**COMMONWEALTH OF PENNSYLVANIA**

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November 15, 2010

**HAND DELIVERED**

Rosemary Chiavetta, Secretary
Pa. Public Utility Commission
Commonwealth Keystone Building
P.O. Box 3265
Harrisburg, PA 17105-3265

**Re: Joint Application of West Penn Power Company d/b/a Allegheny Power, Trans-Allegheny Interstate Line Company and FirstEnergy Corp. for a Certificate of Public Convenience Under Section 1102(A)(3) of the Public Utility Code Approving a Change of Control of West Penn Power Company and Trans-Allegheny Interstate Line Company**
**Docket Nos. A-2010-2176520 and A-2010-2176732**

Dear Secretary Chiavetta:

Enclosed for filing are the original and ten (10) copies of the Reply Brief, on behalf of the Office of Small Business Advocate, in the above-docketed proceedings. As evidenced by the enclosed certificate of service, two copies have been served on all active parties in this case.

If you have any questions, please contact me.

Sincerely,

Lauren M. Lepkoski
Assistant Small Business Advocate
Attorney ID #94800



Enclosures

cc: Parties of Record
Robert D. Knecht
John Wilson

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

| | | |
|---|---|---|
| **Joint Application of West Penn Power Company d/b/a Allegheny Power, Trans-Allegheny Interstate Line Company and FirstEnergy Corp. for a Certificate of Public Convenience under Section 1102(A)(3) of the Public Utility Code Approving a Change of Control of West Penn Power Company and Trans-Allegheny Interstate Line Company** | : | **Docket Nos. A-2010-2176520<br>A-2010-2176732** |

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**REPLY BRIEF**
**ON BEHALF OF THE**
**OFFICE OF SMALL BUSINESS ADVOCATE**

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**Dated: November 15, 2010**

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## I. INTRODUCTION/PROCEDURAL HISTORY

On May 14, 2010, a Joint Application was filed by West Penn Power Company ("West Penn") d/b/a Allegheny Power, Trans-Allegheny Interstate Line Company ("TrAILCo"), and FirstEnergy Corporation ("FirstEnergy") (collectively, the "Joint Applicants"), seeking approval by the Pennsylvania Public Utility Commission ("Commission") of the merger of Allegheny Energy, Inc. ("Allegheny Energy") with FirstEnergy under Section 1102 of the Public Utility Code, 66 Pa. C.S. §1102, and Section 69.901 of the Commission's Rules of Practice and Procedure, 52 Pa. Code §69.901.[1] The Joint Application included extensive testimony by witnesses for the Joint Applicants.

West Penn is a Commission-certificated public utility and electric distribution company ("EDC") which currently operates as a subsidiary of Allegheny Energy and provides service to all classes of customers in western Pennsylvania. Allegheny Energy is a public utility holding company based in Greensburg, Pennsylvania.[2]

TrAILCo is a corporation organized and existing under the laws of the state of Maryland and the Commonwealth of Virginia that is engaged in the business of transmitting electricity in interstate commerce.[3] TrAILCo is an indirect public utility subsidiary of Allegheny Energy and is certificated by the Commission.[4]

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[1] Joint Application at 1, ¶ 1.

[2] Joint Application at 2-3, ¶¶ 5 and 8. Allegheny Energy has three public utility subsidiaries that conduct business as Allegheny Power: West Penn, in Pennsylvania; Monongahela Power Company in West Virginia; and Potomac Edison Company in Maryland, West Virginia, and Virginia.

[3] Joint Application at 2, ¶ 6.

[4] Joint Application at 2-3, ¶¶ 6 and 8.

FirstEnergy is a corporation organized and existing under the laws of the state of Ohio and is a Commission-certificated energy services holding company headquartered in Akron, Ohio.[5] FirstEnergy owns, directly or indirectly, all of the outstanding common stock in the following Pennsylvania EDCs: Metropolitan Edison Company ("Met-Ed"), Pennsylvania Electric Company ("Penelec"), and Pennsylvania Power Company ("Penn Power"). FirstEnergy owns the following additional EDC subsidiaries: the Waverly Electric Light and Power Company (New York), the Ohio Edison Company (Ohio), the Cleveland Electric Illuminating Company (Ohio), the Toledo Edison Company (Ohio), and the Jersey Central Power and Light Company (New Jersey).[6]

Merger Sub is a Maryland Corporation and wholly-owned subsidiary of FirstEnergy formed for the sole purpose of effecting the merger.[7]

Allegheny Energy will merge with Merger Sub. As the surviving corporation, Allegheny Energy will become a wholly-owned subsidiary of FirstEnergy.[8] Each Allegheny Energy shareholder will receive 0.667 shares of FirstEnergy common stock for each share of Allegheny Energy common stock held.[9] Upon completion of the merger, existing shareholders of FirstEnergy will own approximately 73% of the combined company while former Allegheny Energy shareholders will own

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[5] *Joint Application* at 2, ¶ 7.

[6] Joint Application at 2-3, ¶ 7.

[7] Joint Application at 4, ¶ 9.

[8] Joint Application at 4, ¶ 10.

[9] *Id.*

approximately 27% of the combined company.[10] FirstEnergy will remain the corporate parent of Met-Ed, Penelec, and Penn Power (and its out-of-state subsidiaries) and will become the corporate parent of Allegheny Energy and its subsidiaries, including West Penn and TrAILCo.[11]

On May 24, 2010, Administrative Law Judges ("ALJs") Wayne L. Weismandel and Mary D. Long, assigned as the presiding officers in the proceeding, issued an order scheduling a Prehearing Conference for June 22, 1010.

On June 3, 2010, the Commission issued a Secretarial Letter to all parties identifying twelve issues and areas of concern that the Commission wished the parties to address.

On June 14, 2010, the Office of Small Business Advocate ("OSBA") filed a Notice of Intervention and Protest with respect to the Joint Application. The OSBA filed and served its Prehearing Memorandum on June 15, 2010.

Other active parties are the Commission's Office of Trial Staff ("OTS"); the Office of Consumer Advocate ("OCA"); the Pennsylvania Department of Environmental Protection ("DEP"); the International Brotherhood of Electrical Workers ("IBEW"); the Utility Workers Union of America ("UWUA") and UWUA Local 102 ("Local 102") (collectively, "UWUA Intervenors"); the Pennsylvania State University ("PSU"); the Met-Ed Industrial Users Group ("MEIUG") and the Penelec Industrial Customer Alliance ("PICA") (collectively, "MEIUG/PICA"); the West Penn Power Industrial Intervenors ("WPPII"); the Pennsylvania Rural Electric Association ("PREA"); the Pennsylvania

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[10] *Id.*

[11] Joint Application at 4, ¶ 11.

Mountains Healthcare Alliance ("PMHA"); the West Penn Power Sustainable Energy Fund ("WPPSEF"); the York County Solid Waste and Refuse Authority ("YCSWRA"); ARIPPA; the Clean Air Council ("CAC"); Citizens for Pennsylvania's Future ("PennFuture"); Constellation New Energy, Inc. and Constellation Energy Commodities Group, Inc. ("collectively, "Constellation"); Direct Energy Services LLC ("Direct"); the Retail Energy Supply Association ("RESA"); and Citizen Power, Inc. ("Citizen Power").

The Prehearing Conference took place on June 22, 2010, at which a litigation schedule was established.

On July 15, 2010, the Joint Applicants submitted Supplemental Direct Testimony.

The OSBA submitted OSBA Statement No. 1, the Direct Testimony of its witness Dr. John Wilson, on August 17, 2010. OSBA Statement No. 2, the Rebuttal Testimony of Dr. Wilson, and OSBA Statement No. 3, the Rebuttal Testimony of additional OSBA witness Robert D. Knecht, were submitted on September 13, 2010. OSBA Statement No. 4, the Surrebuttal Testimony of Dr. Wilson, was submitted on October 1, 2010.

Evidentiary hearings were held on October 12-15, 2010.

