UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Long Island Lighting Company	**)**	**Docket No. ER98-11-000**

LONG ISLAND POWER AUTHORITY'S MOTIONS TO INTERVENE AND FOR SUMMARY REJECTION OF LONG ISLAND LIGHTING COMPANY'S RATE FILING AND, IN THE ALTERNATIVE, MOTION FOR SUMMARY DISPOSITION, PROTEST, REQUEST FOR HEARING, AND ESTABLISHMENT OF REFUND PERIOD

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TABLE OF CONTENTS

I. INTRODUCTION AND MOTION TO INTERVENE 4

A. Description of LILCO's Rate Filing 4

B. Basis for Intervention 10

II. MOTION TO REJECT LILCO's RATE FILING 10

A. The PSA is a Contract 11

B. The PSA Provides for a Five Year Rate Derived from an Approved First Year Budget and Adjusted in Subsequent Years 12

C. LILCO's Appendix A is Inconsistent with the Requirements of the PSA. 15

1. LILCO's Appendix A Rate Violates the PSA by Omitting the Annual Adjustments and by Including Reopeners . 16

2. LILCO's Proposed Rate Is Not Based on Either the Five Year Budget Used to Establish the Initial Rate or the Five Year Capital Improvement Budget. 17

3. The Proposed Rate Includes Revenue Requirements Generated by a Step-up in Basis of GENCO's Assets in Contravention of Section 8.1.1 of the PSA 18

4. LILCO's Failure to Include Costs in a Monthly Variable Charge Violates the PSA 21

D. Mobile/Sierra Requires Rejection of LILCO's Rate Filing . . . 24

III. MOTION FOR SUMMARY DISPOSITION. 27

A. LILCO Should Be Ordered to Revise the Filed Appendix A to Include a Formula for Adjusting the Monthly Capacity Charge for Contract Years Two Through Five and Eliminate the Reopeners

. . . . 27

B. LILCO Must Refile the Monthly Capacity Charge in Appendix A to Reflect the Reduction Required by PSA Section 8.1.1 . . 29

C. LILCO's Failure to Include Any Costs in the Monthly Variable Charge Violates the PSA 30

D. The PSA's Terms Mandate A Lower Cash Working Capital Allowance for GENCO 31

IV. PROTEST, REQUEST FOR HEARING AND, IF NECESSARY, ESTABLISHMENT OF REFUND EFFECTIVE DATE. 33

A. The Revenue Requirement Derived From LILCO's Proposed Rate Base Is Excessive 33

1. LILCO's Filing Inflates its Capital Expenditure Requirements for 1998 Beyond the Amount LILCO Projected in its 1996 NYPSC Case 35

2. LILCO's Requested Materials and Supplies Allowance Is Excessive 37

B. LILCO'S Requested Return on Equity and Overall Return are Excessive 38

1. The Return on Equity Is Overstated 38

2. GENCO's Proposed Cost of Debt is Overstated for Use in a Rate to be Set for Five Years 44

3. GENCO's Proposed Capitalization Structure of 50% Debt and 50% Equity Is Unreasonable 45

C. The Operations and Maintenance Expenses Underlying the Monthly Capacity Charge Are Greatly Overstated 48

1. LILCO's Method of Calculating Operations and Maintenance Expenditures Masks the Magnitude of the Actual Increase to LIPA 48

2. LILCO Has Used Unduly Conservative and Unsupported Assumptions in Its Calculation of PBOP Costs 50
a. LILCO's Assumptions Regarding Employee Turnover Are Too Low 52
b. LILCO's Assumptions Regarding Medical Cost Trends Are Too High 52
c. The Discount Rate Used by LILCO Is Suspect . 53
d. The Mortality Rates Used by LILCO are Suspect 53
3. The Generation Unit Overhaul Costs Should Be Normalized 54
4. LILCO Inappropriately Includes Research and Development Payments to External Organizations in Its Costs . . . 56
5. LILCO's Allocation Methodology Results in Excessive A&G Costs Allocated to GENCO 56
D. LILCO's Filed Appendix B Fees and Thresholds for the Monthly Variable Payment Adjustment Charge Will Result in Excessive Charges to LIPA 59
E. Appendix E Should Be Revised 64
V. CONCLUSION 66

ATTACHMENTS

1 Articles 8 and 9 of the Power Supply Agreement, dated as of June 26, 1997 ("PSA") which specify the process for establishing most of the charges under the PSA.
2 LILCO's filed Appendix A to the PSA.
3 Affidavit of Elizabeth McCarthy.

4 LILCO press release dated October 21, 1997.

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Pursuant to Rules 212 and 214 of the Rules of Practice and Procedure of the Federal Energy Regulatory Commission ("Commission"), 18 C.F.R. §§385.212, 385.214 (1996), the Long Island Power Authority ("LIPA"), respectfully moves to intervene and for summary rejection of the rates filed by the Long Island Lighting Company ("LILCO") in this proceeding. If the Commission denies LIPA's motion for summary rejection, LIPA files herewith its protest and a motion for summary disposition pursuant to Rules 211 and 217 of the Commission's Rules, 18 C.F.R. §§ 385.211, 385.217. LIPA also requests the Commission to set this matter for hearing if the Commission does not summarily reject LILCO's filing.

If the Commission accepts LILCO's characterization of the filing as an "initial rate" under Section 205(c) of the Federal Power Act ("FPA")[1], LIPA

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[1] 16 U.S.C. § 824d(c) (1996).

requests that the Commission institute an investigation into LILCO's filing under FPA Section 206[2], establish a refund effective date beginning on the closing date of the transaction upon which the filing is predicated, and process this application on an expedited basis.

As an initial matter, the Commission should recognize the relatively unusual and peremptory context of LILCO's filing. The "Power Supply Agreement between Long Island Lighting Company and Long Island Power Authority", dated as of June 26, 1997, ("PSA") is part of the complex and comprehensive restructuring of LILCO that is intended to result in the reduction of what are now the highest electric rates in the continental United States.[3] The PSA provides that LIPA, as the sole purchaser of the capacity from what are now LILCO's generating facilities on Long Island, will approve the costs that it is charged through a budget and oversight process. The PSA thus contemplates that almost all rates that LILCO (now) or GENCO[4] (later) files with this Commission will have been derived jointly by LILCO and LIPA through a cooperative and negotiated process.

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[2]16 U.S.C. § 824e (1996).

[3]The extent of that restructuring is described in detail in LILCO's initial application in Long Island Lighting Company, FERC Docket No. EC97-45-000, and in LIPA's comprehensive "Answer of Long Island Power Authority to Motions to Intervene and Requests for Hearing", filed October 14, 1997, in that docket (hereinafter "LIPA Answer").

[4]GENCO is the entity that will succeed to the ownership of LILCO's generation located on Long Island. GENCO is described, infra.

Despite the fact that LILCO and LIPA executed the PSA less than five months ago, LILCO's filing in the instant proceeding does not reflect such cooperation and negotiation. LIPA interprets the filing to be an attempt by LILCO to foreshorten the rate negotiations. The proposed rates far exceed any level that a review of LILCO's historical data would suggest. In some cases, the filing flatly contradicts the PSA. By making this filing, LIPA is requesting the Commission's support to ensure that LILCO is held to the agreements it negotiated which will bring rate relief and introduce competition to Long Island.

Service of pleadings, documents, or communications with regard to this proceeding should be made upon:

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I. INTRODUCTION AND MOTION TO INTERVENE

A. Description of LILCO's Rate Filing

On September 30, 1997, LILCO[5] filed with the Commission rates for wholesale electric service to be provided to LIPA.[6] The filing includes the PSA as executed by LIPA and LILCO on June 26, 1997. It also contains LILCO's proposed versions of Appendices A, B, and E to the PSA which LILCO unilaterally filed without LIPA's assent.[7] Appendix A contains most of the price terms for the sale of capacity and the delivery of energy under the PSA from GENCO (described below) to LIPA. Appendix B purports to identify the costs of starting individual generating units that will serve as the components of the Monthly Variable Payment Adjustment Charge described in Sections 8.1 and 8.1.5 of the PSA. Appendix E includes the conditions limiting the dispatch of each of GENCO's generating units, i.e., minimum loadings, ramp rates, start-up and scheduled start-up times.[8] The parties,

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[5]LILCO provides electric and gas service in the counties of Nassau and Suffolk and on the Rockaway Peninsula in the Borough of Queens, all on Long Island, New York.

[6]LIPA is a municipal subdivision of the State of New York authorized under the Long Island Power Authority Act to acquire all or any part of the securities or assets of LILCO and to provide electric service on Long Island. N.Y. PUB. AUTH. LAW § 1020-a (Gould 1989 and Supp. 1997).

[7]LILCO's proposed Appendices A, B, and E are included in Attachment C to LILCO's filing.

[8]See also PSA § 2.3(c).

when signing the PSA in June 1997, left these three Appendices to be resolved by further negotiation consistent with the PSA. Thus far, the parties have been unable to agree upon provisions acceptable to both.

As shown below, LILCO's filed Appendix A[9] is fundamentally inconsistent with the executed provisions of the PSA and with the business transaction the parties have negotiated. For that reason, LIPA moves that the Commission reject the rate, without prejudice to LILCO's refiling a rate that meets the requirements of the PSA.

The PSA is part of a larger restructuring of electric service on Long Island under which LIPA will acquire, among other things, LILCO's electric transmission and distribution system, its regulatory assets, and certain jurisdictional power sales contracts and nuclear generation interests. This acquisition will be accomplished through LIPA's purchase of LILCO stock rather than through direct purchase of those assets (the "Acquisition").[10] As part of the plan of agreement describing the Acquisition, LILCO will transfer its fossil-fired generating capacity located on Long Island to GENCO, a subsidiary of the entity to be created by the LILCO/Brooklyn Union Gas

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[9]Attachment C to LILCO's filing.

[10] In Docket No. EC97-45-000, LILCO has applied for Commission approval of these asset transfers under FPA § 203. The terms of the restructuring are described in the agreements and the testimony of LILCO and LIPA officials submitted with that application.

Company ("BU") merger.[11] The output of these units is to be sold to LIPA under a long-term wholesale power sale arrangement, the terms and conditions of which are spelled out in the PSA.

