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November 15, 2010

Via Electronic Filing
Rosemary Chiavetta, Secretary
PA Public Utility Commission
PO Box 3265
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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:

On behalf of Direct Energy Services, LLC enclosed please find the original of its Reply Brief along with the electronic filing confirmation page with regard to the above-referenced matter. Copies to be served in accordance with the attached Certificate of Service.

Very truly yours,

Daniel Clearfield, Esq.

DC/lww
Enclosure

cc: Hon. Wayne Weismandel w/enc.
Hon. Mary Long w/enc.
Cert. of Service w/enc.

CERTIFICATE OF SERVICE

I hereby certify that this day I served a copy of Direct Energy's Reply Brief and upon the persons listed below in the manner indicated in accordance with the requirements of 52 Pa. Code Section 1.54.

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Dated: November 15, 2010

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 No. A-2010-2176520 Docket No. A-2010-2176732

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I. INTRODUCTION

This Reply Brief is submitted by Direct Energy Services, LLC ("Direct Energy") in response to the Main Briefs of the Joint Applicants, the Office of Consumer Advocate ("OCA"), the Office of Small Business Advocate ("OSBA") and the "amicus" brief of the Energy Association of Pennsylvania ("EAPA"). Much of the briefs of these parties are devoted to criticizing Direct Energy's proposed solutions to mitigate the anticompetitive effects of the proposed merger. But the parties' discussion of the four central issues raised by this proceeding provide clear guidance as to the result that is required here.

First, does the Application itself satisfy the Pennsylvania merger standards? The obvious answer is no. The record here compels a conclusion that there is little, if any, hope of a workably competitive market developing in the FirstEnergy ("FE") service territory if the merger is approved. The merger will not only perpetuate the default service structural barriers that prevent the development of full competition but will also give FE – through its EGS and generation owning affiliate, FirstEnergy Solutions ("FES") – the ability to dominate what competition will develop. This will directly impede competitive opportunities for other EGSs and rob customers in the FE service territories of the benefits of a fully competitive market, including receiving the lowest possible prices, the most innovative products and services and receiving a maximum range of choices.

The evidence further shows that the post-merger retail market will be one in which: a) there will be one less viable wholesale and retail competitor; b) the great majority of residential and small commercial customers will remain customers of FE through its affiliated EDCs' default service (some portion of which FES will supply as the winning bidder in the wholesale supply auctions); and c) a majority of the rest will likely be served, either directly or indirectly,

by FE's competitive subsidiary – FES – either by supplying customers directly through one-on-one sales or through opt-out municipal aggregation.[1]

Indeed, FES' recent efforts to sign up municipalities to opt-out aggregation deals before the legality of such contracts has been established by the PUC – plainly aided in its efforts by the name recognition and brand loyalty of its EDC affiliates – provides a taste of what to expect if the merger is approved without competitive protections. Fortunately, the PUC has put a stop to FES' aggressive marketing tactics – for the time being.[2]

The Joint Applicants virtually ignore these facts, focusing most of their efforts on insisting that no wholesale market power problems exist and that the markets in their service territories today are already "workably competitive," and will be so after the merger. Such an assertion is contradicted by any credible definition of "workably competitive" – and by common sense. For a market to satisfy this competitive merger standard the Commission must find that there will be "workable competition." How can a market be characterized as "workably competitive" where: a) virtually no residential or small commercial customers are shopping and only a small minority will likely be shopping after the merger; b) only a handful of potential suppliers, and one dominant provider – the affiliate of the merged company – will be competing for residential and small commercial customers? It cannot.

Second, in light of this evidence, does the Partial Settlement make the merger consistent with Pennsylvania's merger standards? Again, the answer must be no.[3] In their brief, the Joint

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1 The evidence also shows that and there are various times when FES's wholesale generation arm will have market power and this, combined with the existing structural problems in PJM, creates serious market power concerns in the wholesale market, which in turn is likely to result in higher retail prices in FE's affiliated service territories.

2 See, Secretarial Letter of November 10, 2010 concerning "Consolidation of Three Petitions Regarding Municipal Aggregation And Directive re: Customer Switching Pursuant to 'Opt-out' Municipal Aggregation Programs" (Docket Nos. P-2010-2207062; P-2010-2207953; P-2010-2209253).

3 See Section III.A of this Reply Brief and Section VI (pp. 39-58) of Direct Energy's M.B.

Applicants merely regurgitated the list of alleged "benefits" set forth in the Partial Settlement in an attempt to demonstrate that they satisfy the competitive merger standards. They failed to demonstrate however – or even discuss – how the implementation of these so-called benefits permit the merger to meet the merger standards and resolve the competitive concerns raised in the record. The OCA, the only other settling party actually filing a brief, devoted one paragraph to a discussion of how the Partial Settlement allegedly satisfies the *City of York* test. This virtual silence makes it clear that the settling parties are relying on the Partial Settlement itself to provide the necessary legal support for approval, rather than on record evidence. This is legally impermissible.[4] Thus, the unavoidable conclusion is that the Joint Applicants have not satisfied their burden of proof.

Third, would Direct Energy's proposals cure the competitive problems with the merger? The answer to that question is plainly yes. No party really disputes that Direct Energy's proposal to establish an alternative default service provider, and to auction residential and small commercial customers to participating EGSs in return for substantial ($150-$500) customer payment, as well as the creation of a structurally separate BillCo, will create a fully and workably competitive market.[5]

Fourth, should Direct Energy's proposals be adopted as the remedy? Again, the answer should be "yes." It is on this part of Direct Energy's position that the Joint Applicants and the other opponents to Direct Energy's proposal spend most of their time, tossing up multiple roadblocks in the hope that one will "stick." In this Reply Brief, Direct Energy refutes each and

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4 Direct Energy M.B. at 58-60.

5 OSBA is the only party that claims (OSBA M.B. at 60-61) that Direct Energy's proposals will not cure the harms being created by the merger, but does so on the ground that Direct Energy's default service/retail auction proposal would not begin until 2013, after the current default service procurement period ends. This claim is refuted herein.

every one of the myriad criticisms leveled at its proposal to restructure the post-merger FE markets. When the record is viewed comprehensively, it is clear that Direct Energy's restructuring proposal does not violate any law. And, the plan will obviously help customers – not hurt them. But it must be pointed out that, if Direct Energy's proposed solutions to ameliorate the anti-competitive consequences of this merger are not accepted, the necessary result is that the merger (and all the "concessions" provided in the Partial Settlement) must all be rejected. It is difficult to believe that, given that choice, the Joint Applicants would continue to be opposed to Direct Energy's good faith attempts to permit the merger to go forward without sacrificing the development of a competitive retail market for residential and small commercial customers in 70% of Pennsylvania.

The only other alternative would be to approve the merger without ordering the remedies offered by Direct Energy to create a workably competitive market in the face of FE's avowed efforts to dominate the post-merger market. The Joint Applicants and apparently the OCA/OSBA appear perfectly happy to accept this type of market. But the Commission should not be. If this is the result, it will mean that customers in the FE service territory will be consigned to a market where most customers continue to get their power from the "default" option, with just a minority of residential and small commercial customers shopping, a majority of those shopping taking service from an affiliate of the utility and all customers being subject to prices that are higher than if full wholesale and retail competition did exist. Such a market cannot be called "workably competitive." Nor, according to Commissioner Brownell, is it the "end state" for competition that the General Assembly envisioned. And most importantly, such a market will deprive customers of all the benefits of competition and consign them to the "one size fits all" choices they were faced with prior to the advent of restructuring.

