

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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OPINION NO. 84-19

- CASE 28316 - ROCHESTER GAS AND ELECTRIC CORPORATION -
Steam Rates - Expanded Proceeding
- CASE 28612 - ROCHESTER GAS AND ELECTRIC CORPORATION -
Steam Rates

OPINION AND ORDER CONCERNING STEAM
SERVICE AND DETERMINING REVENUE REQUIREMENT

Issued: July 11, 1984

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CASES 28316 and 28612

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

APPEARANCES

Joel Blau, Esq. and Steven Blow, Esq., Staff Counsel, Three Empire State Plaza, Albany, New York 12223, for the Staff of the Department of Public Service.

Nixon, Hargrave, Devans & Doyle (by Richard N. George, Robert L. Daileader and Stanley W. Widger, Esqs., of Counsel), Lincoln First Tower, P. O. Box 1051, Rochester, New York 14603, for Rochester Gas and Electric Corporation.

Algird F. White, Jr., One Steuben Place, Box 314, Albany, New York 12201, for Multiple Intervenors.

Bond Schoeneck & King (by William P. Burrows, Esq., of Counsel), One Lincoln Center, Syracuse, New York 13202, for Lincoln First Bank, N.A.

David Thurston, Pro Se and Harris, Beach, Wilcox, Rubin & Levey (by Thomas M. Hampson, Esq., of Counsel), Two State Street, Rochester, New York 14614.

Harris, Beach, Wilcox, Rubin & Levey (by Angela Panzarella, Esq., of Counsel), Two State Street, Rochester, New York 14614, for Sibleys, Associated Dry Goods.

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CASE 28316 - ROCHESTER GAS AND ELECTRIC CORPORATION -
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(Issued July 11, 1984)

BY THE COMMISSION:

INTRODUCTION

By order issued April 15, 1983 in Case 28316--part of the last Rochester Gas and Electric Corporation (RG&E or the company) combined gas and electric rate case--an expanded proceeding was initiated to consider the prospects for steam service. Later, on July 18, 1983, we authorized, as part of the RG&E general rate increase, a \$1,718,000 temporary steam rate increase, subject to refund or reparations.^{1/} The rates were made temporary because of the continued pendency of the expanded proceeding, and they were set so as to provide less than a full return on investment in order to discourage further the departure of customers while the

1/Cases 28313, et al., Rochester Gas and Electric Corporation, Opinion No. 83-13 (issued July 18, 1983), mimeo pp. 70-74.

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system's future was being considered. (Upon reconsideration, on December 12, 1983, an additional \$169,000 was authorized to insure an opportunity to recover operating costs, interest payments and preferred dividends.^{1/})

In August, 1983, RG&E filed, in Case 28612, for an additional \$5,460,000 increase (since updated to \$5,961,000) above the temporary steam rates. Consequently, this proceeding comprises Cases 28316 and 28612 and at issue is the proper level of rates in the former as well as the subsequent request in the latter.

A prehearing conference was held in Albany on May 12, 1983 and a public statement session was held in Rochester on June 16, 1983; on that date as well the RG&E personnel responsible for the long-range plan for the district steam system (the Steam Report) were cross-examined. An additional conference of the parties was held in Albany on July 29, 1983.

Evidentiary hearings, presided over by Administrative Law Judge David Schechter, were held in Henrietta on December 5, 6 and 7, 1983 and a record consisting of 910 transcript pages and 37 exhibits--numbered 150 through 186--was compiled. Initial briefs were filed by the company, Department of Public Service staff (staff), Multiple Intervenors (MI), and the Lincoln First Bank; RG&E and staff filed replies. Judge Schechter's recommended decision was issued on April 6, 1984. Briefs on exceptions were filed by RG&E, staff and David Thurston, pro se, while replies were submitted by RG&E and staff.

1/Cases 28313, et al., supra, Order Granting In Part And Denying In Part Petitions For Rehearing (issued December 12, 1983).

BACKGROUND

RG&E began steam service to downtown Rochester in 1889 and in the 1920's offered service to industrial customers in the separate westside district. Downtown is served by Station 3 (Beebee Old House) and Station 8, while westside customers are served by Station 9. The system is an open loop system, that is, it lacks a condensate return to retrieve condensed steam for reuse; a more efficient closed loop system is not considered feasible and has not been proposed by any party. The system peaks of 617 customers and 4,090,576 Mlbs.^{1/} of annual sales were reached in 1956 and 1972, respectively. By August, 1983, the system had declined to 171 customers and 1,227,500 Mlbs. in annual sales.

