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PRELIMINARY STATEMENT

In this proceeding, Public Service Electric and Gas Company ("Public Service" or "Company") has filed a proposal which raises issues of crucial importance to the future of New Jersey's natural gas marketplace. There can be no dispute that the objective of the Electric Discount and Energy Competition Act ("EDECA") to establish a fully competitive natural gas marketplace in New Jersey has not been realized. On a nationwide basis, the benefits of natural gas competition have been slow to reach smaller consumers. A recent report issued by the National Regulatory Research Institute found that "most residential consumers have remained with their incumbent utility ...." KENNETH W. COSTELLO & MOHAMMAD HARUNUZZAMAN, CONSUMER BENEFITS FROM GAS CHOICE: EMPIRICAL FINDINGS FROM THE FIRST PROGRAMS, at 43 (NRRI Report No. 00-15, October 2000). Over the past several months, volatile wholesale natural gas prices have further slowed the progress of natural gas competition. Kathy Hennessy, *Deregulation No Cure for High Bills,* ASBURY PARK PRESS, Jan. 21, 2991, at B1; *New Jersey Resources Terminates Gas Marketing Arm, Citing Decreased Interest*, PLATT'S RETAIL ENERGY, July 6, 2001, at 4-5.

In New Jersey, there is no competitive natural gas marketplace for residential and smaller commercial consumers. As noted by Ratepayer Advocate witness Richard LeLash, "[n]o one can truthfully assert that adequate competitive alternatives are available for Public Service's residential and small commercial customers today." *RA-82* at 30. This view of the New Jersey natural gas marketplace was confirmed by Shell Energy Services witness Richard Hornby, who agreed that the is presently no robust competition for New Jersey's smaller consumer. Tr. 621.

The natural gas switching statistics reported by the Board further confirm the lack of robust competition in New Jersey’s retail natural gas marketplace. According to the Board’s May 31, 2001 report of Natural Gas Statistics, only about 7.6 percent of the State’s commercial and industrial customers, and 2.3 percent of residential customers, have chosen a competitive supplier. The Board’s statistics for Public Service are even less indicative of robust competition. As of mid-May, 2001, only 6.7 percent of the Company’s industrial and commercial customers, and only 2,834 of the Company’s 1.4 million residential customers S less than 0.2 percent S were being served by competitive suppliers.

In the face of an indisputable lack of competitive alternatives for consumers, Public Service has presented a proposal which, instead of promoting effective competition, is likely to impede it. Public Service is proposing to transfer to an unregulated affiliate, referred to in the Company’s proposal as “Newco,” the Company’s entire portfolio of interstate natural gas capacity and supply contract. The proposed transfer would be at cost, with no competitive bidding. At the same time, the Company would enter into a no-bid Requirements Contract with Newco to supply Public Service’s basic gas supply service (“BGSS”) customers at “market-based” prices determined largely within Newco’s sole discretion. At the conclusion of the Requirements Contract, Newco and an unknown number of third party suppliers (“TPSs”) holding capacity pursuant to a proposed “Permanent Capacity Release” program, would have unfettered control of the transferred contracts.

The Public Service proposal is in clear violation of specific mandates under EDECA guaranteeing consumers access to reliable and reasonably priced BGSS, under full Board regulation, until a competitive marketplace develops. The Public Service proposal would effectively remove the Board's authority to oversee the procurement and pricing of BGSS, leaving consumers with no "backstop" against the exercise of market power. As a matter of gas procurement policy, it would be an act of extraordinary imprudence, committing Public Service to procure its BGSS requirements at prices determined by the seller. Finally, the proposal would grant unreasonable and unlawful preferences to Public Service affiliates, providing them with the opportunity to earn windfall profits at ratepayer expense.

The Public Service proposal is also likely to concentrate control of essential gas supply resources in the hands of a few unregulated entities which could then exercise market power, leading to reduced reliability and higher natural gas prices. Instead of competition, ratepayers would be subject to an unregulated gas supply oligopoly. With a Public Service affiliate controlling a significant share of electric generation in the PJM market area, the proposal also threatens to raise electricity prices. The proposal would leave no one accountable for assuring that New Jersey has adequate natural gas supplies in the future. The Company has presented its proposal without having performed any market power studies, or any other analysis of its potential detrimental impacts of the proposal on the State's energy consumers.

As noted in the testimony of Ratepayer Advocate Paul Chernick, EDECA reflects the Legislature's intent, among other things, to:

- Lower the current high cost of energy.
- Improve the quality and choices of service.
- Ensure universal access to affordable and reliable electric service.
- Preserve the reliability of power supply ... systems.

- S Authorize the Board of Public Utilities to permit competition in the ... gas marketplace ..., and thereby reduce the aggregate energy rates currently paid by all New Jersey consumers.

- S Provide the Board of Public Utilities with the ongoing oversight and regulatory authority to ... take such actions as it deems necessary and appropriate to restore a competitive marketplace in the event it determines that one or more suppliers are in a position to dominate the marketplace and charge anti-competitive above-market prices.

The Public Service proposal could frustrate all of these goals of EDECA.

New Jersey Supreme Court Justice Gary Stein observed in his dissenting opinion on appeal of the Board's electric restructuring decision for Public Service that "[o]ne need only read newspaper accounts concerning the current increases in electricity generation costs experienced by utilities in California ... to appreciate the significance and the potential implications of the BPU's exercise of its authority over electric utility deregulation and restructuring." *I/M/O Public Service Electric and Gas Company' Rate Unbundling, Stranded Costs, and Restructuring Filings*, 167 *N.J.* 377, 413 (2001) (Stein, J, concurring and dissenting). The California experience provides stark illustration of the risks of allowing a few unregulated entities to gain control of scarce energy resources. New Jersey's energy consumers should not be subjected to the risks of compromised reliability and high energy prices in order to provide Public Service affiliates with the opportunity to gain windfall profits. In accordance with the goals of EDECA, a transfer such as that proposed by Public Service should be entertained only after a robust competitive natural gas marketplace has developed, and the Board is assured that Public Service's gas supply resources are no longer needed to assure that reliable and reasonably priced natural gas is available to New Jersey consumers.

PROCEDURAL HISTORY

This proceeding was initiated on August 11, 2000, with the filing of Public Service's Proposal to Transfer its Rights and Obligations Under its Gas Supply and Capacity Contracts and Operating Agreements to an Unregulated Affiliate and for Other Relief, BPU Dkt. No. GM00080564. The matter was transmitted to the Office of Administrative Law on October 26, 2000, and a prehearing conference was held on December 19, 2000. The following parties were granted leave to intervene: North Jersey Energy Associates ("NJEA"), Shell Energy Services ("Shell"), Mid-Atlantic Power Supply Association ("MAPSA"), The New Power Company ("New Power"), the New Jersey Business Users ("NJBUS"), and the Independent Energy Producers of New Jersey ("IEPNJ").

On March 20, 2001, the Ratepayer Advocate filed a Motion to Dismiss the Company's petition. The motion was fully briefed in April, 2001 but has not been decided.

. Evidentiary hearings commenced on March 26, 2001 and continued on April 16, May 21 and 22, and June 13, 15 and 22, 2001. At the April 16, 2001 hearing, the Company submitted a document entitled "Stipulation of Settlement," signed by Public Service, Shell, and New Power, which was offered as a substitute for the Company's original proposal. (Since that document is more accurately described as a "Joint Position," it will be referred to as such in this brief.) The Joint Position modified the Company's proposal to provide for brief delay in implementing "market-based" pricing for residential customers, and to include some limited, short-term measures to encourage competitive suppliers to enter New Jersey's natural gas marketplace. Discovery concerning the Joint Position was conducted between that time and the resumption of hearings on May 21, 2001. The Addendum included provisions affirming that NJEA's and

IEPNJ’s members would be exempt from “market based” pricing, and providing them with preferential access to capacity that would otherwise be used to benefits BGSS customers. At the May 21, 2001 hearing the Company submitted an Addendum to the Joint Position, which was negotiated to induce NJEA and IEPNJ to sign the Joint Position. Amendments to the proposed Requirements Contract were provided to the parties on May 14 and May 30, 2001.

SUMMARY OF RECOMMENDATIONS

The Ratepayer Advocate's recommendations in this matter are summarized as follows:

S The Board should reject the proposed contract transfer and Requirements Contract. The Board should specifically find that these proposed transactions are contrary to the policies of EDECA, in violation of EDECA's mandates requiring full BPU regulation of BGSS, and imprudent as a matter of gas supply procurement policy.

S Public Service should be directed to implement measures to encourage competition while it retains control of its essential natural gas supply resources.

S In accordance with the legislative directives of EDECA, a transfer should be considered only after a robust competitive natural gas marketplace has developed, and the Board is assured that Public Service's control of its gas supply resources is no longer needed to assure reliable and reasonably priced BGSS.

S In order to avoid an undue preference to Public Service affiliates, and to assure that ratepayers receive the full value of any transferred resources, any transfer should be subject to competitive bidding.

ARGUMENT

I. THE PUBLIC SERVICE PROPOSAL WOULD VIOLATE EDECA'S PROVISIONS REQUIRING FULL BOARD REGULATION OF BGSS.

A. The Proposal Would Virtually Eliminate The Board's Ability to Assure the Availability of Reliable and Reasonably Priced BGSS Through Oversight of the Procurement and Management of Gas Supply Resources.

An essential element of EDECA is its guarantee that consumers will have access BGSS, subject to the regulatory oversight of the Board, as a "backstop" during the transition to a fully competitive marketplace. The definition of BGSS contained in Section 3 of EDECA states that BGSS "is not a competitive service and *shall be fully regulated by the [B]oard*." *N.J.S.A.* 48:3-51 (emphasis supplied). Section 10(u) of EDECA further provides that BGSS providers may recover "all *reasonably and prudently incurred* costs incurred in the provision of [BGSS] ...." *N.J.S.A.* 48:3-59(u) (emphasis supplied). These provisions contemplate that the Board will exercise its full regulatory authority to assure the availability of reliable, reasonably-priced BGSS until a robust competitive market develops. As explained by Ratepayer Advocate witness Richard LeLash, "[t]he Public Service proposal would severely compromise the Board's ability to perform this function, by placing the procurement and management of gas supply resources, as well as pricing decisions, within the discretion of an unregulated entity." *RA-82* at 12.

1. Without Board Oversight, Newco Could Manage Its Gas Supply Resources to Maximize Profits, to the Detriment of Economical and Reliable Service.

Providing natural gas to New Jersey consumers is not a simple matter. Natural gas is a complex product, involving several markets between wellhead and the burner tip. Gas is provided to New Jersey consumers through a combination of products and services, including the following:

- S Natural gas purchased at the wellhead in producing areas in the Gulf Coast and Alberta, Canada.
- S Delivery of the gas from the wellhead to the interstate pipelines in the producing areas.
- S Storage service provided by the interstate pipelines in facilities located in the producing areas and in the Appalachian region.
- S Long-haul transportation on the interstate pipelines directly from the producing areas to New Jersey.
- S Transportation services on a different but overlapping pipeline segments from the producing areas to the storage facilities, and from the storage facilities into New Jersey.
- S A variety of contractual and tariff-based rights to interrupt service to some customers under certain conditions.
- S In-state "peaking" supplies, such as Public Service's liquefied natural gas ("LNG") and propane ("LPG") facilities, which are used to provide the last increments of supply on the coldest days.

