McKinney 1995 & Supp. 2003).

Finally, this is a legislative-type administrative rulemaking, not an adversarial proceeding. The purpose of seeking public comments is to inform the Trustees about the issues of concern. Another round of comments would be of limited use to the Trustees in rendering their final decision in this matter. In addition, the Neighboring States provided the most extensive comments received. They have not explained what purpose would be served by responding to others' comments. Indeed, at the March 18th Public Forum, the Neighboring States praised Authority staff for its cooperation in supplying the information they requested. (Tr. 27:13-17).

Recommendation:

For the reasons stated, Authority staff believes that there was sufficient time for customer review and comment of its rate plan, and does not recommend that the implementation of the rates be delayed.

J. Issue: Implementation of Authority Refund

Public Comments:

No public comments were received.

Staff Analysis:

Authority staff intends to distribute to each of its preference customers their share of the estimated $4.5 million refund in lump sums. Staff suggested this in informal meetings with customers, and has not received any objections. Authority staff would also entertain any reasonable request by full requirements municipal customers regulated by the Authority to distribute the refunds back to end-users.

Recommendation:

Staff recommends that the Authority distribute refunds to the preference customers in a lump sum and entertain reasonable requests from the full requirements systems for distribution of refunds to the end-users.

NEW YORK POWER AUTHORITY
HYDROELECTRIC PROJECTS
FINAL PRODUCTION COST OF SERVICE

($000)

Line	Description	Actual 2001	Actual Test Year (10/01-9/02)	2003	2004	2005	2006
1	Operations & Maintenance/A&G	44,657	49,571	61,256	59,942	62,280	64,457
2	Amortized Roadwork	4,080	4,157	4,288	4,395	4,505	4,617
3	Subtotal O&M/A&G (line 1 + line 2)	48,737	53,728	65,544	64,337	66,785	69,074
5	Shared Services	41,139	32,212	33,137	33,871	35,037	36,229
6	Research & Development	4,500	2,700	3,363	4,245	4,330	4,417
7	Projects' Studies Debt Service	3,737	2,703	2,413	2,273	2,327	2,012
8	White Plains Office Debt Service	2,336	1,433	970	1,308	4,212	4,305
9	Subtotal Indirect Overheads (sum lines 5-8)	51,712	39,048	39,883	41,698	45,906	46,963
10	St. Law. Relicensing, expensed			2,000	2,000	2,000	2,000
11	Retirement Health Costs (Accrued)		-	9,978	10,370	10,786	11,234
12	Capital Costs						
13	Existing Plant						
14	Depreciation	24,647	23,874	23,114	22,505	21,897	21,289
15	Inflation	18,583	15,532	16,235	16,766	17,268	17,740
16	New Plant						
17	Depreciation, debt funded		350	838	5,618	7,430	8,718
18	Interest on debt		730	1,854	8,400	14,176	19,871
19	Depreciation, cash funded		755	2,646	482	667	1,425
20	Inflation		19	90	102	119	156
21	Subtotal Capital Costs (sum lines 14-20)	43,230	41,260	44,777	53,873	61,557	69,199
22	Total Cost of Service (sum lines 3,9,10,11,21)	143,679	134,036	162,181	172,278	187,033	198,470
23	O&M Cost of Service (line 22 - line 21)		92,776	117,404	118,405	125,476	129,271

NEW YORK POWER AUTHORITY
HYDROELECTRIC PROJECTS
FINAL PRODUCTION COST OF SERVICE
($000)

Line	Description		Actual 2001	Actual Test Year (10/01-9/02)	2003	2004	2005	2006
1	Total Cost of Service	($000)	143,679	134,036	162,181	172,278	187,033	198,470
2	Credits for ancillary services	($000)						
3	Black Start, O&M			44	46	47	48	49
4	Voltage Control, O&M			145	150	154	157	161
5	Remaining O&M (page 1, line 23 - (line 3+line 4)			92,587	117,208	118,204	125,271	129,061
6	Operating Reserves, O&M			5.52%	5.37%	5.28%	5.22%	5.16%
7	Regulation, O&M			0.78%	0.76%	0.75%	0.74%	0.73%
8	Subtotal OR, Reg. O&M			6.30%	6.13%	6.03%	5.96%	5.89%
9	Op. Res.+ Reg. O&M credit (line 8 * line 5)	($000)		5,833	7,185	7,128	7,466	7,602
10	Capital Reductions							
11	All ancillary services			7.43%	7.44%	7.34%	7.33%	7.33%
12	Subtotal capital reductions (page 1, line 21 * line 11)	($000)		3,066	3,331	3,954	4,512	5,072
13	Total Ancillary Credits (sum lines 3,4,9,12)	($000)		9,088	10,712	11,283	12,183	12,884
14	Adjusted Cost of Service (line 1 - line 13)	($000)	143,679	124,948	151,469	160,995	174,850	185,586
15	Billing Demand	MW	35,172	35,345	35,854	35,927	36,000	36,073
16	Billing Demand Revenues	($000)	35,172	35,345	51,849	61,375	75,230	85,966
17	Billed demand Rate (line 16 / line 15)	$/kW/m	1.00	1.00	1.45	1.71	2.09	2.38
18	Total Costs less demand (line 14 - line 16)	($000)	108,507	89,603	99,620	99,620	99,620	99,620
19	LTA Generation	GWh	20,258	20,251	20,248	20,248	20,248	20,248
20	Annual Generation	GWh	17,237	19,566	17,830	19,390	19,560	20,223
21	Cost Based Rate @ LTA	$/MWh	5.36	4.42	4.92	4.92	4.92	4.92
22	Cost Based Rate @ annual (line 18 / line 20)	$/MWh	6.30	4.58	5.59	5.14	5.09	4.93
23	Billed actual/Proposed Rates							
24	Energy Rate							
25	January - April	$/MWh	4.92	4.92	4.92	4.92	4.92	4.92
26	May - December	$/MWh	4.92	4.92	4.92	4.92	4.92	4.92
27	Demand Charges							
28	January - April	$/kW/mo	1.00	1.00	1.00	1.45	1.71	2.09
29	May - December	$/kW/mo	1.00	1.00	1.45	1.71	2.09	2.38