Based on the foregoing, the decision for the Commission is plain. Only Direct Energy's proposal provides a viable chance for customers to enjoy the benefits of a workably competitive post-merger market, as the General Assembly not only envisioned but mandated. The Application should either be approved conditioned upon the implementation of Direct Energy's proposals, or it should be rejected.

II. THE BURDEN OF PROOF DOES NOT SHIFT TO DIRECT ENERGY OR ANY OTHER PROPONENT OF CONDITIONS TO A MERGER.

As a preliminary point, the OCA and the Joint Applicants have improperly attempted to shift the "burden of proof" to Direct Energy. The OCA states explicitly (and incorrectly) that Direct Energy "has failed to carry its burden of proof to show that its proposal is legally necessary or in the public interest.[6] The Joint Applicants merely repeat in various contexts that Direct Energy has "failed to show" that its proposal is reasonable or legal.[7] But, as the ALJs are well aware,[8] the ultimate burden remains at all times on the Joint Applicants.[9]

Conditions are frequently proposed by OCA, OSBA and other parties in merger proceedings. Such conditions are always beyond the alleged "benefits" included in the initial

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6 OCA M.B. at 2, 7-8, 9, 28;

7 Joint Applicants' M.B. at 42, 47, 51-58.

8 Earlier this year, ALJ Weismandel described the "burden of proof" as follows: "The 'burden of proof' is composed of two distinct burdens: the burden of production and the burden of persuasion. ... The burden of production, also called the burden of producing evidence or the burden of coming forward with evidence, determines which party must come forward with evidence to support a particular proposition. This burden may shift between the parties during the course of a trial. ... '[T]he burden of persuasion never leaves the party on whom it is originally cast, but the burden of production may shift during the course of the proceedings.' The burden of persuasion, usually placed on the complainant, applicant, or petitioner, determines which party must produce sufficient evidence to meet the applicable standard of proof. ... In order to bear the burden of proof and be entitled to a decision in his favor, a party must bear both the burden of production and the burden of persuasion." *Pennsylvania State Legislative Board United Transportation Union v. Norfolk Southern Railway Company*, Docket No. C-00019522 (dated March 16, 2010 adopted on May, 6, 2010) at 13-15 (citations and footnotes omitted).

9 The entity with the burden of proof is the entity that has both burdens – the burden of production and the burden of persuasion., Sections 1102 and 2807 of the Public Utility Code place the burden of proving "affirmative public benefits" and "properly functioning and workably competitive" markets on the entities seeking approval of the merger or consolidation.

merger application. Proponents of merger conditions have a burden of "production" or of going forward with the evidence to show why their proposals are appropriate remedies to address the legal deficiencies of the merger – but not the ultimate burden of proof.[10]

Direct Energy's plan is proposed as a condition to enable the merger to satisfy the statutory standards.[11] While Direct Energy acknowledges that it bears the burden of production with respect to its proposed conditions it submits that it has satisfied this burden many times over. However, the Commission were to conclude (incorrectly in Direct Energy's opinion) that Direct Energy had failed to satisfy its burden of going forward with evidence showing the legal appropriateness and reasonableness of its proposed conditions, then the proper conclusion would be to reject the merger outright. Absent Direct Energy's proposals there is no way that the Commission could conclude that the Joint Applicants have satisfied their burden of persuasion, and thus, the merger will not satisfy the competitive standards of Section 1102 and 2811(e).

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10 *Milkie v. Pennsylvania Public Utility Commission*, 768 A.2d 1217 (Pa.Cmwlth. 2001); *Reidel v. County of Allegheny,* 159 Pa.Cmwlth. 583; 591, 633 A.2d 1325; 1328; n. 11 (1993)("[T]he burden of persuasion never leaves the party on whom it is originally cast, but the burden of production may shift during the course of the proceedings.").

11 To avoid this conclusion, Direct Energy's proposed conditions are mischaracterized as "seeking affirmative relief from the Commission." OCA M.B. at 7-8, 9, 28; Joint Applicants' M.B. at 36-37, 45; OSBA M.B. at 43-44. This is simply untrue and mischaracterization. Direct Energy is not making application for a merger or seeking permission (or relief) beyond what was requested by the Joint Applicants. OCA citation of *Pa. PUC v. Met-Ed, Penelec*, Docket No. R-00061366 (Order entered January 11, 2008) is inapposite. In that case, PennFuture (as a party to a general rate increase case) proposed a rate increase beyond that sought by the utility. It was held that the burden of proof must be on a party to a general rate increase case who proposes a rate increase beyond that sought by the utility. *See* 66 Pa. C.S. §§ 315(a), 332(a). The ALJs found, and the Commission agreed, that PennFuture had failed to bear its burden of proof with respect to its rate increase proposals. However, Direct Energy is merely a proponent of conditions which, if accepted by the Commission, will allow the post-merger existence of "properly functioning and workably competitive" markets. Importantly, Direct's proposal is consistent with the fundamental goals of the Application itself – the merger of FE with AE – and would not prevent any of the merger's alleged benefits, as characterized by the Applicants, from being realized.

III. THE JOINT APPLICANTS HAVE FAILED TO MEET THEIR BURDEN OF SHOWING THAT THE MERGER SATISFIES THE COMPETITIVE BENEFITS TEST OR THE WORKABLY COMPETITIVE REQUIREMENT

A. The Application, As Modified By The Partial Settlement, Will Not Make The Post-Merger Markets Workably Competitive

Neither the Joint Applicants nor any of the other settling parties present any evidence or detailed explanation to show how the merger, even as modified by the Partial Settlement, satisfies the applicable merger standards. In fact, the Main Briefs of the other parties say virtually nothing about the Partial Settlement. The Joint Applicants merely recite a list of the alleged benefits set forth in that pleading and make a conclusory statement that the merger will result in affirmative benefits.[12] The OCA does even less. In a single paragraph, the OCA states that the Partial Settlement is in the public interest and satisfies the *City of York* standard.[13] By saying so little, the Signatory Parties are creating a strong impression that they seek the approval of the Partial Settlement merely because it is a settlement – even though approval on that basis would violate Direct Energy's due process rights.[14]

The failure of the Signatory Parties to show how the terms of the Partial Settlement meet the statutory merger requirements is likely because the record does not support the Partial Settlement.[15] As discussed in Section VII of Direct Energy's Main Brief, the so-called "competitive enhancements" in the Partial Settlement will not result in the merger producing substantial affirmative benefits, a requirement of the *City of York* and the *Popowsky* cases.[16]

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12 Joint Applicants' M.B. at 17-20.

13 OCA M.B. at 44.

14 Direct Energy M.B. at 58-65 (Section VII). See also *ARIPPA v. Pa. P.U.C.*, 792 A.2d 636, 660 (Pa.Cmwlth. 2002), *alloc. denied*, 815 A.2d 634 (Pa. 2003).

15 See *Petition for Approval of PECO Energy Company's Market Share Threshold Bidding/Assignment Process; Petition for Approval of "The Better Choice" Plan to Meet PECO Energy Company's Market Share Threshold Requirements,* P-00021992 (Order entered February 6, 2003) ("PECO MST") (focus should be on whether there are sufficient evidence to support the Commission's findings of fact).