RA-82 at 12-13; *RA-83* at 18. The Board currently reviews the utilities' activities in procuring and managing these diverse resources as part of each utility's annual gas cost adjustment proceedings, and through its authority to conduct audits and investigations. *RA-82* at 13. On occasion, the Board has required significant changes in utility procurement practices. *See, e.g., I/M/O Board's*

Determination that a Focused Audit be Performed on the Gas Capacity and Gas Supply of South Jersey Gas Company, BPU Dkt. No. GA94110526, Order Accepting Audit With Modifications (Aug. 21, 1995).

Under the Joint Position, the Board's ability to perform its oversight function would be severely compromised. Newco would be under a contractual obligation to provide BGSS supplies, but procurement and management of gas supply resources would be completely within Newco's discretion. *RA-82* at 14; Tr. 235. Further, although Public Service is proposing to retain its in-state LNG and propane facilities, Newco would control the dispatch of these facilities as long as the Requirements Contract remained in effect. *PS-6,* §§ 1.8, 2.4*;* Tr. 459-60. Newco would also have the right to control most curtailments of service to interruptible customers. *PS-6,* §§ 1.8, 2.4; *PS-21* (2d revised response to INF-T-9); Tr.1055.[1]

Newco, having been granted complete discretion over natural gas procurement, could decide to enter into new supply arrangements to pursue new market opportunities. Newco's portfolio of gas supply resources could be completely restructured, and not necessarily in a way that would provide the most reliable and economical service to BGSS customers. *RA-82* at 14. Newco's interests in maximizing its profits could also cause it to manage its gas supply resources in a way that imperils reliability. For example, Newco could dispatch its peaking resources early in the season for sale in the competitive markets, leaving inadequate supplies for a late cold snap. *RA*-82 at 18; RA-*83* at 47. Newco's exercise of right to control interruption rights raises similar

[1] The Company originally stated in a discovery response that Public Service would control interruptions. *RA-60.* However, the Company later acknowledged that, under the Requirements Contract, Public Service would have the authority to direct interruptions only in the event of constraints on its local distribution system. *PS-21* (2d revised response to INF-T-9); Tr. 1055.

concerns. Newco could direct Public Service to exercise these rights for economic rather than operational reasons. *RA-82* at 18.

It appears that Public Service may have already committed Newco to procurement and gas supply management decisions that would prove detrimental to BGSS consumers. As part of the proposed Addendum to the Joint Position, Newco would provide Public Service's large cogeneration customers with access to interstate transportation and storage resources which it determined were not needed to meet Newco's gas supply obligations under the Requirements Contract. *PS-7* at 2-3. By providing cogenerators with preferential access to this capacity, at cost, Newco would divert resources which could otherwise be used to generate margins to benefit BGSS customers. *RA-82* at 33-34. Another provision in the Addendum states that Newco may exercise its "sole discretion" to "restructure, renegotiate, or terminate any [transferred] contract ... if it deems it in the best interest of its BGSS and contract cogeneration customers." *PS-7* at 2-3. This raises the prospect that the Company could make procurement decisions to enhance the cogenerators' access to capacity, rather than minimize the costs of capacity used to supply BGSS customers. *RA-82* at 15.[2]

Further, no one would be accountable for assuring the continued availability of adequate gas supplies for New Jersey consumers. Company witness David Wohlfarth asserted that Newco would have this obligation to acquire additional supply and capacity to meet the needs of Public

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[2] As explained below, Public Service is proposing to continue the current cost-based pricing mechanism for residential customers through March 31, 2004. The Company also states that it is proposing to "unfreeze" the capacity component of its proposed "MPGS" rate after December 31, 2002, and adjust this component to reflect actual costs, including offsetting margin revenues. Tr. 695-96. Thus, uneconomic procurement decisions would ultimately affect all BGSS customers as long as the Requirements Contract remained in effect.

Service's firm customers. Tr. 1026-27. With Newco obligated to provide BGSS supply through 2007, at the latest, it is unclear what incentive Newco would have to assure that adequate gas supplies would be available in the long term. It is also unclear how Newco would meet its obligation to maintain sufficient pipeline resources to supply BGSS in the event third-party suppliers were to exit the market without returning released capacity. The permanent capacity release program included in the Joint Position requires the return of transportation and storage capacity to Newco only at the time the released contracts come up for renewal. Joint Position, Sched. 4; ¶¶ A.9, B.11, B.13. In the event of an exit from the market either before or after that time Newco, and the Board, would apparently have no way to access the capacity. *RA-83* at 46.

As noted by Ratepayer Advocate Witness Paul Chernick, a similar problem exists in California's electric market. California's shortage of electric generation is partly attributable to its dismantling in 1995 of its longstanding biennial statewide electricity planning process. *RA-83* at 46. These types of problems have been addressed in other restructured electric markets by leaving the utility with some responsibility for contracting for new supply, and by including long-term planning in the responsibilities of the ISO. *RA-83* at 46. As Mr. Chernick explained at the hearing:

> ... there should be some entity responsible for the planning and operation of the gas supply system for the region that includes Public Service. Currently that's Public Service. If Public Service gives up that obligation, then some new entity has to step into its place, and one possibility would be a gas ISO.

Tr. 995-96. The Public Service proposal would simply leave a vacuum, relieving Public Service of these responsibilities with no other entity such as a natural gas ISO to take its place.

2. Insufficient Gas Supplies Could Lead to Serious Hardships for New Jersey Consumers.

Insufficient gas supplies can lead to problems much more serious than the rolling blackouts implemented in California as a result of inadequate electric generation. Once gas pressure falls below a certain level, pilot lights on appliances such as boilers and water heaters will not stay lit, a condition known as “flameout.” When an area approaches flameout conditions the utility must shut down the area to avoid explosions. Before gas service can be restored, utility personnel must enter each building to assure that all pilot lights are shut off. When service is restored, the pilot lights must be lit again. A large-scale gas outage could result in large-scale evacuations and property damage. *RA-83* at 47-48.

Large-scale gas outages are not an impossibility. Massachusetts came close to flameout conditions during the 1980-81 winter due to a series of errors by the State’s gas utilities. These included pursuit of interruptible sales to benefit shareholders well into the heating season, failing to procure supplies for nominally interruptible customers with no alternative fuel supplies, and relying on unreliable gas supply resources such as “best efforts” contracts, imported LNG, which became unavailable due to a sunken ship which blocked a terminal in Algeria, and propane air facilities which could not be resupplied when the cold weather exhausted local supplies of propane. To avoid large-scale outages, the Governor was compelled to shut down the Commonwealth’s government, all public schools, and most businesses for several days. *RA-83* at 48.

Under the Public Service proposal, Newco could be tempted to take similar chances with New Jersey’s gas supplies. *RA-83* at 48. Even during the term of the Requirements Contract, it is unclear whether Newco will have sufficient incentives to maintain a reliable supply. The Requirements Contract would limit Newco's liability for a default to "direct damages," a term which may exclude the potentially large economic costs associated with a large-scale outage, and there are no provisions for penalties in the event of a failure to deliver. *PS-6*, § 17.1; Tr. 271-273.

In response to concerns raised by the Ratepayer Advocate during the hearings, the Company has included in its May 31, 2001 amendment to the Requirements Contract provisions giving the right to terminate the Requirements Contract and require Newco to re-transfer the capacitySbut only if Newco fails to meet its delivery obligations on three days during a 12-month period. *PS-6*, §§ 1.8; 13.1. Thus, Newco could fail to deliver sufficient gas supplies two days each year without being subject to this provision.

The Public Service proposal could have serious detrimental impacts on reliability. The Board, lacking any authority over Newco's procurement and management of natural gas resources, would have limited ability to assure the continued availability of reliable and reasonably priced BGSS. This result is fundamentally at odds with EDECA's mandate that the Board retain full regulatory authority over BGSS.

B. The Public Service Proposal Would Violate EDECA's Specific Provisions Governing the Pricing of BGSS, and Would Commit the Board to an Imprudent Gas Supply Arrangement.

1. EDECA Requires that Regulated BGSS be Available to Consumers as a Backstop Against the Exercise of Market Power.

In addition to compromising the overall regulatory authority contemplated by EDECA for BGSS, the Public Service proposal is in clear violation of EDECA's specific mandates concerning the pricing of BGSS. These mandates are found in sections 10(r), 10(t), and 10(u) of EDECA.

Section 10(r) of EDECA states that:

> For at least three years subsequent to the starting date of 100 percent retail competition as provided in subsection a. of this section [that is, December 31, 2002] and thereafter until the board specifically finds it to be no longer in the public interest, each gas public utility shall provide basic gas supply service.

With regard to pricing, section 10(r) states that, during the time BGSS is provided by the utility:

> The charges assessed to customers for basic gas supply service shall be regulated by the board and shall be based on the cost to the utility of providing such service, including the cost of gas commodity and capacity.

Under section 10(t), if BGSS is provided by a non-utility supplier:

> The charges assessed to customer for basic gas service shall be regulated by the board and shall be based on the cost to the supplier of providing such service, including the cost of gas commodity and capacity purchased at prices consistent with makes conditions by the supplier in the competitive wholesale marketplace and related ancillary and administrative costs, as determined by the board or shall be based upon the results of a competitive bid.

Thus, BGSS must be provided by the utility at cost-based rates until at least December 31, 2002. The Board may allow non-utility suppliers the opportunity to provide BGSS after December 31, 2002, in which case prices may be based on either actual procurement costs or the results of a competitive bidding process directed by the Board. The Public Service proposal would violate these provisions by essentially eliminating the Board’s ability to regulate BGSS pricing.

2. The Proposal Would Commit Pricing Decisions to an Unregulated Entity Contrary to EDECA’s Mandate Requiring Regulated BGSS Service.

Public Service is proposing to provide BGSS initially for industrial and commercial customers, and later for residential customers, at prices determined largely within Newco’s discretion. These prices would be based neither on actual costs, nor on the results of a competitive bid. *RA-82* at 22.

Public Service currently provides BGSS service to residential customers at cost-based levelized rates. Most industrial and commercial customers are served under a rate schedule that establishes prices each month based on a market index, but subject to adjustments to reconcile the rates with the Company's actual procurement costs. *RA-82* at 22-23; Tr. 291-94, 297. The Company is proposing to replace the current cost-based rates with market-based rates patterned on the Company's Market Priced Gas Service ("MPGS") rate schedule, which currently applies only to industrial and commercial customers who have returned to BGSS after a period of service from a competitive supplier. *RA-82* at 23. The MPGS tariff was deliberately designed as an unfavorable rate, so that customers returning to Public Service's system would not create increased costs for customers who had remained on the system. Tr. 828. It was intended to recover the incremental costs placed on the Company's system by returning customers. Tr. 217. It was never intended to apply to all BGSS customers. Tr. 829.

The following is a summary of the proposed "MPGS" pricing mechanism:

S Newco would have the right to set a price each month at any level between a floor and a ceiling. *RA-82* at 23; *RA-29* at 20; Tr. 327.

S Through December 31, 2004 the floor rate would be based on two components: (1) a fixed rate component of $1.26 per therm based on the asserted cost of interstate transportation and storage ("Non-Gulf Coast Cost"), plus a commodity component ("Gulf Coast Cost") based on short-term market indexes. *RA-8*2 at 24; *RA-29* at 20; *RA-81*; Tr. 299-300, 304-05.