During the course of this proceeding, the parties engaged in numerous settlement discussions, which resulted in a non-unanimous settlement. A Joint Petition for Partial Settlement ("Settlement") was filed with the Commission on October 25, 2010. The Settlement requests approval of the merger with only those modifications spelled out in the Settlement. The OSBA is not a signatory to the Settlement.

On November 3, 2010, the Joint Applicants, the OSBA, the OCA, Citizen Power, RESA, and Direct Energy filed Main Briefs. The Energy Association of

Pennsylvania ("EAP") filed an *amicus curiae* brief. The OSBA files this Reply Brief in response to some of the arguments presented by other parties.

## II. SUMMARY OF ARGUMENT

The Joint Applicants devoted a substantial portion of their Main Brief to explaining why the Commission should reject Direct Energy's proposal to auction non-shopping customers to electric generation suppliers ("EGSs") on an opt-out basis and to set default service rates solely on the basis of the spot market. The OSBA agrees with many of the Joint Applicants' arguments. Unfortunately, however, the Joint Applicants ignored the fact that most of the arguments that they made against Direct Energy's proposal are also arguments against FirstEnergy's municipal aggregation strategy. In effect, both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal are the opposite sides of the same coin. Both will take away consumers' choice, are unlawful under Act 129 of 2008, will provide illusory incentives, and will destroy default service (as the legislature and the Commission have designed it).

Although the Settlement will produce some affirmative benefits, those benefits will be far outweighed by the harm FirstEnergy's municipal aggregation strategy will do to default service customers. Therefore, consistent with the "net benefits" test articulated by the Supreme Court in *Popowsky v. Pennsylvania Public Utility Commission*, 594 Pa. 583, 610-611, 937 A.2d 1040, 1056-1057 (Pa. 2007), the Commission must reject the proposed transfer of control of Allegheny Energy to FirstEnergy, unless the Commission imposes the following additional conditions:

> a. First Energy Corporation and its affiliates shall not engage in municipal aggregation in the Met-Ed, Penelec, Penn Power, and West Penn service territories prior to the enactment and implementation of authorizing legislation or June 1, 2013, whichever is later; and

b. FirstEnergy shall administratively locate the generating assets of FirstEnergy Corporation and Allegheny Energy, Inc., in separate subsidiaries that shall not coordinate regarding whether to bid in a particular default service procurement and regarding what price to bid.

Furthermore, because Direct Energy's proposal will not take effect until the default service period beginning June 1, 2013, it will not solve the competitive problems Direct Energy claims will result from the merger. Therefore, the Commission should reject the proposal and allow Direct Energy to raise it in the default service proceedings of Met-Ed, Penelec, Penn Power, and West Penn for the period beginning June 1, 2013.

Similarly, because RESA's proposals to change the default service design will not take effect until the default service period beginning June 1, 2013, they will not solve the competitive problems RESA claims will result from the merger. Therefore, the Commission should reject the proposals and allow RESA to raise them in the default service proceedings of Met-Ed, Penelec, Penn Power, and West Penn for the period beginning June 1, 2013.

## III. ARGUMENT

### A. Response to the Joint Applicants

#### 1. Summary

As explained in the OSBA's Main Brief, the OSBA is opposed to the merger principally because of the negative effect it will have on default service. Similarly, the OSBA is opposed to the Settlement because the Settlement would allow FirstEnergy's affiliate, First Energy Solutions ("FES"), to use Allegheny Energy's low-cost generation assets to capture a greater share of the retail market through municipal aggregation. Therefore, the OSBA's Main Brief proposed conditions aimed at avoiding (or at least mitigating) the impact of municipal aggregation on default service and did not pursue some of the other conditions proposed in testimony by OSBA witness Dr. John Wilson.

In their Main Brief, the Joint Applicants responded to all of the conditions proposed in Dr. Wilson's testimony. Inexplicably, the Joint Applicants complained about a lack of detail in some of Dr. Wilson's proposals (as laid out in his direct testimony); but they then ignored his rebuttal testimony, surrebuttal testimony, and cross-examination in which he provided further details.

The Joint Applicants' allegation about a lack of clarity in Dr. Wilson's proposed conditions is especially striking with regard to the separation of the generating assets of FirstEnergy and Allegheny Energy. If the Joint Applicants' complaint was a prelude to an argument in their Reply Brief that they were denied due process, that effort is disingenuous. Dr. Wilson proposed a condition requiring the separation of the generating assets in his direct testimony. If the Joint Applicants actually were confused, they had the opportunity to conduct discovery, raise that confusion in their own rebuttal testimony, or seek clarification during their cross-examination of Dr. Wilson.

Despite the tone of some of the Joint Applicants' comments, the OSBA is satisfied with how the Settlement addresses many of the conditions proposed by Dr. Wilson. Nevertheless, to eliminate any doubt about what the OSBA is actually seeking from the Commission, the following will summarize *all* of the conditions proposed by Dr. Wilson and will respond to the Joint Applicants' Main Brief regarding each of those conditions.

### 2. Retail Competition

#### a. FES and AES as Retail Competitors

As represented by the Joint Applicants, Dr. Wilson expressed concern about the planned elimination of Allegheny Energy's affiliate, Allegheny Energy Supply ("AES"), as a retail competitor of FES.[12] To address that problem, Dr. Wilson testified that "the Commission should at least impose a merger condition that would require FES and AES to be separate subsidiaries of FirstEnergy and that would prohibit the two EGSs from implementing a *de facto* plan not to compete."[13] According to the Joint Applicants, "Dr. Wilson [is] seeing a problem where none exists" and "his proposed remedy is likely to impair competition rather than enhance it."[14]

The Joint Applicants' analysis is unconvincing. However, after reviewing the testimony of all parties, the OSBA decided not to pursue Dr. Wilson's proposal to require

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[12] *See* Joint Applicants Main Brief at 60-61 and OSBA Statement No. 1 at 16.

[13] OSBA Statement No. 1 at 19.

[14] Joint Applicants Main Brief at 61.

FirstEnergy to maintain both FES and AES as retail competitors.[15] Therefore, there is no question for the Commission to decide regarding this matter.

**b. Limitations on Municipal Aggregation**

As represented by the Joint Applicants, Dr. Wilson expressed concern about the impact of municipal aggregation on retail competition.[16] To mitigate that problem, Dr. Wilson proposed, as a condition, that "any such aggregation program should be required to purchase electricity through competitive bidding." Dr. Wilson also proposed, as a condition, that "customers should not be placed into such a municipal aggregation program unless they affirmatively opt into the program."[17] According to the Joint Applicants, the conditions proposed by Dr. Wilson regarding municipal aggregation are not relevant to this merger and should be rejected.[18] The OSBA emphatically disagrees.

The Joint Applicants failed to recognize that FirstEnergy's municipal aggregation strategy will necessarily be detrimental to competition for default service supplies and that the proposed merger wil enhance FirstEnergy's ability to engage in such municipal aggregation. Therefore, in its Main Brief, the OSBA proposed specific conditions on municipal aggregation which are based on Dr. Wilson's testimony and the testimony of witnesses for several other parties.[19] Because of the importance of municipal

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[15] As part of its proposed conditions on municipal aggregation, the OSBA *has* asked that the generation assets of FirstEnergy and Allegheny Energy be located in separate subsidiaries. *See* OSBA Main Brief at 33.

[16] *See* Joint Applicants Main Brief at 61-65; OSBA Statement No. 1 at 17-20; and Hearing Transcript at 559-563.

[17] OSBA Statement No. 1 at 19-20.

[18] Joint Applicants Main Brief at 61-65.

[19] *See* OSBA Main Brief at 16-43.

aggregation, the OSBA's specific response to the Joint Applicants on that subject is set forth in a later, separate section of this Reply Brief.

### 3. Wholesale Competition

As represented by the Joint Applicants, Dr. Wilson testified that "the Commission should require the generation assets of Allegheny and FirstEnergy to be under the control of separate subsidiaries."[20] According to the Joint Applicants, "Dr. Wilson did not explain what 'under the control' means in this context or how such a condition, if adopted, would be converted into a set of coherent operational rules that would put participants on notice of what might—or might not—be impermissible conduct."[21]

In its Main Brief, the OSBA incorporated the specific conditions proposed by Dr. Wilson into its proposed conditions related to municipal aggregation.[22] The OSBA's specific response to the Joint Applicants on municipal aggregation is set forth in a later, separate section of this Reply Brief.

