

Executive Summary

The Electric Discount and Energy Competition Act (EDECA), signed by Governor Whitman in 1999, dramatically changed New Jersey's electricity and gas markets. The Act partially deregulated both markets with the end goal of creating competition, giving consumers more choice, and reducing prices. Among its many provisions, EDECA mandated electricity rate reductions of 10% and capped rates for four years.

The implementation of EDECA, however, has not gone as its supporters expected. Competition has not developed, consumers have little more choice than they had before EDECA, and wholesale energy prices have risen sharply. The implementation of EDECA has also led to the accumulation of a projected \$1 billion in deferred balances.

Deferred balances are losses accumulated by utilities when the cost of purchasing electricity exceeds the capped rates they are allowed to charge customers. EDECA requires that ratepayers reimburse utilities "on a full and timely basis all reasonable and prudently incurred" deferred balances.¹ Utilities are requesting rate increases to begin recovering deferred balances, with interest, in August 2003 when rate caps expire.

Therefore, deferred balances are funds that are borrowed in order to implement rate cuts that do not reflect the true market price of electricity. Ratepayers have essentially been buying electricity on credit for four years, while EDECA-mandated statements on their utility bills have been informing them how much money they were saving because of rate caps.

Governor James E. McGreevey created the Deferred Balances Task Force to examine the issue of deferred balances and to report to him with findings and recommendations. Highlights of the Task Force's findings include:

- No other state in the nation has mandated inflexible rate caps for as long as four years and required ratepayers to pay back deferred balances, including interest costs. Consequently, no other state has a deferred balance debt near as large as New Jersey's.
- Utility efforts to prevent the accumulation of deferred balances have been widely divergent. Although ratepayers have realized savings under rate caps, the average Conectiv residential customer will now be responsible for approximately \$171 in deferred balance debt, the average JCP&L residential customer \$328, and the average Rockland Electric residential customer \$794 (all estimates are before interest payments). PSE&G is not expected to have deferred balances.
- The Board of Public Utilities (BPU), under previous leadership, aggravated the deferred balance totals by expanding and accelerating rate cuts. In addition, despite early and consistent warnings about a growing deferred balances problem, the Board refused to grant requested relief to utilities with mounting deferred balances.

¹ N.J.S.A. C.48:3-57 9(e)

- Important questions remain unanswered about why utility efforts to mitigate deferred balances have not been sufficient to avoid the accumulation of nearly \$1 billion in deferred balances. These questions include:
 - Did utilities make reasonable decisions about purchasing power in the deregulated market?
 - Why haven't more over-priced power contracts been renegotiated in order to reduce deferred balances?
 - Why weren't energy efficiency and conservation programs relied upon more to reduce power usage and, consequently, deferred balances?

Task Force Recommendations

After examining this issue, the Task Force offers the following recommendations for addressing the issue of deferred balances:

- 1) **Sign Senate Bill 869** – This bill would allow, but not require, the BPU to authorize the securitization of portions of the deferred balance debt, giving the Board another tool to help ease the impact of deferred balances on ratepayers. Although securitization may mean ratepayers are responsible for paying debts over a longer period of time, it could help mitigate the immediate impact on rates. In addition, S-869 contains restrictions and safeguards that would limit the use of securitization to assure that it benefits ratepayers.
- 2) **Apply strong consumer protections** – The Task Force strongly supports consumer protections to ensure that the burden of proof for recovering deferred balances is placed squarely on the utility companies. These protections include the requirement of full evidentiary hearings, participation by the Ratepayer Advocate and other interested parties in the hearing process, and an independent audit of utilities' deferred balances. At Governor McGreevey's request, the BPU has proposed all of the above measures. The Task Force applauds these efforts and urges that they be implemented properly, and that strict scrutiny be applied to utilities' claims of deferred balances.
- 3) **Aggressively mitigate further accumulation of deferred balances** – The BPU should continue to work with utilities to employ aggressive mitigation tactics that will slow the accumulation of deferred balances over the next year, before rate caps expire. Principal among these efforts should be a renewed focus on energy efficiency and conservation, as well as the continued restructuring of over-priced power contracts.
- 4) **Mandate bill inserts to educate consumers about deferred balances** – The Task Force recommends the inclusion of a Board Secretary-approved insert in each utility bill explaining the issue of deferred balances to consumers. Ratepayers deserve information about deferred balances and their potential impact on rates, just as they were notified of rate decreases during the first four years of EDECA. Consumers have a right to know that under EDECA they have not benefited from true rate reductions; rather, they have been purchasing electricity on credit, and it is now time

to repay the loan, with interest. This information will help consumers anticipate their future electric costs so that they can plan accordingly.

- 5) **Examine broader changes in EDECA and its implementation** – Deferred balances are just one part of a deregulation effort that has, thus far, failed to live up to expectations. The Task Force urges the Governor and his administration to examine whether changes in EDECA and the electricity market would facilitate real retail competition and better protect and promote the interests of consumers.

I. Introduction

On July 31, 2002, Governor McGreevey signed Executive Order No. 25 creating the Deferred Balances Task Force. The Task Force was charged with examining the deferred balances that electric utility companies have accumulated since the passage of the Electric Discount and Energy Competition Act (EDECA) in 1999. The Order states that the Task Force will issue a report to the Governor, before the Legislature reconvenes, that will “address the reasons why the deferred balances were accumulated, what mitigation steps utilities took to reduce deferred balances and how they ought to be addressed to best protect the interests of ratepayers, including an evaluation of the merits of securitizing deferred balances.” This report is a fulfillment of this charge.

II. Processes and Methodology

The Governor created the Deferred Balances Task Force to educate himself and the public on the issue of deferred balances and to solicit policy recommendations. The Governor instructed the Task Force to report to him before he took action on Senate Bill 869, which would allow the Board of Public Utilities (BPU) to authorize the securitization of deferred balances. Under the requirements of the State Constitution, Governor McGreevey must take action on S-869 by the time the Legislature reconvenes in September.

Task Force members utilized a number of resources in researching and analyzing this issue. Information was solicited by distributing a detailed questionnaire to all relevant constituencies, including utilities, wholesale power generators, industry experts, consumer groups, business groups and legislators (*see Appendix 2 for complete list of questions and respondents; questionnaire responses can be found at www.state.nj.us/deferredbalances*). Questionnaire responses were followed up with further requests for information, both by phone and in writing. The Task Force also utilized the expertise of economists and energy experts from the BPU, as well as the unique mix of perspectives and expertise of Task Force members (*see Appendix 1 for biographies of Task Force members*).

In answering the questions posed by the Executive Order, the Task Force has been mindful not to duplicate the work of two other bodies addressing deferred balances. First, the New Jersey Legislature has held several hearings that have addressed this issue, most recently with regard to S-869.² It is not our intent to duplicate the work of the Legislature in examining these issues. Instead, the Task Force aims to draw from these past investigations and expand on them to provide the Governor and New Jersey citizens with a broad and comprehensive examination of the deferred balances issue as it stands three years after EDECA’s implementation.

² Hearings that address deferred balances include those held by the New Jersey State Senate Economic Growth, Agriculture and Tourism Committee on February 7, 2001, March 8, 2001, and March 26, 2002.

Second, the Task Force is mindful of the fact that the BPU is statutorily mandated to engage in a thorough investigation of each utility's deferred balances. Such detailed analyses are outside the scope of the Task Force's charge. Instead, the Task Force intends to provide an overview of the issue by relying on data and expertise from the BPU, utilities, and outside experts.