- Through December 31, 2004 the ceiling would be equivalent to the Company's proposed new "Emergency Sales Service" which reflects (1) the Non-Gulf Coast Component plus (2) a commodity component equal to the highest cost of gas purchased during the month, plus an "adder" of $1.81 per dekatherm. *RA-82* at 24; *RA-29* at 20; *PS-21* (response to TR-998); Tr. 314-15.
- After December 31, 2004 the Non-Gulf Coast component of both the floor and ceiling rates would be "unfrozen." The Joint Position states that both components of floor and ceiling rates would be "market-based" after December 31, 2004. However, it appears that the Company intended to propose a cost-based rate, to be adjusted annually. Joint Position, ¶ 7; *RA-82* at 24; *RA-29* at 20; *RA-81*; Tr. 695-96.

As part of the Joint Position, the Company is proposing to retain the current levelized rate for residential customers until April 1, 2004, at which time they also would be moved to the proposed new "MPGS" rate schedule. Joint Position, ¶¶ 7, 8.

The proposed "MPGS" pricing mechanism would result in essentially unregulated BGSS rates, contrary to the mandates of EDECA. Newco would have unlimited discretion to select any rate between the floor and the ceiling. *RA-82* at 24; Tr. 327, 340-41. Neither Public Service nor the Board would have any authority to challenge any rate determined by Newco, as long as that rate fell between the floor and the ceiling. Tr. 327, 331-34.

The "ceiling" rate would provide some protection, but that protection would be extremely limited, as the Emergency Sales Service rate can exceed actual costs by a considerable margin. *RA-82* at 24. This can be seen from the "ceiling" rates determined by Public Service under the current MPGS rate schedule. During a recent 12-month period, the MPGS “ceiling” rate for smaller commercial and industrial customers exceeded the cost-based “CS-GS” rate by as much as $2.96 per dekatherm. *RA-82* at 25 & Sched. 1. During the time the current “MPGS” rate schedule has been in effect, the Company has generally followed a practice of setting MPGS rates at $0.26 to $0.27 per therm over the “floor” rate. However, there is no guarantee that this would continue if pricing decisions were entrusted to an entity not accountable to the Board for its pricing decisions. *Id.* As Mr. Wohlfarth acknowledged, the only factor preventing Newco from charging the “ceiling” rate each month would be “market forces.” Tr. 471.

3. Ratepayers Would Lose Many Existing Benefits, and Would Be Subject to Improper Rate Increases.

Consumers would also lose a number of specific benefits they have under the current cost-based rates. Ratepayers would lose the benefits of storage and hedging transactions. *RA-82* at 27. The ratepayers’ shares of margins under the Company’s margin sharing programs would be “frozen” for commercial and industrial customers through December 31, 2003, and Newco could partially or completely offset this benefit by selecting a rate above the “floor.” *RA-82* at 27-28. Beginning on April 1, 2004 residential ratepayers would also lose the stability afforded by their current levelized pricing mechanism. *RA-82* at 28.

These detrimental impacts are compounded by the Company’s proposal to incorporate two improper rate increases in both the “floor” and “ceiling” MPGS rates. First, the Company has proposed a 21-cent increase in the Non-Gulf Coast component. This increase would consist of: (1) an asserted 16-cent increase in pipeline rates that has been neither noticed to customers nor reviewed by the Ratepayer Advocate and the Board, and (2) a 5-cent increase which overstates fixed costs on a per-therm basis by basing weather-normalized usage on a 5-year average which over-weights the recent warmer-than normal winters. *Id.* at 26. In addition the Company is proposing an 8-cent increase in the commodity component, to reflect an asserted increase in the Company's carrying cost on gas in inventory. This is a base rate expense item which the Company has no authority to adjust in the current proceeding. *Id.*

4. The Company is Proposing to Further Diminish Consumer Protections After December 31, 2002.

After December 31, 2003, the Company's proposed pricing mechanism would become even more problematic. The Joint Position and some of the Company's responses to discovery state that the "Non-Gulf Coast" component of both the "floor" and "ceiling" rates will be "market priced" after December 31, 2003. *RA-82* at 29; Joint Position, ¶ 7; *RA-53.* If interstate pipeline resources are to be truly "market priced," then the "Non-Gulf Coast" component could reach very high levels during periods when delivery capacity into New Jersey is constrained. As an example, during the 2000-01 winter, prices for natural gas delivered in New Jersey reached $25 per dekatherm and higher, reflecting a very high premium over the interstate pipelines' tariffed rates. *RA-82* at 29; Tr. 476.

During the hearings, the Company stated that it was actually proposing to continue cost-based pricing for the "Non-Gulf Coast" component. According to Mr. Wohlfarth, the intent was to "unfreeze" the $1.26 per therm rate and adjust it annually to reflect actual costs. Tr. 695-96. At the June 15, 2001 hearing the Company submitted what it referred to as "expected" tariff revisions reflecting this position. *RA-81;* Tr. 694. This "expected" tariff revision is "subject to change," and has not been incorporated in the Joint Position or otherwise agreed to by parties other than Public Service. *Id.* Further, even under the "cost-based" approach described by the Company, the Non-Gulf Coast component would be based on a gas capacity and supply portfolio structured completely within Newco's discretion. Given the Company's proposal that the Board "not have jurisdiction" over Newco's procurement decisions, its ability to review the underlying costs would be limited. Tr. 235. In any event, the Board's ability to regulate BGSS rates would be even further compromised after December 31, 2002.

5. Competitive Forces Will Not be Sufficient to Protect Consumers, Because Competitive Alternatives are Not Available for New Jersey's Residential and Smaller Commercial Natural Gas Customers.

The Company asserted at the hearing that under its proposed "MPGS" rates market forces will be sufficient to protect consumers. Tr. 333, 471. This position should be rejected by the Board. First, as explained at pages 14-15 above, the Legislature has mandated that consumers have the protection of fully regulated BGSS rates. Furthermore, market forces will not protect consumers until a robust competitive market has developed in New Jersey. As Mr. LeLash observed in his pre-filed direct testimony, "[n]o one can truthfully assert that adequate competitive alternatives are available for Public Service's residential and small commercial customers today." *RA-82* at 30.[3] As discussed at pages 56-58 below, the initiatives included in the Joint Position may serve only to require Public Service to share market power with a few large marketers.

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[3] According to the Board's May 31, 2001 report of "Natural Gas Statistics," as of mid-May, 2001, of the Company's 1,437,812 residential customers, only 2,834, or approximately 0.2 percent, were being served by competitive supplier. Of the Company's 179,562 commercial and industrial customers, only 11,948, about 6.7 percent, were being served by competitive suppliers.

Richard Hornby, who testified on behalf of Shell Energy Services, recognized the importance of maintaining regulated BGSS rates until *actual competition develops*. According to Mr. Hornby:

- S There is presently no robust competition for residential and small commercial customers. Tr. 621.
- S Under current conditions, competitive forces do not adequately protect these customers. Tr. 621.
- S Prices for BGSS should be regulated by the Board until there is robust competition. Tr. 621.
- S If the Board should adopt rate mechanism such as the proposed "MPGS" rate schedule, the Board's regulatory authority should include monitoring the exercise of Newco's discretion to set rates between the "floor" and the "ceiling." Tr. 624.
- S The Board should have the ability to change the entire mechanism if it produces unreasonable rates. Tr. 624.

Public Service's "MPGS" pricing proposal does not meet Mr. Hornby's criteria. As explained above, the Board would have no ability to challenge any rate between the "floor" and the "ceiling," and the Requirements Contract would severely limit the Board's ability to order changes in the "MPGS" rate schedule.

Further, the Public Service proposal includes a tariff provision that would limit consumers' ability to leave BGSS service in response to unreasonable prices. Under this provision, BGSS customers would be required take service under an initial term of one year, subject to automatic renewal for successive one-year terms. *RA-29* at 17; Tr. 444; *RA-82* at 31. BGSS customers would have limited ability to choose a competitive option in response to abusive pricing by Newco.

6. With Newco in Control of Procurement Decisions, the Board Would Have No Control Over its Natural Gas Procurement Costs.

Public Service attempted to suggest during its cross-examination of Ratepayer Advocate witness Richard LeLash that the Company's proposal is, in essence, no different from the current arrangements in which the Board lacks direct jurisdiction over Public Service's FERC-regulated contracts with interstate pipelines, but possesses the authority to disallow costs incurred as a result of an imprudent procurement decision. Tr. 717-19. To the contrary, the Company's own discovery responses state that Newco's procurement and management of gas supply resources would not be reviewable by the Board, and this was confirmed by Mr. Wohlfarth at the hearing. *RA-20;* Tr. 235. The Company in fact is requesting the Board's advance approval of this arrangement. Tr. 178. If the Board were to approve the Requirements Contract, its authority to review the exercise of discretion granted to Newco in the Requirements Contract would be, at the very least, subject to question. As Mr. LeLash observed, at the present time "the Board has control of how this portfolio is utilized by the utility. Under the proposals and transactions ... the Board would have no control over how that portfolio is operated." Tr. 740.

7. The Proposed Requirements Contract Limits the Board's Ability to Disallow Imprudently Incurred Costs.

Under the Company's proposal, the Board would have very little recourse in the event "MPGS" pricing were to produce unreasonable rates. The Requirements Contract provides that Newco is entitled to all amounts billed by Public Service under the proposed "MPGS" rate schedule. *RA-82* at 31; *PS-6*, § 2.2. The Board could attempt to change the Company's rate schedules, but this would trigger the “Regulatory Risk” provision, which would entitle Newco to renegotiate the terms of the Requirements Contract “in a manner that preserves the economic value of the Contract ....” *RA-82* at 31; *PS-6,* § 11.2; Tr. 449-50. In the event the renegotiation were to fail, Newco would have the right to proceed to arbitration, in which the arbitrator would:

> endeavor to identify solutions that compensate [Newco] for the services it provides under the Contract consistent with the market value of the services and which enables [Public Service] to provide BGSS service to its customers in a manner and at a price comparable to the manner of service and price for service that third-part gas suppliers operating in New Jersey would provide to similarly situated customers; ...

The arbitrator’s decision, which, under the above provision, would result in a continuation of market-based BGSS pricing, would be binding on the Board. *RA-82* at 31-32; *RA-6,* §§ 11.2, 18.1; Tr. 450-51, 453-54, 590-91. Thus, even assuming the Board had the authority to refuse to flow the full costs through to ratepayers, Public Service would still be obligated to pay them. Thus, the Board could be “faced with a situation where it can control Public Services rates, but not Public Service's finances.” Tr. 891.

As noted above, Public Service is proposing as part of the Joint Position that “MPGS” pricing for residential customers be delayed until April 1, 2004. While this would provide temporary protection for residential customers, acceptance of the Public Service proposal would commit the Board to removing that protection on April 1, 2004. Joint Position, ¶ 8. Moreover, it is unclear whether the Board would fully retain its existing ability to review the rates charged to residential customers. As noted at pages 10-12 above, with procurement and resource management decisions committed to Newco’s discretion, it is uncertain whether economical BGSS will be the highest priority. To give one example, the Requirements Contract does not obligate Newco to use its storage services to benefit BGSS customers. Lower-cost stored gas could be used for off-system sales, and higher-cost flowing gas charged to the residential customers. *RA-82* at 33. There is also no provision in the current version of the Requirements Contract preserving these customers' rights to revenues under the Company's margin sharing mechanisms. *Id.*

It is also unclear how the Board will review the rates charged to residential customers. The May 30, 2001 draft of the Requirements Contract contains a provision which could limit the Board's ability to review the prudency of Newco's procurement and gas supply management activities from the viewpoint of the residential customers. Section 2.2 of the revised draft would obligate Public Service to pay Newco "the actual Gulf Coast Cost of Gas and Non Gulf Coast Cost of Gas ... incurred by [Newco] to supply the gas required by [Public Service's] customers under Rate Schedule CS-RSG." *PS-6*, § 2.2. This provision would require Public Service to pay Newco the *actual* costs incurred by Newco, not *prudently incurred* costs as found by the Board. RA-*82* at 33; Tr. 658-59.

