MWN
McNees Wallace & Nurick LLC
attorneys at law

SUSAN E. BRUCE
DIRECT DIAL: (717) 237-5254
E-MAIL ADDRESS: SBRUCE@MWN.COM

July 20, 2006

James J. McNulty, Secretary
Pennsylvania Public Utility Commission
Commonwealth Keystone Building
400 North Street, 2nd Floor
Harrisburg, PA 17120

VIA HAND DELIVERY

Re: Policies to Mitigate Potential Electricity Price Increases; Docket No. M-00061957

Dear Secretary McNulty:

Enclosed please find for filing with the Commission an original and 15 (fifteen) copies of the Reply Comments on behalf of the Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors (collectively, "Industrial Customers") concerning the above-referenced proceeding.

As reflected on the attached Certificate of Service, all parties to this proceeding are being duly served. Please date stamp the extra copy of this transmittal letter and kindly return it to us for our filing purposes. Thank you for your attention to this matter.

Very truly yours,

McNEES WALLACE & NURICK LLC

By Susan E. Bruce
Susan E. Bruce

Counsel to Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors

SEB:mas
Enclosures
c: Mr. Shane M. Rooney (via electronic mail)
Certificate of Service

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Policies to Mitigate Potential	:	Docket No. M-00061957
Electricity Price Increases	:	

REPLY COMMENTS OF

INDUSTRIAL ENERGY CONSUMERS OF PENNSYLVANIA
PJM INDUSTRIAL CUSTOMER COALITION
DUQUESNE INDUSTRIAL INTERVENORS
PENELEC INDUSTRIAL CUSTOMER ALLIANCE
PENN POWER USERS GROUP
MET-ED INDUSTRIAL USERS GROUP
PHILADELPHIA AREA INDUSTRIAL ENERGY USERS GROUP
PP&L INDUSTRIAL CUSTOMER ALLIANCE
WEST PENN POWER INDUSTRIAL INTERVENORS

David M. Kleppinger, Pa. Bar No. 32091
Susan E. Bruce, Pa. Bar No. 80146
McNEES WALLACE & NURICK LLC
100 Pine Street
P. O. Box 1166
Harrisburg, PA 17108-1166
Ph. (717) 232-8000
Fax (717) 237-5300
dkleppinger@mwn.com
sbruce@mwn.com

Dated: July 20, 2006

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I. INTRODUCTION

In response to the Pennsylvania Public Utility Commission's ("Commission" or PUC") Investigation Order entered May 24, 2006,[1] the Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors (collectively, "Industrial Customers") submit these Reply Comments in this critical investigation on mitigating potential electricity price increases.[2] Industrial Customers welcome this opportunity to respond to Comments filed by other stakeholders as well as address certain statements during the June 22, 2006, *en banc* hearing.

As set forth in the Investigation Order, the purpose of this proceeding is "to address issues and develop policies to <u>mitigate</u> potential electricity price increases upon the expiration of generation price caps."[3] The problems faced by Pennsylvania retail customers, however, go <u>beyond</u> the charge that the Commission set for itself in this proceeding. In this regard, Industrial Customers share the Pennsylvania Department of Environmental Protection's ("DEP") and Office of Consumer Advocate's ("OCA") view that the intent of this proceeding should be not only to develop policies to mitigate future significant price increases but also to begin to develop an action plan to avoid them altogether.

This mission undeniably presents a substantial challenge to Pennsylvania, but one that this Commission is well suited to assume. Unlike in neighboring states, time is more on Pennsylvania's side in that rate caps for a large amount of Pennsylvania's load will remain in

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[1] *See Investigation Order on Policies to Mitigate Potential Electricity Price Increases*, Docket No. M-00061957 (Order entered May 24, 2005)("Investigation Order").

[2] Industrial Customers filed Comments at this docket on June 15, 2006.

[3] *Id.* at Ordering Paragraph No. 1 (emphasis added).

place through at least the end of 2009. That does not mean that this Commission should not embark to solve this problem with all due deliberate speed, particularly given that many Pennsylvania customers are already experiencing the sting of high LMP prices.