The views expressed in this report represent a consensus view among members attempting to complete the Task Force's charge. The views expressed in this report, however, do not necessarily represent the exact or official positions of each individual and organization that comprises the Task Force.

III. Background on Deferred Balances and Energy Deregulation in New Jersey

What are the main provisions of EDECA?

On February 9, 1999, Governor Christine Todd Whitman signed EDECA into law. The goal of the Act was to create competition in the wholesale and retail electricity and gas generation markets, allowing customers to shop for the cheapest generation source. Competition was intended to drive down prices, improve service, and give consumers more choices. To achieve these goals, EDECA provided the following:

- Utilities – fully regulated companies that own and operate the electric distribution lines that bring energy to consumers – are required to either divest their generation capacity, or move the generation portion of their business to a separate entity. Utility companies remain fully regulated monopoly providers of energy distribution. The generation and supply of electricity, however, is now an open and generally unregulated market where consumers can shop for their preferred supplier energy.
- Utilities, however, must still provide some energy supply services during a transitional period required under EDECA. Utilities are responsible for providing such service to customers who have not chosen alternative supplier of electricity. This service is called Basic Generation Service (BGS) and utilities will provide it until the BPU decides otherwise. Because under EDECA utility companies no longer own and operate generation facilities, to provide BGS utilities must buy electricity on the wholesale market and resell it to their retail customers.
- Utilities are required to “unbundle” their rate schedules into discrete categories, including at a minimum “customer account services and charges, distribution and transmission services and charges, and generation services and charges.”³ Consumer bills are required to separately list generation costs and distribution costs, allowing customers to compare prices of different retail suppliers of generation services.
- EDECA mandated that the BPU impose aggregate rate reductions for electric utilities of at least 5% upon implementation of the Act and at least 10% by the beginning of the fourth year of deregulation. The BPU can permit distribution of these aggregate rate reductions to any portion of the utility bill. These rate

³ N.J.S.A. C.48:3-52 4(a)

- reductions, which are imposed until August 2003, are based on the rate levels as of April 1997
- EDECA guarantees utilities “the opportunity to recover above-market power generation and supply costs and other reasonably incurred costs associated with the restructuring of the electric industry in New Jersey.”⁴ This means utilities can recover from ratepayers costs that were ‘stranded’ or are now unrecoverable as a result of deregulation, including interest, as well as unrecovered costs from providing BGS.
 - EDECA delegates to the BPU the responsibility of deciding most of the terms under which deregulation would be implemented. After evidentiary hearings, the BPU established the unbundled rates for each utility, decided the appropriate level of stranded cost recovery, and determined the appropriate mechanism for the recovery of the cost of providing BGS.

What are deferred balances?

Deferred balances are losses accumulated by utilities when the cost of purchasing wholesale electricity exceeds the capped retail rates they are allowed to charge customers. Essentially, deferred balances are funds that are borrowed in order to implement rate cuts that do not reflect the true market conditions for electricity. Deferred balances may also include losses incurred by utilities in administering programs that are funded through customers’ energy rates.⁵ Such programs include EDECA-mandated energy conservation programs, and a public education campaign to educate citizens about deregulation.⁶ The two key provisions in EDECA that cause deferred balances are the imposition of inflexible rate caps for four years and the guarantee that utilities can eventually recover reasonably incurred costs from ratepayers.

Deferred balances are not the only costs that are passed on to ratepayers under EDECA. As stated earlier, ratepayers are also paying for significant amounts of ‘stranded costs,’ or utility expenses that were deemed no longer recoverable in a deregulated market, such as unrecovered investments in power plants. Deferred balances are different from stranded costs in two principal ways: 1) whereas stranded investments are based primarily on decisions made prior to EDECA, deferred balances are, generally speaking, costs incurred since the enactment of EDECA for providing BGS or running EDECA-mandated programs, and 2) unlike stranded costs, ratepayers do not begin to repay deferred balances until after a four year delay, during which interest costs are accruing.

How will deferred balances be paid for?

By law, ratepayers must pay for deferred balances. EDECA provides that utilities “shall be permitted to recover...on a full and timely basis all reasonable and prudently incurred

⁴ N.J.S.A. C.48:3-50 2(c)(4)

⁵ See Appendix #6 for a more technical account of deferred balances and related issues; this account was submitted to the Task Force by the BPU.

⁶ The funding for energy conservation programs were already included in utilities’ rates prior to EDECA.

costs incurred in the provision of...basic generation service.”⁷ This statutory language has been widely interpreted to mean that when the rate caps expire on August 1, 2003, the BPU will approve rate increases so utilities can begin to recover these balances. Thus, under EDECA, as long as the BPU finds these costs “reasonable and prudently incurred,” ratepayers must repay utilities, including interest, for excess costs incurred in purchasing wholesale power to provide BGS.⁸

By August 30, 2002, utilities will have filed deferred balance rate increase requests with the BPU (*see pg. 11 for details of these filings*). The BPU will carefully examine these proposed schedules for recovering deferred balances to determine whether costs were reasonably incurred and the manner in which eligible costs should be recovered.

EDECA does not explicitly authorize the securitization of deferred balances. Securitization is a method of financing debt by issuing bonds that are ‘secured’ by the commitment of specific assets or revenue streams. In this case, utilities would issue bonds that are secured by the irrevocable commitment that they would be paid back through ratepayer charges. Because they are low-risk investments, such bonds would likely have relatively low interest rates. Legislation pending the Governor’s approval (S-869) would give the BPU the explicit authorization to consider and grant utility requests to securitize deferred balances incurred while providing BGS.

Why are deferred balances a problem for New Jersey ratepayers?

For both regulated and unregulated businesses, deferring costs is not a unique financing technique. The BPU has authorized utilities to defer costs in the past. In this particular case, deferring costs has had a decidedly positive benefit, namely, temporarily insulating New Jersey consumers from rapidly rising fuel costs and reducing retail electricity rates. There are several reasons, however, why deferred balances as they are applied under EDECA are problematic.

The first concern is the magnitude of these deferred balances and the impact they will have on electricity rates. Three utilities are expected to amass nearly \$1 billion in deferred balances over a four-year period, far more than almost anyone expected when EDECA was enacted. This raises serious questions as to how these debts were incurred, and whether they could have been avoided. Such questions are even more important to address when ratepayers, by law, must bear the cost.

Second, New Jersey ratepayers will soon likely be burdened with a nearly \$1 billion deferred balance charges that most neither asked for, nor were aware was accruing. In fact, EDECA requires that each customer’s bill “shall indicate the dollar amount of the difference between what the customer’s total charges would have been without the

⁷ N.J.S.A. C.48:3-57 9(e)

⁸ It was officially an order from the BPU that instructed utilities to defer these balances; however, the combination of provisions required by EDECA, such as rate caps and the mandated provision of BGS, leave essentially no other option but to instruct utilities to defer the costs of providing BGS. This deferral provision was appealed to the New Jersey Supreme Court, which found, in 2000, that such treatment was appropriate, reasonable and consistent with the provisions of EDECA.

reduction and the total charges in that bill,” but does not require that customers be made aware of mounting deferred balances.⁹ In other words, EDECA mandates that utilities notify ratepayers of what the CEO of one New Jersey utility called “a false sense of savings,” but requires no corresponding effort to alert customers of the mounting debt they were being forced to accumulate and would be required to pay back with interest.¹⁰ As a result, most consumers will not expect, nor have planned for, the likely substantial rate increases needed to pay for deferred balances.