The decline of the steam system started in the 1970's with the loss of eighty customers to urban renewal projects and was hastened by the 1973 OPEC oil embargo-- which, coincidentally, followed RG&E's conversion of ten steam-producing facilities from coal to oil or gas--and the 1978 oil price increases. The company responded, it says, by seeking gradual increases in steam revenues rather than a full return; by reducing the cost of service by converting three oil-fired boilers to gas; by deferring a steam rate filing scheduled for 1981; and by proposing to revise the steam transfer credit to allocate Beebee Station operating and maintenance costs to the electric department.

In 1979, we ordered a comprehensive review of RG&E's steam operations but the studies originally contemplated were not completed. In closing the proceeding on August 27, 1983, however, we directed the company to file a

^{1/}An Mlb. equals 1,000 pounds of steam.

long-range plan that would examine, among other things, the possibility of converting Beebee Station to coal, scaling-down the system, and eliminating one or both of the steam districts. The Steam Report was submitted on January 24, 1983, but inasmuch as the report could not be adequately considered within the context of the then pending rate case, this expanded proceeding was initiated and, as noted before, temporary steam rates were put in place.

THE COMPANY'S STEAM REPORT

The company noted in its initial brief that its "conclusion that its district steam business could not be returned to economic viability and the coal conversion project [Beebee Station] should not be pursued is based on a projected cost of RG&E steam compared to the cost of the customer's on-site production of steam assuming the customer installs a gas-fired boiler."^{1/} The cost per Mlb. for customer-provided steam (excluding the cost of converting) was found to be:

1983:	\$11.53 to \$13.40
1984:	\$13.41 to \$15.62
1985:	\$14.60 to \$16.77
1986:	\$15.91 to \$18.40

When compared to its "base case" analysis, which assumed 1983 sales of 1,150,000 Mlbs. and 1,000,000 Mlbs. of sales in 1984 and thereafter,^{2/} the company found the cost

^{1/}RG&E's Initial Brief, p. 26.

^{2/}The company made other assumptions it terms conservative, namely that customers would not reduce their individual requirements and that the cost of converting Beebee Station would be only \$25 million. In addition, the company ignored the tax benefits to customers for converting.

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of RG&E steam per Mlb. exceeded the customer's alternatives by:

1983:	\$3.77 to \$5.70
1984:	\$5.62 to \$7.96
1985:	\$7.16 to \$9.09
1986:	\$7.58 to \$9.78 (Beebee Station not converted)
1986:	\$5.45 to \$7.65 (Beebee Station converted and amortization of cost included)
1986:	\$4.46 to \$6.66 (Beebee Station converted but amortization not included)

The second step of the company's analysis was to determine the period required for customers to recover, from the savings they would enjoy by reason of leaving RG&E's system and installing their own facilities, their costs of conversion. Assuming Beebee Station were converted to coal but that the costs of doing so were not recovered from steam customers--i.e., the scenario most favorable to continuing RG&E's steam service--the company found that all 193 customers then on-line would recover their cost of converting to gas-fired boilers within a three- to six-year period and that 123 of the 193 would recover from one to nearly six times their investment within three years.

The company also submitted a "probable case" scenario based on the assertedly more realistic assumption that annual sales would decline after 1984 at a rate of 250,000 Mlbs. per year. As a consequence, the customers' savings from leaving the system would increase dramatically-- \$3.81 per Mlb. in 1984; \$11.99 per Mlb. in 1985; and a range of \$29.51 to \$37.31 per Mlb. in 1986 depending on the status

of Beebee Station--and the payback period for the investment needed to leave would shorten correspondingly. Accordingly, the company concluded the conversion of Beebee Station would not make RG&E steam rates competitive and the project should not be undertaken.

The company also found the conversion of Beebee Station would not be worthwhile for the electric department, for it would provide cost savings of only \$25.8 million in 1982 dollars as opposed to a conversion cost, also in 1982 dollars, of \$25 to \$33 million. Again, the company based its calculations on assumptions it considered conservative or most favorable to conversion.

Finally, the company, as noted in its initial brief, considered other means of controlling costs, such as reducing the number of boilers on standby, but found the potential benefits limited. As for distribution losses, it found that installing a condensate return system or reinsulating would require a "massive construction project, the costs of which would offset the fuel cost savings."^{1/} RG&E reported also that eliminating individual lines, while reducing distribution losses, would reduce sales, and therefore it concluded a reduction in system size would not necessarily benefit the system.