Dr. Wilson also testified that "the Commission should impose conditions aimed at avoiding, detecting, and correcting any anticompetitive conduct that could adversely affect retail default service rates."[23] The Joint Applicants complained about the lack of details regarding any condition aimed at avoiding, detecting, and correcting any anticompetitive conduct and questioned the Commission's authority to impose such conditions.[24]

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[20] *See* Joint Applicants Main Brief at 65 and OSBA Statement No. 1 at 21-22.

[21] Joint Applicants Main Brief at 65.

[22] *See* OSBA Main Brief at16, 33, and 37.

[23] *See* Joint Applicants Main Brief at 65 and OSBA Statement No. 1 at 21-22.

[24] Joint Applicants Main Brief at 65.

Despite the Joint Applicants' criticism of Dr. Wilson, the Settlement requires Met-Ed, Penelec, Penn Power, and West Penn to provide detailed information to the OTS, OCA, and OSBA regarding the default service procurement process and results and regarding wholesale market prices and price trends.[25] These requirements provide the type of information sought by Dr. Wilson to help avoid, detect, and correct anticompetitive conduct. Therefore, except for the OSBA's conditions specifically addressed to municipal aggregation, there is nothing for the Commission to adjudicate regarding Dr. Wilson's proposed conditions relating to wholesale competition.

### 4. 'Harmonizing" Default Service Supply Procurement

As represented by the Joint Applicants, Dr. Wilson proposed a condition providing that "harmonization [of the procurement programs of West Penn with those of Met-Ed, Penelec, and Penn Power] should occur no earlier than with the respective EDC procurement plans for the default service period beginning June 1, 2013."[26] As the Joint Applicants recognized, the Settlement includes Dr. Wilson's proposed condition.[27] Therefore, there is no dispute between the Joint Applicants and the OSBA on this issue.

### 5. Merger Synergies/EE&C Plan Costs

According to the Joint Applicants, "the Merger could allow West Penn to avoid up to $100 million in costs by integrating West Penn into the FirstEnergy Pennsylvania Utilities' customer information system." The Joint Applicants claim that this integration

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[25] Settlement at ¶¶53 and 54.

[26] *See* Joint Applicants Main Brief at 65-66 and OSBA Statement No. 1 at 22-23.

[27] Joint Applicants Main Brief at 66. *See* Settlement at ¶32.

could save ratepayers about $15-$20 million per year in costs related to West Penn's Smart Meter implementation Plan ("SMIP").[28]

Dr. Wilson pointed out that, to achieve these potential savings, West Penn has reduced its reliance on smart meters to achieve the reduction in consumption and peak demand required by Section 2806.1 of the Public Utility Code, 66 Pa. C.S. §2806.1. As a result, West Penn has proposed to amend its Energy Efficiency and Conservation ("EE&C") Plan to add and expand conservation programs for small commercial and industrial ("Small C&I") customers. The result will be about $6 million in increased conservation costs imposed on Small C&I customers.[29] Dr. Wilson testified that, as a merger condition, "West Penn should be required to absorb any increase in SMIP or EE&C costs that might otherwise be imposed on Small C&I customers because of the delay in smart meter deployment." As Dr. Wilson explained, "such a condition would force West Penn to finance these incremental costs out of the anticipated [merger] savings."[30]

According to the Joint Applicants, the increased costs identified by Dr. Wilson would pale in comparison to the anticipated savings to be enjoyed by all customers.[31] However, the Joint Applicants offered no justification for requiring Small C&I customers to "pay" $6 million in order to obtain these savings while residential customers would obtain the savings and also enjoy reduced EE&C costs because of the cost shift to Small C&I customers.

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[28] Joint Applicants Main Brief at 66.

[29] OSBA Statement No. 1 at and OSBA Statement No. 4 at 5.

[30] OSBA Statement No. 1 at 25.

[31] Joint Applicants Main Brief at 67.

Despite the Joint Applicants' argument, the Settlement provides for a $6.19 credit equal to the increased EE&C costs imposed on West Penn Rate Schedules 20, 22, 30 Small, and 30 Large and on Rate 37.[32] Therefore, there is no dispute between the OSBA and the Joint Applicants regarding this condition.

### 6. Detailed Reporting on Executive Compensation

As represented by the Joint Applicants, Dr. Wilson recommended a condition by which "the merged company [would be required] to file detailed reports of executive compensation" and by which "further excessive personal enrichment through executive merger bonuses or awards [would be discouraged] so that any actual merger gain may be directed to the benefit of utility ratepayers."[33] Dr. Wilson based his recommendation, in part, on his observation that "[i]t is sometimes the case that corporate management seeks to use financial gains from mergers and acquisitions to enrich management itself."[34]

According to the Joint Applicants, executive compensation is an issue of state jurisdiction only when the Commission is adjudicating a claim for recovery of such compensation in a rate proceeding. Furthermore, the Joint Applicants argued that the reporting requirements proposed by Dr. Wilson are unnecessary because federal statutes and regulations already provide for transparency regarding executive compensation.[35]

The OSBA disagrees with the Joint Applicants' argument that the use of merger savings to enhance executive compensation is irrelevant to a determination of whether the merger would provide affirmative public benefits on a net basis. However, unlike the

[32] Settlement at ¶18.

[33] *See* Joint Applicants Main Brief at 67-68 and OSBA Statement No. 1 at 27.

[34] OSBA Statement No. 1 at 25.

[35] Joint Applicants Main Brief at 67-68.

Joint Application, the Settlement makes at least some explicit commitments to share the merger savings with ratepayers.[36] Therefore, the OSBA's Main Brief did not request a condition requiring reports about executive compensation. As a result, there is no issue between the OSBA and the Joint Applicants for the Commission to adjudicate in this proceeding.

### 7. Additional Financial Governance Matters

As represented by the Joint Applicants, Dr. Wilson proposed various conditions regarding financial governance, *i.e.*, ring-fencing.[37] According to the Joint Applicants, the conditions proposed by Dr. Wilson are unnecessary.[38] The Joint Applicants' arguments are unconvincing. Moreover, despite the Joint Applicants' litigation position, the Settlement includes most of the conditions proposed by Dr. Wilson, albeit in somewhat different form than he proposed.[39] Because the conditions included in the Settlement generally satisfy the OSBA's concerns, the OSBA's Main Brief did not propose any ring-fencing conditions. Therefore, there is no issue between the OSBA and the Joint Applicants on the issue of ring-fencing for the Commission to adjudicate.

### 8. Customer Service and Reliability

As represented by the Joint Applicants, Dr. Wilson proposed a merger condition requiring the Joint Applicants "to implement those practices [of Met-Ed, Penelec, Penn Power, and West Penn] that are most likely to improve reliability at all of their

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[36] *See, e.g.*, Settlement at ¶¶16,17,18, and 19.

[37] *See* Joint Applicants Main Brief at 68; OSBA Statement No. 1 at 27-33; OSBA Statement No. 2 at 3-7; OSBA Statement No. 4 at 7-9; and Hearing Transcript at 571-582.

[38] Joint Applicants Main Brief at 68-69.

[39] Settlement at ¶¶35, 36, and 37.

Pennsylvania affiliates." As explained by Dr. Wilson, this condition was intended to require the Joint Applicants to fulfill their claim that the merger would improve reliability.[40]

The Settlement includes several concrete commitments that the Joint Applicants represent will improve reliability.[41] Because the conditions included in the Settlement generally satisfy the OSBA's concerns, the OSBA's Main Brief did not propose any further conditions regarding reliability. Therefore, there is no issue between the OSBA and the Joint Applicants on the issue of reliability for the Commission to adjudicate.