Pennsylvania is at a decisive point in its electric restructuring process. Some market participants myopically argue that lower prices are not necessarily an objective of competitive markets and push for greater market exposure for customers.[4] They cite instead the "benefits of being able to negotiate with a competitive supplier."[5] This is hollow comfort for customers facing severe economic pressures because of the skyrocketing price for energy. These market participants forget or ignore that Pennsylvania's explicit policy is for electric competition to be a tool "to protect this Commonwealth's ability to compete in the national and international marketplace for industry and jobs."[6] Others counsel patience – that well-functioning competitive markets put downward pressure on prices. These market participants ignore that electricity demand is extremely inelastic, even in the industrial class because ultimately most manufacturing companies would prefer to produce their products as opposed to shutting down and sending home employees when prices are high. The ultimate demand response measure – having manufacturers leave the Commonwealth because of sustained high prices or unacceptable levels of volatility – should not be counted as a viable demand response option. The message that Industrial Customers impress upon this Commission is that the competitive position of those customers exposed to the current market is already being compromised. Action must be taken to improve the platform for competition in Pennsylvania in order to realize the objectives of the Competition Act. Such Commission action is not an inappropriate intervention in the market

[4] Comments of Reliant Energy, Inc., at 16 ("Reliant Comments").
[5] *Id.*
[6] 66 Pa. C.S. § 2802(7).

but a necessary step to promote the competitive market benefits envisioned by the framers of the Competition Act.

As noted in Industrial Customers' Comments, we do not presume to have all the answers, but this proceeding is an appropriate starting point for crafting solutions. In this regard, Industrial Customers support DEP's call for a comprehensive set of policies and programs for Pennsylvania's retail market and push for reforms to the competitive wholesale market in order to avoid dramatic price increases, such as those currently being felt by Duquesne and Pike County customers as well as customers in neighboring states. In particular, Industrial Customers urge this Commission to consider the following, which are discussed in more detail in Industrial Customers' Comments:

- Proactive involvement by the Commission, DEP, Department of Community and Economic Development, and the Organization of PJM States, Inc. ("OPSI"), in facilitating long-term bilateral contracting between generators and customers on a basis that bypasses the wholesale LMP/capacity market construct in favor of a "cost plus" pricing of these bilateral contracts;
- To the extent that individual generation projects receive Commonwealth resources in the form of favorable siting, low-cost financing, or other assistance, such generation projects need to be encouraged by the appropriate Commonwealth agencies to execute long-term bilateral contracts with Pennsylvania-based customers on a cost-plus pricing basis;
- Actively investigate the viability of a Commonwealth public power authority as recommended by DEP;
- Seek and locate project sites to facilitate new generation construction for the benefit of Pennsylvania consumers and conduct RFPs to construct at those sites within certain

defined criteria, including: (1) specifying percentages of generation to encourage diversity in fuel and ownership and (2) a requirement to engage in long-term bilateral contracts with prospective Pennsylvania customers on a pricing basis other than forward natural gas or LMP price curves;

- Continued action by the Commission and OPSI to proactively work with FERC and within the PJM stakeholder process to facilitate the initiatives listed above and to protect the Pennsylvania retail market from anticompetitive or discriminatory conduct and/or market rules at the wholesale level; and,
- In the short-term, the Commission should:
  - Extend rate caps where stranded cost recovery continues;
  - Initiate utility-by-utility investigations to consider rate stabilization phase-in periods beyond the rate cap expiration;
  - Facilitate market development power to retain potential lost customers and employment; and
  - Allow EDCs to engage in flexible and negotiated pricing and rates on a contract basis consistent with the Competition Act's provisions.

II. REPLY COMMENTS

A. Industrial Customers Support DEP's and OCA's Call That the Commission Investigate Steps To Reduce Market-Driven Electricity Prices To Benefit All Classes of Customers and Protect Pennsylvania's Ability To Compete.