The PSA provides that Appendix A is to contain, among other charges, a Monthly Capacity Charge and a Monthly Variable Charge[12] for these power sales. The Monthly Capacity Charge is 1/12th of the annual Capacity Charge. The Capacity Charge is intended to compensate GENCO for its fixed generation costs as specified in PSA Section 8.1.1. The capacity charge is to be established for each of three five year periods through a filing with the Commission under Section 205 of the FPA. The filing is to establish the costs to be recovered in the first year of each five year period and is to be annually adjusted for each of the following four years according to a formula. The formula is to stay constant; the filing for the sixth and eleventh Contract

[11]The Commission approved that merger in Long Island Lighting Company, 80 FERC ¶ 61,035 (1997). The agreement among the merging entities and LIPA, appended to LILCO's application in FERC Docket No. EC97-45-000 to sell certain jurisdictional assets to LIPA, denotes the merged BU-LILCO entity as "HoldCo" and its generating subsidiary as "GENCO". These terms will be used in this pleading as well. It should also be noted that in advance of the closing of BU's merger with LILCO, BU's shareholders recently formed a holding company called KeySpan Energy Company.

[12]The "Monthly Capacity Charge" and "Monthly Variable Charge" are defined in PSA §§ 1.39 and 1.42 and described in PSA §§ 8.1.1 and 8.1.2. PSA Articles 8 and 9, which specify the process for establishing most of the charges under the PSA, are appended hereto as Attachment 1. Terms that are cited in capitalized form in this pleading have the same meanings as in the PSA.

Years[13] is essentially intended to adjust the numbers used as the base of the formula.

PSA Sections 8.1.1 and 9.1 provide that capacity charge for the first Contract Year

> will be based upon disaggregated generation cost elements relating to the Generating Facilities (including associated common costs) and contained in the proposed 1997 rate year budget in the GENCO 1996 rate case filing with the New York State Public Service Commission, updated for known changes in facts and circumstances, adjusted to the First Contract Year and as set forth in Appendix A. Such budget shall also consider actual historical results prepared on a comparable disaggregated basis for 1996 and thereafter up to the date of adoption of such budget.[14]

The capacity charge is to be adjusted in subsequent years in accordance with mutually agreed-upon indices and LIPA-approved capital improvement budgets. The capacity charge in the first year may not reflect a revenue requirement dependent on revenues generated by any step-up of the book or tax basis of the assets attributable to the Acquisition.[15] The Monthly

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[13]A "Contract Year" is defined in the PSA § 1.9 as a calendar year (unless LIPA proposes otherwise, subject to GENCO's approval). The first "Contract Year" is to run from the closing of the Acquisition to the end of that calendar year. LIPA and LILCO presently contemplate closing the Acquisition on April 1, 1998 or soon thereafter.

[14]PSA § 9.1.1.

[15]PSA § 8.1.1.

Variable Charge is intended to reflect non-fuel variable operation and maintenance costs.[16]

Neither the Monthly Capacity Charge nor the Monthly Variable Charge included in the version of Appendix A filed by LILCO for the first Contract Year of the PSA are based on costs or a budget approved by LIPA. LIPA opposes the charges contained in LILCO's filed Appendix A, as well as the wording of that document. LILCO's filed Appendix A contains several outright contradictions with the PSA. LIPA also has not agreed to, and opposes, the versions of Appendices B and E filed by LILCO.

One of the most glaring deficiencies of the filed Appendix A is that it contains no provision for annual adjustment of the first year rate as contemplated by the PSA. Without that annual adjustment, LIPA will be denied the benefit of GENCO's declining rate base caused by the fact that annual depreciation on GENCO's assets is expected to exceed GENCO's annual completed capital additions. The magnitude of this cost benefit is compounded because LILCO's testimony discloses that the filed Monthly Capacity Charge reflects a rate increase resulting from the step-up of the tax basis of GENCO's assets, in violation of PSA Section 8.1.1.

An additional error in Appendix A is the fact that LILCO establishes the Monthly Variable Charge at zero. LILCO's decision to do so contradicts the

[16]LILCO's filed Appendix A is appended hereto as Attachment 2.

PSA and the fact that certain of the non-fuel costs it relies upon in the filing are commonly classified under the Commission's accounting as variable, not fixed, costs.

As will be demonstrated below, the various inconsistencies between LILCO's filing and the PSA provide the grounds either for rejection of the entire filing or, at a minimum, summary disposition of various key elements of the filing. Additionally, LIPA's protest demonstrates that the Monthly Capacity Charge rests on many unreasonably inflated costs.

LIPA strongly supports the restructuring, LILCO's application in FERC Docket No. EC97-45-000, and the agreements LIPA has executed because they will reduce rates to retail ratepayers on Long Island by an average estimated seventeen percent and provide other benefits.[17] However, LIPA cannot accede to LILCO's unilateral filing of an Appendix A which contains substantially higher rates than LIPA believes can be justified and would be approved under the contractually required budget process. The filed Appendix A as well as the incorrect costs and assumptions in Appendices B and E are fundamentally inconsistent with the signed PSA. If the rates in Appendix A become effective as filed, Long Island ratepayers will pay more for electricity than is justified.

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[17]For a more detailed discussion of the transactions and application of this expected rate reductions, see the LIPA Answer, filed in Docket No. EC97-45-000, supra note 3.

B. Basis for Intervention

LIPA moves to intervene in this proceeding. As the sole purchaser of capacity from LILCO under the PSA and as a party to the PSA, LIPA has an interest that may be directly affected by the outcome of this proceeding and that cannot be adequately represented by any other party.[18] Accordingly, it is appropriate, and in the public interest,[19] that LIPA be permitted to intervene in this proceeding and participate with full rights as a party.

II. MOTION TO REJECT LILCO's RATE FILING

LIPA requests that the Commission reject LILCO's rate filing on the grounds that Appendix A as filed by LILCO is inconsistent with the agreed-upon provisions of the PSA. Under the Mobile/Sierra doctrine[20], Appendix A represents a unilateral change in the executed PSA contract which the Commission cannot lawfully accept for filing.[21]

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[18] 18 C.F.R. § 385.214(b)(2)(ii) (1996).

[19] 18 C.F.R. § 385.214(b)(2)(iii) (1996).

[20] United Gas Pipe Line Co. v Mobile Gas Serv. Corp., 350 U.S. 332 (1956); Federal Power Comm'n v. Sierra Pac. Power Co,, 350 U.S. 348 (1956).

[21] The figures contained in the filed Appendices B and E are also not correct. However, those inconsistencies form part of the basis of LIPA's motion for summary disposition rather than its motion to reject.

A. The PSA is a Contract

The PSA was duly executed by the representatives of LIPA and LILCO on June 26, 1997. Under the Uniform Commercial Code ("UCC"), this instrument would be characterized as a contract with an open price term, and would be binding if the parties so intend.[22] LIPA entered into a binding contract when it executed the PSA. LILCO states in its rate filing that "LILCO and LIPA are parties to the Power Supply Agreement. The Agreement was properly executed by all parties."[23]

The executed provisions of the PSA thus establish the standard against which the rates in Appendix A must be measured for compliance. Those provisions, particularly Articles 8 and 9, establish the procedure for devising the rates and rate adjustment mechanisms to be included in Appendix A. As amplified below, LIPA is requesting the Commission to enforce the PSA by rejecting the rate filing represented by LILCO's filed Appendix A.

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[22]"The parties if they so intend can conclude a contract for sale even though the price is not settled." UCC § 2-305(1) (1995). See City of Bethany v. FERC, 727 F.2d 1131 (1984), for application of UCC open price contract rules in Federal Power Act context (upholding the validity of an open price contract, but applying Mobile/Sierra doctrine rather than the UCC's reasonable price rule).

[23]See LILCO's letter accompanying the filing at p.4.

B. The PSA Provides for a Five Year Rate Derived from an Approved First Year Budget and Adjusted in Subsequent Years

LILCO and LIPA agreed to all of the terms of the PSA other than Appendices A (Formula Rate), B (Monthly Variable Payment Adjustment Charge), and E (Minimum Loadings, Ramp Rates, Start-up and Scheduling Time). According to the terms of the executed PSA, these Appendices were to be developed and agreed upon prior to the closing date of the Acquisition.[24] As of yet, none of these Appendices have been agreed upon. The PSA provisions prescribing how these Appendices are to be completed are described below.

Section 8.1 of the PSA provides that LIPA will pay for electricity delivered under the PSA at prices calculated pursuant to the terms of Appendices A and B. The Monthly Capacity Charge and the Monthly Variable Charge were to be set forth in the formula rate in Appendix A. Section 8.1.1 of the PSA provides that the Monthly Capacity Charge is 1/12 of the annual capacity charge. That section specifies the costs to be recovered in the Monthly Capacity Charge, which are to include, among other items: return on investment; depreciation of the undepreciated cost of the generating facilities and on completed capital additions approved by LIPA; income taxes; and fixed operation and maintenance costs. Section 8.1.1

[24]LILCO and LIPA intend to close the Acquisition as soon after April 1, 1998, as possible.

specifically prohibits any increase in generation charges "as a result of any step-up in the book or tax basis of the assets."

Under Section 8.1.2, the Monthly Variable Charge is equal to variable costs times the number of megawatt hours generated. The components of the Monthly Variable Charge are spelled out in that section, and are to include variable operation and maintenance costs that vary directly with the amount of energy generated (other than certain charges for start up, fired hours of operation, fuel swaps specified in PSA Appendix B, and for fuel).[25]

Article 9 of the PSA spells out how the Appendix A formula rate is to be implemented. Pursuant to its terms, LILCO is to submit for LIPA's review and approval a five year budget that provides details on the fixed and variable costs of operating the GENCO generating facilities. The first such five year budget, upon approval by LIPA, is to establish the Monthly Capacity Charge and the Monthly Variable Charge for the first year of the five year period and to form the basis for adjustment for subsequent Contract Years in the five year period.[26]

The budget plan for the first Contract Year (which begins on the closing date of the Acquisition) is to be based on disaggregated generation

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[25]LIPA will arrange to provide its own fuel for generation according to the provisions of the "Energy Management Agreement between Long Island Lighting Company and Long Island Power Authority", dated as of June 26, 1997 ("EMA").

[26]PSA § 9.1.1; see Attachment 1 to this pleading.

cost elements for the 1997 "rate year" used by LILCO for its retail rate filing with the Public Service Commission of New York ("NYPSC"), updated to the first Contract Year for known changes in facts and circumstances, and considering actual historical results up to the date of adoption of the budget.[27] The budget for the first Contract Year sets the monthly capacity and variable charges for that year, and "forms the basis for adjustment for subsequent Contract Years".[28] For each subsequent Contract Year in the five year period, the Monthly Capacity Charge and the Monthly Variable Charge would be "based on the previous year, as adjusted in accordance with indices and approved capital improvement budgets" according to procedures to be set forth in Appendix A.[29]

GENCO also is required to prepare and submit to LIPA a rolling five year capital improvement budget "for incremental capital expenditures and associated rate adjustments" for LIPA's review and approval.[30] That budget also is to be divided into individual Contract Years.

If LIPA and LILCO are unable to agree on either all or part of the initial budget for the first Contract Year underlying the monthly capacity and

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[27]That case was filed and docketed as NYPSC Case No. 96-E-0132, and is hereinafter referred to as the "LILCO 1996 NYPSC Case."