In sum, RG&E concluded there was no available option that would make company steam competitive with the customers' alternatives. It thus found it appropriate to inform customers that they should convert to alternatives as soon as possible. At the same time, assertedly in the interests of providing customer flexibility and ensuring the orderly phase-out of the system, the company said it was willing to continue providing service, but at compensatory rates, while customers assessed their options and prepared to leave the system.

^{1/}RG&E's Initial Brief, p. 35.

STAFF'S PROPOSAL

Long-Range Prospects

Staff contends the steam system can be preserved. It maintains costs per unit can be decreased by increasing sales and that fuel costs can be reduced by converting Beebee Station to coal. It would require conversion, however, only if a survey of current and former customers revealed that a prerequisite load could be attained by offering take-or-pay contracts at competitive rates. Competitive rates, it believes, could be offered by deferring some expenses now and recovering them later, after the Beebee Station conversion.

Staff notes the underpinning of its proposal is a present worth analysis of revenue requirements for the period 1984 to 1998, which suggests savings of \$48 million if customers use company-supplied steam. Moreover, staff maintains conversion of Beebee Station is more advantageous to electric customers than the two alternatives held out by the company; i.e., using the station only to enhance electric reliability or retiring the units in question and installing new transmission capacity. Staff argues conversion holds a \$58 to \$63 million benefit over the first alternative and has a \$52 to \$57 million advantage over the latter.

Current Rates

Essential to staff's plan is the setting of currently competitive rates. It proposes the temporary rates now in effect be made permanent and frozen at that level until the company secures an adequate number of commitments to take-or-pay contracts or until the company presents an orderly phase-out or abandonment plan.

Staff maintains that (in the absence of resuscitative measures) RG&E's steam system has lost its economic value and that by releasing the steam report and encouraging on-site alternatives the company has accelerated revenue and sales attrition. Consequently, though staff believes the 9% increase in the last case for variable costs, interest payments and preferred dividends was warranted, it opposes a 35% increase for variable costs in the rate year because it believes the company should bear the burden of its intended cessation of steam service. For the same reasons, it opposes the company's requested 59% increase to fully compensatory rates.

Staff argues the rate freeze is not unjust or illegal because "[r]egulation does not assure that a utility will make a profit. . . [and] [t]he possible loss of monopoly power and consequent loss of economic value is a recognized risk of investing in utilities."^{1/} Further, it contends that compensatory rates are not warranted because a similarly situated unregulated company, with no opportunity to provide subsidies from its monopoly gas and electric operations, would be content to recover variable costs and a contribution to fixed costs. It also views application of the Public Service Law §79(1) requirement that "just and reasonable" rates include a return sufficient to attract capital for continued service as illogical when the company envisions the termination of service in 1986. As for §85 of the Public Service Law, which requires "due regard" for the steam system's original cost less depreciation, staff sees it as inapplicable where the system has no real value. Finally, it characterizes the company's plan as a de facto abandonment, a condition which, it says, permits less than compensatory rates.

^{1/}Staff's Initial Brief, p. 17.

PLANNING FOR THE SYSTEM

Recommended Decision

The Judge, in discussing the survey designed to determine customer interest in take-or-pay contracts and thereby determine the likelihood of the plan's success, concluded that "while at this juncture the feasibility of the Staff proposal is in serious doubt in light of the very cogent factual impediments to which RG&E points, any resolution of such doubts in advance of that survey would be less than conclusive and, as such, fall short of public interest considerations."^{1/} He therefore recommends that the survey be conducted.

The impediments noted by the company and cited by the Judge are varied; they are here briefly listed. First, the company alleged that staff's present worth discounting masks the effect of interest on the deferral account balance and that the amount steam customers would have to repay for the underpriced service they received in the initial years is \$17.1 million rather than the \$11.6 million computed by staff. Second, coal burning limitations in the Department of Environmental Conservation (DEC) permit would offset the estimated cost saving.^{2/} Third, staff's pricing plan might prevent further erosion of the customer base but would not lead former customers to return. Fourth, in RG&E's view, staff has allocated too great a portion of the Beebe Station conversion costs to the electric department. Fifth, take-or-pay contracts are of questionable validity and offer little protection in the event the system fails, and staff has failed to address the case of non-contract

^{1/}R.D., p. 63.