Industrial Customers' Comments in this docket encouraged the Commission to expand the focus of this proceeding to investigate steps to reduce electricity prices in the Commonwealth to benefit all classes of customers and protect Pennsylvania's ability to compete for industry and jobs. Although some in this proceeding have argued that recent price increases are attributable to default service designs,[7] the price increases are more appropriately attributable to wholesale price increases. PJM endeavors to mount a defense of LMP and the last-bid-in market; however, Industrial Customers stand by the criticisms of the LMP market set forth in our Comments at this docket. To avoid losing the focus of the debate, however, Industrial Customers recognize that, like it or not, LMP is currently the wholesale market price driver. That does not obviate or excuse, however, the very real price impact of the LMP-based system on customers. Moreover, despite the hefty inframarginal revenues being earned by the vast majority of existing PJM generation and current capacity surpluses, LMP is allegedly not sufficient on its own to sustain resource adequacy. For this reason, the Commission should focus its efforts on working to develop an action plan to improve the operation of the FERC-approved wholesale market in Pennsylvania.

Industrial Customers' recommendation is consistent with the Comments filed by DEP, OCA and Direct Energy.[8] As the OCA correctly notes, "without a fully functioning, workably

[7] Reliant Comments, at 2.

[8] Industrial Customers note with interest that the Electric Power Generation Association ("EPGA") recognizes that the Commission can assist in shaping the wholesale market or how the wholesale market plays out in Pennsylvania. Comments of the Electric Power Generation Association, at 8 ("EPGA Comments"). Similarly, PPL Electric Utilities Corporation ("PPL") concedes that the Commission has authority to provide grants to competitive generators to site in certain locales. Comments of PPL Electric Utilities Corporation, at 33 ("PPL Comments").

competitive wholesale market that produces prices that can form the basis for just and reasonable rates for retail consumers, Pennsylvania's restructuring efforts will be for naught."[9] In particular, Industrial Customers support OCA's recommendation that the Commission require a portfolio of resources, including long-term contracts, priced at something other than forward natural gas curves, that will facilitate generation construction. This recommendation can and should apply not only to EDCs, but also to individual customer contract negotiations.

Industrial Customers also strongly support DEP's call for the Commission to develop a comprehensive set of policies and programs to improve Pennsylvania's retail market and to push for reforms to the competitive wholesale market in order to avoid dramatic price increases.[10] As a positive illustration of industrial and environmental interests co-existing and aligning in this regard, Industrial Customers are encouraged by DEP's sensitivity to the impact that the current market scheme has on Pennsylvania industrials. As DEP correctly recognizes, manufacturing remains the largest share of the Pennsylvania gross state product by category, accounting for 15%, or approximately $75 billion, of Pennsylvania's $423 billion in gross state product for the last year that DEP has data. The objective of the Competition Act was, in important part, to protect this Commonwealth's ability to compete in the national and international marketplace for industry and jobs. When every tenth of a cent increase in electricity translates to $1 million in added electricity for a large industrial consuming approximately 100,000,00 kWh per year, the Competition Act is clearly not meeting its objectives.

Industrial Customers support DEP's proposed plan of action as a reasonable starting point to help bring the reality of the Competition Act closer in alignment with the General Assembly's expectations. Specifically, DEP proposes:

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[9] Comments of the Office of Consumer Advocate, at 8 ("OCA Comments").

[10] Comments of the Pennsylvania Department of Environmental Protection on Policies to Mitigate Potential Electricity Price Increases, at 4 ("DEP Comments").

- Enhanced demand-side management initiatives;
- Changes to the draft default service regulations to enable long-term contracts;
- Encourage default providers to own power plants and provide bilateral contracts to customers;
- Policies that enable resource diversification to reduce the number of hours that natural gas sets prices in PJM;
- Investigate changes to PJM's current wholesale pricing model to determine whether another model produces a more efficient economic outcome; and,
- Establishment of a Pennsylvania Power Authority akin to the New York Power Authority with a mission to provide low-cost electricity to job-producing companies.[11]

Industrial Customers encourage the Commission to use this docket as a springboard for examining DEP's proposal in more detail in order for the objectives of the Competition Act to become reality.