### 9. Blending Distribution Rates

As represented by the Joint Applicants, Dr. Wilson proposed a condition "requiring that any consolidation of the distribution rates of the four EDCs [Met-Ed, Penelec, Penn Power, and West Penn] occur only after the issuance of a certificate of public convenience under Section 1102 to merge the individual EDCs into a single EDC."[42] The Settlement includes Dr. Wilson's proposed condition.[43]

Because the condition included in the Settlement generally satisfies the OSBA's concerns, the OSBA's Main Brief did not propose any further conditions regarding the blending of the four EDCs' distribution rates. Therefore, there is no issue between the OSBA and the Joint Applicants regarding the blending of distribution rates for the Commission to adjudicate.

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[40] *See* Joint Applicants Main Brief at 69 and OSBA Statement No. 1 at 33-34.

[41] *See* Joint Applicants Main Brief at 69-70 and Settlement at 21-27 ¶¶49, 50, 51and 52.

[42] *See* Joint Applicants Main Brief at 70 and OSBA Statement No. 1 at 34-35.

[43] *See* Joint Applicants Main Brief at 70 and Settlement at ¶30.

### B. Response to RESA

RESA witness Mr. Richard Hudson recommended that default service procurement for Met-Ed, Penelec, Penn Power, and West Penn be modified in numerous ways, *e.g.*, to require each EDC to purchase a larger share of default service electricity on the spot market, to shorten the length of any full-requirements contracts, to subject more customers to hourly pricing, and to reduce the amount of default service load that can be served by any one wholesale bidder.[44]

As summarized in the OSBA's Main Brief, RESA's proposals to redesign default service procurement are not relevant to this proceeding, in that they propose to change only *future* default service procurements. Furthermore, the Commission has previously rejected similar proposals by RESA. Therefore, the OSBA recommended that the Commision reject RESA's proposals in this proceeding but allow RESA to pursue those proposals in each EDC's next default service proceeding.[45]

In its Main Brief, RESA repeated the arguments set forth in Mr. Hudson's testimony. These arguments were already addressed in the OSBA's Main Brief. Therefore, there is no need for the OSBA to respond to RESA's Main Brief regarding those issues.

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[44] RESA Statement No. 1 at 21-22.

[45] *See* OSBA Main Brief at 63-66.

### C. Municipal Aggregation

#### 1. Proper Forum

##### a. Limited Scope of the Generic Proceeding

In their Main Brief, the Joint Applicants argued that the conditions recommended by OSBA witness Dr. Wilson regarding municipal aggregation are not relevant to the merger and should be pursued in a generic proceeding.[46]

On October 28, 2010, RESA sought to initiate such a generic proceeding by filing its *Petition of the Retail Energy Supply Association for Investigation and Issuance of Declaratory Order Regarding the Propriety of the Implementation of Municipal Electric Aggregation Programs Absent Statutory Authority*, at Docket No. P-2010-2207062. On October 29, 2010, Dominion Retail, Inc., joined in the effort to initiate a generic proceeding by filing its *Petition of Dominion Retail, Inc. for Order Declaring that Opt-out Municipal Aggregation Programs are Illegal for Home Rule and Other Municipalities in the Absence of Legislation Authorizing Such Programs*, at Docket No. P-2010-2207953. FirstEnergy joined the effort to initiate a generic proceeding on November 9, 2010, when its affiliate, FirstEnergy Solutions Corporation ("FES"), filed its *Petition of FirstEnergy Solutions Corp. for Approval to Participate in Opt-Out Municipal Energy Aggregation Programs of the Optional Third Class Charter City of Meadville, the Home Rule Borough of Edinboro, the Home Rule City of Warren and the Home Rule City of Farrell*, at Docket No. P-2010-2209253.

By Secretarial Letter issued on November 10, 2010, the Commission consolidated the three aforementioned petitions and set a deadline for interested parties to file answers.

[46] Joint Applicants Main Brief at 62, fn 31.

The Commission directs each EDC not to switch any customer to an EGS pursuant to an "opt-out" municipal aggregation contract and each EGS not to switch any customer from default service (or the customer's existing EGS) pursuant to an "opt-out" municipal aggregation contract until these legal issues are addressed and resolved by the Commission.

The OSBA welcomes the Commission's Secretarial Letter. However, the Commission's determination in the consolidated proceeding will not render the OSBA's proposed conditions moot because the scope of that proceeding will not include all of the elements of the OSBA's proposed conditions.

The narrow issue in the consolidated proceeding is whether FES, or any other EGS, is permitted to enter into opt-out municipal aggregation contracts with home rule municipalities without legislation. Regardless of the outcome of that consolidated proceeding, it will be necessary for the Commission to decide in this merger proceeding whether the following conditions should be imposed on the merger:

a. FirstEnergy and its affiliates shall not engage in municipal aggregation in the Met-Ed, Penelec, Penn Power, and West Penn service territories prior to the enactment and implementation of authorizing legislation or June 1, 2013, ***whichever is later***; and

b. First Energy shall administratively locate the generating assets of FirstEnergy and Allegheny Energy in separate subsidiaries that shall not coordinate whether to bid in a particular default service procurement and regarding what price to bid.[47]

[47] OSBA Main Brief at 67.

### b. Expiration of Rate Caps

The first default service periods for Met-Ed, Penelec, and West Penn following the expiration of rate caps will not expire until May 31, 2013. Although Penn Power's rate caps have already expired, the Commission recently approved an additional default service period from June 1, 2011, through May 31, 2013.[48] A principal goal of the OSBA's proposed conditions is to prevent municipal aggregation from inflating default service rates for Met-Ed, Penelec, and West Penn customers immediately following the expiration of rate caps. Because of the proceeding's limited scope, the Commission's decision in the consolidated proceeding will not prevent that rate inflation.

If the Commission decides in the consolidated proceeding that municipal aggregation is lawful in at least some municipalities without the need for additional legislation, the harm the OSBA seeks to avoid during the period immediately following the expiration of rate caps will occur. Furthermore, even if the Commission decides that municipal aggregation is not lawful in any municipality without the enactment of legislation, the General Assembly could enact such legislation well before June 1, 2013. Therefore, under either scenario, the harm the OSBA seeks to avoid during the period immediately following the expiration of rate caps will occur.

As the OSBA explained in its Main Brief, OSBA witness Dr. Wilson and Constellation witness Mr. David Fein both testified regarding the negative impact of municipal aggregation on default service rates.[49] As Mr. Fein explained, the Commission has generally approved the use of full-requirements contracts for default service supplies.

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[48] *See* OSBA Main Brief at 33.

[49] *See* OSBA Main Brief at 33-37.

Full-requirements suppliers absorb the risk that customers will switch into and out of default service. *Municipal aggregation substantially increases that risk.* As Mr. Fein testified, even the *prospect* of municipal aggregation will cause suppliers either to limit their participation or increase the risk premium in their bids in default service procurements.[50] To mitigate that risk premium, Mr. Fein recommended that municipalities be required to decide, prior to default service bidding, whether the municipalities will, or will not, be participating in aggregation during the default service period. Having that information prior to bidding would provide bidders with greater certainty of the default service load they would be bidding to serve.[51] The OSBA's proposed conditions would effectuate Mr. Fein's recommendation during the particularly sensitive period when customers will already face substantially higher prices because of the expiration of rate caps.

#### c. Competitive Procurement

Even if the Commission decides in the consolidated proceeding that municipal aggregation is already lawful in at least some municipalities, the Commission will not be deciding whether that aggregation must be carried out through competitive procurement. Therefore, the Commission will not be disposing of the OSBA's recommendation that municipal aggregation be acquired through competitive procurement.

OSBA witness Dr. Wilson testified that any municipality that wishes to participate in municipal aggregation must purchase electricity "through competitive

[50] Constellation Statement No. 1-SR at 10-11.

[51] *Id.*

bidding."[52] Rather than explicitly requiring competitive procurement of municipal aggregation in perpetuity within the Met-Ed, Penelec, Penn Power, and West Penn service territories, the conditions proposed in the OSBA's Main Brief would prohibit municipal aggregation in those service territories only until legislation is enacted. Therefore, the OSBA's conditions would defer to the General Assembly on the question of competitive procurement.