Company witness David Wohlfarth testified that this provision was not intended to impair the Board's authority to review the prudency of the gas costs charged to residential customers, and that Public Service would bear the risk of any disallowances. Tr.659-60. However, if the Board were to approve the Requirements Contract as prudent, as the Company is requesting, the Board's ability to disallow amounts paid to Newco under the Requirements Contract could be subject to question. Further, even assuming the Board could disallow costs, Public Service would still be obligated to pay them to Newco, thus potentially impairing the utility's financial condition.

The Company's proposal is in clear violation of EDECA's mandates concerning the pricing of BGSS. It would severely limit the Board's ability to regulate BGSS prices as required by EDECA. BGSS rates would be based on neither actual costs, as required through December 31, 2002, nor the results of competitive bidding. Consumers would not be protected against the exercise of market power.

In addition, the transactions being proposed by Public Service represents a blatantly imprudent gas procurement strategy. In effect, Public Service would be outsourcing its gas supply function under an arrangement that would place pricing, as well as resource procurement and management, within the discretion of the supplier, and then allow the supplier to "walk away" with the Company's considerable portfolio of interstate transportation storage resources after three to six years. The proposed arrangement would be detrimental to ratepayers and plainly imprudent. The Public Service proposal should be rejected for this reason, in addition to its clear inconsistency with the mandates and policies of EDECA.

C. The Public Service Proposal Would Limit The Board's Options for Determining the Future Structure of BGSS Service.

Under Section 10(s) of EDECA, the Board is directed to issue a decision by January 1, 2002 as to whether non-utility providers should be provided with the opportunity to compete to provide BGSS after the initial three-year period in which BGSS is to be provided by the utilities. *N.J.S.A.* 48:3-58(s). The Board has now initiated a proceeding, in the Board's Docket No. GX01050304, to consider this important issue. The Public Service proposal would pre-empt that proceeding and limit the Board's ability to assure that BGSS continues as a reliable and reasonably priced "backstop" service during the transition to competition.

As explained in Mr. Chernick's prefiled testimony, should the Board reject the Public Service proposal, the Company's resources could be used in a number of ways to support and stabilize BGSS. For example, the Board could bid out BGSS to one or more non-utility providers, using periodic sales of Public Service's resources into the market to provide price stability for consumers. Alternatively, Public Service could sell its assets for a longer term or permanently, and use the proceeds to reduce delivery rates.[4] The Company's resources could be used in a similar fashion even if the Board were to decide to retain Public Service as the retail BGSS provider. *RA-52* at 51-52. Options such as these would be foreclosed under the Public Service proposal. BGSS would be provided at unhedged prices, subjecting consumers to the whims of the short-term market. *RA-83* at 52.

The Board may need to have access to Public Service's resources to support reliable and reasonably priced BGSS throughout the transition to a competitive natural gas marketplace. The continued availability of reliable and reasonably priced BGSS is an essential element in the transition to a competitive market. The Board should resolve the structure of BGSS and assure that it is operating properly before allowing Public Service's gas supply resources to be removed from regulatory control. *RA-83* at 51.

[4] As noted in Mr. Chernick's testimony, the contracts should be sold permanently only upon the appropriate Board findings this will not harm competition or result in unreasonable BGSS rates. *RA-83* at 6.

II. THE PUBLIC SERVICE PROPOSAL WOULD DEPRIVE RATEPAYERS OF THE FULL VALUE OF THE TRANSFERRED CONTRACTS AND GRANT IMPROPER PREFERENCES TO PUBLIC SERVICE AFFILIATES.

A. The Public Service Proposal Would Not Compensate Ratepayers of the Full Value of the Transferred Assets.

The Board should also reject the Public Service proposal because it does not fairly compensate ratepayers for the full value of the contracts proposed to be transferred. As Mr. Chernick observed in his prefiled testimony, if a transfer of contracts is ultimately allowed, the Board should assure that "the value of these resources not be diverted to PSEG shareholders or other parties, unless ratepayers receive equal or greater value in compensation." *RA-83* at 32. The Board should "avoid a situation in which ratepayers give up low-cost resources and must purchase higher-cost resources ...."

The clearest evidence of the value of the contract is "Public Service's proposal itself." *RA-83* at 33. If Public Service did not believe the contracts were valuable, it would not be offering to transfer them to an unregulated affiliate. The interest of competitive suppliers in obtaining a share of these resources is also an indication of their value. *Id.*

Public Service appeared to acknowledge the value of the contracts in a response to a Ratepayer Advocate discovery request, in which the Company stated that Newco:

> believes, in a deregulated environment, that its trading capabilities and knowledge of Northeastern market, its extensive experience in coordination the use of the portfolio and storage entitlements will provide opportunities, though not without risk, to offset the burden of contract costs that exceed market value. *RA-69.*

If, as stated in another discovery response, Newco would be exploiting "unique" expertise, obtained by Public Service employees earning ratepayer-funded salaries, to make the ongoing value of the contracts higher than their costs, then Newco would be receiving an undue preference, allowing it to make windfall profits at ratepayer expense. *RA-82* at 36-37. If, as suggested during the hearings, Newco's employees would be "fundamentalists" whose value is their general expertise rather than their Company-specific knowledge, it is unclear why other firms could not also realize the same value from the contracts. Tr. 516-17.

Public Service offered the testimony of Dr. Jeff Makholm in support of its position that the value of the contracts is below their costs. Dr. Makholm's testimony is both incomplete and based on faulty assumptions.

1. The Company Has Performed No Analysis of the Overall Costs and Benefits of the Proposed Transactions, and Has Presented Valuation Testimony Addressing Only One Single Aspect of Its Overall Proposal.

With regard to the scope of his analysis, Dr. Makholm considered the value of only a single aspect of an overall proposal which includes a contract transfer, a Requirements Contract, and a variety of other provisions added at the behest of the large gas marketers and congenerators that have signed the Joint Position. Tr. 110-111, 113-14. Dr. Makholm did not offer evidence concerning any of the following aspects of the transaction:

- The aggregation of customer load through the Requirements Contract, at no cost to Newco. *RA-83* at 34; Tr. 20-21, 110-111.
- Newco's right to control the Company's peaking resources. *RA-83* at 34; Tr. 27.
- Newco's control over interruptions, and its access to capacity and natural gas freed up by those interruptions. *RA-83* at 34; Tr. 27-28.
- The transfer of Public Service's gas trading operation and expert Staff to Newco. *RA-83* at 34.

- The high level of pricing flexibility to be provided to Newco for BGSS supply. *RA-83* at 34.
- Newco's option to turn back 50 percent of the contracts in 2004 if the Requirements Contract is not renewed. *RA-83* at 43; Tr. 46.

As Mr. Chernick observed, "these aspects of the proposed transfer may be very valuable; Public Service simply provides no information about their value in the market." *RA-83* at 35, 43.

The Joint Position had not been developed when Dr. Makholm prepared his testimony. Thus, his testimony did not include any analysis of the value of Public Service's concessions to the other signatories, or costs of these concessions to ratepayers. Tr. 113-14.

The Company apparently does not dispute that Dr. Makholm's testimony is very limited in scope. In discovery responses and testimony during the hearings, the Company acknowledged that it has performed no analysis of the costs and benefits of the overall proposal upon consumers, or upon the Company and its affiliates. *RA-65; RA-67; RA-68;* Tr. 500, 514-15.

2. The Company's Valuation Testimony Is Largely Irrelevant to the Actual Value of the Resources the Company is Proposing to Transfer.

Even within the limited scope of Dr. Makholm's testimony, his analysis is flawed. Mr. Chernick identified at least five problems with Dr. Makholm's analysis which make it "largely irrelevant to determining the value of the resources, even without the Requirements Contract." *RA-83* at 35.

- Dr. Makholm arrived at a value for the interstate transportation resources by comparing spot market prices at the wellhead with spot prices at the points of delivery to Public Service. Tr. 51. By using spot prices, Dr. Makholm disregarded the "firmness premium" that gas-dependent consumers must pay to assure a firm supply of natural gas. *RA-83* at 35.

- S Dr. Makholm's analysis was based on three warmer than normal winters. Tr. 63, *RA-83* at 36. In a cold winter, gas is withdrawn from storage more quickly, resulting in higher prices for the rest of the winter and spring, and possibly into the summer and the following fall. *RA-83* at 36.
- S Dr. Makholm assumed that gas demand, including growth in gas-fired generation, and pipeline transportation capacity, would both increase at the same rate as general growth in the economy. Tr. 85, 98. In fact, new natural gas transportation is not likely to keep pace with increased electric generation demand, as those generators with alternative fuel capacity are not likely to contract for firm year-round gas supply. *RA-83* at 36-38.
- S Dr. Makholm estimated the value of the contracts as they are currently used by Public Service under the current regulatory scheme. Tr. 90-91. Under the deregulated market structure envisioned by Public Service, the exercise of market power would tend to increase the value of the contracts. *RA-83* at 38-39.
- S Finally, Dr. Makholm did not consider the value that could be realized through hedging, arbitrage, and other value-maximizing strategies. *Id.* at 39.

The cumulative effect of these flaws is an estimate that significantly understates the likely future value of the contracts. *Id.*

3. Actual Experience Demonstrates That Competitive Bidding is the Proper Way to Establish the Value of the Contracts.

The proper way to establish the value of the contract is through competitive bidding. This is now the "standard procedure for disposal of electric power resources, whether owned generation or purchase contracts." *RA-83* at 40. Mr. Chernick cited three examples in which utilities improved upon negotiated prices by offering the assets for competitive bidding. In 1999, Niagara Mohawk Power Corporation ("NiMo") and New York State Electric and Gas ("NYSEG") proposed to sell their shares in the Nine Mile Point 1 and 2 nuclear plants for a total of approximately $163 million ($71.7 million for NiMo's wholly-owned Unit 1, $63.55 million for NiMo's 41 percent share of Unit 2, and $27.9 million NYSEG's 18% share of Unit 2).Based on a recommendation of the New York Public Service Commission Staff, the utilities withdrew their proposal and conducted a competitive auction, which also included Rochester Gas and Electric's Central Hudson Gas and Electric's 14% and 9% shares of Unit 2. The winning bidder is to pay a total of $815 million, including payments of $418 million to NiMo and $128 million to NYSEGSapproximately triple the negotiated price for NiMo and nearly five times the negotiated price for NYSEG. *RA-83* at 42; *AmerGen Buys Niagara Mohawk's and NYSEG's Interests in Nine Mile Point Nuclear Power Plant*, FOSTER ELECTRIC REPORT NO. 169, July 7, 1999, at 16-17; *Constellation Nuclear Busy Nine Mile Point Nuclear Assets for $1.04 Billion,* FOSTER ELECTRIC REPORT NO. 206, Dec. 13, 2000, at 15-16.