^{2/}It should be noted that the parties agree that the shutdown of the system and likely conversion of customers to natural gas would not significantly increase ambient pollutant levels.

customers. Sixth, significant additional costs, such as the possibility of requiring new mains, installing services and meters, and the tax treatment of the deferred expenses, have been ignored. Seventh, a significantly higher discount rate is warranted for assessing risk. Finally, other risks, including declines in sales levels, financing difficulties and timing problems, have been overlooked.

Judge Schechter disagreed as to the limitations imposed by the DEC coal permit and found as well that take-or-pay contracts are allowed where there is a reasonable opportunity to recover the deferred costs. He agreed, however, with the company that present worth discounting is an inaccurate measure of costs and that staff's view of cost savings from conversion are optimistic. In addition, he considered valid the company's criticisms concerning staff's pricing proposals, the efficacy of take-or-pay contracts and the failure to reflect some additional costs. Nevertheless, he concluded "only the survey can either confirm or negate the doubts,"^{1/} and, as noted, he recommends the survey be conducted.

Mr. Thurston's Comments

Mr. Thurston's brief on exceptions notes that a study of district heating in Rochester is currently being carried out through the New York State Energy Research and Development Authority (NYSERDA) and that, as a result, negotiations to purchase the system have been suspended. Central to Mr. Thurston's comments is a claim that tension between the company and staff has needlessly delayed a resolution, and that customers have little faith in either as a result. Mr. Thurston believes a smaller workable system can be salvaged and operated privately. Thus, he recommends we adopt a "fish or cut bait" approach and encourage RG&E to come to terms with prospective operators of a deregulated system.

^{1/}R.D., p. 64.

Company's Exceptions

RG&E, restating many of its earlier arguments, contends the survey to determine the attractiveness of take-or-pay contracts should not be conducted. It argues that staff's economic analysis is flawed, and that the take-or-pay contract idea has been inadequately examined. For example, it goes on, little thought has been given to what would happen after the contracts expire, to how to collect from customers who move outside the state or whose facilities are destroyed or condemned, or to how to reconcile the tension between contracting and non-contracting customers. RG&E questions as well the legality of deferring the recovery of legitimate expenses and also of requiring the company to invest massive sums of money--\$34 million, it says--in a failing business. It objects also to the inordinate length of time required to implement a plan that will not likely work, especially when customers need immediate answers to assess their situation. Finally, RG&E argues the survey idea is unfocused and customers will be unwilling to commit themselves when it is apparent the system is uneconomic.

Staff replies the survey is an essential first step to restructuring the system, and it points, as evidence of the worth of a survey, to the company's financial support for a NYSERDA study to determine the future of district heating in Rochester. It defends the legality of its proposal and responds to the company's challenges to its economic analysis. Finally, it concludes that only a survey can resolve the question of how many customers and how much load could be expected if staff's proposal were adopted.

Staff's Exceptions

Staff excepts to the Judge's endorsement of several of the company's criticisms of its proposal. It argues that present worth discounting "takes inflation and interest rates into account and allows a stream of different year's dollars to be summed and appropriately compared with an alternative stream of different year's dollars."^{1/} Therefore, it contends, contrary to the Judge, the effect of inflation is not masked by present worth discounting.

With respect to the Judge's finding that staff overestimated the benefits of converting Beebee Station because it ignored the need for additional transmission capacity, staff contends the company did not establish a need for a transmission line into downtown Rochester. In addition, staff argues that even if a line were needed, conversion would still bring significant benefits.

Last, responding to the Judge's comment that its timetable was overly optimistic, staff says its only concern is finding a viable approach that may "be begun immediately and be carried out expeditiously."^{2/} It requests that we decide whether a survey is needed before considering other issues.

The company responds that present worth discounting is appropriate where the relevant inquiry is the comparison of differing revenue streams, but that is not the case here. It says the critical issue here is how much will be at risk when the take-or-pay contracts expire in 1988. With respect to the need for transmission capacity into downtown Rochester, the company says the benefit of the coal conversion to the electric department is considerably lower than the \$41

1/Staff's Brief on Exceptions, p. 9.

2/Id., p. 11.

million suggested by staff because the units projected to produce 200,000 MWh annually are old and will also be required to produce send-out steam; RG&E considers 20,000 MWh more likely. As for the staff request to determine the desirability of the survey before examining the other problems with its proposal, RG&E contends such a strategy will result in wasted time and money. Finally, RG&E asserts an inconsistency exists between staff's proposed rate freeze and the attempt to put off resolution of other issues.