Third, deferred balances under EDECA remove positive market incentives for both consumers and utilities. For consumers, because their rates have not reflected the true market cost of electricity, they lack the proper price signals to make informed decisions about their level of electricity consumption. For utilities, the natural market incentives to constrain costs are diminished because, by law, they have assurances that ratepayers will pay their excess costs.

Finally, the rationale behind deferring these costs needs to be examined further. Consumers will be paying interest on these deferred balances for years, as much as an estimated \$250 million depending on how they are financed, which raises the question of why rate decreases were implemented in the first place if consumers were just going to be required to pay for the rate cuts years later.¹¹

What is the history of electricity deregulation and the deferred balances debate?

The foundation for EDECA was laid by a series of reports issued between 1995 and 1997 by Governor Whitman and the BPU under then President Herbert Tate. These reports (*New Jersey Energy Master Plan Report, Phases I and II*, and *Restructuring the Electric Power Industry in New Jersey – Findings and Recommendations*) presented policy proposals for transitioning the state’s natural gas and electric power industry from the traditional rate regulated industry it had been for over 80 years to an unregulated industry guided by market forces. Most of the core policy components of EDECA were contained in these reports.

The legislative debate over EDECA focused relatively little on deferred balances, and centered instead on issues such as stranded costs, municipal aggregation and the questions of how quickly, if at all, competition would materialize.¹² Most lawmakers who supported EDECA did not express concern with deferred balances, instead voicing confidence that competition would develop and would lead to decreases in retail and wholesale rates. Lawmakers made such declarations as “rates will come down and stay

⁹ P.L. 1999, C.48:3-52 4(b)

¹⁰ Rockland Electric CEO Stephen Bram’s testimony before the New Jersey State Senate Economic Growth, Agriculture and Tourism Committee on March 8, 2001.

¹¹ Estimates for interest payments are supplied by the BPU; this estimate is based on a 5.5% interest rate over a 15-year payback period.

¹² Several interest groups contend that the legislative debate was also quite limited in scope because the text of the legislation was revealed to the public late in the process, leaving relatively little time to discuss the text of the bill before it moved through the Legislature.

down,” and “you will see the effects of competition in much lower rates.”¹³ Governor Whitman stated plainly “consumer choice means consumer savings.”¹⁴

Among utilities and interest groups, however, there was relatively uniform opposition to the combination of rate caps and passing the burden of deferred balances on to ratepayers (commonly called ‘pass-through’). Utilities generally expressed concern with the rate cap portion of the equation. In testimony given during the EDECA debate, a representative from JCP&L warned that “mandating unrealistic rate reductions will undermine the long-term benefits of a free competitive market.”¹⁵ JCP&L instead advocated that rates be able to fluctuate with market changes. Other utilities, such as Rockland Electric, offered similar warnings about rate caps. Despite these reservations, however, the utilities and the New Jersey Utilities Association were generally supportive of EDECA.

Interest groups, particularly consumer organizations, were generally opposed to the pass-through portion of the deferred balance equation (many were also in favor of larger mandated rate decreases). These interest groups characterized pass-through, of both deferred balances and stranded costs, as a gift to utilities and an unfair burden on ratepayers.

Those concerned with the combination of inflexible rate caps and pass through offered a range of alternatives. These included adjusting the caps on a periodic, or even emergency, basis to better reflect market conditions; instituting a Levelized Energy Adjustment Clause that would essentially reconcile deferred balances on an annual basis; not allowing utilities to pass through losses; or, not allowing the pass-through of interest from deferred balances. In the end, however, lawmakers rejected these proposals and adopted inflexible rate caps with pass-through of costs and interest to consumers.

IV. An Account of the Accumulation of Deferred Balances

What has happened to the electricity market in New Jersey since the implementation of EDECA?

While some competition has developed in the energy wholesale markets, retail competition in the electric generation market under EDECA has not developed as expected. As of July 2002, less than 7,000 of the state’s 3.6 million electric customers had switched to alternate energy suppliers, under 0.2% (*See Appendix 3*). Consequently, many of the intended outcomes of deregulation, including greater choice for consumers and lower prices, have not materialized.

¹³ “Shifting power: lawmakers OK deregulation,” Randy Diamond, *The Bergen Record*, January 29, 1999.

¹⁴ “Governor signs bill deregulating utilities, opening power world,” Ralph Siegel, *The Associated Press*, February 9, 1999.

¹⁵ Elizabeth Ard, Vice President of Regulatory and Government Affairs, JCP&L, testimony before the Senate Economic Growth, Agriculture and Tourism Committee, November 12, 1998.

The lack of competition is due in large part to the combination of retail rate caps and large increases in wholesale energy prices. Since the enactment of EDECA, wholesale energy prices have risen sharply, largely because of an increase in natural gas costs (*See Appendix 4 for a graph of wholesale energy prices*). Because of increased wholesale prices, energy suppliers cannot compete in the market with utilities whose prices are artificially low under mandated rate caps. These factors have driven the accumulation of deferred balances in two ways: 1) as energy prices escalated, the market price for electricity began to far exceed the capped rates utilities were allowed to charge, and 2) with less competition, more customers relied on BGS, increasing the volume of deferred balances.

What is the scope of the deferred balances problem?

By August 2003, the total deferred balances accumulated by utilities is expected to be nearly \$1 billion.¹⁶ Assuming a modest interest rate of 5.5%, interest payments on this debt could range from \$79 million to \$259 million, depending on the length of time it takes to repay them.¹⁷ Repayment of deferred balances could significantly impact ratepayers for years to come, and could impose a particular burden on consumers with low or fixed-incomes and businesses with large electricity costs. Utilities report that their requests for deferred balance rate increases could be as high as 20%.¹⁸

The chart below illustrates the estimated size of deferred balances for each utility (*see Appendix #5 for a graphs of deferred balance accumulation*).

¹⁶ As of May 2002, utilities have reported deferred balances totaling \$560 million. By August 2003, this total is expected to grow by \$381 million. Although this appears to be an increase in the rate at which deferred balances are growing, these figures are skewed by the fact that \$330 million in deferred balances were absorbed by utilities in two mergers that have occurred since the passage of EDECA. With the exception of this sudden reduction, BPU staff contend that deferred balances have been growing at a consistent pace.

¹⁷ These figures, supplied by the BPU, range from a four-year payback period to a 15-year payback period.

¹⁸ Rockland Electric's response to the Deferred Balances Task Force questionnaire

Chart 1: Deferred Balances by Utility*

Utility	Est. Deferred Balances by August 2003	Approx. Number of Customers	Approx. Deferred Balances per Customer			
			Average Residential	Average Commercial	Average Industrial	Average All Customers
JCP&L	\$695 million	1,017,000	\$328	\$2,612	\$39,239	\$685
Conectiv	\$176 million	505,000	\$171	\$1,285	\$22,146	\$350
Rockland Electric	\$110 million	69,700	\$794	\$6,805	\$39,903	\$1,575
PSE&G	\$0	2,029,000	\$0	\$0	\$0	\$0
Total**	\$981 million	3,620,700	\$299	\$2,362	\$34,827	\$615

*All estimates are calculated by BPU staff based on utility estimates of their deferred balances, and are for the principal owed, without the interest

**Per customer averages exclude PSE&G's customers, who are not responsible for any deferred balances.

As the chart above indicates, the average residential customer may be burdened with repaying nearly \$300, plus interest. The average commercial and industrial user will likely be responsible for \$2,362 and \$34,827 respectively. As the chart also illustrates, however, utilities have accrued widely divergent deferred balances, meaning ratepayers will face vastly different consequences depending on what utility they are served by. For example, a residential consumer in Princeton will not be responsible for repaying any deferred balances, whereas, on average, a consumer in West Milford will be responsible for repaying nearly \$800.