B. Arguments That POLR Service for Large C&I Customers Must Be Based on Real-Time Prices Are Inconsistent with the Competition Act and Contrary to the Commonwealth's Interests.

In its Investigation Order, the Commission listed hourly pricing as a strategy to encourage demand response and reduce the peak demand for electricity.[12] Several commenters addressed this issue specifically, providing additional support for Industrial Customers' position that hourly real-time prices must not be the only POLR option for large commercial and industrial customers.[13] Only retail marketers favored hourly real-time pricing as a pricing strategy for Large C&I POLR service.

As explained in Industrial Customers' Comments, some large C&I customers may prefer an hourly priced POLR rate, and it is an appropriate POLR <u>option</u> to provide customers.

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[11] DEP Comments, at 13-14. With respect to this last recommendation, Industrial Customers note that timing is important, especially given the expected divestiture of Exelon generation units due to its pending merger with PSEG.
[12] Investigation Order, at 5.
[13] *See, e.g.*, Comments on Behalf of the Office of Small Business Advocate, at 3 ("OSBA Comments"); Comments of Duquesne Light Company, at 3-4 ("Duquesne Comments"); Comments of Metropolitan Edison Company, Pennsylvania Electric Company and Pennsylvania Power Company, at 7 ("FirstEnergy Comments").

However, many large C&I customers have load profiles and/or production processes preventing utilization of hourly pricing mechanisms. Hourly prices are tied to natural gas, which means the prices will likely be high and volatile. Energy-intensive businesses simply cannot remain competitive in the global economy under these circumstances. Hourly prices devastate energy intensive businesses, erode jobs and inhibit the capital investment required to keep businesses competitive.

Duquesne's recent experience bears out Industrial Customers' concern. Duquesne reports that its customers, "by and large, do not want hourly pricing." While agreeing that hourly service may be a viable option for some large C&I customers, Duquesne found that:

> less than 10% of its large C&I customers have the sophistication and financial wherewithal to administer it effectively. Hourly priced service exposes customers to price volatility and financial uncertainty that most are unwilling to tolerate. For the most part, Duquesne has found that customers want certainty. They need to budget for expenses, and they don't want to be surprised by rapidly escalating prices or extreme volatility.[14]

Based on its experience and the experience of its customers, Duquesne advises that volatile hourly prices "are not a necessary or desirable part of a competitive market." First Energy also cautions the Commission regarding mandatory hourly POLR pricing for large C&I customers, explaining that its implementation must be balanced by several important practical considerations," including the impact of higher and volatile rate levels on industrials and the consequences to the Commonwealth's economy and employment levels.[15]

More to the point of the Commission's concern regarding reducing peak demand, Duquesne reports that hourly default service pricing has not affected Duquesne's load profile and shows no indication of managed load shifting. The Office of Small Business Advocate

[14] Duquesne Comments, at 3.
[15] FirstEnergy Comments, at 7.

("OSBA") also notes that hourly pricing for Duquesne's large C&I customers has not significantly changed their consumption pattern, but, rather simply forced those customers to above higher prices or to purchase fixed-price service from an EGS.[16] As Duquesne recognizes, its current POLR service for large C&I customers is "ugly" and "benefits no one but marketers who have seen artificial and unnecessary competitive advantage at customers' expense." Industrial Customers are encouraged by Duquesne's acknowledgment that deregulation was supposed to create meaningful competition in the interest of the public good and, furthermore, that the Company is being responsive to customers' legitimate concern that Duquesne's RFP process can result in an uncertain and high price. As Duquesne explains, the current process affords marketers the opportunity to wait until the RFP process sets an inflated "market price" and then offer prices just below that ceiling price in order to enroll customers.[17] Artificially boosting shopping levels by such means cannot be equated with "true competition," let alone success under the Competition Act.

In their comments, marketers provided general claims that hourly pricing encourages demand response but none provided support other than the theoretical reasons referenced by First Energy. There are a myriad countervailing reasons, however, that militate against mandating hourly pricing as the only POLR option for Large C&I customers.