16 *City of York v. Pa. P.U.C.*, 295 A.2d 825 (Pa. 1972); *Popowsky v. Pa. P.U.C.*, 937 A.2d 1040 (Pa. 2007).

Moreover, nothing in the Partial Settlement even remotely ameliorates the anticompetitive and discriminatory conduct that will result from the merger. The other non-settling parties, including Citizen Power agree.[17] In fact, Citizen Power concluded that the terms in the Partial Settlement "do not substantially address the likelihood that the proposed merger will result in anticompetitive behavior and therefore cannot be found to remedy this deficiency in the Joint Application."[18]

Indeed, some of the Partial Settlement's so-called "competitive enhancements" have *already* been eviscerated. While the Joint Applicants were busy arguing that the post-merger market would be fully competitive, Allegheny was independently proposing charges that are *not* covered by the Partial Settlement and which are much more harmful to competition. For example, the Partial Settlement states that after consummation of the merger, Allegheny will "discontinue billing EGSs for a Commission-approved supplier administrative charge that is applied on a dollar per MW-month to all EGSs serving load." [19] In their main briefs both RESA and Direct Energy explained that this charge does not currently exist, and if it were to be proposed it would be unreasonable.[20] Two days before main briefs were filed, West Penn filed its proposed supplier tariff which does not even include the charge referenced in the Partial Settlement. Instead, West Penn is proposing a new and arguably even much more competitively

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17 Accord RESA M.B. at 11-23 (Section D); OSBA M.B. at 13 ("[B]ecause of its advantage as the incumbent utility and its ownership of local generation capacity, FirstEnergy's municipal aggregation strategy will make it harder for other electric generation suppliers to compete. 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.").

18 Citizen Power M.B. at 13. Specifically, with respect to the "Competitive Market Issues" in the Partial Settlement, Citizen Power even concludes that the "it is difficult to see how the [wholesale pricing] information alone would prevent possible anticompetitive or discriminatory conduct in either default service auction or wholesale markets." Citizen Power M.B. at 12-13. With regard to the "Retail Market Enhancements," Citizen Power reached a similar conclusion: These enhancements "do not address the substantial competitive concerns that will result from the merger." Citizen Power M.B. at 13.

19 PS ¶ 47.

harmful charge – a $6 per bill charge for consolidated bills rendered for an EGS![21] Such a charge would result in any EGS trying to serve the residential market in West Penn's service territory having to pay an exorbitant fee for West Penn to send one bill with the EGSs generation charges to its customers,[22] making it virtually impossible for a non-affiliated EGS to successfully compete (FES will be able to weather the charge because it will simply be an intra-company payment). Thus, not only does the Partial Settlement fail to deal with real issues facing competitors, offering proposed solutions to problems that don't exist, it allows the Joint Applicants to continue to install other requirements s that would be extremely harmful to competition. The Partial Settlement cannot be found to render the merger compliant with the competitive merger standards of the law.

B. The Joint Applicants' Claim That The Retail Markets In Their Affiliated Service Territories Are Today Workably Competitive And Will Be After The Merger Is Contradicted By The Record Evidence.

Incredibly, the Joint Applicants insist that the merger will meet the Section 2811(e) competitiveness standard because "workably competitive markets" will exist in their service territories after the merger; they even insist that such markets exist today![23] They further allege that "Direct Energy did not submit any evidence suggesting that FE or any of its affiliates had engaged in anticompetitive or discriminatory behavior" and that Direct Energy's witness

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20 Direct Energy M.B. at 61; RESA M.B. at 35.

21 See Page 6 of the Summary of Major Changes for Tariff Changes for West Penn Power Company d/b/a Allegheny Power Electric Generation Supplier Coordination Tariff. Effective January 1, 2011, R-2010-2207928.

22 By way of comparison, PECO recovers .2% from EGSs using POR and EDC-consolidated billing. See PECO Energy Company Tariff Electric Pa. P.U.C. No. 1SD, First Revised Page No. 92 at Section 9. Converting this to a "per bill" charge equates to a $.20 per bill assessment for POR/EDC-consolidated billing. Allegheny proposal is 3,000% greater

23 Joint Applicants' M.B. at 47-48.

admitted this.[24] The Joint Applicants are, of course, entitled to their own opinion, but they are not entitled to their own facts.

First, the notion that no evidence was submitted to show that the merger is likely to result[25] in anticompetitive and discriminatory conduct after the merger is utterly false. Direct Energy has meticulously set forth that evidence in it its Main Brief. In summary, Direct Energy demonstrated that there is little, if any, hope of a workably competitive market developing in the FE service territory if the merger is approved. The merger will not only eliminate a viable competitor from the field – Allegheny Energy Supply – but will perpetuate structural barriers created by the current default service structure that inhibit full competition. This will give FE – through its EGS and generation owning affiliate, FES – the ability to dominate what competition will develop, thus directly impeding competitive opportunities for other EGSs and robbing customers in the FE service territories of the benefits of a fully workable competitive market. Such benefits include receiving the lowest possible prices, the most innovative products and services, and a maximum range of choices.[26]

It is true that Direct Energy's witness Dr. Morey forthrightly agreed that he did not have any evidence that FirstEnergy was currently engaging in any unlawful conduct, i.e., the violation of antitrust laws or the existing codes of conduct.[27] But, the merger standard does not merely prohibit past unlawful conduct; it plainly prohibits anticompetitive or discriminatory conduct, including the unlawful exercise of market power, such that makes it likely that a workably competitive market will not develop. Direct Energy has also shown how, after the merger, the

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24 *Id., (emphasis added).*

25 The Joint Applicants continually frame the issue as whether anticompetitive conduct has occurred or is certain to occur, post-merger. The statute uses the words "likely to result" 66 Pa. C.S. § 2811(e).

26 Direct Energy M.B. at 20-34. *See also* Citizen Power M.B. at 9-11.

27 Tr. 781-82.

structure of the retail market will discriminate against EGSs and in favor of default service. Direct Energy has shown further how EGSs will be discriminated against by FE's "retail marketing strategy" which has as its avowed goal for FE to be the dominant or majority retail provider in its service territories. Finally, Direct Energy has shown how that strategy will result in an anticompetitive market where FE's affiliate will dominate and a handful of other EGSs will have to fight to compete with this dominant provider.[28]

The Joint Applicants insist that there is nothing wrong with this result and even claim that it "is common in restructured electric markets in the United States . . . ."[29] Unfortunately, the Joint Applicants cite no evidence for this proposition; the only record evidence of which Direct Energy is aware is the data showing FE's success in dominating the retail market in its EDC service territories in Ohio – where FES makes 80% of the retail sales.[30] Such domination is illegal under Section 2811(e), however, because it will harm consumers and prevent the development of a fully competitive market.[31]

The Joint Applicants tout the statistics in PPL and claim that such results if replicated in its post-merger Pennsylvania EDC service territories would make those markets workably competitive.[32] First, while residential shopping levels are slightly higher in PPL (35%) than in other service territories, both Direct Energy witnesses pointed out that these higher levels

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28 Direct Energy St. 1, at 6, 10, 36-38; Direct Energy St. 1-SR at 7-8, 38-39; Direct Energy St. 2 at 21.; See Direct Energy M.B. at V.B.