If it were not for the completion of two utility company mergers during the first three years of deregulation, the scope of this problem would be even greater. As a condition of the mergers between JCP&L and First Energy, and between PEPCO and Conectiv, the BPU required that \$300 million and \$30 million in deferred balances be absorbed by the utility, respectively. Without these mergers estimated deferred balances would have totaled \$995 million for JCP&L, \$206 million for Conectiv, and in excess of \$1.3 billion for all utilities combined.

It should be noted that these deferred balance totals represent what utilities have reported as of May 2002, and what they estimate accumulating through July 2003. The BPU will evaluate these costs and will not permit recovery of any costs it deems to have been unreasonably incurred.

What is the expected rate impact of deferred balances?

The BPU has ordered utilities to file, by August 30, 2002, "deferral cases" in which they are to provide detailed schedules showing how their deferred balances were incurred,

how they propose to recover them in rates, and supporting testimony addressing the prudence of the deferred costs and steps taken to mitigate these costs.

Below is a chart summarizing the rate increases requested in these filings. The amount in parentheses is the total deferred balances that would be recovered during one year. As the chart indicates, under amortization, deferred balances would be recovered more quickly than under securitization, but at a higher initial increase in electricity rates. All utilities assume four years to repay deferred balances under amortization and 15 years to repay them under securitization.

Chart 2: Utility Rate Increase Requests

Utility	Deferred Balance Rate Increase Requested - Securitization	Deferred Balance Rate Increase Requested - Amortization
PSE&G	None*	None*
JCP&L	3.5% (\$69 million)	10% (\$195 million)
Conectiv	n/a**	5.1% (\$43 million)
Rockland Electric	Has not yet filed	Has not yet filed

*PSE&G is currently expected to have a net over-recovery of approximately \$41 million, which will be passed back to ratepayers

** Although Conectiv is not requesting securitization at this time, it may do so if the Governor signs S-869.

According to JCP&L, if their request was granted in full, an average monthly residential electricity bill would increase by \$7.57 under amortization, and \$4.17 under securitization, in order to recover deferred balances. If granted in full, Conectiv’s deferred balance rate request would result in an increase of just under \$4 on the average monthly residential electricity bill.

Utilities have also filed for additional increases based on factors independent of deferred balances. Like deferred balance rate increases, these ‘base rate’ increases would become effective on August 1, 2003, when rate caps expire. PSE&G filed for a 12.8% overall rate increase, which would result in an additional \$8 on the average residential consumer’s monthly bill. JCP&L’s total rate increase requests, including their requested deferred balance increases, are 7.8% under securitization, and 14.3% under amortization. According to JCP&L, if granted in full, these total requested rate increases would result in increases of \$4.01 and \$7.42 per month for the average residential JCP&L customer,

under securitization and amortization, respectively.¹⁹ Finally, Conectiv's total rate increase would result in a \$6.89 increase in the average residents' monthly utility bill.

It should be underscored that requests for rate increases will not necessarily be granted in their entirety. The BPU will undertake a careful evaluation of utility rate requests to determine what is in the best interest of consumers, within the bounds of current statutes and while maintaining the financial integrity of utilities. These figures, however, provide a general sense of the impact deferred balances may have on overall rates.

How do ratepayer savings from rate caps compare to the accumulated deferred balance debt?

Although ratepayers are potentially responsible for nearly \$1 billion in deferred costs, it is important to remember that they will have saved significant amounts during the transition period because of rate caps. There are many complications to accurately measuring these savings. For example, no one knows what regulated rates would have been without rate caps. In February 2001, BPU President Tate offered an estimate that ratepayers would save a total of \$2.4 billion, a generous estimate that also factored in additional savings from separate tax reductions.

However one measures the savings, there are difficulties with comparing aggregate levels of savings and aggregate levels of deferred balances. First, as mentioned earlier, both savings and deferred balances are unevenly imposed on ratepayers. For example, according to President Tate's figures, \$1.4 billion of the aggregate savings were realized by PSE&G customers who will have no deferred balances to repay. This leaves \$1 billion in estimated savings for the other three utilities, as compared to \$1 billion in deferred costs, plus interest

Second, the fact that ratepayers saved money under rate caps does not alone justify the accumulation of deferred balances. These 'savings' were in large part funds that were essentially borrowed and now must be paid back, with interest. It is very possible that ratepayers, on net, would have saved more without the combination of rate caps and delayed pass-through that caused the accumulation of deferred balances and interest payments. It is also possible, even under the provisions of EDECA, that if costs were mitigated more effectively the accumulation of such substantial deferred balances could have been avoided.

Finally, as mentioned earlier, there are a number of problems with deferred balances that go beyond measures of costs versus savings, such as the fact that they potentially skew incentives for utilities and ratepayers, and the fact that ratepayers generally were not informed about what was happening to their energy prices.

¹⁹ JCP&L verified to BPU staff their estimates for impact on the average monthly residential bill for both deferred balances and total rate increases.

After the passage of EDECA, how did each utility restructure and how did they procure power?

To comply with EDECA, the BPU issued Orders that directed the restructuring of each utility. These Board Orders addressed issues ranging from how utilities would separate their generation and distribution functions, to how they would implement their mandated rate cuts. Each restructuring order reflected the Board approved outcome of a complex, multi-issue negotiation and settlement process in which utilities and other parties crafted a restructuring package intended to best meet the individual needs of each utility and its customers.

Below is a brief overview of how each utility restructured and how it secured its power during the first three years of deregulation. The manner in which each utility secured power for the first three years is derivative of its restructuring orders.²⁰ Although a comprehensive analysis of the merits of each utility's restructuring and power procurement strategies is beyond the scope of the Task Force's charge, this overview will provide a general sense of how each utility procured power and, in hindsight, may point to trends in purchasing that significantly impacted deferred balances.

It should be noted, that to secure power for the fourth year of deregulation, all utilities participated in an auction overseen by the BPU, called the "BGS Auction," in which utilities bid for a significant portion of the energy they would be required to supply to customer who haven't chosen alternate suppliers of energy. This auction, held in February 2002, offered a forum for pure price competition, and was intended to result in the lowest electricity costs possible.

Conectiv (formerly Atlantic Electric)

Restructuring

Conectiv attempted to sell nearly all of its generation capacity. It sold its minority interests in the Hope Creek, Salem and Peach Bottom nuclear units (aggregating 378 megawatts (Mw) of power) to PSEG Power, an unregulated affiliate of PSE&G, and to PECO Energy in October 2001. An agreement to sell Conectiv's fossil-fueled generation units fell through in April of this year, but these units have since been placed back on the market.

Conectiv has a petition pending before the BPU to securitize \$440 million of nuclear-related stranded costs and upfront costs for restructuring old power contracts.

Power Purchasing

Prior to selling its generation capacity, Conectiv primarily procured power for BGS from its own plants, as well as energy purchased from other generation sources under pre-existing long-term contracts. It obtained the remainder of its BGS supply from a combination of supply contracts secured through a bidding process, and purchases made on the "spot-market." (Purchasing power on the "spot market" refers to instances when a company buys power 'on the spot' in the wholesale energy markets where prices

²⁰ See Appendix 6 for a more detailed explanation of this issue.

fluctuate with market conditions, as compared to instances when a company secures power from previously agreed-on contracts at locked-in prices.)