[28]PSA § 9.1.1.

[29]Id.

[30]PSA § 9.1.2.

variable charges, or for the first year of the five year capital improvement budget, the disputed portions of the appropriate budget "shall be resolved in a proceeding before the FERC."[31] The non-contested portions of either budget are to become effective automatically.

C. LILCO's Appendix A is Inconsistent with the Requirements of the PSA

LILCO's filed Appendix A and the rates set forth therein are not consistent with the annually-adjusted, budget-based rates required by the PSA. LIPA requests the Commission to reject[32] Appendix A (without prejudice to LILCO's filing an Appendix A that is consistent with the PSA) for the following reasons:

- The proposed rate does not include the indices required by Articles 8 and 9 of the PSA and precludes LIPA's bargained-for benefits.
- LILCO's proposed rate is based on neither the Five Year Budget nor the Five Year Capital Improvement Budget both to be approved by LIPA under Section 9.1 of the PSA. Nor has LILCO

[31]PSA § 9.3.

[32]LIPA is not seeking rejection of the non-rate terms of the PSA. LIPA has executed the agreement and does not seek its change. If the Commission determines that the entire filing should be rejected and resubmitted, LIPA does not object.

presented a budget dispute to the Commission for review in its filing as required by Section 9.3 of the PSA.

- The filed rate includes a revenue increase due to a step-up in the tax basis that is prohibited by Section 8.1.1 of the PSA.
- LILCO failed to include a Monthly Variable Charge as required by the PSA by characterizing all non-fuel variable costs as fixed costs.

1. LILCO's Appendix A Rate Violates the PSA by Omitting the Annual Adjustments and by Including Reopeners

LILCO's Appendix A bears little resemblance to the annually-adjusted rate described in the PSA. Rather, it specifies a flat Monthly Capacity Charge of $27.3 million per month, with no annual adjustment other than a property tax true-up. The filed Appendix A does not specify that the rate is to be applied for five years or for any fixed period. In addition, it contains provisions for "reopeners" (nowhere mentioned in the PSA) under which either party may petition FERC for a rate adjustment to reflect changes in long term interest rates, or in certain cost allocations. These limited reopeners are not the functional equivalent of the annually-adjusted rate the parties provided for in the PSA. The reopeners require a FERC rate case before they can be effective, whereas the annually-adjusted, indexed rate, once it becomes effective, makes annual adjustments in the rate without further rate filings within the five year period.

More importantly, LILCO's flat rate with its limited reopeners excludes certain key adjustments that LIPA bargained for and obtained in the PSA. LILCO's rate contains an annual allowance for depreciation of almost $40 million per year.[33] Under the PSA, the capacity charge includes a component for recovery of "return on investment". But, even though net investment in plant declines in Contract Years two through five as GENCO recoups its capital costs through depreciation charges, there is no decline in rate base[34] or reduction in rates to reflect this reduction in LILCO's investment in plant. Moreover, although the PSA permits the rate base to be changed by LIPA - approved capital additions pursuant to a five year capital improvement budget and requires an annual adjustment in the capacity charge to reflect increases or decreases in indices, neither provision appears in LILCO's Appendix A.

2. LILCO's Proposed Rate Is Not Based on Either the Five Year Budget Used to Establish the Initial Rate or the Five Year Capital Improvement Budget

Section 9.1 of the PSA contemplates that the capacity charge in Appendix A will be derived from the five year budget prepared by GENCO and approved by LIPA which includes the elements specified in Section

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[33]See Attachment A to LILCO's Filing.

[34]If properly taken into account, aggregate reductions in rate base attributable to depreciation would approximate $200 million by Contract Year five.

8.1.1. The PSA also contemplates the inclusion of adjustments from the LIPA approved capital improvement budget. These budgets are to be prepared on a Contract Year, i.e., calendar year, basis.

LILCO's filing does not refer to either budget. LIPA has not approved either budget. LILCO's filing does not request the Commission to resolve a dispute concerning either budget, as required under PSA Section 9.3. Finally, the cost projections submitted by LILCO through testimony (not the wording of Appendix A), are not based on a Contract Year basis. The costs purport to reflect projections for the last nine months of 1998 and the first three months of 1999 — a fiscal year nowhere specified in the PSA.

Therefore, almost nothing about LILCO's filing, except the formal specification of the Monthly Capacity Charge, is in accordance with the procedure required by Articles 8 and 9 of the PSA. LILCO's rate filing should therefore be rejected.

3. The Proposed Rate Includes Revenue Requirements Generated by a Step-up in Basis of GENCO's Assets in Contravention of Section 8.1.1 of the PSA

Section 8.1.1 of the PSA prohibits any increase in generation charges as a result of any step-up of the book or tax basis of GENCO's assets. This prohibition is intended specifically to preclude GENCO from claiming any increase in revenue requirements from a step-up in tax basis caused by the Acquisition. Nevertheless, as LILCO concedes in the prefiled

testimony of Anthony Nozzolillo, LILCO has increased GENCO's rate base to reflect the Federal income tax it must pay on the difference between the imputed market value of the assets[35] and their tax basis. This Federal income tax payment reduces GENCO's accumulated deferred tax liability to zero and thereby increases GENCO's rate base and revenue requirement.[36] LIPA calculates that this adjustment increases GENCO's rate base by at least $52 million and the annual revenue requirement by at least $6.0 million, in direct contravention of the PSA.

Mr. Nozzolillo's testimony does not deny that LILCO's revenue requirements are increased through the tax step-up of what will become GENCO's assets. He asserts instead that this rate increase should be disregarded because it is "essentially offset" by a decrease in the provision for federal income taxes for ratemaking purposes. LILCO's attempt to disguise this violation of the PSA cannot be countenanced for several reasons.

First, the PSA prohibits a rate increase due to a step-up in the tax basis of the assets. This prohibition may not be circumvented by a coincidental and unrelated reduction in cost. Indeed, the "offset" will occur

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[35]The imputation of a market value arises in the context of the transfer of these assets from present-day LILCO to GENCO before the closing of the Acquisition.

[36]Testimony of Anthony Nozzolillo, Exh. No. _____ (AN-1) at p. 11.

whether the PSA includes the Section 8.1.1 prohibition or not. LILCO's theory would require the Commission, in effect, to construe the specific prohibition of Section 8.1.1 out of the contract. The Commission does not adhere to that theory of contract construction.[37]

Second, LILCO is inappropriately attempting to obtain "double credit" and, indeed, double payment, for the same cost. As part of the Acquisition, LIPA will purchase, among other things, LILCO's regulatory tax assets, i.e. the probable future revenues it expected to collect from ratepayers to pay the future federal income tax resulting from benefits that had previously been flowed through to ratepayers. As explained more thoroughly in the Affidavit of Elizabeth McCarthy,[38] LILCO's "offset" argument is based on the decreased future tax payments resulting from the increased tax basis of GENCO's assets. However, this reduction in the federal income tax provision for rate purposes would occur even if the tax basis of GENCO's assets did not increase. Through its purchase of the regulatory tax asset, LIPA essentially will have provided LILCO with the cash to make the tax payments due as a result of the prior flow-through benefits. LILCO's claim that this increased deduction should be counted as an offset to LIPA's increased

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[37]Cf. DeNovo Oil & Gas, Inc., 71 FERC ¶ 61,057 (1995); Amoco Production Co. and Oryx Energy Co., 61 FERC ¶ 63,021 (1992), Greenberg v. Service Business Forms Indus., Inc., 882 F.2d 1538, 1540 (10th Cir. 1989), cert. denied, 439 U.S. 1045 (1990).

[38]Appended hereto as Attachment 3.

payments through the revenue requirement increase resulting from the tax step-up in GENCO's assets essentially means that LIPA will reimburse LILCO again for the same taxes. The prohibition against such double payment in Section 8.1.1 thus has a sound basis and must be upheld by this Commission.

A third, and related point, is that the reduction in GENCO's recoverable Federal income taxes claimed by Mr. Nozzolillo as an offset to the step-up increase in revenue requirements is a "known change" in operating costs resulting from LIPA's acquisition of LILCO's regulatory tax assets. Section 9.1.1 of the PSA already requires LILCO/GENCO to include that change in the determination of the initial budget that was supposed to provide the basis for the initial Monthly Capacity Charge. LILCO cannot, therefore, claim it as an offset to a contractually required limitation on GENCO's permitted cost recovery.

4. LILCO's Failure to Include Costs in a Monthly Variable Charge Violates the PSA

Finally, LILCO's Appendix A omits the Monthly Variable Charge entirely, asserting that "it has now been determined that there will not be any variable O&M costs."[39] This "determination" is unsound for many reasons. Not only did LILCO exclude LIPA from participating in the determination, but LILCO has also failed to support its determination with

[39]Testimony of Adam Madsen, Exh. No.__ (AMM-1), p.9.

any information in its filing, and has ignored key elements of GENCO's cost of service that properly should be treated as variable costs.

It is important to understand at the outset that LIPA will supply its own fuel for generation in GENCO's facilities under the EMA. The Monthly Variable Cost, therefore, was intended to recover the non-fuel variable costs of generation.

Under well established regulatory practice,[40] all or part of the production costs recorded to the following accounts are variable costs:[41]

500 Operating supervision and engineering
501 Steam plant fuel and fuel handling
502 Steam expense - operations
503 Steam from other sources
504 Steam transferred - credit
505 Electric expense - operations
510 Maintenance supervision and engineering
512 Maintenance of boiler plant
513 Maintenance of electric plant
514 Maintenance of miscellaneous plant
547 Other plant fuel and fuel handling

The omission of these non-fuel variable costs is important both because of their magnitude (LIPA estimates those costs to be in excess of

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[40]See National Association of Regulatory Utility Commissioners, Electric Utility Cost Allocation Manual, 35-38 (1992).

[41]References are to the Commission's Uniform System of Accounts. Amounts recorded to accounts 500, 502, 505, and 510 are allocated between fixed and variable costs.

$24 million[42] for 1998) and because of their effect on LIPA's purchases from third parties. Under LILCO's Appendix A, LIPA would pay GENCO's variable costs as a part of the Monthly Capacity Charge, even when the units are not run. These costs would not be charged to LIPA at all when the units are not serving LIPA if they are included in the Monthly Variable Charge instead of the Monthly Capacity Charge.