29 Joint Applicants' M.B. at 50.

30 Tr. 263.

31 Direct Energy M.B. at 19-39 (Section V.B.2).

32 Joint Applicants M.B. at 50.

appeared to be aberrations and were equally likely to drop back to historic levels when default services prices were reset.[33]

The Joint Applicants should not be allowed to recast the merger standard so that it can be met if the merging companies simply refrain from overtly forbidding retail access; the question is not whether competition will be completely or virtually shut out but whether a workably competitive market is likely to develop. Dr. Morey explained that workably competitive does not mean a few competitors serving a minority of customers. He explained that there are several key characteristics of a workably competitive market including: (a) many buyers and sellers; (b) no barriers to entry, exit or expansion; and (c) sufficient information for buying decision.[34] Contrary to the impression that Joint Applicants attempted to create, the Joint Applicants' witness Dr. Hieronymus essentially agreed with this definition of workably competitive, and also agreed that one of the key attributes of such a market is many sellers and many buyers.[35]

If the results in other service territories are any indication, the post-merger FE residential and small business markets will not come anywhere near to displaying the attributes of a workably competitive market. Instead, those markets will be marked by:

- Few Sellers: There are just two suppliers making non-green offers in Penn Power and only four in Duquesne.[36] While there are more in PPL's service territory, it remains to be seen how long this will last.[37] Further, among those EGS participating in the market it is likely that FES will have the greatest share of the market of those shopping. So, realistically, the real number of separate sellers will be even smaller.

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33 Tr. 779-780, 989.

34 Direct Energy St. 1-SR at 4-6.

35 Tr. 654-55. Dr. Hieronymus subsequently added "contestability" as another attribute of such a market. (Tr. 672-673), but clearly, contestability does not produce any benefits to customers, which is required by the statute.

36 Direct Energy Cross Exam Exhibit 7.

37 See footnote 44, supra.

- Few Buyers: Most importantly, only a minority of residential and small business customers are shopping in any of the jurisdictions. No market has even a majority. After almost 12 years, Duquesne has less than 20% of the residential customers shopping.[38]

- Lack of Sufficient Information: Another failing in the post-merger market is likely to be a lack of fully informed and engaged customers. The record shows a serious lack of information about competitive choices with a majority of customers in the FE service territory either not considering competitive alternatives or not even knowing that options exist.[39] Thus, the "sufficient information" requirement is not satisfied.

The record shows, therefore, that there is no reasonable likelihood that a workably competitive market will exist in the FE-affiliated service territories.[40]

The Joint Applicants try to undercut this evidence by citing Dr. Morey for the proposition that market barriers to enter the retail electricity market are not insurmountable,[41] that various companies, such as Direct Energy are sufficiently capitalized[42] and that its own witness, Mr. Graves, testified that Pennsylvania is "flush" with competitors who have assets necessary to achieve sufficient scale."[43] They also point to PPL for the proposition that sufficient "scale" has already been obtained by EGSs in that market.

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38 Tr. 919 (only 19.8% of residential customers in the Duquesne Light service territory are shopping).

39 See Section IV.F of this Reply Brief.

40 It should be noted that OSBA opines that Direct Energy's restructuring proposal will not solve problems in the wholesale and retail markets because Direct is proposing that it is alternative default service/retail auction remedy would not take effect until 2013. OSBA M.B. at 60-61. As to the wholesale markets, Direct Energy proposed that the Joint Applicants divest some portion of their generation assets as soon as the PUC identified the appropriate plants to divest. This was explained in Direct Energy's Main Brief (*See* Direct Energy's M.B. at 35-39, 55-56 (Sections III.B.2.b and IV.B) and Appendix D.), and would immediately address the market power problems in the wholesale market. As to the retail market, Direct Energy proposed forms of immediate relief that should limit market power until the structural remedies can be implemented. For example, Direct Energy proposed: (a) limitations on the use of the EDC name and logo; (b) cross-subsidy reporting; and (c) the use of a Commission appointed Market Monitor. Direct Energy's alternative default service remedy was proposed to begin in 2013 so as to not interfere with existing wholesale contracts to supply the existing default service load. While Direct continues to believe that a delay until the existing default service plan period is the best course, the Commission would have the authority to implement Direct Energy's plan sooner, if it thought that it needed to more quickly address the lack of competition in the post merger FE service territory.

41 Joint Applicants' M.B. at 49.

42 Joint Applicants' M.B. at 49-59.

43 Joint Applicants' M.B. at 50.

First, the statute focuses on creating conditions in which the actual benefits of a competitive market are delivered (requiring steps that would "preserve the benefits of a ...workable competitive ...market").[44] A market in which EGSs "could" enter but are not doing so does not preserve those benefits. Moreover, as indicated above, the "workable competitive" definition has several attributes, not just "ease of entry." It will be small solace to customers in the service territories of Met-Ed and Penelec, for example, to know that EGSs could enter, if they do not in fact do so. The evidence is that, under the present structure, very few are actually entering the residential and small commercial markets, or are likely to do so.

Moreover, Joint Applicants' arguments purposely ignore the important difference between "entry" and entry leading to sustainable competition. The actual level of switching in the markets in which the generation caps have been removed shows plainly that sustainable competition has not been achieved. The fact is that, years after the generation caps have been removed, very few EGSs are making offers to residential and small commercial customers in the Penn Power or Duquesne service territories – and very few customers are shopping.[45] Without sufficient sustainable market share EGSs cannot develop the scale necessary to fully deploy value added products and services, or to even make a long-term commitment to the market, as Dr. Morey explained:

> Competing against the established default service model, which is discriminatory with respect to new and relocating customers making the EDC the provider of "first resort" rather than the provider of "last resort," means EGSs must lure customers away from default service one at a time. ...EGSs wind up with small shares of the residential and small business markets, which does not enable them to obtain economies of scale that would lower

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44 Tr. 779-780, 987-989; Direct Energy St. 1-SR at 34.

45 Joint Applicants' Exhibit FG-1 (only 15.6% of residential customers are shopping in PennPower's service territory), Tr. 919 (only 19.8% of residential customers in the Duquesne Light service territory are shopping); *Id.*, Direct Energy St. 1-SR at 34.

> their average costs sufficiently to allow them to offer a more diverse set of energy-related services. Moreover, small numbers of customers limit EGSs' buying power in the wholesale market, and results in higher costs for the EGSs and lower benefits for the retail customers they serve.[46]

This is the type of market one sees in the other service territories – including PPL. But the merger statute requires more. And Direct Energy believes the Commission wants to see a fully competitive market, as well. As to the suggestion that since Direct Energy (and some other EGSs) are well capitalized, this somehow translates into an assurance that a workably competitive market will develop, Dr. Morey testified that being "well capitalized" may be required in order to sustainably participate in a market, but it does not affect whether an EGS will be able to achieve a sufficient market share and, therefore, have the scale economies to be able to sustain their market presence.[47] The Joint Applicants' focus on the characteristics of their potential competitors rather than the actual or likely state of the markets is yet another example of misdirection. The essence of their argument is that they can meet the statutory standard and keep competitors out of their service territory merely by showing that their EGS competitors are well capitalized. The merger standard isn't intended to reward companies who are successful at finding ways to keep their most vigorous competitors out.