Jersey Central Power and Light (JCP&L)

Restructuring

JCP&L has divested nearly all of its generating capacity. By late 1999, it had sold nearly all of its fossil-fueled generation units (totaling 1,558 Mw) and its 25% interest in the TMI-1 nuclear plant (196 Mw). In August 2000, JCP&L sold its Oyster Creek nuclear plant (619 Mw). JCP&L has retained a 50% ownership in the Yards Creek pumped storage plant (200 Mw), with PSE&G owning the other half. JCP&L is currently reviewing its options for this facility, including its possible sale.

In June of this year, JCP&L issued \$320 million in ratepayer-backed securitized bonds, including \$307 million of stranded costs for its Oyster Creek plant, as well as \$13 million in transaction costs.

Power Purchasing

JCP&L relied heavily on purchases from the spot markets in order to meet its requirement to provide BGS from 1999 to 2002. As the cost of power in these markets increased, JCP&L's deferred balance increased dramatically.

JCP&L did enter into several 'parting agreements' with generation units that it sold. As part of the sale of its fossil-fueled units, JCP&L negotiated a parting contract that gave it the option of purchasing generating capacity at a fixed range of prices through May 2002. As part of the sales agreement with the purchaser of Oyster Creek, JCP&L negotiated a parting contract that allowed it to purchase power from the unit at a fixed price through March 31, 2003. A similar parting contract with AmerGen allowed JCP&L to purchase power from the TMI-1 nuclear plant at fixed prices through the year 2001.

During the first three years of the transition period, JCP&L also relied on supply from the generating units it had not yet sold, and some long-term contracts with other energy suppliers.

Public Service Electric and Gas (PSE&G)

Restructuring

PSE&G transferred its generation assets (aggregating approximately 10,000 Mw) to an unregulated affiliate, PSEG Power. As a result of this transfer as well as the other restructuring transactions, the BPU authorized PSE&G to securitize \$2.4 billion of its stranded costs. These costs are already incorporated into PSE&G's rates.

Power Purchasing

For the first three years of deregulation, PSE&G received BGS power from its unregulated affiliate, PSEG Power. PSE&G entered into a Board-approved three-year

contract with PSEG Power, which provided power at a cost equal to the BGS rates PSE&G was allowed to charge customers. In other words, PSE&G locked in the majority of its power for three years at a fixed price, insulating itself from the cost fluctuations that helped produce large deferred balances for other utilities. PSE&G secured most of the remainder of its power from pre-existing contracts.

Rockland Electric

Restructuring

Orange and Rockland, the parent company of Rockland Electric and now a subsidiary of Con-Ed, supplied all of Rockland's pre-EDECA energy requirements. In July 1999, Orange and Rockland divested all of its generating assets, which consisted of its interests in the Bowline (400 Mw) and Lovett (453 Mw) fossil-fueled plants, and its gas turbines and hydroelectric facilities (124 Mw).

Power Purchasing

PJM Interconnection is the organization that administers New Jersey's electricity transmission system and spot energy markets. One of PJM's roles is to act as an intermediary between utilities that need to purchase power in the spot market, and various power suppliers and generators that participate in New Jersey's market. Rockland was not a member of PJM until March 2002. As a result, Rockland was limited in where it could purchase its power. Instead of participating in PJM markets, Rockland relied on its parent company's existing power contracts, parting agreements with its former generating units, and spot and other short-term power purchases primarily in New York's power markets. In March 2002, after becoming a member of PJM, Rockland obtained 90% of its BGS requirements from PJM.

What steps did each utility take to mitigate the accumulation of deferred balances, and what new mitigation steps are utilities planning to take over the next year?

There are several approaches utilities can take to mitigate the accumulation of deferred balances. The primary method is for a utility to reduce the price it pays for power. Utilities can do this through purchasing strategies that hedge against unexpected fluctuations in market prices; renegotiating power contracts that are above market price, or; when a utility sells generation assets, entering into parting agreements with the purchaser of those assets.

Utilities can also engage in energy efficiency and conservation programs that reduce customers' use of power, thereby lowering the utility's power needs and decreasing deferred balances.²¹ This can be done in a number of ways, ranging from the promotion

²¹ By EDECA mandate, utilities are implementing energy conservation programs; however, these programs focus more on long-term strategies to increase energy efficiency (e.g. programs geared toward 'market transformation') rather than the targeted reduction of deferred balances (e.g. programs that target the reduction of peak-time usage which contributes most heavily to the accumulation of deferred balances). Moreover, with such significant deferred balances, utilities should be engaging in greater conservation efforts than are mandated by EDECA.

of energy efficient products, to the implementation of incentive programs to constrain usage. Finally, the promotion of competition can decrease the BGS requirements of utilities and reduce losses. For example, programs that encourage the participation of competitive suppliers can help reduce deferred balances.

Each utility will face a review of its deferred balances by the BPU. Utilities will have to demonstrate the reasonableness and prudence of their actions and whether they took adequate steps to mitigate deferred balances accumulation. Scrutinizing the validity of utilities' deferred balances claims is the responsibility of the BPU, and will occur in detail during its investigation of deferred balance rate increase requests. The following section provides an overview of the major mitigation efforts utilities have undertaken.

Conectiv

In its response to the Task Force's questionnaire, Conectiv cites the renegotiation of pre-existing energy contracts, along with participating in the BGS auction, as its primary mitigation efforts. Since the enactment of EDECA, Conectiv has renegotiated two of its energy contracts, with Pedricktown and Chester, to save customers \$92.4 million in net present value (NPV), according to the BPU's estimates.

Conectiv's response to the Task Force questionnaire does not mention mitigation activities related to energy efficiency or conservation.

JCP&L

JCP&L's total deferred balance is by far the largest total among the utilities (projected close to \$1 billion before relief from its merger with First Energy reduced the expected total to \$695 million).

JCP&L has successfully renegotiated just one of its 15 long-term energy contracts. It renegotiated its contract with the Bayonne cogeneration facility, producing \$27 million in NPV savings. JCP&L reports that it is continuing negotiations of 6 of its other 14 energy contracts. In addition, JCP&L realized net proceeds of \$48 million from the sale of its fossil-fueled generation units and its TMI-1 nuclear unit, which resulted in a reduction of its deferred balance.

JCP&L has BPU approval to implement a voluntary load reduction pilot program, using financial incentives to reduce energy usage during peak summer periods. Under this program, any savings realized by a participant reducing energy use are split between the user and the utility (i.e. half of the savings are used to pay the user for participating in the program and the other half to reduce deferred balances).

JCP&L has also proposed a seasonal savings pilot program to provide assured reductions in energy use during identified times of peak usage. Participating customers would be paid a fixed rate per kilowatt-hour for promising to reduce usage. This program is still pending BPU approval.

PSE&G

PSE&G renegotiated its pre-existing energy contracts, restructuring over 90% of them (measured on a capacity basis). Up-front payments from the renegotiation of their three largest contracts resulted in a \$129 million credit in the company's deferred balance account.

PSE&G's most recently renegotiated contracts include: an agreement with the Newark Bay Facility, restructured to produce \$41.8 million in NPV savings; an agreement with the Camden Cogen and Bayonne plants, resulting in \$64 million in NPV savings and up-front payments; an agreement with the Eagle Point facility in West Depford resulting in \$102.5 million NPV savings and up-front payment, and; an agreement with American Ref-Fuel resulting in \$40 million in NPV savings.

In its response to the Task Force questionnaire, PSE&G made no mention of energy efficiency or conservation efforts to reduce deferred balances.

Rockland Electric

On a per customer basis, Rockland Electric has by far the largest deferred balances. Rockland's deferred balance is over twelve times the company's entire 2001 net income and is almost equal to its entire net worth.