The New York Power Authority negotiated a sales agreement with Entergy worth about $500 million for its FitzPatrick and Indian Point 3 nuclear plants. After the agreement was announced, Dominion made an unsolicited offer for the plants, and subsequent offers and counteroffers led to a revised agreement with Entergy which included additional payments worth about $100 million. *RA-83* at 42; *Entergy Buys Two NYPA Nukes for $806 Million,* FOSTER ELECTRIC REPORT NO. 184, Feb. 16, 2000, at 18; *While Dominion Submits Competitive Bid for NYPA's Nukes, Entergy Defends its Bid and Reveals Further Details,* FOSTER ELECTRIC REPORT NO. 185, March 1, 2000, at 25; *NYSA Picks Entergy Over Dominion as Winning Bidder for Nukes in Record-Setting Deal,* FOSTER ELECTRIC REPORT NO. 188, Apr. 5, 2000, at 19..

In October 1999, AmerGen reached a negotiated agreement to purchase Vermont Yankee. In November 2000, under pressure from the Vermont Public Service Commission, AmerGen increased its offer to a purchase price of $23.8 million. In January 2001, Entergy made an unsolicited offer of $50 million. The petition for approval of the agreement was dismissed by the Vermont Public Service Board after AmerGen made another offer, and a number of other parties indicated their interest in bidding if the process were opened up. *RA-83* at 42-43; *More Utility Deals and Planned Sales,* FOSTER ELECTRIC REPORT NO. 176, Oct. 20, 1999, at 20, 21; *Vermont Regulators Give Entergy Nuclear Another Chance to Bid on Vermont Yankee; Dominion Wants to Bid as Well* FOSTER ELECTRIC REPORT NO. 206, Dec. 13, 2000, at 16-17; *Entergy Nuclear Outbids AmerGen for Vermont Yankee, and May Pay Even More,* FOSTER ELECTRIC REPORT NO. 208, Jan. 17, 2001, at 21; *Electric Shorts,* FOSTER ELECTRIC REPORTS NO. 211, Feb. 28, 2001, at 25; *Investigation Into General Order No. 45 Notice filed by Vermont Yankee Nuclear Power Corporation re: Proposed Sale of Vermont Yankee Nuclear Power Station and Related Transaction;* Dkt. No. 6300, Order Dismissing Petition (Vt. PSB Feb. 14, 2001).

In all three instances, even limited competition resulted in higher prices than negotiated agreements. *It is difficult to believe that competitive bidding would not result in a better deal for ratepayers than a proposal which Public Service, in effect, negotiated with itself.*

Administrative estimates of value such as that attempted by Dr. Makholm are also a poor indication of value. Mr. Chernick is aware of at least three examples involving electric generation assets in which administrative estimates of value have greatly underestimated actual prices. *RA-83* at 44.

In June, 1998, the Pennsylvania PUC, based on a detailed evidentiary record including market price projections by several parties, estimated the value of GPU's fossil generation assets at assets at $1.2 billion. RA-*83* at 44*; Application of Metropolitan Edison Co.,* Dkt. No. R-00974008, Opinion and Order, Attachment A (Pa. PUC June 26, 1998)*; Application of Pennsylvania Electric Co.*, Dkt. No. R-00974009, Opinion and Order Attachment A (Pa. PUC June 26, 1998) (Complete Orders available at http://puc.paonline.com). In July through November of 1998, GPU reached agreements to sell these assets to Sithe and other buyers for a total of $2.3 million, nearly twice the administrative estimate. *RA-83* at 44 & n. 31. Sithe announced that it was reselling the former GPU assets it had acquired to Reliant at prices for $2.1 billion, 25% higher than GPU's $1.68 billion sales price to Sithe. *Id.* at 44-45; *GPU Sells Most of its Remaining Non-Nuclear Generating Assets to Sithe Energies*, FOSTER ELECTRIC REPORT NO. 152, Nov. 18, 1998, at 5; *Reliant Energy Buys Former GPU Generating Assets from Sithe Energies for $2.1 Billion*, FOSTER ELECTRIC REPORT NO. 185, March 1, 2000, at 29.

In a May 1998 decision involving the restructuring of Duquesne Lighting, the Pennsylvania PUC estimated the market value of Duquesne's generation at about $124 million.

Duquesne later sold its wholly owned generation to Orion Power for $1.7 billion. RA-*83* at 45; *Application of Duquesne Light Co.*, 185 *PUR 4th* 389, 445, 449-51 (Pa. PUC May 21, 1998); *Other Mergers, Generation Sales and Utility Deals,* FOSTER ELECTRIC REPORT NO. 175, Oct. 6, 1999, at 12.

In July 1999 the Connecticut Department of Public Utility Control estimated the market value of the Millstone Unit 2 nuclear plant at $25/kW and the market value of Unit 3 at $185/kW. In August 2000, Dominion won an auction for Unit 2 and 93.5% of Unit 3 with a bid of $1.3 billion. This was six times the $221/kW value that would have resulted from the DPUC's administrative estimates. *RA-83* at 45; *Application of the Connecticut Light and Power Co. for Calculation of Stranded Costs*, 195 *PUR 4th* 74, 110 (Ct. DPUC July 7, 1999). *Dominion Resources Buys Millstone Nuclear Plant from Northeast Utilities,* FOSTER ELECTRIC REPORT NO. 198, Aug. 16, 2000, at 18.

These examples show the unreliability of administrative estimates such as Dr. Makholm's. For this reason, and the other reasons explained above, his estimate of the value of the proposed transaction should be rejected. The Public Service proposal would deny ratepayers fair compensation for the value of resources acquired for their benefit with ratepayer funds. The Public Service proposal would, instead, transfer the value of Company's gas supply resources to the Company's affiliates, by providing them with unreasonable preferences, in violation of the Board's Interim Affiliate Standards.

B. The Company's Proposal Would Grant Unreasonable Preferences to Public Service Affiliates, In Violation of the Board's Affiliate Relations Standards.

Section 3, Part 1 of the Affiliate Standards provides that "[a]n electric and/or gas public utility shall not unreasonably discriminate against any competitor in favor of its affiliate(s) or related competitive business segment ...." Part 3 of Section 3 provides that "[a]n electric and/or gas public utility shall provide access to utility information, services, and unused capacity or supply on a non-discriminatory basis to all market participants, including affiliated and non-affiliated companies ...." These provisions clearly prohibit Public Service from providing preferential access to gas supply resources to an affiliated market participant, a description that includes Newco. The Company's proposal to transfer most of its gas supply resources to Newco is in clear violation of the above rules. *RA-82* at 35.

Public Service's justification for failing to offer these transactions to non-affiliated suppliers is that "no third party supplier has sought out a release of capacity," and that the Company's ability to extract value from the contracts is "unique." *Id.* at 36. The failure of competitive suppliers to seek out capacity transfers in the past is largely irrelevant, as the Company has never offered storage capacity, nor has it offered capacity in conjunction with the right to provide BGSS supply for approximately 1.6 million customers. *RA-82* at 36. While current FERC rules require transfers of capacity to be made at FERC-approved tariff rates, it is likely that other suppliers would have bid more favorable terms for BGSS service. *Id.* at 35.

Furthermore, FERC restrictions on transfers of capacity are not a valid justification for providing a preference to an affiliate. If Public Service's resources cannot be offered in the competitive market in a way that extracts their full value for ratepayers, the appropriate course is for the utility to retain the resources, not to provide an affiliate with an opportunity to gain windfall profits at ratepayer expense. Tr. 924-25.

The Public Service proposal also appears to grant an unreasonable preference to Public Service's electric generation affiliate, PSEG Power. According to Mr. Wohlfarth, PSEG Power receives balancing service, which involves the use of Public Service's interstate transportation and storage services. Tr. 503-05. This supply arrangement predated the formation of PSEG Power, and the Board allowed it to continue as part of its electric restructuring Order for Public Service. *RA-66;* Tr. 501-02. The Board's decision to allow these resources to continue to be dedicated to PSEG Power appears reasonable in light of PSEG Power's current obligation to supply all of Public Service's BGS customers at regulated rates. This may no longer be the case when PSEG Power becomes free to use its electric generation resources in the competitive market. *RA-82* at 37. By preserving this benefit for PSEG Power without competitive bidding, the Public Service proposal grants an undue preference, at the expense of the ratepayers who have paid for the resources used to provide this benefit.[5]

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[5] The capacity to be made available to other electric generators under the proposed Addendum to the Joint Position does not include the capacity used to provide service to PSEG Power. Tr. 541-42. As explained at page 11 above, Public Service is proposing to provide this benefit to other electric generators by diverting capacity that could otherwise be used to generate margin revenues for the benefit of BGSS customers.

III. THE PUBLIC SERVICE PROPOSAL COULD RESULT IN AN UNREGULATED OLIGOPOLY IN NEW JERSEY'S NATURAL GAS AND ELECTRIC MARKETS, BRINGING REDUCED RELIABILITY AND HIGH ENERGY COSTS FOR CONSUMERS.

A. The Proposed Transactions Are Likely to Create Unfettered Market Power in New Jersey's Wholesale Natural Gas Market by Placing Scarce Gas Supply Resources in the Hands of a Few Unregulated Entities.

1. Recent Developments in California's Energy Markets Demonstrate the Risks of Concentrating Control of Scarce Energy Resources.

The Public Service proposal is an extremely risky one for New Jersey's energy consumers. The Company is proposing to place control of scarce gas supply resources in the hands of Newco and an unknown number of other unregulated market entities. The proposal is likely to create unregulated market power in New Jersey's wholesale natural gas supply market, leading to escalating energy prices and compromised reliability. Given New Jersey's increasing dependence on natural gas-fired electric generation, and Newco's affiliation with PSEG Power, a major player in the PJM electricity market, the proposal also threatens to increase electricity prices.

The serious problems that could result from the Public Service proposal were described in detail in the testimony of Ratepayer Advocate witness Paul Chernick. The Public Service proposal is likely to create *horizontal market power*. *RA-83* at 17. Horizontal market power occurs when a supplier with a significant share of available resources finds it profitable to drive up prices by withholding some supply from the market. The supplier sells less, but receives a higher price for the amounts sold. *Id*. In periods of scarcity, significant price escalation can occur even in the absence of illegal collusion. *Id.* at 17, 32.

The recent developments in California's electric market illustrate the types of problems that can result from the exercise of horizontal market power. Following the passage of

California's restructuring legislation, the State's three major investor-owned electric utilities sold off all of their in-state fossil and geothermal generating facilities to non-utility generation firms. In order to minimize the utilities' ability to manipulate the market, they were required to sell their remaining generation into the State Power Exchange, and buy all of the electricity required for basic generation service ("BGS") customers though the Power Exchange spot market. *Id.* at 7. For a few years, the market functioned well. Starting in May 2000, however, a number of developments, including a drought which reduced hydroelectric supplies and load growth which was not matched by new generating capacity, created a shortage of generating capacity, thus putting upward pressure on electric prices. *Id.* at 8. WILLIAM MARCUS & JAN HAMRIN, HOW WE GOT INTO THE CALIFORNIA ENERGY CRISIS at 2-3 (2001) (available at http://www.jbsenergy.com).

At the same time, wellhead natural gas prices were increasing, and gas supplies in California were constrained due to an explosion on El Paso's main gas pipeline into Southern California and low levels of in-state storage. *RA-83* at 8-9. Since gas-fired generation established the prices in the California Power Exchange most of the time, natural gas shortages also helped push up electric prices. *Id.* at 8. Rebecca Smith, *California Power Plants Get Jolt as Natural-Gas Supplies are Cut*, WALL STREET JOURNAL, Nov. 16, 2000, at A-1.