Discussion

Judge Schechter recommends the survey be conducted, despite the problems with staff's analysis, because he believes it is in the public interest to discover whether customers are willing to commit themselves to long-term take-or-pay contracts. But we are unpersuaded that conducting such a survey now would make sense.

It is abundantly clear that the system's decline is becoming more rapid. In August, 1983, there were 171 customers being served and less than a year later--despite rates below the level suggested by normal ratemaking--there are only 115 customers on-line and 27 others have set a date certain for leaving the system. Correspondingly, the most recent forecast of annual sales is approximately one-half the original rate year projection and the continuing loss of customers ensures that sales levels will fall even further. Given these circumstances, it seems the survey would merely delay the inevitable while sending the wrong signals to the customers remaining on-line. District heating may have a future in Rochester as a customer-owned enterprise and NYSERDA is studying that possibility, among others, but a traditional regulated steam system appears unworkable.

Given that conclusion, the "fish or cut bait" approach is warranted and attention should be shifted from bailing out the system to finding a reasonable method of terminating regulated steam service. Accordingly, the company is directed to submit, within thirty days, a detailed plan for abandoning the system by a specific date or phasing it out step by step. The proposal should examine, among other things, the extent, if any, to which customers' conversion costs would be defrayed and the accounting treatment of such items as plant retirement, cost of removal and undepreciated investment. Following our review of the company's proposed plan and any comments by intervenors or customers, we shall determine the next steps toward an orderly termination of the company's steam business.

RATES

Recommended Decision

Judge Schechter concluded the only issues ripe for resolution in this case pertain to the permanent rate levels to be adopted for Case 28316 and Case 28612. In his estimation, the central issues are: "1) Is the utility now entitled to a 'full' return on its steam plant investment, as RG&E urges?; and 2) Should such investment now be deemed valueless for ratemaking purposes, as Staff urges?"^{1/} He answered both questions negatively, the first on the grounds that "RG&E's position overlooks its own assessment of the steam department's prospects"^{2/} and the second because staff's view "fails to accord 'due regard' to the applicable original cost concept and its argument that the system has no value is unpersuasive."^{3/}

^{1/}R.D., p. 65.

^{2/}Id.

^{3/}Id.

On the basis of his reading of the temporary rate order in Case 28316, the Judge found that we did not "foreclose permanent steam rates reflecting a return on an original cost less depreciation basis."^{1/} He concluded that we contemplated neither a normal nor a zero return but considered a less than normal return proper for an indisputably failing business. He characterized a full return on the steam plant as "patently unwarranted" given the company's own perception that staff's remedial measures are futile. Nevertheless, he believed a positive return on steam plant is required inasmuch as the plant "has some value considering that service, as necessary, will continue to be rendered to remaining steam customers through 1986."^{2/}

In so finding, the Judge rejected staff's rate freeze proposal and decided that the company should recover, in addition to its variable costs, some return on investment. Starting with the DCF-derived companywide equity allowance, he fashioned a formula that is supposed to recognize the "negative growth" of the steam department while reflecting a "remaining three year life." Specifically, he would disregard the growth component, divide the yield by the number of years remaining and then subtract that figure from the yield to determine the equity allowance. For Case 28316, the calculations are: 10.3% yield ÷ by 3 years = 3.4%; 10.3% - 3.4% = 6.9%. That 6.9% equity return would produce an overall return on steam plant of 8.47% and a \$2.64 million permanent rate increase. Accordingly, he found reparations were required to increase revenues to that level.

1/Id., p. 66.

2/Id.

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In making his calculation, the Judge relied on the uncontested steam revenue and expense projections in Case 28316 rather than on current data. He held the cases cited by the company supporting the use of current data were inapposite, for they antedated the fully forecasted rate year technique and, moreover, he saw the company's position as inconsistent with its refusal to extend the original suspension period to consider the rate effects of the Steam Report.

For Case 28612, he recommends the same approach. The calculations, using Judge Vernieu's recommended decision, are: 11.9% yield x 2/3 (reflects fact that two of the three remaining years of operation will be completed) = 7.93%; 11.9% - 7.9% = 3.97%. The result is a \$4.309 million increase (above the temporary rates set in Case 28316).