LILCO's failure to include non-fuel variable cost in the Monthly Variable Charge will impose additional costs on LIPA in other ways. First, Section 11.1 of the PSA provides that LIPA may determine to reduce ("ramp down") the amount of capacity purchased from GENCO beginning in Contract Year seven of the PSA. Should it choose to exercise this right, LIPA is required to pay GENCO all, or a portion of, the present value of the Capacity Charge related to the ramped down capacity. This payment will be overstated to the extent that LILCO includes variable costs in the Capacity Charge. This may result in either (1) a payment to GENCO of variable costs that it could avoid, thus providing a significant windfall to GENCO; or (2) a significant economic barrier to the exercise of the ramp down option. This economic barrier, in turn, may lock LIPA into a continuation of the capacity sale that it determines

[42]In the workpapers accompanying the LILCO 1996 NYPSC Case, LILCO concluded that $24.1 million included in Accounts 502, 505, 512 and 514 were energy related. The LIPA estimate mentioned above was derived according to a slightly different process.

would otherwise be uneconomic. The establishment of a proper Monthly Variable Charge, therefore, is important for the implementation of the PSA.

Second, LILCO's failure to provide a Monthly Variable Charge not only violates the PSA but also **is anticompetitive**. If GENCO's variable costs are improperly included in the Monthly Capacity Charge, GENCO may achieve an unfair competitive advantage relative to other energy suppliers. Under those circumstances, LIPA may purchase GENCO energy even when LIPA's fuel and GENCO's variable costs exceed the alternative seller's bid. As LIPA diversifies its sources of energy and substitutes energy suppliers other than GENCO, LIPA will, be paying GENCO through the Monthly Capacity Charge for variable costs GENCO is able to avoid. LILCO's failure to include a variable charge in its filing is thus not a mere accounting oversight but a material change that is not consistent with the PSA and the EMA and the parties' business deal incorporated therein.

D. Mobile/Sierra Requires Rejection of LILCO's Rate Filing

LILCO entered into a binding contract with LIPA and then filed rates with the Commission which contravene that contract. The Mobile/Sierra[43] doctrine requires the Commission to reject LILCO's filed rate. Under that doctrine, "rate filings consistent with contractual obligations are valid, rate

[43] See supra note 20.

filings inconsistent with contractual obligations are invalid."[44] It is well settled that "[t]he Commission has no discretion to accept a Section 205 filing that contravenes a private contract."[45]

In Metropolitan Edison Co.,[46] the Commission rejected a unilateral rate increase because the utility proposing the increase failed to follow contractual requirements to notify its customer of rate changes, and to negotiate with the customer prior to filing the rate change. Unlike the Metropolitan Edison Co. case, where the contract merely required a discussion prior to filing, the PSA requires the establishment of budgets and formulae before the matter may be brought to the Commission.

The TANC proceeding is closely analogous to the instant situation. In TANC, the Commission considered whether a Transmission Rate Schedule ("TRS") filed by Pacific Gas and Electric Company ("PG&E") contravened an earlier agreement that the parties had executed -- the Principles of Tesla-Midway Transmission Service Agreement (also known as the "SOTP"). The Commission reviewed and compared provisions of the SOTP and the TRS,

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[44] Richmond Power & Light v. FPC, 481 F.2d 490, 493 (D.C. Cir. 1973).

[45] Transmission Agency of Northern California v. Pacific Gas & Elec. Co., 55 FERC ¶ 61,417 (1991) ("TANC") (citing Papago Tribal Utility Auth. v. FERC, 628 F.2d 235, 245 (D.C. Cir. 1980)).

[46] 52 FERC ¶ 61,057 (1990); 52 FERC ¶ 61,304 (1990).

and determined that there were significant differences between the two. For this reason, the Commission rejected the TRS, stating:

> While there may be some provisions of the TRS with no equivalent in the SOTP that are nevertheless consistent with the SOTP, others appear to be inconsistent with the SOTP. We cannot, however, under the Sierra-Mobile doctrine, accept for filing under section 205 any transmission service schedule that does not provide for the basic service contracted for in the SOTP.[47]

The Commission is similarly constrained here. The material inconsistencies between the PSA and Appendix A filed by LILCO go to the heart of the PSA transaction. Under the terms of Appendix A as filed, rates will not be reduced as GENCO's net investment declines as a result of depreciation. The end result of this is that GENCO will receive a return on investment it will have already recovered from LIPA through depreciation. The indices which are required by PSA Sections 8.1.1 and 9.1 were negotiated to assure LIPA that GENCO's cost increases would be limited by, and pegged to, objective measures. The long term budget approval and Contract Year mechanisms detailed in the PSA provide LIPA with additional control and oversight over GENCO's costs. The prohibition on rate increases arising from Acquisition-caused increases in GENCO's book or tax basis was obviously included for LIPA's benefit. The Commission cannot permit LILCO

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[47] TANC, 55 FERC ¶ 61,417 at p. 62,252.

to withdraw those cost controls by filing an Appendix A that contravenes the PSA in this manner.

III. MOTION FOR SUMMARY DISPOSITION

If the Commission decides not to grant LIPA's motion to reject LILCO's rate filing in its entirety, LIPA requests the Commission to grant summary disposition on the issues listed below and to require LILCO to revise its filing, particularly the Monthly Capacity Charge, the Monthly Variable Charge, and the form of Appendix A, to conform with the requirements of the PSA.

A. LILCO Should Be Ordered to Revise the Filed Appendix A to Include a Formula for Adjusting the Monthly Capacity Charge for Contract Years Two Through Five and Eliminate the Reopeners

The version of Appendix A that LILCO filed does not specify anything more than a first year rate. Neither the filed Appendix A nor any other part of LILCO's filing, other than the supporting testimony of Adam Madsen,[48] provide any indication of how the rate is to be adjusted during the remaining four years of the initial five year rate period or at any other time during the PSA term. Although certain language of the PSA may be construed to imply that the initial rate is to continue for more than one year, the length of the rate period cannot be determined even from that language. The filed Appendix A is thus at odds with the PSA.

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[48]Madsen testimony, Exh. No. __ (AMM-1), p. 12.

Moreover, the filed Appendix A contains two rate reopeners that are not authorized under the terms of the PSA. The first, entitled "Change in Long Term Interest Rates", provides that either LILCO or LIPA may request the Commission to reopen and adjust the Monthly Capacity Charge to account for a change in the rate of return on equity if interest rates on U.S. Treasury Bonds change by 200 basis points for any consecutive three month period as compared with the three month average Treasury Bond interest rate for the period ending September 30, 1997. The second, entitled "Change in A&G/Common Cost Allocation" purports to give either LILCO or LIPA the right to petition the Commission to change the Monthly Capacity Charge to account for a change in the allocation of the "Administrative and General and Common costs components."

PSA Section 9.1 specifies how the Monthly Capacity Charge is to be established for the first year and adjusted during the remainder of the 15 year term of the contract.[49] The executed version of the PSA included as Attachment B to LILCO's filing contemplates that LILCO and LIPA will use the guidelines detailed in PSA Articles 8 and 9 to complete Appendix A with specific charges and rate adjustment mechanisms. The Appendix A filed by LILCO does not reflect the agreement of the parties.

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[49]See discussion, supra at notes 14-16 and accompanying text.

LIPA requests the Commission to summarily rule, pursuant to Rule 217 of the Commission's Rules, that LILCO's version of Appendix A is not consistent with the PSA and must be revised before the filed rates can take effect. LIPA is not requesting the Commission to specify at this time what form the annually adjusting formula must take. LIPA is simply requesting the Commission to rule that, in the absence of an agreement with LIPA, LILCO must refile an Appendix A that provides a formula for adjusting the Monthly Capacity Charge during the first five year rate period and does not contain the return on equity and Administrative and General ("A&G") reopeners. LIPA and LILCO can then litigate before the Commission the issue of whether the refiled formula is appropriate.

B. LILCO Must Refile the Monthly Capacity Charge in Appendix A to Reflect the Reduction Required by PSA Section 8.1.1

LIPA has explained extensively, supra, why the filed Appendix A violates PSA Section 8.1.1. That provision states, in relevant part, that GENCO's "[g]eneration charges will not be increased as a result of any step-up in the book or tax basis of the assets."

As a matter of contract, therefore, LILCO/GENCO is prohibited from proposing a Monthly Capacity Charge that will recover revenues attributable to a step-up in basis. If the Commission decides not to reject LILCO's entire filing, the Commission should grant LIPA's request for summary disposition

on this issue and require LILCO to refile a Monthly Capacity Charge that is at least $6 million lower to reflect the elimination of those costs.

C. LILCO's Failure to Include Any Costs in the Monthly Variable Charge Violates the PSA

LILCO's Appendix A omits the Monthly Variable Charge entirely, asserting that "it has now been determined that there will not be any variable O&M costs."[50] The inclusion of a Monthly Variable Charge in the PSA evidences the parties' intent that GENCO would incur variable costs when GENCO delivers energy to LIPA. The PSA was executed on June 26, 1997, only slightly more than four months ago. Mr. Madsen's determination that GENCO will not incur such costs is obviously a relatively recent revelation. As explained at length above,[51] that determination is both unreasonable and contrary to the PSA. Moreover, LILCO/GENCO's deletion of the Monthly Variable Charges is anticompetitive and might substantially affect LIPA's energy purchasing decisions as between GENCO and its competitors.

For these reasons, LIPA requests the Commission to summarily dispose of LILCO's assertion that GENCO will not incur variable costs. LIPA also requests the Commission to order LILCO to refile Appendix A to show a reduction in the Monthly Capacity Charge reflecting the transfer of variable

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[50]Madsen testimony, Exh. No. _____ (AMM-1), p. 9.

[51]<u>See</u> discussion <u>supra</u> Part II.C.4.

costs to the Monthly Variable Charge consistent with the Commission's commonly applied classification of fixed and variable costs.[52]

D. The PSA's Terms Mandate A Lower Cash Working Capital Allowance for GENCO

LILCO's filing requests a cash working capital allowance of $14,854,000[53] based on a 45 day lag between cash receipts and payments.[54] LILCO provided no additional support for a 45 day cash working capital allowance.

LILCO is not entitled to a 45 day allowance because the payment provisions of the PSA will minimize GENCO's cash working capital needs to much less than 45 days. First, PSA Section 8.5 provides that GENCO will bill the Monthly Capacity Charge to LIPA on the first business day of the month, and LIPA is required to pay by the tenth business day of the month via electronic transfer.

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[52]LILCO's filing does not provide sufficient detail to determine the costs by FERC account for the "rate year" it used (April 1, 1998 through March 31, 1998) for purposes of the filing. However, the filing does provide sufficient account level detail for 1996. See Verderber testimony, Exh. No. __(FKV-2, Schedule 1). The 1996 costs for FERC account nos 500 and 502-514 totals $41.6 million. The fuel costs in accounts 501 and 547 should be excluded from consideration under the PSA because LIPA will supply fuel under the EMA. A portion of the $41.6 million (related to Accounts 500, 502, 505 and 510) is fixed costs, but the available data is not sufficient to apportion the costs between fixed and variable.