These developments created a climate in which unregulated market power could be exercised. According to the Independent System Operator ("ISO") that operates California's Power Exchange, major owners of electric generation withheld capacity from the market, driving up electric prices. *RA-83* at 9; FRANK WOLAK & ROBERT NORDHAUS, COMMENTS ON STAFF RECOMMENDATION ON PROSPECTIVE MARKET MONITORING AND MITIGATION FOR THE

CALIFORNIA WHOLESALE ELECTRICITY MARKET (Market Surveillance Committee of the California ISO, March 22, 2001)(available at http://www.caiso.com/surveillance/overview/committee.html). In addition, the California Public Utilities Commission concluded that an El Paso affiliate that controlled much of the remaining El Paso capacity withheld gas supply, pushing gas prices, and consequently electric prices, still higher. *RA-83* at 9; Nathan Hodge, *Geography Holds the Key to the El Paso Market-Power Investigation,* FINANCIAL TIMES ENERGY, TRANSPORTATION, AND STORAGE HUB at 1-2 (May 16, 2001). There are also indications that generators may have withheld gas they were purchasing under long-term gas contracts, placing the gas in storage during times of high prices and purchasing gas on the spot market, often from their own gas-marketing affiliates, further driving up natural gas and electric prices. *RA-83* at 9; MARCUS & HAMRIN, *supra*, at 3-6.

At the time these events occurred, two of California's electric utilities were operating under price caps. The combination of increased wholesale prices and retail price caps pushed these utilities into financial distress. The ensuing credit problems caused some small generators to shut down (because they were not being paid by the utilities) and others to sell power out of state. The result is well knownSspiraling electricity prices, power shortages, and rolling blackouts. *RA-83* at 10; *QFs, California PUC Battle Pricing Formula Issues in State and at FERC,* ELECTRIC UTILITY WEEK, May 14, 2001, at 4-5; David Lazarus, *PG&E May Default in a Matter of Days,* SAN FRANCISCO CHRONICLE, Jan. 17, 2001, at A-1; Susan Sward & David Lazarus, *How PG&E Missteps Preceded Crisis,* SAN FRANCISCO CHRONICLE, Jan 22, 2001, at A-1.

California is now attempting to undo some of the changes that were implemented a few years ago. However, its options are limited, because essential resources are now beyond regulatory control. The State has stepped in to make power purchases on behalf of consumers, and has set up an agency to build new generation, pipelines and transmission facilities. *RA-83* at 11; *Paying the Bills: The State Joins the Creditors' Line in California,* ELECTRIC UTILITY WEEK, Feb. 26, 2001, at 1-2; *Socal Ed's Deal with Davis Faces a Rocky Road to State Approval,* ELECTRIC UTILITY WEEK, Apr. 16, 2001, at 1, 8. The Governor has threatened to confiscate the divested power plants. *RA-83* at 11; Bernadette Tansey, *Power Grab***S***Some Democrats Favor Seizing Plants,* SAN FRANCISCO CHRONICLE, Apr. 9, 2001, at A-1.

Although California represents the most extreme example, similar problems have occurred in other states. In a number of states, including New Jersey, New York and Massachusetts, utilities which have divested generation are now purchasing power at higher-than-expected prices. There have been indications of market manipulation in virtually all restructured markets, including New England, New York, and PJM, which serves New Jersey. The threat of market power abuse has been serious enough for the ISOs in all three areas to implement price caps, including a comprehensive scheme of price caps for the three major generators serving New York City. *RA-83* at 11-12; Andrew Caffrey, *Federal Energy Panel Next Approves Power Price Controls for New York,* WALL STREET JOURNAL, June 29, 2001; Kristen McNamara, *Heat Stresses Mid-Atlantic Power Grid; Brownouts Warned,* DOW JONES NEWSWIRES, July 25, 2001.

The Public Service proposal could create similar conditions in New Jersey's wholesale natural gas marketplace. A few unregulated entities could control scarce energy resources, driving up both natural gas and electricity prices for consumers. As clearly set forth in EDECA, the transition to a competitive marketplace requires careful regulatory oversight. As explained in detail below, the Public Service proposal is likely to create unregulated market power, while severely limiting the Board's ability to implement remedial measures. This proposal is both contrary to the public interest, and in violation of the policies and mandates of EDECA.

2. The Public Service Proposal Could Concentrate Control of Essential Pipeline Transportation and Storage Resources and In-State Peaking Supplies, Leading to Higher Prices and Diminished Reliability.

As explained at pages 8-9 above, natural gas is provided to New Jersey using a combination of resources, including wellhead supply, interstate transportation and storage resources, in-state peaking supplies. Each of these categories of resources represents one or more geographic markets. The markets closer to the wellhead are referred to as "upstream" markets, while those closer to the burner trip are referred to as "downstream." *RA-83* at 18. Newco is not likely to have market power in the "upstream" markets, as it controls only a small percentages of the resources serving markets close to the wellhead. *Id.* at 20. However, in geographic markets farther downstream, Public Service controls increasingly higher market shares.

Public Service has not performed any analysis of the degree to which Newco would control each of the relevant geographic markets. *RA-83* at 22 & Sched. PLC-4; *RA-64;* Tr. 490-91. However, based on available information, it appears that Newco would control substantial shares of the relevant downstream markets. Mr. Chernick estimates that the long-haul transportation contracts to be transferred to Newco represent approximately 15 percent of capacity from the south and west into the entire Northeast region. Moreover, the Northeast region as defined by the United States Energy Information Administration ("EIA") includes Virginia and Pennsylvania, both of which are upstream of New Jersey. Public Service's share of long-haul transportation into New Jersey and downstream areas such as New York and New England may be even higher. *Id.* at 20-21.

It also appears that the tight supply conditions that would facilitate the exercise of market power are likely to occur in the markets for interstate pipeline and storage serving northern New Jersey. According to Shell Energy Services witness Richard Hornby, the pipeline transportation and storage resources needed to provide reliable natural gas service to this market are "constrained," with most of the capacity needed to provide service within Public Service's territory controlled by Public Service. Mr. Hornby also believes that "there is not a workably competitive market for firm supplies of delivered gas to the [Public Service] service territory," and it will be "many years" before such a market exists. *Id.* at 22-23. During cross-examination, Mr. Hornby expanded on this theme, stating that "there's a need for more investment in pipeline infrastructure ... I don't know that there's a consensus as to how long it will take ... before there might be a competitive market in firm transportation." *Id.* at 23; Tr. 613.

Mr. Hornby's view of the market is borne out by other available information on the supply of and demand for pipeline capacity to the Northeast. A recent report of the federal Energy Information Administration ("EIA") states that "[p]ipeline capacity in the New York City area appears inadequate to meet growing market demand," and expresses particular concern about a developing capacity bottleneck in the Leidy area,[6] which is "rapidly becoming a potential constraint for pipeline gas flowing to the East Coast, and particularly for northern New Jersey and New York City." *RA-83* at 24; *The Northeast Heating Fuel Market: Assessment and Options* (EIA Report # SR/OIAF2000-03), Ch. 4 at 38 (available at http://www.eia.doe.gov). An EIA presentation at the 1999 NARUC Winter Meeting showed average demand on the pipelines

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[6] The Leidy area is major hub area in north central Pennsylvania with numerous interconnections among major interstate pipelines. *RA-83* at 24.

serving New Jersey in the peak month of the 1997-98 at over 95 percent of capacity. *RA-83* at 24; James Tobin, *Natural Gas Pipeline and Storage Deliverability*, Presentation to NARUC 1999 Winter Meeting, Washington, D.C., Feb. 21-24, 1999, Slide 5 of 21 (available at http://www.eia.doe.gov).

Even Public Service appears to acknowledge the potential for the exercise of market power by entities controlling substantial shares of pipeline resources into New Jersey. In comments filed with the Federal Energy Regulatory Commission ("FERC") in April, 1999, Public Service urged the FERC to continue its cost-based price regulation of long-term interstate pipeline transportation and storage services, because the pipelines "continue to have market power in the primary market" for these services. *RA-61* at 17; Tr. 485-87.

The Joint Position includes a number of measures, negotiated with a few large suppliers, intended to encourage competitive suppliers to enter the natural gas marketplace. Public Service witness David Wohlfarth asserted that these measures make any analysis of concentration in the capacity markets serving New Jersey "moot." Tr. 491. To the contrary, there is no assurance that the initiatives included in the Joint Position would be any more successful than the Company's previous failed efforts to encourage competition for residential and small commercial customers. *RA-82* at 30. These initiative include capacity release programs which remain open for participation during a limited three-year "window," economic incentives that expire in 2004, and an agreement to discuss, but not necessarily a commitment to implement, a BGSS pilot program that would be limited to 30 percent of the Company's customers and a maximum of three non-utility providers. *RA-82* at 40-42. As discussed in more detail at pages 56-58 below, the programs appear designed to allow a few major suppliers to remain in the market long enough to obtain access to some of the Company's valuable transportation and storage resources, at which point these resources would remain within their control and beyond the regulatory oversight of the Board. *RA-82* at 41-42.

As Mr. Chernick noted in his testimony, "[e]ven the emergence of a small number of large third-party suppliers may do little to moderate Newco's market power." *RA-83* at 55. In California, the three generating companies accused of manipulating the market have market shares ranging from 4 to 6 percent. The market shares for all three total only 17 percent, and the shares of the five largest independent generators total only 25 percent. *Id.* at 21; *Dynergy's Watson Defends Calif. Suppliers, Says Per-MW Profit Same as Two Years Ago,* PLATT'S ENERGY TRADER, May 24, 2001, at 1, 12. Even if the initiatives in the Joint Position result in significant market entry, Newco could still be left with a large enough market share to exercise market power, and third-party suppliers could gain market power as well. *RA-83* at 55. New Jersey consumers could be subject to an unregulated gas supply oligopoly.

Further, the market concentrations produced by the Company's proposal could increase. Public Service is proposing that, once the contracts are transferred to Newco, there be no restrictions on further transfers of the contracts, mergers, spin-offs, or other transactions that could further concentrate control of the interstate pipeline resources serving New Jersey and broader markets. *RA-83* at 22; *RA-20;* Tr. 233-35. Even without a merger, the emergence of other large unregulated holders of transportation and storage resources could result in greater market power problems if Newco and other unregulated suppliers are able to manipulate prices to their mutual advantage. *RA-83* at 22.

Information about the plans of Public Service's parent corporation, Public Service Enterprise Group ("PSEG"), to engage in mergers and other transactions is unavailable, as Public Service has asserted that disclosing such information would violate Securities and Exchange Commission rules. *RA-84;* Tr. 1055-58. Nevertheless, the Board should not consider approving a proposal that would remove such future transactions from the Board's jurisdiction without considering the potential problems that could result. Tr. 902. The Board is well aware of the recent proliferation of energy-related mergers in New Jersey and nationwide. The possibility of additional mergers is not a factor that should be disregarded by the Board.

In addition to creating market power in the downstream markets for pipeline transportation and storage capacity, the Public Service proposal could result in manipulation of the market for peaking supplies. As noted at page 10 above, Public Service is proposing to provide Newco with the right to control the dispatch of its peaking supplies as long as the Requirements Contract remains in effect. These are essential resources, providing nearly one-third of the gas needed to supply firm customers on a peak day. *RA-83* at 27; Tr. 1027. Public Service witness David Wohlfarth referred to these resources as the Company's "crown jewel." Tr. 1027. Newco could increase market prices and its profit by withholding peaking supplies, depleting peaking suppliers by drawing on them at inappropriate times, or by drawing on pipeline supplies when peaking would have been more economic. *RA-83* at 27; *RA-82* at 18.