Company's Exceptions

RG&E argues the Judge erred in recommending that rates in Case 28316 be set using the rate case data available as of July, 1983. It reasserts its position that we are bound here by New York Telephone Company v. Public Service Commission,^{1/} which requires the use of actual data where available, and contends it is immaterial that the case was decided before the move to a fully forecasted rate year. It opines that we must search for the most accurate data for setting rates, and it cites for further support the Policy Statement on Test Periods in Major Rate Proceedings. Accordingly, it urges that actual data--which reflect sales below those forecast in Case 28316--be employed to prevent an undercollection of revenue.

^{1/}29 N.Y. 2d 164 (1971).

In response, staff argues the company is estopped from claiming an entitlement to rate relief and reparations based on updates because the company's refusal to extend the suspension period precluded the timely consideration of steam rates. Further, staff says the issue here relates to reparations, which are discretionary and not mandatory, and we are not required to allow retroactive reparations even if we set higher permanent rates prospectively.

RG&E excepts also to the Judge using a reduced return on equity for the steam department. It contends granting a return "less than the risk-free cost of money is confiscatory"^{1/} and that setting a different rate for steam is inconsistent with the practice of setting an overall rate of return for combination utilities.^{2/} Finally, it posits that the recommendation overlooks the fact that the 15.1% return on equity was intended to reflect the return needed on all operations and it contends a low return on steam plant requires a correspondingly higher return on gas and electric plant.

Staff does not answer this exception directly but says that the steam system is moribund while the gas and electric systems are "ongoing entities." The main thrust of staff's response is its speculation that the company was holding back for its reply brief on exceptions its argument regarding entitlement to fully compensatory rates, in which case, staff noted, it would request that the argument be disregarded or that staff be granted leave to reply.^{3/}

1/RG&E's Brief on Exceptions, p. 33.

2/For this practice, it cites Case 27276, Consolidated Edison Company of New York, Inc., Opinion No. 78-27, 18 NY PSC 1764 (1978).

3/See discussion infra, regarding this issue.

Staff's Exceptions^{1/}

Staff objects to the Judge's compromise position that allows a return on steam plant. It contends, first, that it is improper to use a traditional DCF model, which contemplates a stream of dividends, when no dividends can be assumed. Moreover, it argues it is unrealistic to set rates on the premise of a 1986 shutdown without recommending a formal abandonment proceeding. Further, it posits that increasing rates will undermine the survey and that, in any event, there is no justification for rates higher than variable costs, which it characterizes as the minimal point at which a competitive firm would continue to provide service. In this regard, it asserts that it is "questionable whether RG&E would have been inclined to 'phase out' its steam service if it did not also have a franchised monopoly in the provision of the closest substitute--natural gas."^{2/}

Thus, staff renews its claim that a rate freeze is in order. It argues that in Case 28316 the company's variable costs (including depreciation, a return on working capital, interest payments and preferred dividends) were met, and that is all that is required. As for Case 28612, staff contends a rate freeze is in order as well because the Steam Report accelerated the decline of the system and the company should "bear the consequences of presenting an ill-conceived long-range plan rather than seeking a more orderly transition."^{3/} As a result, staff proposes a freeze until the company presents a detailed plan for either maintaining or abandoning the system.

^{1/}The Genessee Hospital and Xerox Corporation, both major steam users, also have submitted letters objecting to the recommended rate increase.

^{2/}Staff's Brief on Exceptions, p. 8.

^{3/}Id., p. 7.

RG&E submits, concerning the rate issues, three replies. It contends the Steam Report cannot be blamed for the accelerated decline of the steam system; that it is entitled to fully compensatory rates; and that it should not be required to undertake more studies if staff's plan is rejected.

Discussion

In determining the level of rates--both prospectively and for the time temporary rates have been in effect--we start by recognizing that a large number of the company's steam customers have left the system over the past two years, that, more recently, the rate of departure has increased dramatically, that the system can no longer survive economically, and that abandonment is inevitable after a reasonable phase-out period. In such circumstances, we are not obligated (and it would not be feasible) to follow traditional ratemaking principles and provide the company the level of expenses or return required by an on-going concern. This is particularly so here, where the company has failed to acknowledge that the system is no longer economically viable or to take steps to petition for its eventual abandonment.

Faced as we thus are with setting rates for a reasonable phase-out period, we are willing to authorize only such revenues as may be necessary, given the existing number of customers, to cover the expenses incurred in providing service. Further, we believe it reasonable to moderate any rate increases during the phase-out period, for we are reluctant to impose on the relatively few remaining customers the burden of paying the full costs of a steam system built to meet the needs of approximately 650 customers.