[53]Attachment A to LILCO's filing, p. 2.

[54]Nozzolillo, Exh. No. __(AN-1), p. 12, lines 12-16.

Second, the Monthly Capacity Charge is 1/12th of the Annual Capacity Charge, which, in turn, is to be based on the budget proposed by GENCO and approved by LIPA each year. The Monthly Capacity Charge does not reflect GENCO's actual monthly costs as they are incurred. As a consequence, LIPA's payment of the Monthly Capacity Charge in some months will provide funds to GENCO well in advance of GENCO's incurrence of a cost rather than afterward. Since most of the costs that GENCO should properly recover through the Monthly Capacity Charge are fixed, they will occur in a systematic pattern. Therefore, the collection of uniform revenues throughout the year minimizes the cash working capital requirements that GENCO must provide.

The combination of these two contractual requirements demonstrate the unreasonableness of the proposed 45 day cash working capital allowance. The PSA may reasonably be construed to limit GENCO's demonstrable cash working capital requirements to the 10 day period between the issuance of GENCO's invoice and payment by LIPA. LIPA requests the Commission to summarily dispose of the proposed cash working capital allowance and require LILCO to refile a Monthly Capacity Charge that reflects a cash working capital allowance of no more than 10 days, consistent with the payment schedule required of LIPA in the PSA.

IV. PROTEST, REQUEST FOR HEARING AND, IF NECESSARY, ESTABLISHMENT OF REFUND EFFECTIVE DATE

In addition to the issues raised in LIPA's motions to reject and for summary disposition, supra, LIPA takes issue with many other aspects of both the cost elements underlying LILCO/GENCO's requested Monthly Capacity Charge as well as Appendices B and E. The sum total of these objections should impress upon the Commission the need to institute an investigation and hearing into this filing under FPA Sections 205 and 206. The extent of LIPA's objections to a filing that was originally intended to be the result of a contractually-required budget and ratemaking process demonstrates the peremptory nature of LILCO's filing. Instead of working through the contractually mandated budget and negotiation process that was intended to benchmark GENCO's costs and performance, LILCO's filing at least implies an intention to begin the PSA implementation with the highest cost base imaginable. If the Commission accepts LILCO's proposal for filing as an initial rate, LIPA requests that the Commission institute an investigation and hearing into the proposed rates, terms and conditions of service under Section 206 of the FPA, and establish a refund effective date beginning on the effective date of the rate.

A. The Revenue Requirement Derived From LILCO's Proposed Rate Base Is Excessive

PSA Section 9.1.1 describes the cost support for the initial Monthly Capacity Charge and Monthly Variable Charge as follows:

> The budget plan for the first Contract Year of the first Five Year Budget Plan will be based upon the agreed upon disaggregated generation cost elements relating to the Generating Facilities (including associated common costs) and contained in the proposed 1997 rate year budget in the GENCO 1996 rate case filing with the New York State Public Service Commission, updated for known changes in facts and circumstances, adjusted to the First Contract Year and as set forth in Appendix A. Such budget shall also consider actual historical results prepared on a comparable disaggregated basis for 1996 and thereafter up to the date of adoption of such budget.

LILCO's filing does not follow this format. The cost support included with LILCO's filing purports to show costs for a "Rate Year" from April 1, 1998 through March 31, 1999.[55] There is no apparent attempt to adjust the projections to the first Contract Year, which would run from the date of closing[56] through December 31, 1998.

LIPA has already demonstrated that the revenue requirement is inflated by LILCO's failure to comply with PSA Section 8.1.1. LILCO has not reduced the revenue requirement to offset any revenues generated through a step-up in rate base attributable to the Acquisition.[57] The rate base also is

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[55]See, e.g., Testimony of Adam Madsen, Exh. No. __(AMM-1), p. 8, lines 14 through p. 9, line 11 and Testimony of Francis K. Verderber, Exh. No. __ (FKV-1), pp. 3-4.

[56]See also discussion at n.13, supra, at p. 7.

[57]See discussion supra Part II.B.

improperly inflated through the inclusion of a 45 day cash working capital allowance.[58] Even if the Commission does not grant LIPA's request for summary disposition requiring LILCO to reduce the filed Monthly Capacity Charge to account for those adjustments, issues of material fact remain that warrant a hearing.

Similarly, LILCO's proposed allowance of $23,645,000 for materials and supplies[59] and the inclusion of capital expenses in excess of those requested in LILCO's 1996 New York Public Service Commission ("NYPSC") Case are excessive. These issues are discussed below.

1. LILCO's Filing Inflates its Capital Expenditure Requirements for 1998 Beyond the Amount LILCO Projected in its 1996 NYPSC Case

LILCO's proposed rate base in its filing for this Commission was derived in part by taking its investment in plant as stated in LILCO's 1996 NYPSC Case for the NYPSC-required 1997 rate year and adding its projected capital construction expenditures of $31.6 million in 1998 and $28.6 million in 1999.[60] The projected capital expenditures for 1998 and 1999, however, far exceed the projections that LILCO included in its 1996 NYPSC Case for the same years. In LILCO's 1996 NYPSC Case, LILCO projected its total

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[58]See discussion supra Part III.D.

[59]LILCO's Filing, Attachment A, p. 2.

[60]Brennan testimony, Exhibit No. ___(JKB-1), Schedule No. 3, Page 1 of 7.

capital construction expenditures to total $17.4 million in 1998, and $19.0 million in 1999.[61] LILCO has thus requested this Commission to approve a Monthly Capacity Charge based in part on projected capital expenses for 1998 that exceed its request to the NYPSC by $14.2 million[62] or 82%. This request is almost double the capital expenditure projection filed with the NYPSC approximately a year ago. LIPA believes that this increase is not warranted.

Mr. Brennan claims that the projected capital expenditures reflect the initiatives by LILCO to control or reduce expenditures.[63] The sharp increase in projected capital spending suggests otherwise. Mr. Brennan provides no explanation, such as changes in facts or circumstances that have occurred since LILCO's 1996 NYPSC Case. Therefore, LILCO's charges should be based on the level of capital expenditures it proposed in its 1996 NYPSC Case.

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[61]The projections provided in LILCO's filing to this Commission are its non-nuclear production capital construction expenditures. LILCO will sell its interest in the Nine Mile Point nuclear facility to LIPA as part of the Acquisition. The projection provided from the NYPSC 1996 Rate Case also excludes any nuclear production capital construction expenditures. LIPA derived these figures from LILCO's NYPSC Case No. 96-E-0132, Exhibit No. 12, Schedule 31, Page 1 of 4. LIPA will provide this document upon request.

[62]$31.6 million less 17.4 million (as projected in LILCO's 1996 NYPSC Case).

[63]See Brennan Testimony, Exhibit No. ___ (JKB-1), p. 12.

In summary LIPA believes that LILCO's filed revenue requirement of $327,634,000 should be reduced by at least $7,947,000 to account for the above-described adjustment. This revenue requirement calculation uses, but neither adopts nor endorses, LILCO's filed return on equity and capitalization structure. The problems with those issues are discussed below.

2. LILCO's Requested Materials and Supplies Allowance Is Excessive

LILCO Witness Nozzolillo states that the $23,645,000 for materials and supplies is based on LILCO's 1996 year end figure inflated by 2.4% per year.[64] The allowance is based on the assumption that LILCO will have to finance a materials and supplies inventory in order to provide service. LILCO's requested allowance, however, ignores the reduction in financing requirements that GENCO will realize through the PSA's payment provisions and resulting cash flow. Through the collection of its fixed costs through the Monthly Capacity Charge, GENCO may collect cash in certain months before it is required to make payments for materials and supplies. The requirement that LIPA pay GENCO's invoice for the Monthly Capacity Charge by the tenth business day of the month via electronic transfer further reduces GENCO's financing requirements for materials and supplies. LIPA estimates that GENCO's allowance should be no more than $23 million, i.e., a revenue requirements reduction of $645,000.

[64]Nozzolillo testimony, Exh. No. ____ (AN-1), p. 13.

B. LILCO'S Requested Return on Equity and Overall Return are Excessive

The filing assumes a return on equity of 10.5% and a projected capital structure of 50% debt and 50% equity. Both of these assumptions are incorrect.

1. The Return on Equity Is Overstated

The analysis and rationale underlying LILCO's proposed return on equity are both faulty. Although LILCO's Monthly Capacity Charge is based on a return on equity of 10.5%[65], its cost of capital witness, Dr. Jerome Hass, recommends a return on equity of 10.8%.[66] LILCO's witness Nozzolillo remarks upon, but does not explain, LILCO's decision to use the 10.5% return rather than 10.8%.[67] Dr. Hass derived his 10.8% recommendation by applying both the Discounted Cash Flow ("DCF") and Capital Asset Pricing Model ("CAPM") methodologies to a group of 13 purportedly comparable companies. These 13 companies are not generation only entities; they currently are vertically integrated utilities that he determined to be "low risk."[68] After determining the cost of capital for the

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[65]LILCO's Filing, Attachment A, p. 2.

[66]Testimony of Jerome Hass, Exh. No. __ (JEH-1), at pp. 3, 52.

[67]Nozzolillo Testimony, Exh. No. __ (AN-1), pp. 15-16.

[68]See Hass Testimony, Exh. No. __ (JEH-1), pp. 37-39 and Schedules JEH-1 through JEH-3 for a description of his rationale for choosing the comparable companies and his application of the tests of comparison.

comparable companies as a group and finding a mid-range average cost of equity of 10.3%, Dr. Hass concludes that GENCO will have higher financial risk than these companies because LILCO informed him that GENCO's capitalization structure will be 50% debt and 50% equity.[69]

Dr. Hass's analysis and recommendation are flawed. Indeed, he does not appear to understand the fundamental characteristics of the transactions that will lead to the implementation of the PSA. His description of the transaction is as follows:

> Q. What exactly is the nature of LILCO's electric generation business?
>
> A. If all goes according to plan, LILCO will sell its electric transmission and distribution business to LIPA and enter into a long-term contract to supply LIPA with electricity generated from LILCO's plants to distribute to residential, commercial, and industrial customers on Long Island. Under the proposal being presented to the Commission in this case, LIPA will purchase the fuel for generating the electricity in LILCO's facilities and LILCO will bill LIPA monthly for other expenses, based on a cost of service for the first year of the contract.[70]

There is no mention in this description of: (i) GENCO's existence at all, much less as a subsidiary of HoldCo; (ii) the fact that LIPA will purchase LILCO through the acquisition of LILCO's stock; (iii) the fact that the "cost of service" is required under PSA Article 9 to be established in advance through

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[69] Id. at pp. 52-53. LIPA discusses GENCO's proposed capital structure in the following section.