3. The Natural Gas Marketplace Proposed by Public Service Has Many Similarities to the California's Electricity Markets, Which Have Experienced High Prices and Serious Reliability Problems.

As explained in Mr. Chernick's testimony, the natural gas marketplace envisioned in the Public Service proposal would have many similarities to the California's electric generation market. In New Jersey, as in California, essential energy supply resources now serving firm customers under regulated rates would be divested to unregulated entities. In New Jersey, resources needed to deliver firm gas supply would be controlled by Newco and an unknown number of TPSs, just as the California generation market is dominated by a few large generators. Indeed, Newco's degree of control could be even greater, due to the high percentage of pipeline resources Newco is likely to hold, and its control of Public Service's peaking facilities and interruption rights during the term of the Requirements Contract. Further, there are strong indications that tight supply conditions that facilitate the exercise of market power may already exist in New Jersey's natural gas market, compared to a California restructured electric market that started with a surplus of generation. In short, Public Service is proposing a market structure that would be "ripe for the abuse of market power." *RA-83* at 23.

As in California, the Board would have limited options for addressing market power problems that could emerge as a result of the Public Service proposal. As acknowledged by Public Service witness David Wohlfarth, the transactions, once approved, could not be reversed. Tr. 265; *RA-26*. Control of essential gas supply resources will have been irrevocably transferred beyond the Board's regulatory control.

In states other than California, potential market power problems have been addressed by the formation of ISOs with authority to handle the dispatch of generation, monitor the market for signs of abuse, and implement remedial measures if market power is found. *RA-83* at 28-29. The safeguards that have been implemented within the PJM market area were described in the rebuttal testimony of Public Service witness Pierre Landrieu:

- Before the PJM utilities were granted market pricing authority, the FERC "had a fairly thorough proceeding in which it examined market power influences and found that there is not the ability to exercise market power in PJM with the rules, the market rules that exist today." Tr. 1014.
- The FERC also required PJM to establish an independent Market Monitoring Unit that "does nothing except sift the market data and looks for evidence of possible market manipulation or market power." Tr. 1015. It issues an annual report on the state of the market, and has some authority to mitigate market power. *Id.*
- Every load serving entity in PJM must either own or contract for capacity sufficient to maintain a reserve of 18 percent over its peak load. Tr. 1012.
- Buyers are permitted to enter into long-term contracts, reducing the market's reliance on volatile spot prices. Tr. 1013.

These kinds of safeguards have not completely eliminated the exercise of market power in restructured electric markets. As noted by Mr. Chernick, "[i]n virtually all restructured electric markets, including New England, New York, and PJM, market-clearing energy prices have frequently been higher than can be explained by the marginal cost of producing energy, implying (or suggesting) the existence of market power." *RA-83* at 11. PJM's Market Monitoring Unit has found such evidence of market power during periods of high usage in 1999. *RA-89.* In some instances, price caps have been required to mitigate against the threat of market abuse. New York, for example, has imposed comprehensive bid caps on the three major owners of divested generation. *RA-83.* at 11-12.

4. Public Service Has Proposed No Safeguards Against the Exercise of Market Power.

Public Service has proposed to divest its natural gas resources with none of the safeguards that exist in restructured electric markets in New Jersey and other states. There has been no investigation of the ability of Newco or other market participants to exercise market power. *Id.* at 22 & Sched. PLC-4; *RA-64;* Tr. 490-91. There is no proposal for a regional gas-dispatching organization comparable to PJM, and Public Service is not proposing that the Board, or any other entity, have the authority to mitigate market power caused by Newco's actions. *RA-83* at 29. Indeed, Public Service has proposed that the Board have *no* authority over any actions of Newco, including economic withholding of gas supply, or mergers or other transactions that could further concentrate control of gas supply resources. *RA-20;* Tr. 233-35. Public Service has proposed no reserve requirements or other measures to assure that market participants would have adequate resources to meet their peak loads. Finally, as explained below, commercial and industrial BGSS customers, and later residential BGSS customers, would be supplied natural gas at prices dependent on the whims of the short-term market. Thus, even the incomplete protections implemented in restructured electric markets would not exist for New Jersey's natural gas consumers.

B. Newco Could Exercise its Market Power in the Natural Gas Market to Manipulate Electric Prices in PJM to Increase Profits for Public Service's Electric Generation Affiliate.

1. Newco Could Manipulate Natural Gas Prices to Raise Electric Prices, Benefitting Its Electric Generation Affiliate.

As explained by Mr. Chernick, market power in New Jersey's natural gas market could also affect prices for electricity. A substantial share of PJM's electric generation resources are owned by PSEG Power, another Public Service affiliate. The affiliation of a major gas supplier with a major electric generator could allow Newco to increase profits for PSEG Power by using power in the natural gas market to raise wholesale electric prices, especially after PSEG Power is relieved of its BGS supply obligations in August 2002. As Mr. Chernick explained, at times when gas-fired units establish the market-clearing price for electricity, increases in natural gas prices increase the prices paid for all generation sold in the spot market. Thus, an increase in natural gas prices would result in higher prices for all of PSEG Power's generation, including its coal, nuclear, and oil-fired plants. *RA-83* at 30. Newco could raise prices for PSEG Power's gas-fired plants without fear of harming the economics of the gas-fired units, as any increase in natural gas prices would affect transactions between two affiliates, and would have no impact on the bottom line of the parent corporation, PSEG. Both the higher electric prices paid to PSEG Power and the higher natural gas prices paid to Newco by customers other than PSEG Power would create windfall profits for the parent corporation, PSEG. *RA-83* at 31.

High natural gas prices were a factor in the sharp price increases that occurred in California's wholesale electric market. As noted at page 39 above, there are indications that some electric generators exacerbated this problem by withholding from the market gas they were purchasing under long-term contracts. *RA-83* at 9. The Public Service proposal could create an even greater potential for manipulation. The California generators controlled only the gas supply needed to fuel their own facilities. The Public Service proposal would create unregulated affiliates which, together, would be major players in both the natural gas and electric markets. *RA-83* at 13.

Furthermore, the Board contract transfer is being proposed at a time of substantial uncertainty for New Jersey's wholesale electric markets. On July 12, 2001, the FERC initiated a proceeding to combine PJM with the other two ISOs in the Northeastern United States to form one Regional Transmission Organization on an expedited basis. *Regional Transmission Organizations,* FERC Dkt. No. RTO1-99-000, Order Initiating Mediation (July 12, 2001), 66 FERC ¶ 61,065. Rebecca Smith, *Regulators Order Formation of Big Grids to Ease Bottlenecks in U.S. Energy,* THE WALL STREET JOURNAL, July 12, 2001; Richard A. Oppel, Jr., *Energy Commission Divides Control of Eastern Power Grid,* THE NEW YORK TIMES, July 12, 2001; *In an Abrupt Policy Changes, FERC Orders Single RTOs for the Northeast and Southeast and Suggests Formation of Just Two More RTOs for the Rest of the Country,* FOSTER ELECTRIC REPORT NO. 222, July 18, 2001, at 1, 2-3. Maryland, District of Columbia, and Virginia have raised serious concerns that the FERC proposal could create an unstable regional wholesale market. *PSCs Request Rehearing and Motion for Stay with the FERC*, Press Release Issued by Maryland PSC, August 1, 2001 (available at http://www.state.md.us/psc); *PJM Interconnection, LLC,* Dkt. Nos. RTO1-2-000 and RTO1-99-000, Request for Rehearing and Motion for Stay of the Maryland Public Service Commission, the District of Columbia Public Service Commission, and the Virginia State Corporation Commission (Aug. 1, 2001). It is particularly inappropriate to consider a major change in the control of essential energy resources at time when a fundamental change in the structure of the State's wholesale electric marketplace is under consideration.

2. Contrary to Public Service's Rebuttal Testimony, There Are Insufficient Safeguards to Prevent Newco From Manipulating Prices Within the PJM Electric Market.

Public Service has performed no analysis of the impact of natural gas prices on market prices for electricity in PJM. *RA-85;* Tr. 1072. Nevertheless, the Company presented rebuttal testimony suggesting that Newco will not be able to manipulate electric prices in PJM. The

Company's rebuttal witness, Pierre Landrieu asserted that due to differences between the California and PJM electric markets Newco will not be able to manipulate electric prices in New Jersey. Mr. Landrieu gave several reasons for this conclusion, none of which is valid.

Mr. Landrieu testified that Newco would have less opportunity than the California gas suppliers to affect electric prices because PJM is less dependent on gas-fired generation. Tr. 1009. However, as explained by Mr. Chernick, natural gas prices affect the market clearing price whenever "the marginal plants, ... the last ones dispatched, are gas fired." Tr. 995. This can occur in markets less heavily dependent on natural gas than California. *Id*. Further, during cross-examination Mr. Landrieu acknowledged that gas-fired generation represents a substantial portion of PJM's installed capacity, about 20 percent, and this is expected to increase to 33 percent by 2006. Tr. 1073-78.

Mr. Landrieu noted that PJM, which permits long-term bilateral contracts, is less dependent on spot prices than the California electric market. Tr.1013. Mr. Landrieu however, did not consider whether potential changes in the provision of basic generation service ("BGS") in New Jersey and other PJM states could increase PJM's reliance on the spot market. Tr. 1083-89. He was unaware of a pending proposal by New Jersey's electric utilities to implement a BGS auction. Tr. 1083-85. This proposal, filed on June 29, 2001, could result in the acquisition of an unknown percentage of BGS supply on the spot market. *I/M/O Provision of Basic Generation Service*, BPU Dkt. No. EX010050303, Public Service Company Specific Addendum at 4, GPU Company Specific Addendum at 2, ACE, Conectiv Company-Specific Addendum at 3, Rockland Company Specific Addendum at 8 (June 29, 2001) . Mr. Landrieu acknowledged that a regulatory directive to purchase a portion of BGS supplies in the spot market “could send us in the direction of California ....” Tr. 1089.

Mr. Landrieu noted the FERC’s investigation of market power issues before the PJM utilities were permitted to implement market pricing. Tr. 1014. However, the FERC Order in which Public Service was permitted to implement market-based electric pricing specifically noted the FERC’s concerns that Public Service might offer discriminatory or unreasonable rates for gas supply to competing electric suppliers. *Public Service Electric & Gas Co.* Dkt. No. ER97-837-000, Order Conditionally Accepting for Filing Proposed Market-Based Rates at 3 (FERC Feb. 12, 1997 (*PS-15* at 3*).* The Public Service proposal would increase this concern by increasing the ability of a Public Service affiliate to manipulate natural gas prices.