The future of municipal aggregation legislation is uncertain. However, during the soon-to-expire session, the House Consumer Affairs Committee and the House Appropriations Committee approved House Bill 2619. House Bill 2619 specified that "[a] municipal aggregator of electricity shall use a competitive procurement or request-for proposal process to select the electric generation supplier from the lowest responsible qualified bidder . . . ."[53]

#### d. Opt-Out Aggregation

OSBA witness Dr. Wilson testified that any municipality that engages in municipal aggregation should be required to assure that all of its resident participants "affirmatively opt into the program."[54] As with the issue of competitive procurement, the conditions proposed in the OSBA's Main Brief do not explicitly prohibit opt-out municipal aggregation within the Met-Ed, Penelec, Penn Power, and West Penn service territories. Instead, the OSBA's conditions would prohibit municipal aggregation in

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[52] OSBA Statement No. 1 at 19-20.

[53] House Bill 2619, Printer's Number 4406, page 11, lines 19-23. The legislation is available on-line at the General Assembly's web site: http://www.legis.state.pa.us

[54] OSBA Statement No. 1 at 19-20.

those service territories prior to the enactment of legislation. Therefore, the OSBA's conditions would defer to the General Assembly on the question of opt-out aggregation.

House Bill 2619 would have given a municipality the option to choose either an opt-out or an opt-in aggregation program.[55] The OSBA's conditions would not attempt to supersede an ultimate legislative decision to permit municipalities to choose between an opt-out or an opt-in program. Specifically, the OSBA's conditions would not attempt to prohibit opt-out aggregation within the Met-Ed, Penelec, Penn Power, and West Penn service territories if opt-out aggregation is permitted in non-FirstEnergy service territories. Instead, the OSBA seeks only to allow the General Assembly, rather than FirstEnergy and its affiliates, to make that decision.

**e. Separate Subsidiaries**

Regardless of what the Commission decides about whether aggregation is already lawful in some municipalities, the consolidated proceeding will not reach the question of whether the generating assets of FirstEnergy and Allegheny Energy should be maintained in separate subsidiaries. Therefore, the Commission will not have disposed of the OSBA's condition to require such separation.

The OSBA's proposal *would* impose restrictions on FirstEnergy not applicable to other utilities. The reason is simple. FirstEnergy, and not any other utility, is the entity that has a strategy to divert Allegheny Energy's low-cost generation from the wholesale and default service markets and use it to give FES an advantage in the retail market, including both direct sales and municipal aggregation.

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[55] House Bill 2619, Printer's Number 4406, page 11, lines 1-15. The legislation is available on-line at the General Assembly's web site: http://www.legis.state.pa.us

In their Main Brief, the Joint Applicants argued that OSBA witness Dr. Wilson's proposal to keep the generation assets of Allegheny Energy and FirstEnergy separate is unclear and should not be adopted because the record shows that the merger will not affect wholesale competition.[56] There is nothing unclear about Dr. Wilson's proposal that these assets be located in separate subsidiaries. In fact, the location of these generating assets in separate subsidiaries is exactly what the Joint Applicants initially proposed.[57]

Rather than arguing that Dr. Wilson's proposal is unclear, the Joint Applicants should have concentrated on clarifying their own intentions regarding those assets. Specifically, Joint Applicants witness Mr. William Hieronymus asserted that there is "no basis" for requiring separate generation subsidiaries.[58] Nevertheless, the Joint Applicants indicated that, at least initially, it was their intent to maintain the FirstEnergy and the Allegheny Energy generation assets in separate subsidiaries.[59] Furthermore, FirstEnergy CEO Mr. Anthony Alexander testified that FirstEnergy has made no decision as to where the generation will reside, under what subsidiary, and how the generation assets may be moved around. Mr. Alexander also testified that FirstEnergy will deal with those questions at a later date.[60]

The condition to keep the generating assets of FirstEnergy and Allegheny Energy separate is important because it would prevent the elimination of a competitor in default

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[56] Joint Applicants Main Brief at 65.

[57] Joint Application at Exhibit F-1.

[58] Joint Applicants Statement No. 4-R at 32.

[59] Joint Application at Exhibit F-1.

[60] Hearing Transcript at 282.

service procurements that the merger would otherwise cause. It is also important because opt-out municipal aggregation would destroy default service as the legislature and the Commission have designed it and would have a negative impact on retail competition.

As the record evidence shows, FirstEnergy's business strategy is to use Allegheny Energy's low-cost generation fleet to facilitate aggressive marketing at the retail level, which includes expanding municipal aggregation. Interestingly, the Joint Applicants' Main Brief did not address the testimony of Dr. Wilson and Constellation witness Mr. Fein regarding the threat opt-out municipal aggregation poses to default service rates. However, the Main Briefs of the OSBA and Direct Energy summarized that evidence in detail and explained the consequences of FirstEnergy's strategy.[61]

The OSBA's proposal to require the generation assets of FirstEnergy and Allegheny Energy to be located in separate subsidiaries and their output to be bid and sold separately is aimed at mitigating the harm that this merger will inflict on default service and retail competition. If municipal aggregation is permitted (either by the legislature or by the Commission's decision in the consolidated proceeding), the unique circumstances presented by FirstEnergy's business strategy make this merger proceeding the proper forum to determine ways to mitigate that harm.

### 2. Need for Statutory Authorization

With regard to the legality of municipal aggregation, the Joint Applicants' Main Brief divided municipalities into two categories: 1.) Non Home-Rule Municipalities and 2.) Home-Rule Municipalities.[62] The Joint Applicants conceded that legislation must be

[61] *See* OSBA Main Brief at 18-20 and Direct Energy Main Brief at 26-34 (confidential).

[62] Joint Applicants Main Brief at 62-63.

enacted before Non Home-Rule municipalities are permitted to participate in municipal aggregation. Therefore, the Joint Applicants indicated that FirstEnergy has no intention of entering into contracts with Non Home-Rule municipalities for aggregation until legislation is passed.[63] However, the Joint Applicants took the position that it is lawful to enter into opt-out aggregation contracts with Home-Rule municipalities even if legislation is not enacted.[64] FES has already acted on the Joint Applicants' view of the law by soliciting opt-out contracts for municipal aggregation, *e.g.*, with Meadville.[65]

As set forth in the OSBA's Main Brief, the Joint Applicants' legal position is erroneous. Contrary to the Joint Applicants' assertion, an EGS, *e.g.*, FES, needs legislative authorization before it may participate in opt-out municipal aggregation, regardless of whether the municipality is Non Home-Rule or Home-Rule.[66]

The Joint Applicants pointed to *City of Philadelphia v. Schweiker*, 579 Pa. 591, 605 (Pa. 2004) as authority for FirstEnergy to enter into opt-out contracts with home-rule municipalities.[67] However, that case does not support the Joint Applicants' position.

*Schweiker* was an appeal by the City of Philadelphia and its mayor from the Commonwealth Court's decision to dismiss their amended complaint challenging the legality of certain amendments to Pennsylvania's Parking Authority Law.[68] The City of Philadelphia's amended complaint included nine counts. However, the count pertinent to

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[63] *Id.*

[64] *Id.*

[65] Direct Energy Cross Examination Exhibit No. 5 and Hearing Transcript at 278.

[66] OSBA Main Brief at 38-43.

[67] Joint Applicants Main Brief at 61.