Finally, the Joint Applicants trot out the statement made by a Direct Energy employee when announcing Direct Energy's entry into the Duquesne residential and small business market.[48] The Joint Applicants failed to read the entirety of Direct Energy's answer discussing this statement, explaining that Duquesne market is "open and competitive" to the extent that it

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46 Direct Energy St. 1-SR at 38-39.

47 Tr. 827.

48 Joint Applicants' M.B. at 51.

can be, given the nature and structure of default service in Duquesne.[49] Moreover, the Direct Energy statements about the Duquesne market were made outside the context of a merger where the applicable standard requires that the Joint Applicants prove that the post-merger retail market will not contain anticompetitive or discriminatory conduct which deprives customers of a workably competitive market – not just that some competition is possible. Again, the question is whether the Commission really wishes to consign customers in the FE-affiliated EDC service territories to an oligopolistic, default service-dominated market with an affiliate of the EDC – FES making the majority of the retail sales. That plainly was not the vision of the General Assembly in enacting this section – and the Commission should not settle for such a result now.

C. The Joint Applicants' Own Analysis Demonstrates The Merger's Potential For Anticompetitive Effects In The Wholesale Market.

1. The Joint Applicants' attempt to explain away the actual screen failures demonstrated in their own analysis is unsupported.

The Joint Applicants have admitted that their proposed merger will violate the applicable FERC screens for market power in three of ten of the most pertinent cases presented in their own analysis.[50] In three of ten cases analyzed in the PJM Post-ATSI Integration case, the existing HHI standards included in the FERC screens are exceeded. However, the Joint Applicants' have not performed any analysis to demonstrate that these screen failures do not indicate an unacceptable level of market power. Instead, they merely argue that the screens themselves are not dispositive under FERC's analysis and that the screen failures are small.[51]

The Joint Applicants have not provided additional analysis to support their argument, based on the facts and circumstances of the proposed merger. Instead, Joint Applicants only cite

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49 Joint Applicants' Cross-Exam Exhibit 16.

50 Joint Applicants' Main Brief at 25; Joint Applicants' St. 4 at 9.

51 *Id.*

limited FERC cases suggesting that certain base load plants cannot withhold capacity from the market as readily as other generators. However, other than in broad generalizations (e.g., that the plants at issue in both cases are coal plants), Joint Applicants have not explained how those cases are similar to that of the instant merger. Accordingly, based on the three actual screen failures in the most pertinent cases, and Joint Applicants failure to meet their burden of production elated to demonstrating that the screen failures are somehow immaterial, the Commission should impose the divestiture mitigation proposed by Direct Energy, or deny the merger application based on failure to satisfy the standards of Section 2811.

2. Joint Applicants do not acknowledge how dangerously close to actual screen failure their analysis is in nine of ten pertinent cases.

While the Joint Applicants acknowledge, and then attempt to dismiss, the three actual screen failures in their PJM Post-ATSI Integration case analysis, they make no mention of the six additional instances in which the HHI change data and the corresponding post-merger HHI figures come dangerously close to exceeding the screens. The overall data for the PJM Post-ATSI Integration case demonstrate that the HHI change ranges from 99 to 111 in nine out of ten cases. In those same nine cases out of ten, post-merger HHI ranges from 866 to 1054.[52] The fact that in nine out of ten cases, either the screen was triggered, or was very close to being triggered, casts additional doubt on the Joint Applicants unsupported assertions that the proposed merger will not have anticompetitive effects on wholesale competition. Moreover, the Joint Applicants' apparent claim that the PUC must accept the newly revised FTC/DOJ standards – which are even more lenient – is incorrect.[53]

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52 OCA St. 2 at 37 (Table 7); Joint Applicants' M.B. at 26; Direct Energy M.B. at 35-39 (Section V.B.2.b).

53 The Joint Applicant's argue that under the new DOJ/FTC guidelines, even the three existing screen failures would not be considered so. Joint Applicants' M.B. at 26. However, FERC does not blindly follow the DOJ/FTC, just as this Commission does not blindly follow the FERC guidelines. Accordingly, there are several unsupported leaps to Joint Applicants' logic. In order for the DOJ/FTC guidelines to apply in this

3. The Joint Applicants do not adequately respond to the effects of PJM Structural Failures.

The PJM Market Monitor has made it clear that the market structure in PJM's energy, reserve and capacity markets create ample opportunity for participants to exercise market power,[54] and that its market power mitigation efforts in the Allegheny Power and the Penelec control zones for the energy,[55] capacity[56] and reserve[57] markets have only been successful "in most cases."[58] The logical conclusion is that both of the merging companies today have unmitigated market power in *some* instances. The Commission should be extremely concerned about this existing market concentration that the Joint Applicants' own study revealed will be exacerbated by the structural deficiencies in the PJM market itself.[59]

The Joint applicants dispute the significance of the PJM Market Monitor findings, pointing out that it has made similar conclusions for years and the Commission has not seen fit to be concerned in past cases.[60] But this is the first post rate cap proceeding in which the Commission has had to confront these structural deficiencies. The Joint Applicants also suggest that, because Allegheny has no generation in the Penelec zone and FirstEnergy has no generation in the Allegheny zone, the market power of the Joint Applicants resulting from these structural

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case, FERC would first have to adopt them, and then this Commission would have to as well. It seems unlikely this Commission would adopt these changes without first giving full consideration to the matter. Similarly, it seems unlikely that FERC would adopt these standards without formally amending its Merger Policy statement in a public process.

54 Direct Energy St. 1 at 22.

55 Direct Energy St. 1 at 23-26.

56 Direct Energy St. 1 at 21-22, 26-30.

57 Direct Energy St. 1 at 29-30.

58 Direct Energy St. 1 at 23.

59 Direct Energy St. 1 at 21-30; Direct Energy St. 1-SR at 13-18; Direct Energy M.B. at 38-39.

60 Joint Applicants' M.B. at 32.

deficiencies will not be increased by the merger.[61] But that is not the standard. The statutory standard focus is on the result in the retail markets. The Joint Applicants don't appear to dispute that these instances of market power for Allegheny and FE are there – just that they will not get worse after the merger. This implicit admission should be sufficient to cause the Commission to find that the PJM Market Monitor's structural issues, together with the Joint Applicants' own analysis of market screen failures and near failures, requires a conclusion that anticompetitive conduct is likely to be present in the post-merger wholesale market, requiring remediation as recommended by Direct Energy.

IV. THE CRITICISMS OF DIRECT ENERGY'S ALTERNATIVE DEFAULT SERVICE PROVIDER PROPOSAL ARE INCORRECT AND UNWARRANTED

A. Direct Energy's Retail Market Restructuring Proposal Is Appropriately Raised In This Merger Case as a Remedy to the Joint Applicants' Likely Anticompetitive Conduct.

The Joint Applicants, OCA, OSBA and EAPA all claim that Direct Energy's proposals to ameliorate the anticompetitive consequences of the merger, including its proposal that an independent (non-affiliated) default service provider be selected by the PUC and that a retail auction of customer accounts be conducted to create a workably competitive market, have nothing to do with this case, "pays little more than lip service to the transaction,"[62] and allegedly is just a "platform to level broad-based criticisms against the entire statewide DSP model."[63] A merger proceeding allegedly "is not the forum in which to consider any issues associated with default service."[64] At the heart of the opponents' attack is their assumption that Direct Energy's call for change is based solely on generic complaints about the default service structure in Pennsylvania. But they are wrong. Direct Energy's position in this case is about the way in

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61 Joint Applicants' M.B. at 3.