At the same time, we are mindful that the phase-out period should be limited in duration (consistent with the need of the existing customers to convert to alternate energy sources), and we recognize that meeting even out-of-pocket operating expenses may require authorizing a significant increase in the rates charged during that period. Indeed, such an increase will avoid the improper price signals which might result from keeping rates artificially low, and it will thus encourage customers to leave the system during the phase-out period.

With these considerations in mind, we conclude that the temporary rates set in Case 28316 should be made permanent and that, in Case 28612, the company should be allowed to recover its out-of-pocket expenses, which requires a rate increase of approximately 32%. These conclusions are discussed in turn.

1. Case 28316

When temporary rates were set in this case, the steam system had lost a number of customers and its future was dim. Accordingly, we expanded the on-going investigation of the system's prospects and requested that the issue of abandonment be considered.^{1/} That investigation has now revealed that the economic decline of the system is irreversible and that abandonment within approximately a year to 18 months is inevitable. Accordingly, we find the level of temporary rates--designed to recover the system's variable costs--may be made permanent, for the steam system was and is in a de facto phase-out period leading to abandonment, and that under such circumstances, a return on the steam investment is not reasonable or feasible.^{2/} As a result, neither reparations nor refunds are warranted under the circumstances.

1/Case 28316, Order Granting in Part and Denying in Part Petitions for Rehearing (issued December 12, 1983), mimeo p. 10.

2/See, Market Street Railway Co. v. California Railroad Commission, 324 U.S. 548 (1944).

2. Case 28612

In the rate year, it is likely, given recent indications, that customers will depart at an increasing rate, especially given the significant rate increase that is needed. Further, because of the small number of customers, the steam system is not economically viable and should be phased out over a reasonable period. As a result, we find, consistent with the Market Street Railway decision, supra, as well as sound marketing principles, that during the phase-out period, the level of rates should be set so as to be sufficient to allow recovery only of out-of-pocket expenses.

This level of allowed rates is reasonable because it reflects the inevitable fate of the system while allowing the company to recover its prudently incurred expenses. Moreover, it recognizes the economic burden placed on the remaining customers, who may also face expenses of converting to alternative energy sources. Finally, RG&E's resulting return, as computed on a consolidated company basis, is reasonable even under business-as-usual criteria.^{1/}

CONCLUSION

Our resolution of the issues presented in these cases leads us to conclude that Rochester Gas and Electric Corporation requires, prospectively, \$3,170,000 in additional annual revenues from steam service, over the amount produced by the temporary rates now in effect, as set forth in Appendix A. The approximately 32% increase comprises a

^{1/}In addition, recent updates suggest a reduced allocation of employees to the steam department and a corresponding reduction in its expenses. And because our income tax expense for the steam department has been computed without recognition of the interest deductions related to the investment in steam facilities, RG&E's shareholders will benefit accordingly. Thus, the company will be provided some return on its investment even with respect to the steam department standing alone.

CASES 28316 and 28612

\$2,729,000 increase in base rates and a \$441,000 increase in fuel adjustment revenues resulting from a change in the factor of adjustment.

The Commission orders:

1. Rochester Gas and Electric Corporation (the company) is directed to cancel the tariff leaves and supplements listed in Appendix B on or before July 15, 1984.

2. The company is authorized to file amendments to its steam tariff schedule designed to produce additional annual revenues in Case 28612 in an amount and manner consistent with the foregoing Opinion. The company shall serve copies of its compliance filing on all parties listing appearances in these proceedings. Any comments on the compliance filing must be received at the Commission's offices within ten days of service of the company's proposed amendments. Amendments specified in the compliance filing shall not become effective on a permanent basis until approved by the Commission. The company is authorized to file the amendments on or after July 16, 1984 to go into effect on not less than one day's notice, subject to refund if any showing is made that the new rates are not in full compliance with this Opinion and Order. The requirement of §80(10) of the Public Service Law to newspaper publication of the amendments authorized in this paragraph is waived, provided the company notifies each customer affected by the compliance filing.

3. The company is directed to file, within thirty days of the date of this Opinion and Order, a proposed plan for abandoning the steam system by October 1, 1985. The

CASES 28316 and 28612

plan shall examine, among other things, the issue of customer assistance and the accounting treatment of such items as plant retirement, cost of removal and undepreciated investment. Copies of the plan shall be served individually on all remaining customers and on all parties listing appearances in these proceedings. The period for comment shall be two weeks from service.

4. The temporary rates set on July 18, 1983 in Case 28316 and revised through rehearing on December 12, 1983 shall be made permanent for the period they will have been in effect.