Because Rockland claims in its response to the Task Force questionnaire that its high usage per customer contributes to its large deferred balances, energy conservation programs would seem a vital part of its deferred balance mitigation efforts. Thus far, Rockland cites only bill inserts promoting the value of energy efficiency under current programming to reduce energy demand. Rockland does have, however, a pending proposal to implement an Emergency Demand Reduction Program, which would provide financial incentives to certain customers to encourage decreased energy usage when purchased energy prices are high, thereby mitigating any increase to its deferred balance.

Rockland also has a pending proposal to use financial incentives to encourage increased participation by alternate providers of electricity generation, which could reduce Rockland's BGS burden and, consequently, its deferred balances. Rockland also cites joining PJM as a mitigation effort.

Because NUG contracts constitute only 2.5% of its supply needs, Rockland calculated that it was not economical to renegotiate them. In its response to the Task Force questionnaire, Rockland states, "there is little or no opportunity to further mitigate the accumulation of deferred balances in Year 4."

Why do utilities have such widely divergent deferred balances?

There are many factors that contribute to the size of a utility's deferred balances, including the terms of its restructuring order, whether it divested generation capacity, its power purchasing decisions and the characteristics of its customer base. The BPU will conduct a detailed analysis of the merits of each utility's deferred balances as it

investigates their rate increase requests. Although such an individualized, detailed analysis is beyond the scope of its charge, the Task Force has drawn some general distinctions between the utilities, and here highlights areas that deserve scrutiny by the BPU.

The primary reason PSE&G has no deferred balances is the three-year contract it entered into with PSEG Power to provide energy at a cost equivalent to PSE&G's Board-ordered BGS rates. As PSE&G states in response to the Task Force questionnaire, "this BGS contract removed the risk of price volatility from PSE&G and its customers." Successful renegotiation of long-term contracts also helped eliminate other potential sources of deferred balances for PSE&G.

In contrast, JCP&L sold most of its generating assets, relied relatively little on parting contracts, and instead relied heavily on the spot-market and short-term energy contracts. This left JCP&L more exposed to wholesale power market volatility than the other utilities, and undoubtedly contributed to its high deferred balances.

Conectiv's deferred balances were also driven by its reliance on wholesale power markets, although it was not as reliant on short-term and spot markets as JCP&L. Conectiv continued to partially rely on some of its generation assets and has not, to date, completely divested itself of them. Conectiv was also able to reduce its deferred balances through successful renegotiation of two of its pre-existing power contracts.

Rockland Electric's almost full exposure to volatile wholesale power markets largely accounts for its high per capita deferred balances. Rockland's parent company completely divested its generating assets and, because Rockland was not a member of PJM, it had to participate in the higher-cost New York power market until March of 2002. Therefore, Rockland was exposed to unfavorable market conditions that other utilities did not face. In their response to the Task Force questionnaire, Rockland attributes several other causes for its deferred balances, including a wealthier customer base with a higher use of energy per residential customer.

This brief examination of utility mitigation and power procurement efforts reveals that there are serious questions the BPU needs to address to determine what portion of deferred balances should be paid by ratepayers. These questions include:

- Did JCP&L, Conectiv and Rockland Electric make reasonable decisions about how much spot market power to purchase and how much power to purchase at fixed prices under longer-term contracts?
- Did utilities enter into power contracts at the right time and for the right duration?
- Why was PSE&G the only utility to lock in a three-year contract guaranteed at BGS price levels?
- Why didn't Rockland Electric join the PJM system earlier?
- Why weren't energy efficiency and conservation programs relied upon to a greater extent, or at all, to reduce power usage, particularly during high cost peak periods?

- Why weren't conservation programs that are currently awaiting approval from the BPU submitted for approval earlier?

Finally, it should be noted that deferred balances are only part of each utility's larger financial profile, and they are only one indicator of how a utility has performed under deregulation. For example, all utilities have different levels of stranded cost recovery that are already reflected in customers' rates. In addition, utilities' rates differed considerably before deregulation. While a useful reference point, however, these considerations are outside the scope of the Task Force's charge.

When did the BPU become aware of the deferred balance problem, and what steps could it have taken to mitigate the impact?

There were very early indications that deferred balances would become a significant problem. Even before EDECA was passed, the *New Jersey Energy Master Plan Report* issued by Governor Whitman and the BPU, which, as noted previously, set the groundwork for EDECA, warned that it may be difficult to simultaneously mandate price reductions and full recovery of stranded and deferred costs without heavily burdening ratepayers.

On April 27, 2000, a letter from the BPU directed the four electric utilities to report their deferred balances on a monthly basis. This request stemmed from a growing concern among some BPU Commissioners and staff that deferred balances were mounting quickly.

Utilities also began alerting the BPU to the growing problem. In April 2000, JCP&L informally contacted the BPU to warn of mounting deferred balances. In December 2000, Rockland formally filed a petition for relief from mandated rate reductions. EDECA provides for suspension of mandated reductions in emergency situations, when the "financial integrity" of a utility is in jeopardy.²² The BPU, however, never acted on Rockland's request.²³

In February 2001, former BPU President Tate, in testimony before the Senate Economic Growth, Agriculture and Tourism Committee, revealed that, as of December 31, 2000, utilities had accumulated \$451 million in deferred balances, and projected a total of \$1.5

²² N.J.S.A. 48:3-61 13(h)

²³ The December 11, 2000 petition from Rockland requested that the overall rate levels not be changed, which meant the BPU would not implement the scheduled 2% rate reduction. Rockland argued that the scheduled 2% rate reduction was inappropriate given the company's rapidly growing deferred balances, the potential that it would suffer financial harm, and the potential that customers would face rate shock in 2003. On December 19, 2000, the Division of the Ratepayer Advocate issued a letter opposing Rockland's request, arguing that the petition was not supported by documented evidence, the financial harm test was not included, and the deferred balance problem may be a result of Rockland's energy purchasing strategy. To date, the Board has not taken any action on the petition, and the 2% rate reduction went into effect as scheduled.

billion before rate caps would expire in August 2003.²⁴ (See Appendix 5 for a chart setting forth the month-by-month accumulation of deferred balances.)

On March 30, 2001, President Tate testified again, readjusting his total deferred balances estimate to \$1.8 billion. During this testimony, President Tate assured the Senate Committee that “we are fully prepared to deal with deferred balances at the end of the transition period.” In reference to utilities’ 2002 rate filings in which they would attempt to recover deferred balances, President Tate said, “at that time, the Board will...be able to implement the tools necessary to help mitigate deferred balances.”^{25, 26}

Most advocates and policymakers contended, however, that aggressive mitigation efforts should have been taking place once it became apparent that deferred balances kept climbing toward \$1 billion, not when utilities filed for rate increases in 2002. Instead of mitigating the potential deferred balance impact during the first three years of deregulation, the BPU under President Tate took two actions that aggravated the problem.

First, in the Board’s 1999 restructuring orders, the BPU increased and accelerated rate reductions above and beyond EDECA requirements. EDECA mandated rate reductions of 5% immediately, and 10% by the beginning of year 4. In its 1999 restructuring orders, the BPU mandated that each utility meet the following aggregate rate reductions for each year of deregulation (percentage decreases are based on 1999 rates):

Chart 3: Aggregate Rate Reductions Mandated by the BPU

Year	PSE&G	JCP&L	Conectiv	Rockland
1999	5%	5%	5%	5%
2000	7%*	6%	5%	5%
2001	9%	8%	7%*	7%*
2002	13.9%	11%	10.2%	11.6%

*These rate reductions were imposed on January 1, as opposed to all others, which were imposed by August 1.