[68] *City of Philadelphia v. Schweiker*, 579 Pa. 591, 596-603 (Pa. 2004).

the question in this merger proceeding involved the Supreme Court's decision regarding the allegation that the amendments to Pennsylvania's Parking Authority Law were impermissible and that they unconstitutionally infringed upon Philadelphia's home rule charter and corresponding ordinances.[69] The Supreme Court summarized the decision of the Commonwealth Court on this point, as follows:

> . . . the Home Rule doctrine--which allows for autonomous self-governance relative to municipal affairs--does not apply with respect to the Parking Authority, because the Parking Authority is not an agency of a municipal government, but rather, is an agent of the Commonwealth. *See id.* at 1223 (citing *Herriman v. Carducci*, 475 Pa. 359, 380 A.2d 761 (1977)). In addition, the court stated that Article 9, Section 2 of the Constitution specially provides that the powers and authority under home rule charters are expressly limited by acts of the General Assembly. *See id.* (citing *Ortiz v. Commonwealth*, 655 A.2d 194 (Pa. Cmwlth. 1995), *aff'd* 545 Pa. 279, 681 A.2d 152 (1996)). As to the counts premised upon the alleged violation of the pledge previously given by the Legislature, the Commonwealth Court determined that such a legislatively conferred pledge does not create a contractual right, and that the General Assembly 'unquestionably has the authority to review the Authority's method of appointment.'[70]

The Supreme Court ruled that the Commonwealth Court had not erred in granting the demurrer as to this count of the amended complaint.[71]

Despite the Joint Applicants' representation, *Schweiker* does not support their position on the legal question at issue in this merger proceeding. In *Schweiker*, the

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[69] *Id.* at 600.

[70] *Id.* at 602.

[71] *Id.* at 612.

Supreme Court was determining whether the General Assembly could limit the City of Philadelphia's home rule powers. Of significance to this merger case, the Supreme Court concluded that the General Assembly *could* limit the City's powers as a home-rule municipality.[72] In this merger proceeding, the legal question is whether the Home Rule Charter and Optional Plans Law must yield to the specific language of the Public Utility Code.

### D. Mutual Threat to Default Service

#### 1. Summary

The Joint Applicants devoted a substantial portion of their Main Brief to explaining why the Commission should reject Direct Energy's proposal to auction non-shopping customers to EGSs on an opt-out basis and to set default service rates solely on the basis of the spot market. The OSBA agrees with many of the Joint Applicants' arguments. Unfortunately, however, the Joint Applicants ignored the fact that most of their arguments against Direct Energy's proposal are also arguments against FirstEnergy's municipal aggregation strategy. In effect, both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal are the opposite sides of the same coin. Both will take away consumers' choice, are unlawful under Act 129, offer alleged benefits to ratepayers which are illusory, and will destroy default service (as the legislature and the Commission have designed it).

[72] *Id.* at 602-612.

### 2. Customer Choice

As the EAP pointed out, the full name of the Competition Act is the "Electricity Generation Customer Choice and Competition Act."[73] The title of the Act places emphasis on "Customer Choice." In the instant proceeding, the Commission has been presented with two approaches to redefining default service and taking away "Customer Choice." First, the municipal aggregation strategy of FirstEnergy will automatically switch default service customers to FES unless those customers affirmatively opt-out. Second, Direct Energy's proposal will automatically auction off default service customers to EGSs unless those customers affirmatively opt-out of the auction. As the EAP observed, the point of "Customer Choice" is to provide customers with information and the opportunity to shop, not to force them to shop.[74] Both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal rely on opt-out mechanisms which will force customers to shop unless they take affirmative action not to shop.

### 3. Inconsistent with Act 129

By forcing customers to take affirmative action to choose default service, both FirstEnergy's municipal aggregation program and Direct Energy's proposal are inconsistent with Act 129. Specifically, Section 2803 of the Public Utility Code, 66 Pa. C.S. §2803, defines the Default Service Provider ("DSP") as follows:

> 'Default service provider.' An electric distribution company within its certified service territory or an alternative supplier approved by the commission that provides generation service to retail electric customers who:

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[73] EAP *Amicus Curiae* Brief at 4-5.

[74] *Id.* at 5.

> (1) contract for electric power, including energy and capacity, and the chosen electric generation supplier does not supply the service; or
>
> (2) ***do not choose an alternative electric generation supplier***. (emphasis added)

Section 2807(e)(3.1) of the Public Utility Code, 66 Pa. C.S. §2807(e)(3.1), states the obligations of a default service provider. In pertinent part, Section 2807(e)(3.1) provides as follows:

> Following the expiration of an electric distribution company's obligation to provide electric generation supply service to retail customers at capped rates, if a customer contracts for electric generation supply service and the chosen electric generation supplier does not provide the service or ***if a customer does not choose an alternative electric generation supplier***, the default service provider shall provide electric generation supply service to that customer pursuant to a commission-approved competitive procurement plan. (emphasis added)

The Joint Applicants' own witness, Mr. Michael M. Schnitzer, opined that his definition of default service is if a customer does nothing, the customer is on default service.[75] Specifically, Mr. Schnitzer testified as follows:

> Well, I mean, in the sense that they are on default service, but the point is that however they got there, by doing nothing, that's where they ended up. And that's my definition of default service, if you do nothing, what happens. [76]

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[75] Hearing Transcript at 938.

[76] Hearing Transcript at 938.

Under FirstEnergy's municipal aggregation strategy, FES will essentially take over the role of the default service provider. For example, FES Vice President Mr. Tony Banks explained to the House Consumer Affairs Committee, as follows:

> Municipal aggregation is not much different than the structure already in place today in Pennsylvania. Today, if customers take no action to shop for electric generation service, they automatically receive default service from their local electric utility. Similarly, under opt-out municipal aggregation, ***customers who take no action will automatically default to the generation supplier*** with whom their municipality has negotiated a price, presumably lower than the utility default service price.[77] (emphasis added)

Similarly, Direct Energy proposes that a customer who does not affirmatively choose to shop will be auctioned off to an EGS. Under Direct Energy's proposal, the only customers who would be eligible for default service would be those customers who affirmatively choose default service.[78] Therefore, just as under FirstEnergy's municipal aggregation strategy, the *de facto* default service provider under Direct Energy's proposal will be the EGS to which a customer is assigned in the auction.

As Sections 2803 and 2807(e)(3.1) recognize, customers who take no action are to receive default service, not service from an EGS. Therefore, both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal are unlawful under Act 129. Admittedly, there is one significant difference between the two. Specifically, the General Assembly is considering legislation which would authorize opt-out municipal aggregation, thereby overriding how Act 129 defined default service. However, that

[77]Direct Energy Cross-Examination Exhibit No. 9.

[78] Direct Energy Main Brief at 44.

legislation has not been enacted. Therefore, neither opt-out municipal aggregation nor Direct Energy's opt-out auction is lawful at the present time.

### 4. Destruction of Default Service

#### a. Summary

Municipal aggregation and Direct Energy's proposal are structured somewhat differently, but each will have the same effect, *i.e.*, the destruction of default service as designed by the General Assembly and the Commission. Direct Energy's proposal will revise the current default service model, thereby destroying default service instantly in the FirstEnergy service territory. In contrast, opt-out municipal aggregation will destroy default service over time in all of Pennsylvania, as political pressures force more and more municipalities to contract for aggregation.

#### b. Shopping

A premise underlying both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal is that a radical change in the current default service design is necessary in order to promote shopping.[79]

In that regard, Direct Energy argued in its Main Brief that "only a handful of customers are being served by an EGS in the West Penn Power, Met-Ed, or Penelec service territories, and a few residential and small business customers are currently shopping in Penn Power service territories."[80] However, Direct Energy failed to acknowledge that West Penn, Met-Ed, and Penelec are under rate caps until December

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[79] *See* Joint Application at 17, ¶28; Joint Applicants Statement No. 1 at 17; and Direct Energy Main Brief at 20-22.

[80] Direct Energy Main Brief at 20.

31, 2010. Therefore, the relevant evidence about the amount of shopping under the current default service model in their service territories will not be available until after the rate caps have expired.

In any event, if the experience following the expiration of Penn Power's rate caps is any indication, there is likely to be a substantial amount of shopping in the Met-Ed, Penelec, and West Penn service territories without any change in the default service design. Specifically, OSBA witness Mr. Knecht presented evidence that showed a dramatic increase in shopping after the expiration of Penn Power's rate caps. As Mr. Knecht pointed out, between January and June 2007, commercial customer shopping in Penn Power's service territory increased from 4.4% of the load to 45.3%, while residential shopping increased from 0.0 to 4.7%.[81] Mr. Knecht also provided a chart that shows shopping by size of customer within the commercial rate class as of May 2007 in the Penn Power service territory[82]:

| **Table IEc-R2<br>May 2007 Penn Power Shopping** | |
|---|---|
| | Percent Shopping |
| 0 to 25 kW | 7.5% |
| 25 to 100 kW | 17.0% |
| 100 to 500 kW | 46.8% |
| Over 500 kW | 75.8% |
| **Average** | **41.4%** |

[81] OSBA Statement No. 3, Attached Rebuttal Testimony of Robert Knecht from Docket No. P-00072342.