5. Except as here granted, all exceptions to the Administrative Law Judges' recommended decisions in Cases 28609, et al. (insofar as pertinent to steam service) and Case 28316 are denied.

6. Except as here modified, the recommended decisions of the Administrative Law Judges are adopted as part of this Opinion and Order.

7. These proceedings are continued.

By the Commission,

(SIGNED)

JOHN J. KELLIHER
Secretary

ROCHESTER GAS AND ELECTRIC CORPORATION

Steam Department
Income Statement and Rate of Return Per Commission
12 Months Ended July 31, 1985
(000's)

	Per ALJ Before Rate Increase	Commission Adjustments	As Adjusted	Increase Per Commission	Per Commission
<u>Revenues</u>	\$10,266	1) \$ 150	\$10,416	\$2,729	\$13,145
Customer					
Total Revenues	10,266	150	10,416	2,729	13,145
Expenses	10,023	2) (19)	10,004		10,004
Depreciation	611		611		611
Amortization	5		5		5
Taxes - Local, State, Other	2,370	3) (259)	2,111	6) 184	2,295
Operating Income Before Federal Income Taxes	(2,743)	428	(2,315)	2,545	230
Federal Income Taxes Payable	(1,517)	4) 498	(1,019)	7) 1,171	152
Investment Tax Credit Adjustment					
Provision for Deferred Income Taxes - Net	78		78		78
Interperiod Tax Allocation	12	5) (12)	-	-	-
Total Federal Income Taxes	(1,427)	486	(941)	1,171	230
Operating Income	(1,316)	(58)	(1,374)	1,374	0
Adjustment for Allowance for Funds Used During Construction	-	-	-	-	-
Balance for Return	\$(1,316)	-	\$(1,374)	-	\$ 0
Average Rate Base	\$11,568		\$11,568		\$11,568
Rate of Return	(11.38%)		(11.88%)		0.0%

CASES 28316 and 28612

APPENDIX A
Page 1 of 3

ROCHESTER GAS AND ELECTRIC CORPORATION

Steam Department
Explanation of Commission Adjustments
(000's)

1) <u>Revenues</u>			
a) To reflect existing factor of adjustment (1.1809) in base tariff revenues; plus revenue tax gross-up.		\$ (115)	
b) To reflect proposed factor of adjustment (1.3153) in determining FCA revenues; plus revenue tax gross-up.		<u>265</u>	<u>\$ 150</u>
2) <u>Expenses</u>			
To eliminate 1985 estimated wage increase reflected by ALJ (2 months)			<u>\$ (19)</u>
3) <u>Taxes - Local, State, Other</u>			
a) Property Taxes - to reflect decrease in rate year property taxes per letter from RG&E dated June 12, 1984.		\$ (269)	
b) Revenue Taxes - impact on adjustments 1a and 1b above.		<u>10</u>	<u>\$ (259)</u>
4) <u>Federal Income Taxes Payable</u>			
Operating Income Before F.I.T. (column 3)		\$ (2,315)	
F.I.T. deductions consistent with no return:			
Deferred Fuel	\$ (98)		
Taxes Capitalized	(8)		
Additional Deductible Property Taxes	42		
Pensions Capitalized	(6)		
Accounting Cost Capitalized	(11)		
Additional Deductible Depreciation	103		
Cost of Removal	(17)		
Taxes Deferred Amortized	9		
Date of Taxable Status	84		
ITC Basis Adjustment	<u>2</u>		
Taxable Income		<u>100</u>	
		\$ (2,215)	
Tax at 46%		\$ (1,019)	
Less Amount per ALJ		<u>(1,517)</u>	<u>\$ 498</u>

ROCHESTER GAS AND ELECTRIC CORPORATION

Steam Department
Explanation of Commission Adjustments
(000's)

5) <u>Interperiod Tax Allocation</u>	
To reflect flow through of capitalized overheads.	<u>\$ (12)</u>
6) Revenue Taxes at 6.75%.	<u>\$ 184</u>
7) Federal Income Taxes Payable: Operating income before F.I.T. at 46%	<u>\$1,171</u>

ROCHESTER GAS AND ELECTRIC CORPORATION

Amendments to Schedule P.S.C. No. 4 - Steam

Twelfth Revised Leaf No. 23

Fourteenth Revised Leaf No. 24

Nineteenth Revised Leaf No. 17

Supplements Nos. 25 and 26

file #
#102

C-28316