[70] Id. at pp. 34-35.

a budget process and that GENCO will be paid the budgeted capacity costs in equal monthly installments through the Monthly Capacity Charge, whether the underlying costs have been incurred or not; and (iv) GENCO's opportunity to earn additional sums if GENCO meets contractually established performance standards for capacity availability, dependable capability, heat rate, and property tax minimization.[71]

In addition to not displaying a thorough understanding of the Acquisition and transactions underlying the PSA, Dr. Hass's list of purportedly comparable companies do not bear any intuitive relationship to LILCO or GENCO. In his own words:

> The 13 low-risk electric utilities appear to be appropriate benchmarks for LILCO's electric generation business under its contract with LIPA and the tariff proposal before the Commission. Such electric utilities, with relatively low rates, face little uncertainty regarding the assuredness of customer demand from competition, can effectively utilize the fuel-cost pass-through provisions of their tariffs without worry about pushing its prices above competitive levels, and can seek rate relief from their regulatory authorities if their cost of service exceeds their prevailing tariffs (or, if regulatory constraints are relaxed as competitive conditions are introduced over the next five years, they can simply raise rates to competitive levels).[72]

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[71] See PSA, Article 10 and Appendix F thereto.

[72] Hass Testimony, Exh. No. ____ (JEH-1) p. 36.

Leaving aside the question whether Dr. Hass's criteria are appropriate for choosing companies comparable to GENCO for benchmark purposes,[73] the companies included on his list[74] do not even meet his stated criteria. Two of the companies on his list, ENOVA Corp and Edison International, do business in California. On January 1, 1998, before the closing of the Acquisition underlying this proceeding, these two companies will no longer be providing power supply to identifiable customers other than the California Power Exchange. It simply cannot be said that they "face little uncertainty regarding the assuredness of customer demand from competition." They are not generally expected to be able to bring their rate up to competitive levels when retail access is implemented in just two months, nor will the concept of fuel cost passthroughs have any continuing validity. Indeed, neither company has been renowned for having "relatively low" rates.

Similar observations could be made about Consolidated Edison Company. Although it will not be subject to retail access as quickly as ENOVA and Edison International, its recent settlement approved by the NYPSC concerning how it will restructure itself and its services does not generally meet his stated criteria. In fact, one of the primary motivations for

[73]If the Commission sets this proceeding for investigation and hearing, LIPA would expect to sponsor a cost of capital witness itself.

[74]See Hass Testimony at Schedule JEH-1 through JEH-3.

that restructuring was that Consolidated Edison was not considered to have "relatively low" rates.

Dr. Hass's inclusion of several of the other purportedly comparable companies on his list is equally perplexing. For example, WPL Holdings, includes regulated electric utilities,[75] power marketers, and unregulated enterprises. It is in the midst of completing an unusual three-way merger with two Iowa utilities with which WPL's operating subsidiaries are not interconnected.[76] Neither WPL Holdings' corporate structure, its risk characteristic, nor its activities have any apparent analogy to GENCO.

Two additional companies, Union Electric and CIPSCO, are in the process of completing a merger. Dr. Hass's testimony does not indicate whether he considered how that factor might have affected the financial characteristics, particularly the dividend yields and growth rates, of those companies.

Finally, Dr. Hass's ultimate recommendation of a 10.8% return on equity is computed by taking the 10.3% return derived from his analysis of the "comparable" companies and applying an upward adjustment to account for his perception that GENCO faces more financial risk than those

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[75]Wisconsin Power & Light Company and South Beloit Water & Gas Company.

[76]See the proposed merger among WPL Holdings, IES Industries, Inc. and Interstate Power Company, which is the subject of Interstate Energy Corporation, FERC Docket No. EC96-13-000 and related proceedings.

companies. This conclusion, however, does not appear to be consistent with the fact that GENCO will be the generating subsidiary of a utility holding company with the equivalent of a guaranteed contract for the sale of all of its capacity to a single customer, LIPA. In analogous circumstances, the Commission has held that the appropriate adjustment is downward, not upward.[77]

LILCO's requested 10.5% return on equity for a generating company that is guaranteed payment of its allowed capacity costs plus incentive payments for meeting production goals is inflated. The analysis and rationale provided to support that recommendation do nothing to dispel the impression that this proposed return on equity represents LILCO's attempt at profit enhancement rather than a reasonable reflection of its cost of capital. It also contradicts Commission precedent arising in similar situations. At the very least, LILCO's lack of legal and factual support for its requested 10.5% return on equity mandates the institution of an investigation and hearing in this proceeding.

By applying Dr. Hass's CAPM methodology to recent market conditions, LIPA estimates LILCO's present day cost of equity is approximately 9%. LIPA further believes that GENCO is subject to even less

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[77] South Carolina Generating Co., 34 FERC ¶ 63,074 (1986), aff'd 40 FERC ¶ 61,116 (Opinion 280) (1987), order on reh'g, (Opinion 280-A), 43 FERC ¶ 61,217 (1988), order on reh'g, (Opinion 280-B), 44 FERC ¶ 61,008 (1988). See also Allegheny Generating, 65 FERC ¶ 63,026 (1993).

risk than present day LILCO. Nevertheless, for purposes of developing an approximation of the amount by which LILCO's proposed revenue requirement is overstated, LIPA suggests that the Commission use a return on equity of no greater than 9% to determine the excess revenue requirements included in LILCO's filing.

2. GENCO's Proposed Cost of Debt is Overstated for Use in a Rate to be Set for Five Years

LILCO proposed a cost of debt for GENCO that will be overstated if the Monthly Capacity Charge determined in this filing is not adjusted annually as contemplated by PSA Section 9.1. LILCO includes in Attachment A to its filing a table entitled "Long Island Lighting Company, GENCO Weighted Average Cost of Debt, Electric Generation Rate Year Ending March 31, 1999." This table listed approximately $275 million of currently outstanding LILCO tax-exempt debt that GENCO will be assuming as part of the Acquisition and computes the weighted average cost of such debt for a rate year ending March 31, 1999. This table does not reflect the likely refinancing of most of this debt during the initial five year rate period at substantially lower interest rates than displayed in the table. Interest rates have dropped since those bonds were issued.

Examples of potential debt savings to be realized by GENCO during the first five year rate period are as follows. First, approximately $50 million of the GENCO assumed debt is currently callable and can be expected to be

refinanced within six months of the Effective Date at interest rates that are more than 200 basis points lower than the existing interest rates. Second, $178 million of the GENCO assumed debt will become currently callable during the initial five-year period of the PSA and the 7.15% and 6.90% interest rates on such debt are substantially higher than current market rates. If GENCO prudently manages its debt and refinances this debt at a lower cost, GENCO's weighted cost of capital will become substantially overstated during the five year rate period. This issue should be addressed at hearing.

3. GENCO's Proposed Capitalization Structure of 50% Debt and 50% Equity Is Unreasonable

LILCO's filing assumes a capitalization structure of 50% debt and 50% equity.[78] Mr. Nozzolillo's testimony purports to support GENCO's anticipated debt total of approximately $275 million.[79] He does not directly support his claimed common equity capitalization of a like amount. Mr. Nozzolillo later characterizes the debt level as "relatively high" and argues that "GENCO is accepting more financial risk in order to minimize revenue requirements."[80]

The $275 million in equity that LILCO's proposed capitalization ratio implies is not supported by any verifiable reference point. Indeed, LILCO's

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[78]Nozzolillo Testimony, Exh. No. __(AN-1), p. 13.

[79]Id. at Schedules 3, 4.

[80]Id. at p. 14.

requested rate base is only approximately $516 million. A 50/50 debt to equity ratio using the $275 million in debt, implies a capitalization of $550 million. No reason is given why the proposed capitalization of GENCO should be greater than the requested rate base on the first day of operation, particularly as that rate base may be reduced by Commission determination in this proceeding. If the Commission accepts for purposes of this issue the veracity of GENCO's proposed debt structure, a capitalization structure equal to LILCO/GENCO's initial rate base would show a debt to equity ratio that is substantially greater than 1:1, i.e. a debt to equity ratio greater than 50/50.

LILCO does not support the reasonableness of the proposed GENCO capitalization by reference to any comparable group of companies. Indeed, GENCO has not yet been established, and neither present day LILCO nor BU has announced individually or collectively, what the capitalization will be of the yet-to-be established HoldCo, the future parent of GENCO. Even if HoldCo's capitalization structure had been determined, it would not be appropriately imputed to GENCO because HoldCo's capitalization would reflect a disproportionate amount of equity due to the approximately $1.7 to $1.9 billion in net[81] cash proceeds to be received by LILCO as a part of the Acquisition.

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[81]The term "net cash" reflects the amount left after payment of taxes and other costs associated with the Acquisition.

According to LILCO's 1996 NYPSC Case, LILCO's present-day capital structure allocated to its electric business is approximately 66% debt and 34% equity. LIPA recommends that the Commission impute a similar capitalization structure to GENCO for purposes of computing the return component of the Monthly Capacity Charge. As noted several times in this pleading, the PSA assures that GENCO will be paid all of its capacity costs approved through the budget process, (or by this Commission) plus additional payments if the PSA performance incentives[82] are met.

There is no need for GENCO to be more conservatively capitalized than LILCO is today. Indeed, application of the proposed 50/50 capitalization will result in additional costs to LIPA that are not justifiable. Given the context of this transaction today, the Commission should apply its traditional approach and apply LILCO's current capitalization structure. [83]

If LIPA's proposed return on equity of 9% and capitalization structure of 66% debt and 34% equity is applied to LILCO's filed rate base, the revenue reduction would be approximately $11,620,000. The change in revenue requirement related return would be different if LIPA's requested reductions in LILCO's rate base are adopted as well.

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[82] See note 71 supra and related text.

[83] Cf., Kentucky West Virginia Gas Co., 2 FERC ¶ 61,139 (1978).

C. The Operations and Maintenance Expenses Underlying the Monthly Capacity Charge Are Greatly Overstated

LILCO's filing includes $120,863,000 of O&M expense for this initial Contract Year.[84] For the reasons outlined below, it is clear that this amount is greatly overstated.

1. LILCO's Method of Calculating Operations and Maintenance Expenditures Masks the Magnitude of the Actual Increase to LIPA

LILCO's calculation of its projected O&M expenses inappropriately presents 1996 actual expenses, thereby masking the true magnitude of increase projected for the initial contract year. LILCO's Exhibit No. __ (FKV-2), Schedules No. 2 and 3, compares forecasted GENCO O&M expenditures for the initial Contract Year of $120.9 million to 1996 actual costs of $107.7 million, a $13.2 million (12.3%) increase. However, LILCO's calculation fails to make comparable adjustments to the 1996 actual amounts to eliminate certain non-recurring costs. LILCO's calculation also fails to factor out those costs which: (i) LIPA will assume after the closing of the Acquisition, or (ii) were otherwise not reflected in the budget for the initial Contract Year. In effect, LILCO is comparing apples to oranges, masking the true magnitude of the cost increase between 1996 and the initial contract year. Based on LIPA's analysis, set forth below, the true cost increase sought by LILCO for O&M expenses alone is $20.8 million (20.8%).