62 Joint Applicants' M.B. at 38. *See also* OCA M.B. at 9, 32-33; OSBA M.B. at 44-45; EAPA M.B. at 4.

63 Joint Applicants' M.B. at 38.

which the Joint Applicants will be providing default service and how that provision contributes to a failure to satisfy Section 2811(e). The opponents fail to even acknowledge that their argument was advanced in the Joint Applicants' Motion in Limine and rejected by the ALJs. The ALJs found that:

> Although we do not believe that it is appropriate to revisit the wisdom of the Commission's approach to default service in the context of a merger proceeding, it does seem that the testimony offered by Direct Energy is relevant to the issue of whether the merger is "likely to result in anticompetitive or discriminatory conduct . . . . which will prevent retail electricity customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive retail electricity market." Accordingly, we will deny the Joint Applicants' motion to exclude the testimony from the record.[65]

The ALJs were entirely correct. As can easily be observed by reviewing the extensive discussion of these issues in Direct Energy's Main Brief,[66] Direct Energy has met its burden of production by presenting credible testimony that the nature and structure of default service in the Joint Applicants' service territory, together with FE's own default service policies and procedures, will likely result in most residential and small business customers continuing to receive generation service from the default option. For example, customers in the MetEd/Penelec, PennPower and West Penn Service territories were assigned to default service at the time of unbundling[67] and, subsequently, all applicants and moving customers are assigned *automatically* to default service – whether they want to shop or not.[68] These pro-default service policies not only keep people from experiencing the competitive market, but also help to advance FE's own retail marketing strategy, which utilizes the name recognition and brand loyalty of its

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64 Joint Applicants' M.B. at 38.

65 Scheduling and Briefing Order (dated June 23, 2010), at p. 2-3 (footnote omitted, emphasis added).

66 *See*, Direct Energy M.B. at 13-39 (Section V).

67 Tr. 936-937.

68 Direct Energy M.B. at 22-26 (Section V.B.2.a.i).

affiliated EDC/default service provider to switch default service customers to products offered by its affiliated EGS. The result is likely to be that FES will be highly successful in switching customers via municipal aggregation (for small customers) and direct sales (for larger ones).[69]

The present default service structure is a key element of this anticompetitive strategy. If it was not, why would the Joint Applicants be fighting so hard to defeat Direct Energy's proposal? FE's affiliated EDCs do not make a profit directly from their provision of default service. FE's affiliate would still be free to compete by participating in the proposed retail auction. Why then is FE so opposed? The answer is obviously because having a structure where most mass market customers remain on FE-provided default service is key to successfully deploying FE's retail marketing strategy, the goal of which is to dominate the post-merger retail market. It's as simple as that.

Accordingly, Direct Energy's proposed remedy directly addresses this barrier to the development of workable competition – by proposing that the FE-affiliated EDC be removed as the default service provider and that a retail auction be conducted so that a fully robust competitive market be created to compete with FES. Thus, default service has everything to do with the competitive issues in this case.

The basis of the Joint Applicants' argument that Direct Energy's proposed default service restructuring is not relevant to the merger is a handful of quotes from Direct Energy's witnesses that acknowledged that the default service structure in the FE and Allegheny-affiliated service territories is similar to the structure in place in other EDC territories.[70] While Direct Energy witnesses readily agreed that other service territories in Pennsylvania had similar default service structures and rules, the difference here is that: 1) the Joint Applicants have called that structure

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[69] Direct Energy M.B. at 26-35 (Sections V.B.2.a.ii and iii).

into question by virtue of the proposed merger that would combine four EDCs and eliminate a significant competitor in the wholesale and retail markets in Pennsylvania; 2) FE is planning to exploit that structure for its own corporate benefit by implementing a retail strategy that is intended to make its affiliate the dominate retail provider of service in its service territories; and 3) the Commission is obligated to consider whether a workably competitive market will result after this merger, an investigation that is not mandatory in the other EDC service territories because the merger standard has not been brought into play.

1. Existing Anti-Competitive or Discriminatory Conduct is Prohibited by Section 2811(e) if it is Likely to Exist After the Merger.

The Joint Applicants try to buttress their contention about the claimed irrelevancy of default service by suggesting that, pursuant to Section 2811(e), any "competitive harm" resulting from the merger must be shown to be proximately caused by the merger. Since the default service structure exists today, pre-merger, and will continue whether or not the merger is approved, the Joint Applicants suggest that it cannot be part of the analysis. The Joint Applications are simply wrong. While harmful conduct caused by the merger (e.g., the elimination of a competitor) is covered by Section 2811, the plain language of the statute also invalidates a merger which perpetuates conduct that "will prevent retail electricity customers . . . from obtaining the benefits of a properly functioning and workable competitive retail electricity market."[71] The statutory language further requires the PUC to take steps to "preserve the benefits" of a workable competitive market – not preserve the market as it existed prior to the merger, regardless of how uncompetitive it was. Nowhere in the statutory language is it required that the "result" be specifically caused by the merger; only that the "conduct" be present (i.e.,

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70 Joint Applicants M.B. at 37-38.

71 66 Pa. C.S. § 2811(e)(1) (emphasis added).

"result") after the merger. It is illogical to suggest that Section 2811 was intended to only deal with anticompetitive conduct by a merger applicant only if the anticompetitive conduct was caused by the merger. In any event, the record here establishes that both types of conduct will result if the merger is approved without remediation, i.e., the merger will perpetuate anticompetitive and discriminatory conduct (i.e., FE's use of the existing default structure) as well as result in additional anticompetitive conduct which will be facilitated by the current default structure, and which would not occur absent the merger.

Moreover, Direct Energy's arguments have been presented not only in response to the merger requirements in Section 2811(e) but also to those in Section 1102 as well. It is well-established that the merger may not be approved unless it is demonstrated that the proposed combination will affirmatively benefit the public and specifically will "affirmatively promote the 'service, accommodation, convenience or safety of the public' in some substantial way,"[72] and "competitive impact is a substantial component of a rational net public benefits evaluation in the merger context."[73] Direct Energy's proposal if implemented would provide affirmative competitive benefits and is thus relevant to the merger from this standpoint as well.

2. The Opponents Claims are Inconsistent with the Partial Settlement.

Finally, the opponents' arguments amount to a claim that issues that have previously been resolved in separate or generic proceedings cannot be raised here. But the Partial Settlement is filled with issues that were originally resolved in other cases. So, while the opponents excoriate Direct Energy for having the audacity to suggest changes to the existing default service rules, the Partial Settlement decided that: "(1) any harmonization of default service procurements for [the FE-affiliated EDCs] will not occur until after May 31, 2013; and (2) the Joint Applicants will not

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72 *City of York v. PA Public Utility Commission*, 295 A.2d 825, 828 (Pa. 1972).

oppose hourly pricing for large commercial and industrial customers in the next default service procurement plans for [the FE-affiliated EDCs]."[74] Moreover, the Partial Settlement contains a host of conditions that were not contained in the Joint Applicants filing including, universal service, environmental improvements and smart meters, to name a few.[75] That the opponents can argue on one hand that certain changes in the structure of default service universal service plans, smart meter deployment plans and a host of other items are properly addressed here but that Direct Energy's proposed remedies to address a core issue of a merger – the alleged competitive effects of the transaction – "has nothing to do" with the merger is hypocritical, to say the least.[76]

Direct Energy has presented credible evidence that the structure of and rules associated with default service, combined with FES's strategy to attempt to dominate the retail market in its service territory, will result in an anticompetitive and discriminatory market. Plainly, these issues are relevant to the merger's effect on retail competition and should be considered here.[77]

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73 *Popowsky v. Pennsylvania Public Utility Commission*, 937 A.2d 1040, 1056 (Pa. 2007).