[82] *Id.*

### c. Redefining "Default Service"

In their Main Briefs, both the OCA and the Joint Applicants pointed to the testimony of Joint Applicants witness Mr. Schnitzer to show that Direct Energy's proposal will turn default service on its head.[83] Specifically, Mr. Schnitzer testified:

> Direct Energy's proposal is a radical departure from the default service model that the Commission has adopted for major Pennsylvania utilities over the past decade and more recently to meet the requirements of Act 129. Direct Energy is proposing to turn default service on its head.
>
> If default service is defined to mean the service received by customers who choose not to choose, then under Direct Energy's proposal, the actual default service for such customers is to be involuntarily assigned to an EGS. The rate charged to the customer would be established by a consultant hired by the Commission 'to determine just and reasonable retail market prices' for two consecutive six month periods tied to a market index. But after that time, the supplier of the 'choose not to choose' customer could set prices without Commission oversight.
>
> For Mass Market customers, what Direct Energy calls default service would actually be a new 'opt-in' service option offered by a third party that customers must affirmatively choose. But this new 'opt-in' service would be a totally unhedged spot price product- not the type of product that is generally preferred by Mass market customers.
>
> Thus, the actual effect of Direct Energy's proposal is dramatic. Mass Market customers who today choose not to choose default to a largely fixed price service, which is competitively procured in the wholesale market under the oversight of this Commission. Under Direct Energy's proposal the *actual default service is involuntary assignment.* Those same choose not to choose customers would be involuntarily assigned to an EGS whose pricing,

[83] OCA Main Brief at 17-18 and Joint Applicants Main Brief at 36-37.

> after an initial one year period, would not be subject to Commission oversight. Customers wishing to avoid such involuntary assignment and receive a Commission sanctioned default service would have to affirmatively elect such service, but they would not be able to obtain stable pricing to which they are accustomed. The only service offering under the Commission's jurisdiction would be a completely unhedged and volatile spot price offering.[84]

Mr. Schnitzer's criticisms of Direct Energy's proposal are valid; however, his criticisms are also applicable, and valid, with regard to FirstEnergy's municipal aggregation strategy. Opt-out municipal aggregation involuntarily assigns customers to an EGS that elected officials have chosen for them and makes those customers affirmatively choose default service.

Mr. Schnitzer tried to distinguish opt-out municipal aggregation from Direct Energy's proposal on the grounds that, under municipal aggregation, customers will receive a discount off the default service rate and will be able to return to a reasonably structured default service if they do not want to participate in municipal aggregation. In contrast, under Direct Energy's proposal, customers no longer will have the option of returning to the current default service arrangement. Instead, customers will have to choose volatile default service based on spot market prices.[85]

A major problem with Mr. Schnitzer's analysis is that he ignored the fact that municipal aggregation will raise default service rates. Both OSBA witness Dr. Wilson

[84] OCA Main Brief at 18 and Joint Applicants Main Brief at 36-37.

[85] Hearing Transcript 945-955.

and Constellation witness Mr. Fein explained that municipal opt-out aggregation will lead to higher default service rates.[86] For example, Mr. Fein testified as follows:

> Municipal Opt-Out Aggregation, however, fundamentally changes the patterns and ways in which customers both leave and return to Default Service. If it seems that Municipal Opt-Out Aggregation policies are likely to be implemented in the near term, bidders in procurements under DSPs already approved by the Commission will recognize and account for the significant load variability differences that Municipal Opt-Out Aggregation programs present with respect to serving a portion of an EDC's Default Service supply requirements. In order to address such differences, wholesale suppliers may either limit their participation in Default Service procurements or else account for the increased risk of large-scale declining and returning load under Municipal Opt-Out Aggregation through additional premiums in their bids. Reduced participation and/or additional premiums will lead only to *less* competitive Default Service procurements with *less* competitive Default Service bids, to the *detriment* of utilities' Default Service consumers. Higher Default Service prices will be paid by *all* customers who remain on Default Service, even though all municipalities may not have implemented or do not plan to implement Municipal Opt-Out Aggregation programs.
>
> In summary, the implementation of Municipal Opt-Out Aggregation represents a new 'default' product for *certain* municipalities' customers that will *increase* the costs of EDCs' statutorily-mandated Default Service product for *all* customers. Potential wide and growing disparities between customers, *including* between municipalities, that may result from Municipal Opt-Out Aggregation would be harmful to the Commission's energy future.[87]

[86] *See* OSBA Main Brief at 33-37.

[87] Constellation Statement No. 1-SR at 10-11. (emphasis in original)

If default service rates are driven up because of reduced participation of bidders in default service procurements or because of additional risk premiums to account for municipal aggregation, then FES's customers will be receiving a discount off an inflated default service rate. Therefore, contrary to Mr. Schnitzer's contention, municipal aggregation customers may not receive a discount at all; instead, they may be paying higher prices for generation than they would have if municipal aggregation had never been enacted.

Moreover, municipal aggregation will drive up the default service rates for customers residing or doing business in municipalities that are *not* participating in aggregation. If customers pressure officials in non-participating municipalities to enter aggregation contracts in order to get "discounts," default service rates are likely to rise even more, further undermining the value of the "discounts" and further increasing rates for those customers in municipalities still receiving default service.

#### d. Discriminatory Rates

One of the key features of the current default service design is procurement by rate class. The goal is to avoid rate discrimination by allowing the market, rather than the regulatory process, to determine relative costs of service. Consistent with that goal, Section 2807(e)(7) of the Public Utility Code, 66 Pa. C.S. §2807(e)(7), specifies that "[a]ll default service rates shall be reviewed by the commission to ensure that the costs of providing service to each customer class are not subsidized by any other class." Unfortunately, the early evidence suggests that FirstEnergy's municipal aggregation strategy will allow just the kind of rate discrimination the Commission and the General Assembly have sought to avoid.

For example, Small C&I customers in Meadville will receive a 4% discount off the default service rate, but residential customers will receive a 6% discount off the default service rate.[88]

### 5. Illusory Benefits

Both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal will offer illusory benefits.

Direct Energy's proposal supposedly will offer a monetary benefit to customers if they do not opt out of the auction. Direct Energy explained the proposal in its Main Brief, as follows:

> In the auction, relevant data for customers in a tranche would be provided to potential bidders. Utilizing this data and with knowledge of the pre-determined price to serve, each EGS would be asked to bid a certain dollar amount to win the right to serve a tranche of customers. The proceeds of the auction would be placed into a pool, and would be returned (less an amount, which Direct Energy estimates to be not more than 5% for education and administrative costs) to the residential and small commercial customers who participated in the account auction, by way of a check to each customer. The record shows that the acquisition offers would likely be somewhere between $150 and $500 per account. This means that, in total, the auctions could generate between $300 million and $1 billion in revenue. The net revenue would be distributed equally to the auction participants.[89]

Unfortunately, Direct Energy failed to acknowledge that EGSs may try to recover the so-called acquisition offers over time. As explained by Direct Energy in its Main Brief, an acquisition offer is the amount an EGS bids to win customers through the

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[88] Direct Energy Cross-Examination Exhibit No. 5.

[89] Direct Energy Main Brief at 47.

auction. Those acquisition offers will be paid by the EGSs and distributed to the customers participating in the auction. However, nothing in Direct Energy's proposal prohibits an EGS from seeking to recover some or all of the acquisition offers through higher generation prices in the future. In that regard, Direct Energy witness Mr. Frank Lacey testified as follows:

> Direct Energy would amortize the cost of that investment over the useful life of that investment and earn a return on the investment over time.[90]

When Mr. Lacey was questioned on cross-examination with regard to this testimony, he acknowledged that Direct Energy will attempt to recover a return on its investment in acquisition offers through the prices that Direct Energy will charge its customers.[91] Therefore, Direct Energy's proposal is a case of bait and switch, *i.e.*, offer customers a financial incentive to participate in the auction but then eventually recover that incentive through higher rates.