Requiring spot market pricing for large customers subjects these customers to arbitrary price increases and prices so volatile that they frustrate the effective budgeting required for Large C&I customers to compete for investment capital. If larger customers are unable to specifically determine and plan for these budgetary expenses, the overall production process for these customers may be hindered. Particularly in the absence of a vibrant retail market, requiring a

[16] OSBA Comments, at 3.
[17] Duquesne Comments, at 4.

POLR pricing strategy that hobbles large customers' ability to do business is directly inconsistent with sound public policy. Accordingly, all customers must be offered at least one fixed price POLR option; no customer should be forced to pay hourly prices for service from the EDC.

C. EDCs Must Be Permitted To Provide POLR Service As a Reasonable Option for Customers.

Industrial Customers support calls for the Commission to ensure that EDCs be permitted to serve as a meaningful alternative for all customers as a strategy to mitigate potential price increases. In this regard, Industrial Customers support the OCA's recommendation that EDCs be provided with the ability to secure a portfolio of resources to serve default customers at stable rates. As properly noted by the OCA, the job of Pennsylvania's EDCs should not be simply to serve as a "passive conduit" that merely passes on to its customers the cost of one-year power contracts that happen to be available on a particular date. As Duquesne notes, EDCs have not only an obligation to serve but also an obligation to give customers a choice.[18]

Reliant points out in its Comments that retail choice allows individuals to be the final arbiter of their provider and electric service product.[19] The EDC should be an available option for customers to consider. As highlighted by Reliant, a provider that does not act in the best interests of its customers will lose its customers to a provider that does provide the electric service attributes sought by individual customers. It is a telling sign of the state of the competitive market that customers seek to retain EDCs as an alternative to existing service offerings. This should be viewed as a sign that the competitive market is not offering services that are attractive to customers.

The Competition Act specifically permits EDCs to serve as an alternative for default service. The Competition Act contemplates as one of EDCs' duties the obligation to serve. By

[18] Tr. 105, ll. 16-18 (Testimony of Mr. Eichenmiller).
[19] Reliant Comments, at 13.

allowing EDCs serving as a POLR provider to obtain electricity at "prevailing market prices," the General Assembly intended default service providers, including EDCs, to utilize various avenues in procuring electricity to meet POLR customers' needs. Under Section 2807(e)(3), a POLR provider is permitted to utilize long-term contracts, hedging, and forward pricing to develop a diverse portfolio to ensure customers are receiving just and reasonable rates, as long as these methodologies have a connection to the prevailing market price at the time in which they were entered (*i.e.*, the long-term contract reflects the prevailing market price on the date of execution). Assuming this requirement is met, the EDC is adhering to the terms of the Competition Act.

Keeping EDCs as a meaningful alternative for default service also keeps competitive pressure on EGS to be competitive over the long term. The view from the trenches is that EGSs are wholly reliant on PJM spot markets and forward natural gas curves in their pricing offers to customers. Competitive default service at prices other than LMP or forward natural gas curves would help to encourage competitive suppliers to offer better and more innovative pricing. Without such competitive pressure, customers remain vulnerable to above-market prices. Vice Chair Cawley highlighted that U.S. Steel seeks long-term, fixed price contracts from Duquesne Light and "not from an EGS, because an EGS is permitted to charge above market prices."[20] In a truly competitive retail market, customers would not be consigned to receiving service under "above market" contracts.

To this end, the Commission should permit EDCs to offer long-term fixed price electrical supply contracts to industrial customers as a form of default service.[21] The Competition Act specifically recognizes EDCs' ability to develop and implement retail rates that will specifically

[20] Tr. 66, ll. 18-22 (Question from Vice Chair Cawley).
[21] Tr. 41,ll. 14-17.

address customers' needs. Under Section 2806(h), the Commission has the authority to "approve flexible pricing and flexible rates, including negotiated, contract-based tariffs designed to meet the specific needs of a utility customer and to address competitive alternatives." 66 Pa. C.S. § 2806(h). In other words, EDCs may propose a retail rate design that best serves the needs of its customers, including flexible pricing and flexible rates as long as the underlying electricity serving these customers is procured at prevailing market prices.