The rate reductions for 2000 and 2001, shown in the chart above, were not required under EDECA; rates could have remained at an aggregate reduction of 5% during these years. In addition, some of the 2002 reductions represent greater reductions than the 10% required by EDECA. In sum, the BPU aggravated the problem of deferred balances by accelerating and increasing the mandated rate reductions. While this decision increased immediate, but temporary, benefits to customers, it also had the effect of making the deferred balances higher than they otherwise would have been.

Second, the BPU rebuffed efforts to implement the emergency clause contained in EDECA to halt scheduled rate reductions. Although the clause may be vague and the

²⁴ BPU President Herbert Tate’s testimony, New Jersey State Senate Economic Growth, Agriculture and Tourism Committee, on February 7, 2001

²⁵ BPU President Herbert Tate’s testimony, New Jersey State Senate Economic Growth, Agriculture and Tourism Committee, on March 8, 2001

²⁶ Herbert Tate resigned as BPU President three weeks after this testimony.

burden of proof less than clear as to when the “financial integrity” of a utility is compromised, the Board chose not to pursue the formal and informal requests of utilities for relief from their mounting deferred balances.

Have other states experienced deferred balance problems similar to New Jersey?

Currently, twenty states have deregulated retail electricity markets (see *Chart 4*). Sixteen of these states have imposed a cap on retail rates and twelve states have allowed utilities to pass through excess costs to ratepayers.²⁷ Eight states, including New Jersey, combine rate caps and pass through; however, only New Jersey does so with inflexible rate caps that aren't adjusted for four years. Consequently, no other state allows deferred balances to mount for four years and then passes them along to ratepayers, plus interest. New Jersey also had among the highest mandated rate cuts of any state. As a result of these factors, New Jersey is the only state that has accumulated such large deferred balances and the only state to face, as a result, the prospect of large rate increases to pay back this debt.

Other states offer alternative examples of electric restructuring. In New York, restructuring plans vary between utilities, but Con Edison, the state's largest utility, does not have rate caps. The New York Public Service Commission has allowed virtually immediate pass through of increased energy costs to consumers. This arrangement has prevented any build-up of deferred balances and interest payments. However, as a result, New York electric rates have changed as much as 50 percent from month to month.

Texas's deregulation act required a six percent rate cut, as well as pass through to ratepayers. However, unlike New Jersey, the Texas law allowed utilities to update their prices twice per year, subject to approval by the Texas Public Utility Commission, thus passing through costs on a periodic basis. This timely pass through has prevented the accumulation of large amounts of deferred balances.

Pennsylvania has inflexible rate caps with no pass through, so utilities cannot charge ratepayers for costs that exceed capped rates. This has caused some utilities in Pennsylvania considerable financial difficulties, such as First Energy of Pennsylvania, which had to absorb the excess market costs of power and had to file for relief under the “financial impairment” exception of Pennsylvania's deregulation law.

California is not listed as a deregulated market because the state re-regulated its retail supply market after supply shortages caused rolling blackouts and the financial integrity of some utilities was compromised. Since January 2001, the California Department of Water Resources has purchased power on behalf of the state's utilities, and retail choice was suspended in September 2001.

In its deregulation law, California required utilities to divest their generation capacity and froze rates at 1996 levels. Unlike New Jersey, California prohibited utilities from

²⁷ Regulatory Research Associates' *Regulatory Focus Special Report: Fuel and Wholesale Power Cost Recovery – A State-by-State Review*, published February 26, 2002.

entering into long-term energy contracts, leaving them vulnerable to the fluctuations of the spot markets. Utilities were not allowed timely pass-through, and when energy prices skyrocketed due to a lack of supply (or, as some have alleged, market manipulation), utilities began to accumulate massive debts, \$10 billion for Pacific Gas and Electric and Southern California Edison combined. These liabilities and an accompanying cash shortage drove PG&E to file for reorganization under Chapter 11 Bankruptcy.

Chart 4: Provisions of State Deregulation Plans²⁸

Restructured/Deregulated Retail Electric Markets (20)	Rate Caps (16)	Cost Pass Through to Ratepayers (12)
Arizona*	•	
Connecticut	•	
Delaware	•	•
District of Columbia	•	
Illinois	•	•
Maine		•
Maryland	•	
Massachusetts	•	•
Michigan	•	
Montana	•	
Nevada*		•
New Hampshire	•	•
New Jersey**	•	•
New York		•
Ohio	•	
Oregon*		•
Pennsylvania	•	
Rhode Island	•	•
Texas	•	•
Virginia	•	•

* Retail competition does not include residential customers at this time.

**Unlike any other state, New Jersey's rate caps are inflexible for four years, and pass through is not permitted during that time period.

Have any other states approved securitization by utilities?

Securitization by utilities has been authorized by legislation in 12 states, typically as part of a state's deregulation effort. In all cases, securitization was used to finance stranded costs. The proposed legislation in New Jersey authorizing securitization of deferred balances would be a first nationally; however, no other state has built up such large deferrals so as to require securitization of deferred balances. According to the BPU, the

²⁸ Ibid, excerpted from Table 1 – General Practice on Fuel and Wholesale Power Cost Recovery, p.1.

major bond rating agencies have voiced no concern with the proposal to utilize securitization for the financing of deferred balances.

To date, almost \$29 billion of securitized bonds have been sold by utilities nationwide, including nearly \$3 billion by New Jersey electric utilities (\$2.525 billion by PSE&G and \$320 million by JCP&L). Conectiv has petitioned the BPU for approval to sell \$440 million of securitized bonds.

What have been the primary causes of the accumulation of deferred balances?

Although there is a range of different factors that have contributed to the accumulation of deferred balances, several key causes can be identified. By definition, the primary causes are the provisions of EDECA that mandate inflexible rate reductions and allow pass through to consumers only after four years. Lawmakers mandated reductions that, as it turned out, did not reflect real costs in the electricity market. This had the effect of forcing consumers to buy electricity at discount prices but pay for some of those discounts later, with interest – essentially the purchase of electricity on credit.

The artificially low rate caps contributed to the lack of retail competition under deregulation, as low rates made it difficult for alternate suppliers of generation to compete in the electricity market. President Tate testified that, because of rate caps “there is increasing difficulty for third party suppliers to make competitive offerings.”²⁹ With this lack of competition, energy costs remained high and most consumers relied on BGS, increasing the volume of deferred balances.

The manner in which the BPU managed the implementation of EDECA also contributed to the accumulation of higher deferred balances. The BPU expanded and accelerated rate cuts, and refused to grant timely relief to utilities with growing debts or otherwise address the problem, despite clear warnings that deferred balances were mounting.

In addition, serious questions have been raised about whether utilities have taken adequate measures to mitigate the accumulation of deferred balances. The Task Force’s findings raise doubts about whether utilities made prudent choices in securing power in the deregulated market, and spark questions as to why several old power agreements have yet to be renegotiated. In addition, there are serious concerns as to why utilities have not done more to promote energy efficiency and conservation.

Finally, the increase in energy prices certainly played a significant role in the accumulation of deferred balances. These costs, however, became a bigger problem because of the inflexibility EDECA mandated and the BPU. Because the trends of the newly deregulated electricity market cannot be predicted, implementing inflexible rate caps along with pass through to ratepayers represented a calculated risk that has not turned out as expected. Therefore, wholesale prices must be viewed as a secondary cause

²⁹ BPU President Tate’s testimony, New Jersey State Senate Economic Growth, Agriculture and Tourism Committee, on March 8, 2001

of the deferred balance problem because, without EDECA's inflexibility, the rising energy prices alone would not have caused the deferred balances to build to such levels.

