BPU's Experience in Evaluating Investors in Generation and Distribution

NARUC Energy Partnership Program

Sofia, Bulgaria

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Distribution in New Jersey

- The majority of the distribution of electricity and gas in New Jersey is controlled by a large company with the following structure:

PSEG Overview

Twelve months Ending 12/31/01

- Revenues: $9.8B
- Net Income: $770M
- ROE 18.9%
- Assets $25.4B

PSEG

PSE&G	PSEG Power LLC	PSEG Energy Holdings
Customers 2.0M Electric 1.6M Gas	Capacity 11,505 MW operating <u>3,516</u> MW net additions 15,021 MW	Capacity 2,047 MW operating 1,399 MW net additions 3,446 MW Customers: 3.6M

	PSE&G	PSEG Power LLC	PSEG Energy Holdings
Revenues:	$6.1B	$4.7B	$1.1B
Net Income:	$230M	$394M	$161M
ROE	9.4%	>25%	10.9%
Assets	$12.9B	$5.4B	$7.4B

PSE&G – Regulated Distribution Company

- The BPU only regulates the distribution company which is characterized by excellent service quality with rates that are about average for this area of the country. Profitability is reasonable for this type of regulated activity.

PSEG Power – Unregulated Generation Company

- This company owns the generation assets formerly owned by PSE&G prior to deregulation/restructuring. The company is very profitable due to the acquisition of generating assets from PSE&G at an attractive price and relatively high current (though declining) wholesale electricity prices.

PSEG Energy Holdings

- This company owns diversified operations including off-shore utility investments (South America, Eastern Europe, China), a leverage leasing company, an HVAC Company, etc. Profitability has been problematic.

Regulatory Problems/Concerns

- PSE&G is the only company which currently generates cash, the other two subsidiaries use cash for expansion.
- Because the total company uses more cash than it generates, considerable borrowing in the capital markets is required.

Regulatory Problems/Concerns

- PSEG Energy Holding recently took a $400 million write-down associated with investments in Argentina.
- The magnitude of the borrowing coupled with losses at PSEG Energy Holding has caused the rating agencies to downgrade the debt of all subsidiaries, including the regulated distribution company.

Regulatory Problems/Concerns

- Unfortunately, other holding companies operating in New Jersey have experienced similar problems:
  - GPU, Inc., parent of Jersey Central Power & Light Company, sold out to First Energy, after experiencing losses in Britain and Australia.
  - Conectiv, Inc., parent of Atlantic City Electric Company, sold out to Pepco, Inc., after incurring significant losses in investments in telecommunications.

Solution

- What is needed is a regulatory paradigm, which allows for the free flow of capital but contains at least some restrictions such that errors do not negatively impact the regulated utility.

How to Assure a Fair but No Excess Return on Investments in the Utility Sector

- Let the market set the price – investors understand markets.
  - In New Jersey, the market determines the wholesale price of electricity – not regulators.
  - The market is highly transparent and contains significant controls, which virtually eliminate manipulation.

How to Assure a Fair but No Excess Return on Investments in the Utility Sector

- Use Bidding – lowest bidder gets the contract.
  - Utility purchases of power for consumers who do not choose an alternate supplier.
  - This was done via the auction process and proved successful in securing a competitive price for power.

How to Assure a Fair but No Excess Return on Investments in the Utility Sector

- Negotiation among parties
  - Sometimes there is no alternative due to complexity, changing specifications, etc.
  - Problems arise due to asymmetric information.

Negotiation and long-term contracts have been used for:

- Various co-generation projects.
- Resource recovery projects.

The pricing in many of these contracts has never been able to take account changing fuel costs, environmental conditions, financial markets, etc.

BPU Experience

- Our experience is that the market-dominated approaches are superior to long-term contracts signed as a result of negotiation.

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