D. No Confusion Must Exist Regarding the Cost-of-Service Basis and Justness and Reasonableness of Industrial Rates Prior to Pennsylvania's Electric Restructuring.

To ensure a complete record in this proceeding, Industrial Customers must respond to an exchange during the *en banc* hearing regarding industrial rates during cost-of-service regulation. A question from the bench suggested that Duquesne Light Company, and by implication other utilities, offered *subsidized* rates of "two or three cents" to industrial customers under cost-of-service regulation.[22] To be clear, all rates charged by utilities during cost-of-service regulation, including industrial rates, were developed based on cost-of-service principles and approved as "just and reasonable" by this Commission. The fact that industrial rates were lower than residential and small commercial rates during cost-of-service regulation was fully justifiable on the basis that the utilities' cost to serve these customers was less than the cost of serving other customers.

Suggestions that industrial customers look to return to a regime in which they received subsidized rates ignores that such rates were *not* subsidized but tied directly to the utilities' cost to serve these customers. No such "cost-of-service" link exists in the current regime driven by LMP. The end result is that, at least in Duquesne's service territory, industrial customers on

[22] Tr.106, ll. 2-3.

Rates L and HVPS are confronted with POLR rates of 9.74¢ and 8.49¢ per kWh, respectively, which is a 108.4% and 121.6% increase, respectively, when comparing Duquesne's POLR II and current POLR III rates. No incentive exists for competitive suppliers to significantly discount these "market-based" POLR rates to provide customers with a meaningful competitive alternative. When compared to the Commission-approved just and reasonable prices charged by Duquesne Light Company under cost-of-service regulation, this level of increase can only be described as "unjust and unreasonable."

Simply put, neither Pike's nor Duquesne's POLR rates can be viewed as showing that the transition to greater competition in the electricity generation market is progressing in a way that benefits all classes of customers and protects this Commonwealth's ability to compete in the national and international marketplace for industry and jobs. In response to Vice Chair Cawley's question to Duquesne, this is why the very large customers in Duquesne and elsewhere are complaining. Their investment in Pennsylvania is at serious risk if forced to sustain electricity rates at this inflated level. As EEI noted, electricity is the lifeblood of the U.S. economy.[23] If electricity prices in Pennsylvania are not competitive with other areas of the country or other areas of the world, there is a direct impact on Pennsylvania's economy. The legitimate and valid complaints of large industrial customers, who have already paid hundreds of millions of dollars in stranded costs with the promise of competition bringing direct consumer benefits, should be a call to action for this Commission, consistent with the recommendations set forth in DEP's Comments and Industrial Customers' Comments. With the cost of electricity being an "important factor in decisions made by businesses concerning locating, expanding and retaining

[23] EEI Comments, at 2.

facilities in this Commonwealth," the Commission must ensure that its policies do not result in increased costs to the customers that the Competition Act seeks to help.

III. CONCLUSION

Industrial Customers appreciate the Commission's consideration of its Comments, Reply Comments and testimony during the *en banc* hearing and look forward to the next steps in this critical investigation. Industrial Customers advocating for competitive markets for electricity were driven by a desire to obtain direct access to lower prices, better service, contracting flexibility, and the belief that it might be possible to enable the forces of effective competition to better serve the public interest. The construct that has evolved and upon which wholesale and retail prices are determined, however, contains none of the indicia of competitive markets – low/no barriers to market entry and exit, demand elasticity, ease of product deliverability, transparent market information, innovation of products and services, short- and long-term service arrangements and unconcentrated generation asset ownership.

Pursuant to the Public Utility Code and the Competition Act, the Commission has the obligation to ensure that resulting rates are just and reasonable. Given the interplay between the wholesale and retail markets, little assurance exists that Pennsylvania's retail market is producing "just and reasonable" rates as envisioned by the framers of the Competition Act for the reasons set forth in Industrial Customers' Comments and herein. Accordingly, Industrial Customers respectfully request that the Commission endorse DEP's, OCA's and Industrial Customers' call for the development of a comprehensive set of solutions to avoid higher prices, not just mitigate them. Such a process must continue with all deliberate speed, given that solutions will require time to implement and the dates of rate cap expiration are fast approaching.