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[84]Attachment A to LILCO's Filing, p. 1.

Forecasted initial contract year O&M costs			120.9[85]
Actual 1996 O&M costs per LILCO	$ 107.7		
Less: PSC assessment	(2.6)		
New York Power Pool	(2.6)		
Employee incentive awards	(1.7)		
NE Power Coordination Council	(0.1)		
Property insurance	(0.5)		
Advertising	(0.1)		
Comparable actual 1996 O&M costs			100.1
Actual cost increase filed by LILCO		$	20.8

This cost increase is not adequately explained or supported by LILCO's filing. The reasonableness of the increase in costs from 1996 to the initial Contract Year is further suspect based on the significant historical decline in LILCO's electric O&M, excluding fuel, purchase power, and nuclear costs as reported in LILCO's actual operating results. LILCO's historical total electric O&M has declined from $391,041,000 in 1994 to $375,207,000 in 1995 and to $364,981,000 in 1996. This is an aggregate decrease of $26,060,000 or 6.7% over the three year period. Further, according to a LILCO press release dated October 21, 1997, earnings for the Company's electric business unit

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[85]This figure includes costs that should be classified as variable and recovered through the Monthly Variable Charge. See discussion supra at Part I.A. It also includes amounts that would be recoverable through the Monthly Variable Payment Adjustment Charge. See discussion infra at Part IV.D.

for the nine months ending September 30, 1997 were higher than the comparable period in 1996 due to reductions in O&M expenses.[86]

2. LILCO Has Used Unduly Conservative and Unsupported Assumptions in Its Calculation of PBOP Costs

LILCO's methods and assumptions used to calculate its post-retirement benefits other than pension costs ("PBOP")[87] are not justified and could be overstated by at least $4 million[88] for the initial Contract Year. As explained in more detail below, many of the cost and actuarial assumptions used by LILCO are unduly conservative or unsupported.

LILCO's filing does not include a specific line item for PBOP calculation.[89] LIPA's review of information provided by LILCO demonstrates, however, that LILCO originally had budgeted electric PBOP costs, before amortizations and deferrals, for 1998 of $8.6 million. This figure was based on projections done in 1995 using then current data. In a letter dated September 24, 1997, LILCO's actuary provided LIPA with a revised

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[86]That press release is appended hereto as Attachment 4.

[87]LILCO uses the term "OPEB" or "other pension employment benefits" for the same meaning as PBOP. This pleading will use the latter acronym to conform to Commission precedent.

[88]This figure is based on costs allocable to GENCO alone. The figures used in the remainder of the discussion are based on costs for present day LILCO's entire electric operation.

[89]See Verderber Testimony, Exh. No. __(FKV-1), pp. 14-16 and Exh. No. (FKV-2), Schedule 4, page 4.

calculation for 1998 of $15.1 million. This represents a 41% increase over the comparable actual PBOP costs.

LILCO also provided LIPA with information regarding the calculation of PBOP costs under Statement of Financial Accounting Standards No. 106, "Employers Accounting for Post-retirement Benefits Other Than Pensions" ("SFAS No. 106"), for 1998 as calculated by its actuary. SFAS No. 106 requires LILCO to recognize the expected costs of providing post-retirement benefits when services by such employees are rendered rather than when such costs are actually paid. In general, the assumption basis that has been used to calculate costs over the last few years since LILCO adopted SFAS No. 106 in 1993 is unduly conservative, resulting in PBOP costs that are too high.

Evidence of the unreasonableness of LILCO's assumptions is that LILCO informed LIPA that as of year-end 1996, just four years after the adoption of SFAS No. 106, it accumulated an unrecognized net gain of $75.4 million, which was 28% of LILCO's then accumulated post-retirement benefit obligation. This unrecognized net gain is comprised of LILCO's calculation of its "experience gains," i.e., results that show that its experienced costs are more favorable than its original assumptions, and from changes in those original assumptions. This significant net experience gain is symptomatic of the overly conservative assumptions applied by LILCO. The

most significant LILCO actuarial assumptions that LIPA finds to be inappropriate are explained below.

a. *LILCO's Assumptions Regarding Employee Turnover Are Too Low*

The employee turnover assumptions LILCO used are extremely low and a study of actual turnover experience has never been completed. LIPA estimates that the use of a more appropriate employee turnover assumption would reduce LILCO's actuarially determined post-retirement benefit cost by $10 million.

b. *LILCO's Assumptions Regarding Medical Cost Trends Are Too High*

LILCO recently changed its health care arrangements for most of its current workforce to a managed care approach. However, LILCO did not change the trend rate for the cost of future health care claims used to compute this element of its PBOP cost to reflect the national experience which shows almost no year to year increase in health care costs under these circumstances over the last few years. In addition, LILCO's trend is based upon its 1995 experience, inflated with outdated trend assumptions. LIPA recommends that this element of the PBOP be computed by assuming that the average claims cost has increased by a total of 5% since 1995, and that it will increase by 5% per annum in the future. LIPA estimates that this

change would reduce LILCO's actuarially determined post-retirement benefit cost by $9.1 million by 1998.

c. The Discount Rate Used by LILCO Is Suspect

The discount rate used by LILCO to compute its PBOPs is not reasonable. In its past calculations, which contributed to the large unrealized net gain discussed above, LILCO used 7.75% in 1995 and 7.25% in 1996 and 1997. LILCO contemplates using a 7.00% rate for 1998 (which should be based on the interest rate environment as of the beginning of fiscal year 1998, or April 1997). The pattern of discount rate changes used by LILCO do not correlate well with changes in the interest rates over the same periods. For example, interest rates declined significantly from 1995 to 1996, thereby justifying LILCO's reduction in discount rates for that year. They rose again from 1996 to 1997, but LILCO did not adjust the discount rate accordingly. From January 1, 1997 to April 1, 1997, interest rates rose slightly again. LIPA believes that the rates prevalent on April 1, 1997 should determine the discount rate for 1998. Therefore, instead of reducing the discount rate from 7.25% to 7.00%, as contemplated by LILCO, LIPA believes the appropriate discount rate to use for 1998 is 7.5%. This change would reduce LILCO's actuarially determined post-retirement benefit cost by $5.2 million.

d. The Mortality Rates Used by LILCO are Suspect

LILCO's 1998 actuarial assumptions changed the mortality basis from the 1984 table used for its previous calculations to a 1994 table. This change accounted for the bulk of the $8.6 million increase in PBOP costs over LILCO's 1996 calculations. LIPA believes that the mortality calculation is still not correct and that the PBOP cost should be reduced. LIPA will quantify the amount of reduction if this case is set for hearing.

It is clear that additional explanations and justifications are required of LILCO to support its PBOP costs. In addition to the issues identified above, LIPA believes that the assumptions used by LILCO for employee marital status and life insurance expenses are very conservative and are not supported. Given the magnitude of the differences noted above, LIPA is convinced that the expense figure, as proposed, is overstated and not justified.

3. The Generation Unit Overhaul Costs Should Be Normalized

The PSA provides that the Monthly Capacity Charge shall include an allowance for scheduled major maintenance and overhauls. LILCO's actual 1996 overhaul costs totaled $4.7 million. However, LILCO's 1998 projected cost for scheduled major maintenance and overhauls is $12.2 million.[90] This is an increase of $7.5 million, or 160% over 1996. In

[90] Brennan testimony, Exh. No. ___(JKB-1), p. 6.

his testimony, Mr. Brennan states that the increase is due to the "difference in number of overhauls." He further states that "major overhauls for GENCO's Northport Units are required in 1998. These are GENCO's largest and the most expensive to overhaul."

In LILCO's 1996 NYPSC Case, Mr. Brennan stated that "major overhauls are performed on a regular cycle of five to seven year intervals....[91] LILCO owns nine steam generating units that require periodic major overhauls. If these are overhauled on a seven-year cycle, an average of 1.3 units would be overhauled each year. LILCO's proposed 1998 forecast includes expenses for 2.5 major overhauls.[92] Because all units are overhauled on a regular basis, the expected long term costs will be regularly incurred and can be estimated. These facts lead to the conclusion that the scheduled major maintenance and overhaul costs should be normalized. This is not changed by the mere coincidence that the Northport units will require overhaul during the period of the initial Contract Year. It is also important to normalize these costs to prevent the annually adjusting rate contemplated in the PSA from providing GENCO with an overcollection in later years.

LIPA has performed an analysis of LILCO's historical and projected costs for generating unit overhauls. Based on the results of that analysis,

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[91]NYPSC Case No. 96-E-0132, Brennan testimony, Exh. No. ___ (JKB-1), p. 14.

[92]See Brennan testimony, Exh. No. ___ (JKB-1), p. 6

LIPA has concluded that an appropriate allowance for scheduled major maintenance and overhauls is $8.4 million. For this reason LIPA requests that the Commission disallow $3.8 million of LILCO's requested allowance for overhaul expenses.

4. LILCO Inappropriately Includes Research and Development Payments to External Organizations in Its Costs

LILCO's payments to external research and development organizations should be excluded from LILCO's cost of service. As explained in witness Brennan's testimony and as shown in Exhibit No. ___ (JKB-2), Schedule 2, calendar year 1998 GENCO research and development costs are projected to total $2.8 million. This amount includes external fees of $735 thousand payable to Empire State Electric Energy Research Corporation, and $220 thousand payable to New York State Electric Research and Development Association. At a minimum, LIPA believes that such costs for external research and development activities should be excluded from LILCO's cost of service. Instead, such costs will be paid directly by LIPA to these external organizations to the extent that LIPA chooses to participate in such programs. In addition, LIPA does not concede at this time that the remaining costs are appropriate.

5. LILCO's Allocation Methodology Results in Excessive A&G Costs Allocated to GENCO

LILCO allocated electric A&G and common A&G costs to GENCO based on studies of labor charges to GENCO and transmission and distribution.[93] This methodology results in GENCO bearing 46.26% of electric A&G costs and 35.3% of common A&G costs for 1998. LILCO's A&G allocation methodology is flawed, resulting in excessive costs being allocated to GENCO as explained below.