Similarly, FirstEnergy's municipal aggregation strategy relies on an illusory benefit to customers. As explained earlier in this Reply Brief, the promised discount off the default service rate is likely to be a discount off an inflated default service rate. Furthermore, even with the "discount," an aggregation customer may pay more for generation than if municipal aggregation had not been implemented.

#### 6. Inertia

As a practical matter, both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal will result in a *de facto* default service rate which is neither

[90] Direct Energy Statement No. 3-SR at 17.

[91] Hearing Transcript at 1015.

regulated by the Commission nor determined in accordance with a procurement plan approved by the Commission. In theory, market forces will prevent an EGS from overcharging customers under both municipal aggregation and Direct Energy's proposal.[92] However, market discipline will be effective in preventing overcharging only if ratepayers are willing and able to devote time and attention to understanding and exercising their options.

Both the Joint Applicants and Direct Energy presented testimony about how inertia will make it difficult to compete against each other's product. However, both failed to acknowledge the benefit that they themselves will receive from inertia when it comes to their own product.

Direct Energy argued in its Main Brief that "status quo bias" keeps most customers on default service and that inertia is the exact reason why Direct Energy's proposal is needed.[93] However, Direct Energy failed to acknowledge inertia as a problem with its own proposal. Specifically, when he was asked whether status quo bias will work in favor of the EGS to which the customer is auctioned, Mr. Lacey testified that "I don't think there would be a status quo bias."[94]

Similarly, the Joint Applicants addressed inertia with regard to Direct Energy's opt-out auction. Specifically, Mr. Schnitzer testified, as follows:

> The issue with Direct's proposal, with the opt-out effectively assignment to EGSs is that customers who end up being served by EGSs under that model have not affirmatively elected to be served by

[92] *See* Hearing Transcript at 281 and Direct Energy Main Brief at 48-49.

[93] Direct Energy Main Brief at 36.

[94] Hearing Transcript at 1031.

> EGSs. It's the opt-out provision that gets them there.
>
> And so then the question is, how is that going to work out for customers. And really what this is all about is what happens to the so-called sticky customers, or Your Honor, to your questions of Mr. Graves a few moments ago, those customers who for $6.00 a month just don't find it to be worth their time or whatever to seek another option.
>
> And under the current default service arrangements, those customers get the benefit of the best that the wholesale procurement can do for them as the Commission approves it. And under an assignment to an EGS, they are subject to whatever kind of customer and market segmentation the EGS might choose to do in terms of its pricing and they may or may not get prices that reflect marginal costs or the most efficient price of wholesale markets, and they may not be moved to switch at a moment's notice if they don't.[95]

However, as OCA witness Ms. Barbara Alexander pointed out, inertia is also likely to keep municipal aggregation customers from returning to default service or switching to another EGS.[96]

The fact of the matter is that both Direct Energy's proposal and FirstEnergy's municipal aggregation are based on opt-out mechanisms for providing service and will benefit from inertia. Therefore, market forces may provide little price discipline except in preventing relatively extreme differences between the opt-out price and competitive alternatives.

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[95] Hearing Transcript at 953-954.

[96] Hearing Transcript at 953-955.

### 7. Recommendation

Both FirstEnergy's municipal aggregation strategy and Direct Energy's proposal threaten default service. There is no compelling need for the Commission to approve either one of them.

As OSBA witness Mr. Knecht testified, Penn Power's experience following the expiration of rate caps implies that there will be significant shopping in the Met-Ed, Penelec, and West Penn service territories without changing the current default service design.[97] Mr. Knecht also noted that Direct Energy's proposal (and the default service design changes advocated by RESA) will not take effect until the default service period beginning June 1, 2013.[98] Therefore, the changes advocated by Direct Energy and RESA can be deferred to the proceedings in which the Commission reviews the default service plans of Met-Ed, Penelec, Penn Power, and West Penn for that default service period.[99]

In its Main Brief, the OCA argued (as does the OSBA) that there is no reason to mandate major changes in default service at this time.[100] Specifically, the OCA pointed to the following testimony of its witness Mr. Richard Hahn:

> Given the recent enactment of Act 129, and the resolution of the default service cases to date, the Commission is now well positioned to obtain information on the purchasing practices that provide the best opportunity to meet the requirements of Act 129 for the provision of default service at the least cost over time. It makes no sense to mandate major changes from these types of plans so soon after they have been approved and while they are still in the

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[97] OSBA Statement No. 3 at 5.

[98] *Id.*

[99] *Id.* at 5-11.

[100] OCA Main Brief at 30-31.

> process of being implemented. Over the next two and a half years, *the Commission is well positioned to determine the relative costs and benefits of the* various default service procurement plans under Act 129.[101]

In addition to the practical arguments made by both Mr. Knecht and Mr. Hahn, opt-out aggregation is unlawful for most (if not all) municipalities.

If the Commission were to impose the OSBA's proposed conditions relating to municipal aggregation, FirstEnergy would not be prejudiced because FES would be permitted to engage in municipal aggregation for the default service period beginning June 1, 2013, if the General Assembly ultimately provides statutory authorization.

Similarly, if the Commission were to reject Direct Energy's proposal to auction off customers to EGSs on an opt-out basis, Direct Energy would not be prejudiced because it would be able to pursue its proposal in one or more of the FirstEnergy EDCs' default service proceedings for the period beginning June 1, 2013.

Finally, if the Commission were to reject RESA's proposed changes in default service design, RESA would not be prejudiced because it (or any of its individual EGS members) would be able to pursue these changes in one or more of the FirstEnergy EDCs' default service proceedings for the period beginning June 1, 2013.

In view of the foregoing, the Commission should reject Direct Energy's proposal and RESA's proposed changes in default service design. The Commission should then approve the Settlement, subject to the conditions on municipal aggregation proposed by the OSBA.

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[101] *Id.*

## IV. CONCLUSION

For the reasons set forth in its Main Brief and in this Reply Brief, the OSBA respectfully requests that the Commission:

1. Reject the proposed direct or indirect transfer of control of Allegheny Energy to FirstEnergy, unless the Commission imposes the following additional conditions:

    a. First Energy Corporation and its affiliates shall not engage in municipal aggregation in the Met-Ed, Penelec, Penn Power, and West Penn service territories prior to the enactment and implementation of authorizing legislation or June 1, 2013, whichever is later; and

    b. FirstEnergy shall administratively locate the generating assets of FirstEnergy and Allegheny Energy, in separate subsidiaries that shall not coordinate regarding whether to bid in a particular default service procurement and regarding what price to bid.

2. Reject Direct Energy's proposal to auction off the non-shopping customers of Met-Ed, Penelec, Penn Power, and West Penn to EGSs on an opt-out basis.

3. Reject Direct Energy's proposal to base the default service rates of Met-Ed, Penelec, Penn Power, and West Penn entirely on spot market prices.

4. Reject RESA's proposals to change the design of default service for Met-Ed, Penelec, Penn Power, and West Penn.

Respectfully submitted,

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Dated: November 15, 2010

**BEFORE THE**
**PENNSYLVANIA PUBLIC UTILITY COMMISSION**

| | | |
|---|---|---|
| **Joint Application of West Penn Power Company doing business as Allegheny Power, Trans-Allegheny Interstate Line Company, and FirstEnergy Corp. For a Certificate of Public Convenience Under Section 1102(a)(3) of the Public Utility Code Approving a Change of Control of West Penn Power Company and Trans- Allegheny Interstate Line Company** | : | **Docket Nos. A-2010-2176520**<br>**A-2010-2176732** |

## CERTIFICATE OF SERVICE

I certify that I am serving two copies of the Reply Brief, on behalf of the Office of Small Business Advocate, by e-mail and first-class mail (unless otherwise noted) upon the persons addressed below:

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