Respectfully submitted,

By Susan E. Bruce
David M. Kleppinger (I.D. No. #32091)
Susan E. Bruce (I.D. #80146)
McNEES WALLACE & NURICK LLC
100 Pine Street
P. O. Box 1166
Harrisburg, PA 17108-1166
Ph. (717) 232-8000
Fax (717) 237-5300
dkleppinger@mwn.com
sbruce@mwn.com

Counsel to Industrial Energy Consumers of Pennsylvania, PJM Industrial Customer Coalition, Duquesne Industrial Intervenors, Met-Ed Industrial Users Group, Penelec Industrial Customer Alliance, Penn Power Users Group, Philadelphia Area Industrial Energy Users Group, PP&L Industrial Customer Alliance, and West Penn Power Industrial Intervenors

Dated: July 20, 2006

CERTIFICATE OF SERVICE

I hereby certify that I am this day serving a true copy of the foregoing document upon the participants listed below in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).

VIA FIRST-CLASS MAIL

Eric Thumma
Department of Environmental Protection
400 Market Street
P. O. Box 2063
Harrisburg, PA 17105-2063

John R. Shaddock, President & CEO
Shared Services Consortium, LLC
6 Kacey Court, Suite 204
Mechanicsburg, PA 17055

Robert McCullough
McCullough Research
3816 S.E. Woodstock
Portland, OR 97202

David Magnus Boonin
1210 Pine Street
Philadelphia, PA 19107

Douglas L. Biden
Electric Power Generation Association
800 North Third Street, Suite 303
Harrisburg, PA 17102

Kevin J. Moody, Esq.
Wolf Block Schorr & Solis-Cohen LLP
213 Market Street, 9th Floor
Harrisburg, PA 17108-0865

Jay L. Kooper
Hess Corporation
One Hess Plaza
Woodbridge, NJ 07095

Stacey Rantala
National Energy Marketers Association
3333 K Street, N.W., Suite 110
Washington, DC 20007

Ariel C. Lager, Esq.
Customized Energy Solutions, Ltd.
100 N. 17th Street, 14th Floor
Philadelphia, PA 19103

William R. Lloyd, Jr., Esq.
Office of Small Business Advocate
Suite 1102 Commerce Building
300 North Second Street
Harrisburg, PA 17101

Irwin A. Popowsky, Esq.
Office of Consumer Advocate
Forum Place, 5th Floor
555 Walnut Street
Harrisburg, PA 17101-1923

J. Michael Love, President & CEO
Energy Association of Pennsylvania
800 North Third Street, Suite 301
Harrisburg, PA 17102

Mark Baird, Director
Midwest Regulatory Affairs
Reliant Energy, Inc.
7642 W. 450 N
Sharpsville, IN 46068

Martha Duggan, VP Business Development
Constellation New Energy
111 Market Place, 7th Floor
Baltimore, MD 21202

Timothy W. Merrill, General Manager
NRG Energy Center PBG LLC
111 South Commons Avenue
Pittsburgh, PA 15212

William Patterer
PECO Energy Company
2301 Market Street, S15-2
Philadelphia, PA 19103

Paul Russell, Esq.
PPL Electric Utilities Corp.
Two North Ninth Street
Allentown, PA 18101

John Laudenslager
Duquesne Light Company
Mail Drop 15-3
411 Seventh Avenue
Pittsburgh, PA 15219

Ramona Cataldi, Esq.
Klett Rooney Lieberr Schorling
240 North Third Street, Suite 700
Harrisburg, PA 17101-1503

David Hughes
Citizen Power
2121 Murray Avenue
Pittsburgh, PA 15217-2105

Cynthia Menhorn
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

John L. Munsch, Esq.
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

Maureen Mulligan
33 Greening Life Lane
Shermansdale, PA 17090

Susan E. Bruce

Susan E. Bruce

Dated this 20th day of July, 2006, in Harrisburg, Pennsylvania.