First, the PSA provides that the initial Monthly Capacity Charge and Monthly Variable Charge will be based on LILCO's 1996 NYPSC Case adjusted for, among other things, known changes in facts or circumstances. LILCO's methodology for allocating electric A&G and common A&G costs in the instant filing ignores this agreed-upon principle. LILCO has failed to remove or otherwise take into consideration the effects of the Acquisition on its allocation methodology, including the impact of the formation of a holding company structure and the probable resulting increase in the new LILCO/BU's non-regulated activities. For example, certain A&G costs for corporate support activities such as corporate strategic planning and shareholder relations and reporting that have little direct and discernable benefit to GENCO have been included by LILCO in the initial Contract Year budget. Further, LILCO's allocation methodology does not allocate any common A&G costs to the new business represented by the $1.7 billion to $1.9 billion net

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[93] Verderber Testimony, Exh. No. _____ (FKV-1) at pp. 5-6.

cash proceeds LILCO expects to receive from the transaction. These flaws in LILCO's A&G allocation methodology will result in Long Island electric rate payers subsidizing LILCO's non-electric generation operations.

Second, Witness Verderber's testimony[94] indicates that LILCO used different electric A&G and common A&G allocation rates for years 1996, 1998, and 1999 as follows:

	GENCO Allocation	
	Electric A&G	Common A&G
1996	44.63%	33.58%
1998	46.26%	35.30%
1999	45.64%	34.84%

As shown above, the GENCO A&G allocation rates increase from 1996 to 1998 and then decline in 1999. Like its treatment of overhaul costs, LILCO's filing with this Commission uses the highest amounts for purposes of determining the initial Contract Year budget. This practice will result in GENCO recovering significantly more than its actual costs in subsequent years. LIPA has calculated that using the higher 1998 allocation rates instead of the 1996 rates (which are based on actual data) increases costs allocated to GENCO by $2.4 million above the appropriate amount. Also, it is not clear from LILCO's filing how LIPA would realize the benefit of

[94]Verderber Testimony, Exh. No. _____ (FKV-1), p. 11.

the lower A&G allocation rate in 1999. For these reasons and the reasons cited above relating to overhaul costs, A&G costs should be allocated using the allocation rates developed from actual 1996 data.

D. LILCO's Filed Appendix B Fees and Thresholds for the Monthly Variable Payment Adjustment Charge Will Result in Excessive Charges to LIPA

The Monthly Variable Payment Adjustment Charge ("MVPAC") is intended to provide for the payment of costs related to the number of generating unit starts, fired hours of operation, and fuel swaps in accordance with prices and threshold levels to be defined in Appendix B of the PSA.[95] Such charges are to be excluded from the Annual Capacity Charge.[96] In principle, the MVPAC is designed to recover certain costs that result from operation of the generating units that are neither fixed, and therefore to be recovered in the Monthly Capacity Charge, nor varying with energy production, and therefore to be recovered in the Monthly Variable Charge. In theory unit starts cause extra wear and tear on the generating units resulting in added costs in comparison to the levels that would otherwise be experienced with continuous operation. LILCO's filed Appendix B would

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[95] PSA § 8.1.5.

[96] PSA § 8.1.1.

impose charges for unit starts, hours of operation, and fuel swaps in excess of stated thresholds, which are analogous to "take or pay" levels.[97]

Although LIPA does not dispute the underlying rationale for the MVPAC, LILCO's filing would result in excessive charges to LIPA due to overstated prices and unreasonable threshold levels set forth in its proposed Appendix B. In addition, LILCO failed to deduct the charges resulting from the proposed Appendix B from the proposed capacity charge as required by the PSA, Section 8.1.1.

Based on information provided by LILCO prior to its filing, LIPA has determined that LILCO's proposed Appendix B charges are overstated for three reasons: (1) LILCO's proposed prices for steam generating units include anticipated capital expenditures; (2) LILCO's proposed prices for steam units are based on costs related to "cold" starts for such units; and (3) certain internal combustion units would apparently be charged for both starts and hours of operation.

Although not described in Mr. Brennan's testimony, LIPA understands that the charges LILCO proposes are based on both maintenance expenses and anticipated capital expenditures. Capital expenditures are to be subject to LIPA approval in accordance with PSA Article 9. The inclusion of capital expenditures in the prices set forth in Appendix B would result in the double

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[97] See also Brennan Testimony, Exh. No. _____ (JKB-2) Schedule No. 4.

charging of such costs to LIPA to the extent that such capital costs are warranted, and would impose charges for costs not yet incurred. Because these capital costs have not been presented for LIPA's approval in a capital expenditure budget, the imposition of these capital charges by way of Appendix B contravenes the terms of the PSA.

The prices proposed by LILCO in Appendix B are also excessive because they are based on "cold" starts alone. A cold start is defined as a generating unit start after it has been off line for at least 90 hours. In reality, a large percentage of LILCO's steam unit starts occur while the units have been off line less than 90 hours (i.e., "warm" or "hot" starts). For example, data for the period 1982 through 1992 for LILCO's Northport units 1-4 indicate that 76% of the starts for these units were warm or hot starts. Data provided by LILCO indicates that the costs of warm and hot starts are significantly less than the cost of cold starts. Thus, the use of cold starts alone as the basis for the Appendix B prices significantly overstates the costs of steam unit starts.

Based on information provided by LILCO prior to filing, LIPA understands that the charges for fuel swaps are based on 5% of the costs of a cold start under the assumption that fuel swaps occasionally result in the forced outage of a generating unit. However, in this event, the unit would be restarted quickly. Therefore, rather than a cold start, this event would be

a hot start with significantly lower cost than a cold start. Therefore, using the filed Appendix B charges, LILCO would overcharge LIPA for fuel swaps. In addition, the starts caused by fuel swaps should not be counted in the starts otherwise incurred or LIPA will effectively be charged for both a fuel swap (based on the cost of a unit start) and a unit start for the same event.

The filed Appendix B includes charges for certain internal combustion units related to both numbers of starts and for hours of operation. LIPA believes that this amounts to double charging for the claimed wear and tear costs. Units should be charged either the costs for starts or the costs for hours of operations, but not both.

LILCO's filed Appendix B threshold levels for start ups, hours of operation, and fuel swaps are improperly established for two reasons: (1) the thresholds are based on actual experience for a single year, 1996, rather than normalized for the results over several years; and (2) the proposed thresholds are based on the average results for individual units, and therefore do not provide credit for starts, hours of operation, or fuel swaps below the threshold levels, or for diversity among similar units.

LILCO does not budget unit starts, hours of operation, or fuel swaps. Therefore, for purposes of Appendix B, it is LIPA's understanding that LILCO used the actual 1996 operations as a proxy for expected 1998 operations. An examination of data provided by LILCO prior to its filing reveals

considerable variation in these operations from year to year. LILCO has not provided any support for the notion that 1996 represents a reasonable expectation for the 1998 levels of start ups, hours of operation, or fuel swaps for determination of the Appendix B thresholds. For these reasons, LIPA contends that the threshold levels set forth in Appendix B should be normalized to reflect a period of several years, rather than a single year.

LILCO has based the threshold levels set forth in the filed Appendix B on the average numbers of starts for units at each station or otherwise on an individual unit basis. This proposed arrangement would not provide credit for start ups, hours of operation, or fuel swaps less than the threshold level despite the fact that historical results reveal considerable variation in these events. In addition, the proposed thresholds would not provide credit for diversity among similar units (e.g., Northport units 1-4) in which starts in excess of the threshold level on one unit may be offset by fewer starts on another unit. Variations in starts among similar units are the normal result of maintenance shutdowns and other factors.

A more reasonable basis for establishing the threshold levels would be to set them to zero. That is, all charges related to Appendix B would begin with the first start, hour of operation, or fuel swap. The costs associated with the expected normal level of start ups, hours of operation, and fuel swaps would be deducted from the Annual Capacity Charge in accordance

with the PSA Section 8.1.1. This is consistent with the typical use of such charges for system dispatch, in which these costs are considered in every decision that would involve unit start up, operation, or fuel swap, and not just events above a stated threshold.

In the alternative, threshold levels should reflect the minimum levels of starts, hours of operation, or fuel swaps that occurred during a historical period such that the effective "take or pay" level would reflect a level no greater than historical minimum levels. In this case, the cost difference between normal levels and the lower threshold levels would be deducted from the Annual Capacity Charge.

Based on LILCO's proposed Appendix B, and the actual 1996 unit start ups, hours of operation, and fuel swaps, the annual MVPAC would total $949,000. LILCO has not deducted this amount from the Annual Capacity Charge in accordance with the PSA, Section 8.1.1 and, as a result, would double charge LIPA for this amount. The cost impacts of other changes discussed above are dependent on the specific remedies that may be adopted.

E. Appendix E Should Be Revised

LILCO did not obtain LIPA's consent to the version of Appendix E that it filed. Appendix E is intended to govern the limitations on the dispatch of

GENCO's generating units to deliver energy to LIPA.[98] Appendix E is to include tables for minimum loadings of each unit, ramp rates, start-up times, minimum scheduled shutdown durations and internal combustion loadings.

Among the changes that must be made to the filed Appendix E are the following. First, the ramp rate for the Port Jefferson Units should be revised from 2 MW/minute to 4 MW/minute because of performance improvements resulting from replacement of the Port Jefferson control systems with distributed control systems.

Second, the second sentence on page E-3 should be removed because it is not a limitation of dispatch. Third, a footnote should be added to the table of Minimum Loadings on page E-1 to specify when variations in minimum loadings may occur. LIPA will be pleased to provide the necessary wording when appropriate.

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[98] PSA § 2.3(c).

V. CONCLUSION

LILCO's filing in this proceeding directly contravenes key provisions of the PSA, proposes rates that are excessive, and may hinder the development of effective competition on Long Island. Appendices B and E contain unacceptable charges and conditions for operating GENCO's generating facilities.

Indeed, LIPA estimates that approval of the adjustments it addresses in this pleading would reduce LILCO's requested revenue requirement by a minimum of $37 million. If this case is set for hearing, LIPA reserves the right to address additional issues.

For these reasons, as detailed above, LIPA requests:

(i) that it be permitted to intervene in this proceeding;

(ii) that the Commission reject LILCO's rate filing without prejudice to refiling after reaching agreement with LIPA;

(iii) in the alternative, if the Commission does not reject LILCO's filing, LIPA requests the Commission to grant summary disposition on the issues described above as well as on any other issues for which summary disposition appears to be appropriate and to institute a hearing to discuss all other issues;

(iv) if the Commission accepts LILCO's proposal for filing as an initial rate, LIPA requests that the Commission institute an

investigation and set the filing for hearing under Section 206 of the Federal Power Act and establish a refund effective date as of the closing date of the Acquisition; and

(v) that the Commission provide LIPA with other appropriate relief.

Respectfully submitted,

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Dated: November 4,1997

CERTIFICATE OF SERVICE

I hereby certify that I have this day caused a copy of the foregoing document to be served upon each person designated on the official service list compiled by the Secretary in this proceeding.

Dated at Washington, D.C., this 4th day of November, 1997.

____

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