V. Recommendations for Addressing the Issue of Deferred Balances

The most important duty of the Task Force is to recommend "how [deferred balances] ought to be addressed to best protect the interests of ratepayers." In analyzing this issue, the Task Force has attempted to answer three basic questions:

- 1) How can the impact of deferred balances on ratepayers be reduced?
- 2) What can be done to ensure that the process for addressing deferred balances is fair, and that only legitimate costs are passed on to ratepayers?
- 3) What can be done to ensure that this situation does not occur again?

The Task Force considered a wide range of potential answers to these three questions, working under the premise that, by law, utilities must be able to recover legitimately-incurred deferred balances. The Task Force arrived at the following five recommendations.

Recommendation #1: Sign Senate Bill 869

The Task Force recommends that Governor McGreevey sign S-869, which would allow the BPU to consider and, if appropriate, approve the securitization of portions of the deferred balance debt. This bill would simply give the Board another tool to help ease the impact of deferred balances on ratepayers. Under the bill, if a utility requested securitization, the BPU would examine this request against other financing options, and determine which method was in the best interest of ratepayers.

S-869 contains many restrictions that would limit the use of securitization. For example, under the bill only deferred balances incurred from providing BGS are securitizable.³⁰ The bill contains other safeguards against the unwise use of securitization. For example, S-869 prohibits the issuance of any bonds with a term longer than 15 years, and requires the BPU to find that the use of securitization provides a benefit to consumers over other forms of financing.

Securitization is not a unique financing technique, and is already allowed under EDECA to recover stranded costs. As stated earlier, these securitized bonds would be backed by an irrevocable promise to bondholders that ratepayer charges would be used to pay back the bondholder over the life of the bond. This assurance gives securitization two principal advantages over traditional financing: 1) because they pose a low risk to investors, these bonds typically have lower interest rates than other financing tools, and 2) because of the low interest and the security of the investment, these bonds typically allow for a longer period of time to pay back the debt than other financing mechanisms. What this means for ratepayers is that, under certain circumstances, securitization would

³⁰ There is not yet a consensus opinion as to what proportion of deferred balances are eligible for securitization under S-869.

reduce the immediate rate increase needed to pay back deferred balances and provide ratepayers a savings over other forms of financing.

The Task Force, however, had two concerns with the potential securitization of deferred balances. First, securitized bonds lock ratepayers into a commitment to repay a certain amount of deferred balance debt, typically for a longer period of time than other financing methods. Second, because interest payments mount over several years, securitization typically has a higher total cost of financing than other methods. The Task Force recognizes there is also some concern among consumer groups that securitization would be used for short-term rate relief at the cost of causing the deferred balances problem to grow even larger over time as bonded debt accumulates.

The Task Force is confident, however, that the BPU under current leadership will ensure that securitization is only used in the best interest of consumers. In addition to the BPU's thorough review of all financing options, the safeguards and restrictions built into the bill protect against the securitization that does not benefit consumers. In the final analysis, the potential for securitization to provide real relief for ratepayers outweighs the concerns about how securitization might be used.

Recommendation #2: Aggressively mitigate further accumulation of deferred balances

A vital step toward mitigating the rate impact of deferred balances is to control their growth over the next year. There are some proposals toward this end that the Task Force deemed not feasible. For example, partially repealing rate caps would require, by law, an extensive administrative process that would likely be completed just months before rate caps expire in August 2003. In addition, to reduce rate caps below the EDECA-mandated 10% reduction would require that the Legislature amend EDECA.

The most prudent method is to more aggressively implement existing mitigation techniques. One of the most promising opportunities is to increase the focus on energy efficiency and conservation programs. When the Task Force asked utilities about their mitigation techniques, they scarcely mentioned energy conservation. Yet, in the future, such efforts would have a direct impact on reducing deferred balances, particularly during peak usage periods when spot-market energy prices typically rise well above the capped rates. There are several examples of low-cost conservation efforts. One example, load reduction programs that can reduce deferred balances at a very low cost, as the financial incentives for the program are funded directly out of energy conservation savings.

Another area of focus should be further improvement in energy purchasing strategies. The BPU has already taken very significant steps toward this end by implementing the BGS auction for procurement of energy in Year 4. The competitive bidding process employed at the auction drove down wholesale prices for all utilities, which addressed most of their power needs for the next year. However, utilities still have many existing power contracts that present opportunities for saving. The Task Force urges the BPU and

utilities to continue to work together toward aggressively renegotiating such contracts in order to mitigate the continuing accumulation of deferred balances.

Recommendation #3: Apply strong consumer protections

The Task Force strongly supports the adoption of consumer protections to ensure that the burden of proof for recovering deferred balances is placed squarely on the utility companies. These protections include the requirement of full evidentiary hearings, participation by the Ratepayer Advocate and other interested parties in the hearing process, and an independent audit of utilities' deferred balances.

At Governor McGreevey's request, the BPU has developed a rigorous process for investigating the prudence of utilities' deferred balances that encompasses all of the consumer protection measures mentioned above. Deferred balance rate requests will be referred to an Administrative Law Judge (ALJ), who will hold public and evidentiary hearings on the matter. During this process, the ALJ will conduct discovery and hear evidence from the utility, the BPU staff, the Division of the Ratepayer Advocate, expert witnesses and other interested third parties. After completing this process, the ALJ will submit an initial decision to the BPU for consideration as it conducts its evaluation of deferred balances.

The BPU will also secure the services of one or more consultants to audit the deferred balances of each utility. The auditors' findings will be submitted in the deferral cases before the ALJ where they will be subject to discovery, cross-examination and rebuttal by the utility and the other participating parties.

The Task Force applauds these efforts and urges the BPU to rigorously implement them by devoting adequate resources to the process and applying strict scrutiny to utility claims of deferred balances. This is particularly important in light of the many unanswered questions that must be addressed before utilities are reimbursed for deferred balances, such as whether they made reasonable decisions when purchasing power, and whether every effort was made to mitigate the accumulation of deferred balances.

Recommendation #4: Mandate bill inserts to educate consumers about deferred balances

The Task Force recommends the inclusion of a Board Secretary-approved insert in each utility bill explaining the issue of deferred balances to consumers. Ratepayers deserve information about deferred balances and their potential impact on rates, just as they were notified of rate decreases during the first four years under EDECA. Consumers have a right to know that under EDECA they have not benefited from true rate reductions; rather, they have been purchasing electricity on credit, and it is now time to repay the loan, with interest. This information will allow ratepayers understand how their rates are being set, and to anticipate their future electric costs so that they can plan accordingly.

There are additional education efforts that utilities and the BPU can undertake to increase awareness about this issue and its impact. Bill inserts that explain what deferred balances

are, how they have accumulated, and what the potential rate impact will be, represent a starting point in this education effort.

Recommendation #5: Examine broader changes in EDECA and its implementation

This Task Force was charged with the important but relatively narrow task of addressing the issue of deferred balances. It is clear, however, that deferred balances are just one part of a larger issue – a deregulation effort that has, so far, failed to live up to expectations. Despite several positive elements of the deregulation effort, the fundamental goals of providing consumers with a competitive marketplace that drives down prices and gives consumers a range of choices for energy generation have not been realized. The Task Force urges the Governor and his administration to examine broader changes in EDECA and the electricity market that would bring about real retail competition and better protect and promote the interests of ratepayers.