74 Partial Settlement at p. 14, ¶¶ 32-34.

75 *See* Partial Settlement, ¶ 15 to 57. For example, the Partial Settlement proposes changes to West Penn's Customer Assistance and Low-Income Usage Reduction Programs even though each program is provided pursuant to generic, state-wide Policy Statement (52 Pa. Code §§ 69.261 to 69.267 – CAP; 52 Pa. Code §§ 58.1 to 58.18 - LIURP) and the current structure and spending levels have been approved in the respective EDCs Universal Service Plans. Also the FE EDCs agree in the Partial Settlement to a date specific for the installation of 90% of smart meters and "will have voluntary time of use rates available" to customers. *See* PS ¶¶ 23-24. These items were both the subject of separate proceedings in which the SMIP for the Joint Applicants was established.

76 Moreover, the Joint Applicants ignore the fact that Direct Energy's proposed changes to default service would take effect only after the completion of the default service plans starting in 2011, becoming, in effect, the next default service plan for those utilities. Every POLR and default service plan adopted for each utility over the past decade has undergone some change from the previous plan. The implication that utility POLR or default service in Pennsylvania is an unchanging monolith that cannot be altered unless and until the utility decides it is time to do so has no basis in reality.

77 OCA as well as the Joint Applicants suggest that the Commission should not adopt the proposed remedy for anticompetitive and discriminatory conduct resulting from the merger because the Commission did not adopt a similar proposal in a past default service proceeding. OCA M.B. at 31-32. That proceeding involved the first default service plan for West Penn Power. *Petition of the West Penn Power Company d/b/a Allegheny Power for Approval of its retail Electric Default Service Program and Competitive*

B. The Direct Energy Proposal Is Consistent With The Public Utility Code and the Commission's Regulations and Does Not Violate the Due Process of Any Party

A variety of parties have insisted that Direct Energy's proposed default service restructuring should be rejected because it "disregards the procedural and substantive requirements imposed by the Commission's default service regulations."[78] The gist of the argument is that, while they admit (as they must) that the Choice Act and PUC's regulations permit an alternative DSP provider to be selected, they insist that there are only three "processes" that can be utilized to do that – and Direct Energy allegedly has not used any of them. They claim as well that Direct Energy has not met any of the alleged substantive requirements such as showing that the current EDCs are not fit. OCA actually suggests that Direct Energy has effectively petitioned to be the alternative DSP, but has failed to satisfy the criteria required for such a petition.[79] The Joint Applicants even claim that Direct Energy's proposed remedy "raises serious due process issues,"[80] although they state neither the alleged violation or even whose due process right allegedly is being violated!

These arguments seriously distort the Direct Energy proposal and its legal basis, misread or ignore the actual language of the regulations and assert non-existent rights for non-existent parties. Ironically, virtually every one of these alleged "failings" could be asserted about a host

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Procurement Plan for Service at the Conclusion of the Restructuring Transition Period, P-00072342 (Order entered July 25, 2008). As an alternative to West Penn Power's plan, Direct Energy suggested that the Commission consider reassignment of DSP responsibility and a customer auction. Tr. 999. In that case, as proposed, the customer auction would only have been considered if the Commission did not open a proceeding to consider the appointment of one or more alternative DSPs to open the markets to competition. Here, as proposed, the alternative DSP and auction proposals would work together to prevent the Joint Applicants from exercising anticompetitive and discriminatory market power. In 2008, , the Commission did not act on either proposal to open the market. But, that 2008 decision not to act should in no way preclude the Commission from acting in 2010 to remedy the anticompetitive and discriminatory caused by a merger.

78 Joint Applicants' M.B. at 39.

79 OCA M.B. at 7-8,26-28.

80 Joint Applicants' M.B. at 40.

of the alleged "benefits" contained in the Partial Settlement, such as rate reductions, the smart meter deployment, the time-of-day rate filing and the modifications to the West Penn and FE-affiliated EDC universal service plans, among others.

First, Direct Energy's opponents have thoroughly mischaracterized Direct Energy's plan as some type of stand-alone proposal, divorced from the merger. Direct Energy's proposal to restructure default service in the FE-affiliated EDC service territories plainly has been made in this proceeding in response to evidence showing that the FE/Allegheny combination will not meet the competitive merger standards. In fact, each of Direct Energy's witnesses explained that they were recommending that the Commission order these modifications as conditions of merger approval, not as separate independent steps.[81] If the Commission accepts Direct Energy's recommendations, the Joint Applicants would be required to implement these steps only if they wished the merger to be approved by the Commission. It is beyond cavil that, upon finding a likelihood of anticompetitive and discriminatory conduct, the Commission may impose conditions necessary for the "accommodation, safety and convenience of the public,"[82] that will allow the post-merger existence of "properly functioning and workably competitive" markets.[83]

Further, its proposed structural remedies are not conditioned on Direct Energy either acting as the ADSP or achieving any particular result in the an auction conducted by the DSP.[84] Indeed, there is no guarantee that Direct Energy would gain any customers or responsibilities from the default restructuring and auction.

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81 *See* Direct Energy M.B. at 40-55 (Section VI.A).

82 66 Pa. C.S. § 1103(a).

83 66 Pa. C.S. § 2811(e).

84 Direct Energy St. 3 at 6. To be an effective remedy, the alternative DSP should not be an affiliate of either FE or Allegheny Power. Direct Energy St. 3 at 4, 14-15.

Moreover, Direct Energy's specific proposal with respect to default service restructuring is that the PUC would initiate an investigation to both establish the procedural rules and criteria for the alternative DSP and, after a competitive process, select the alternative DSP provider. The PUC's existing alternative DSP rule specifically contemplates that the Commission could take such action, stating that "the Commission may propose through its own motion that an EDC be relieved of the default service obligation."[85] Direct Energy is asking that the Commission start a proceeding by its "own motion." Thus, it is hard to fathom how Direct Energy's opponents can claim that its proposal is not consistent with this part of the regulations.

The Joint Applicants also claim that Direct Energy's proposed remedy does not comply with the "substantive requirement" that the existing EDC be shown to be operationally and financially unfit to continue to be the default service provider.[86] The regulation has no such requirement. As the Joint Applicants' own quote from the regulation establishes, the section states that the Commission will exercise its authority under this provision when it finds that DSP replacement "is necessary for the accommodation, safety and convenience of the public." That provision would plainly be met by a PUC determination that it needs to make a change in order to mitigate the anticompetitive effects of the merger.[87] Moreover, the regulation does not require that the Commission find that the incumbent EDC is financially or operationally "unfit" before making a replacement – it merely states that the Commission will "consider" those factors.[88]

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85 52 Pa. Code § 54.183(b)(3) (The DSP may be changed by one of the following processes: . . . (3) The Commission may propose through its own motion that an EDC be relieved of the default service obligation).