Mr. Landrieu testified that PJM’s Market Monitoring Unit has found no significant market power problems. Tr. 1014. Mr. Landrieu cited one of the Market Monitoring Unit’s “State of the Market” reports in support of this conclusion, but acknowledged on cross-examination that he reads these reports, but “I don't sit and study them.” Tr. 1117. Had he done so, he might have discovered that the Market Monitoring Unit found evidence of market power in the 1999 report, and repeated those concerns in its 2000 report. *PJM Interconnection State of the Market Report***S***1999* at 18, 35-37 (*RA-89); PJM Interconnection State of the Market Report* S*2000 (RA-87A)*, slides entitled “Market Structure” and “Capacity Markets”. Evidence of market power in PJM was also found in another recent paper published by University of California’s Program on Workable Energy Regulation. This paper found “market imperfections leading to an increases in total spot market costs of about 41 percent” during the first five months of market-based bidding in PJM, and that, during that period, “at least one firm likely behaved in a non-competitive manner by setting prices." ERIN T. MANSUR, PRICING BEHAVIOR IN THE INITIAL SUMMER OF THE RESTRUCTURED PJM WHOLESALE ELECTRICITY MARKET at 1, 29 (PWP-083 April, 2001) (available at http://www.ucei.org).

PJM's authority to mitigate market power is less comprehensive than suggested by Mr. Landrieu in his direct examination. Tr. 1015. The Market Monitoring Unit, in a report to the FERC, specifically noted its lack of authority "to limit specific market offers to a defined competitive level in order to prevent economic withholding." *Report to the Federal Energy Regulatory Commission***S***Enforcement Remedies* at 7 (April 2001)(*RA-88).* If PJM lacks the tools to prevent the direct withholding of *electric* supply, then it is difficult to see how it could control market power exerted through the withholding of *gas* supplies.

Mr. Landrieu predicted a "supply glut" in PJM in 2006. Tr. 1016. This is inconsistent with his testimony on cross-examination that builders of new generation will have long-term sales contracts before commencing construction. Tr. 1093.

Mr. Landrieu suggested that, in order to obtain financing, generators will enter into long-term, fixed-price gas supply contracts. Tr. 1021. However, as he acknowledged on cross-examination, in a competitive market, bid prices for gas-fired generation are based on *market* prices for natural gas rather than embedded costs. Tr. 1089-93. This occurred in California, where gas-fired generators withdrew their capacity from the market (because it was more profitable to sell the gas), or bid their units based on natural gas spot prices, when natural gas prices rose. Tr. 1093; *RA-83* at 9; MARCUS & HAMRIN, *supra*, at 5.

. Finally, Mr. Landrieu testified that he could not "imagine why NEWCO or Public Service would ever want to leverage gas prices up ... in a way that would raise electric prices because we are [a] net buyer of energy." Tr. 1020. On cross-examination, however, Mr. Landrieu changed his testimony, stating that he meant to say that only *the utility*, *Public Service*, is a net buyerSa fact which is hardly surprising because Public Service does not own any electric generation! Tr. 1123. Mr. Landrieu further testified that Public Service is not permitted to share data with PSEG Power, and he therefore does not know whether PSEG Power, or PSEG as a whole, is a net buyer, nor is he able to speak to the issue of whether PSEG Power would have the incentive to raise electric prices. Tr. 1123-27.

Mr. Landrieu's unfounded and sometimes contradictory testimony should be given no weight. Public Service is proposing to create a corporate structure in which affiliated unregulated entities will have substantial market shares in the wholesale markets for both natural gas and electricity. As Mr. Chernick observed, the resulting "concentration of unregulated gas and electric functions in a single holding company may produce even more serious interactions between gas and electric supply than those in California." *RA-83* at 13. The ALJ and the Board should reject Public Service's attempt to minimize the seriousness of this potential problem.

The Public Service proposal, instead of fostering energy competition, threatens to subject New Jersey's natural gas and electric consumers to market power, resulting in higher prices, and diminished quality and choices of service. It should be rejected as contrary to the policies and objectives of EDECA.

IV. THE JOINT POSITION DOES NOT REPRESENT THE INTEREST OF CONSUMERS, AND DOES NOT PROVIDE AN APPROPRIATE FRAMEWORK FOR FOSTERING COMPETITION.

Public Service has characterized the Joint Position as "balance among various interests" that should be implemented as a package. Tr. 525, 528. To the contrary, the Joint Position represents the special interests of the parties that have signed itSPublic Service (and its affiliates), a few large natural gas suppliers, and the Company's large cogeneration customers. The only customer representatives, New Jersey Energy Associates ("NJEA") and the Independent Energy Producers of New Jersey ("IEPNJ"), represent large cogeneration customers which have negotiated provisions to continue their special contracts and thus exempt them from the provisions which would adversely affect residential and commercial BGSS customers. *PS-7* at 1-2.

A. Newco is Proposing to Implement Limited Programs to Encourage Competition, With Limited Board Authority to Implement Additional Programs if Needed.

As explained by Ratepayer Advocate witness Richard LeLash, the Joint position does not provide an appropriate framework for encouraging competition in New Jersey's natural gas marketplace. *RA-82* at 38-43. The Joint Position includes three components which would facilitate the entry of competitive suppliers: voluntary assignment of transportation and storage capacity, economic incentives for customers choosing a competitive supplier, and a BGSS pilot program allowing up to three suppliers to provide service to relatively large aggregated groups of customers. *RA-82* at 38. All three of these initiatives could be implemented without transferring Public Service's interstate transportation and storage contracts to an unregulated affiliate. *Id.;* Tr. 526-27. This is the preferable approach, because all three of the proposed initiatives have inherent limitations, and the proposed transfer would make it difficult or impossible for the Board to implement additional initiatives if these do not succeed.

Most important, the current proposal would limit the Board's ability to make the transferred resources available to competitors. The Joint Position would offer these resources to competitive suppliers but subject to a number of limitations:

- There would be a three-year "window" in which competitive suppliers could qualify to obtain temporary, and later permanent, access to transportation and storage capacity. *RA-82* at 40; Tr. 217-22.
- "Permanent" release would be subject to "turnback" rights at the time the underlying contracts were subject to renewal. At that time, the competitive supplier would be required to turn back to Newco any capacity in excess of that needed to serve its then existing customer base. *RA-82* at 40, Tr. 223-25.
- At the conclusion of the program, all of the capacity would be in the hands of unregulated entities (Newco and an unknown number of competitive suppliers) which would then be under no obligation to provide access to additional market participants. *RA-82* at 40; *RA-83* at 53; Tr. 235, 265.

If these limited programs were not to succeed in creating robust competition, the Board would be unable to require Newco to make additional capacity available.

The proposed economic incentives would also be limited. All would expire no later than 2004. Joint Position, ¶¶ 7, 11; Tr. 493-97. With ratemaking decisions within Newco's discretion, the Board could have limited ability to implement further incentives after 2004.

Finally, the proposed BGSS pilot program has several deficiencies. First, the signatories to the Joint Position have committed only to participate in a collaborative; there is no firm commitment to actually implement a program. Joint Position, ¶ 14. Second, even if implemented, the program would be subject to the following restrictions:

- The program would be limited to a maximum of 30 percent of the Company's BGSS customers, with no guarantee that this target would be reached. Joint Position, ¶ 14; *RA-82* at 41.
- Participation would be limited to three large suppliers. Joint Position, ¶ 14 (b); *RA-82* at 41.
- There is no provision for customer representatives, or potential suppliers who have not signed the Joint Position, to participate in the collaboratives that would define the parameters of the program. Joint Position, ¶ 14; *RA-82* at 41.
- The program is limited to a two-year term, from April 1, 2003 to March 31, 2005. Joint Position, ¶ 14, *RA-82* at 41.

These programs, viewed together, appear designed to benefit the major suppliers that have signed the Joint Position. The economic incentives and the BGSS pilot program would be in effect long enough for a few large suppliers to obtain access to shares of the transferred contracts. Thereafter, with all of these resources in the hands of a few unregulated entities, the Board would have limited ability to expand the availability of these resources to additional market participants. Thus, the Joint Position could well encourage the development of a gas supply oligopoly, rather than the robust competitive marketplace envisioned by EDECA. *RA-82* at 41-42; *RA-83* at 55-56.

The initiatives included in the Joint Position could be fashioned into positive proposals. The testimony of Ratepayer Advocate witness Richard LeLash describes a number of modifications to address the limitations and deficiencies discussed above. These include the following:

- The Board should retain control of essential gas supply resources until robust competition has been established. *RA-82* at 44-45.
- Since the proposed shopping credits are to be funded by ratepayers, they should be no higher than necessary to encourage competition. *RA-82* at 45.
- The Ratepayer Advocate and the Board's Staff should be included in the collaboratives to develop the proposed BGSS pilot program..In addition, there should be a number of changes to the proposed program including elimination of the proposed limitation to three suppliers, elimination of artificial restrictions on the how a supplier can price its bid, and participation by the Ratepayer Advocate and the Board' staff in the process the process for selecting the winning bidders. *RA-82* at 46-49.

The programs suggested in the Joint Position can and should be implemented, with the modifications suggested by Mr. LeLash, *by Public Service as a regulated utility. RA-82* at 44-49. In this way, the Board will assure its continued ability to continue its efforts to foster competition until a robust competitive market has developed and is well established.

B. The Joint Position Provide No Tangible Ratepayer Benefits, and Does Not Reflect the Interests of Ordinary Consumers.

The Joint Position as proposed would provide no tangible ratepayer benefits. The economic incentives, which, as noted, would be in effect only for a limited period of time, would be funded wholly at ratepayer expense. *RA-82* at 43-44; Tr. 523. The other purported ratepayer benefit asserted by the Company, relieving ratepayers of the risk of stranded costs, is greatly overstated by the Company. Company witness David Wohlfarth appeared to acknowledge during cross-examination that it was unlikely that Newco would find itself with excess capacity. According to Mr. Wohlfarth, if Newco were to lose customers it would have the ability to "[take] action with its portfolio make necessary adjustments such [that] the costs will track pretty much the current trend." Tr. 439. Moreover, as explained in detail above, the market structure envisioned by Public Service is likely to result in windfall profits for Newco and a limited number and a few of its major competitors. Stranded *benefits* are a much greater possibility than stranded costs. *RA-83* at 40. Further, in the unlikely event stranded costs were to occur, Newco would have the option to return up to 50 percent of the transferred contracts to Public Service in the event the Requirements Contract were not renewed after its initial term. *PS-6*, § 3.2; *RA-82* at 39-40. There is no comparable symmetric option for ratepayers in the event there are stranded benefits. *RA-83* at 43.

The Joint Position also is not defensible as a balanced compromise among competing interests. Public Service, a few major suppliers, and a few large congenerators, have agreed to expropriate the value of resources which have been paid for, and were acquired to benefit, the Company's 1.6 million BGSS customers. In the process, they have bargained away ratepayers' right to the protections of BGSS service. Ratepayers would be subject to high and unstable rates, uncertain reliability, and diminished consumer protections. The Joint Position would not assure a competitive gas supply market, and would severely limit the Board's ability to deal with the market power that is likely to result from this proposal. *RA-82* at 52; *RA-83* at 53-54. It is in no way a balanced compromise which will promote EDECA's objective of vigorous competition, lower prices, and improved quality of service for New Jersey's energy consumers.

CONCLUSION

For the reasons set forth above, Public Service's proposal to transfer its interstate transportation and storage contracts and other gas supply resources to an unregulated affiliate is contrary to the policies and specific mandates of EDECA. This proposal, if adopted, would create inordinate risks for New Jersey's energy markets and energy consumers, while providing Public Service affiliates with the opportunity to gain windfall profits at ratepayer expense. The Ratepayer Advocate respectfully submits that the ALJ and the Board should adopt the findings and recommendations set forth above and in the Ratepayer Advocate's testimony in this matter.

Respectfully submitted,

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By:______________________________
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