86 Joint Applicants' M.B. at 39-41.

87 The language in 52 Pa. Code § 54.183(b) is virtually identical to the operative language in 66 Pa. C.S. § 1103(a) which authorizes the Commission to approve an application for a certificate of public convenience when the transaction meets this same standard. Of course, competitive issues are key to a finding under Section 1103(a) and the Commission is authorized to impose "just and reasonable" conditions if necessary in order for the transaction to meet this standard.

88 See 52 Pa. Code § 54.183(b)(3).

The Commission has discretion to take action even if the incumbent is not found unfit from a financial or operationally basis.[89] Direct Energy witness Lacey did show that there are several participants in the market who would be superior to FE in performing the role of DSP. That is because there are numerous EGSs who would be just as qualified and competent to serve that role, but all of them would be superior to FE because FE's provision of the service "is inherently anticompetitive and discriminatory."[90]

Further the Joint Applicants' off-hand claim that Direct Energy's proposed remedy "raises serious due process concerns," is equally baseless.[91] Direct Energy's proposal for a change in default service was limited to the DSPs involved in the merger and the service areas in which they operate.[92] The Joint Applicants and all parties to this proceeding have had notice of this proposal,[93] and have obviously responded to it – voluminously – both at a hearing and in writing, as did the statutory parties. They would also be involved in the investigation, being proposed by Direct Energy, to establish the rules and procedures for that restructuring.[94] The

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89 52 Pa. Code § 54.183(c).

90 Direct Energy St. 3 at 5-6.

91 The Joint Applicants do not fully state a due process claim because they never allege which property interest will be deprived by the proposal: "It is well established that the root requirement of due process is that 'an individual be given an opportunity for a hearing before he is deprived of any significant property interest. . . ." *Pennsylvania Coal Min. Ass'n v. Insurance Dept.* 370 A.2d 685, 692 (Pa. 1977).

92 Clearly, this was not a proposal for change throughout the Commonwealth, but rather a proposal for change in default service in a limited geographic area and for a very small number of DSPs. Moreover, Direct Energy did not request that it be named the DSP in the affected service areas, thereby triggering the filing requirements set forth in 52 Pa. Code § 54.183, but instead, proposed that as a condition of the merger and to promote competition, FirstEnergy should agree to be relieved of its DSP responsibilities.

93 The only relevant notice requirements in this case, are those promulgated pursuant to the Public Utility Code. Those rules provide that notice of merger applications "must be published in the Pennsylvania Bulletin and as may otherwise be required by the Commission. 52 Pa. Code § 5.14. A notice of the filing of the Joint Application was published in the Pennsylvania Bulletin on May 29, 2010. Additionally, as directed by the Commission, notice of the filing of the Joint Application was published in the Pittsburgh Post-Gazette on May 28, 2010. Two public input hearings were held in Greensburg, Pennsylvania,. Evidentiary hearings were held in Harrisburg on October 12 through 15, 2010. Consequently, the notice and hearing provisions required to satisfy due process under the regulations were met. There are no additional due process requirements for intervenors in the application process.

94 See Direct Energy M.B. at Appendix D.

Joint Applicants never state what other process should be due to them. Moreover, interested parties were on notice (or should have been) that the Choice Act directs the Commission to impose conditions on mergers in order to address anticompetitive conduct. No other party or individual has a "property interest" in having the existing EDC continue to provide default service, since the Choice Act specifically authorizes such a switch.[95] Thus, the Joint Applicants' vague claims of a due process violation are devoid of merit and should be dismissed.

In addition, even if the Direct Energy proposed remedy did not or does not comply with some aspect of the Commission's regulations, however ministerial, the parties fail to consider that the Commission has plenary authority to waive or amend its own rules and regulations, and has done so in similar circumstances.[96] The Commission frequently does this (at least implicitly) in merger cases where the order approves a host of conditions that go into effect upon merger consummation, without following otherwise applicable rules or procedures.[97]

The parties to the Partial Settlement parties, of course, themselves are proposing a host of changes in the tariffs rules or operations of the Joint Applicants without following the otherwise applicable statutory provisions or regulations and procedures. This includes changes in the Joint Applicants' low income assistance and LIURP Plans,[98] rate credits to West Penn residential

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95 It should be noted that customer groups, OSBA and OCA have been involved in this proceeding. In any event, customers may well have a personal or property interest in receiving electric service from someone – but they certainly don't have a property interest in receiving it from their current EDC. Moreover, any interested customer would have the opportunity to participate in the PUC investigation setting the rules for and selecting the ADSP.

96 *Petition of Direct Energy Services, LLC for Issuance of an Emergency Order*, Docket No. P-00062205, Final Opinion and Order entered April 20, 2006.

97 *See* Direct Energy M.B. at 41, fn 162.

98 The Partial Settlement provides for changes in Universal Service Plans (in terms of funding and level of participants; (PS, ¶¶ 20-22) yet the Joint Applications have not filed a petition to amend their existing Universal Service and LIURP Plans. 52 Pa. Code § 54.74 (Universal Service and Energy Conservation plans must be submitted and approved by the Commission); 54.73 (criteria for approval of Universal Service and Energy Conservation plans. A revision to an EDC or NGDC's filed plan usually requires a petition for modification. *See*, 52 Pa. Code §§ 54.74(a)(3), (b)(8); 52 Pa. Code §§ 62.4(a)(3), (b)(8).

customers,[99] and changes to the Joint Applicants' smart meter deployment and Act 129 energy efficiency plans.[100] Of course, none of these matters was initially addressed in the Joint Application.

If the rule is that a provision to be imposed as a condition for merger approval is invalid if it does not follow the Commission's otherwise applicable rules and procedures, then all of these Partial Settlement provisions must also be rejected. Direct Energy does not believe that these merger concessions need to be rejected for this reason because the initial legal premise is invalid. But, if the Commission were to find otherwise with respect to Direct Energy's proposed default service revision, it is difficult to see how these various provisions in the Partial Settlement could nonetheless be adopted. The bottom line is that this "non-compliance with normal PUC regulation and procedure" arguments is irrational and inconsistent with the facts and the law as well as past practice.

1. OCA's Contention that the Alternative DSP Will Cause Customers to Lose Consumer Protections is Without Merit.

OCA also contend that customers will lose consumer protections as a result of choosing an alternative DSP (or ADSP).[101] Specifically, OCA opines that the ADSP will not be subject to regulatory oversight[102] and will not have an obligation to serve.[103] These arguments are simply untrue. It is clear that the ADSP would be subject to the Commission's oversight. It is also clear

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99 The Partial Settlement authorizes minimal rate "credits" to West Penn residential customers of $3.57 million for three years (PS, ¶ 17) yet West Penn has not filed a tariff filing pursuant to 66 Pa. C.S. § 1308; nor has it filed the data required for a rate change (52 Pa. Code § 53.51), nor has it provided notice to its customers of the rate change (52 Pa. Code § 53.45).

100 The Partial Settlement changes the implementation schedule for West Penn's existing and previously approved Smart Meter Implementation Plan ("SMIP"), as well as adding a new element to the FE-EDCs Energy Efficiency and Conservation Plans [PS ¶¶ 23-24] yet none of the companies has filed petitions to modify their existing plans or have shown that they meet the substantive standards for such modifications.

101 OCA M.B. at 34-36, 40-41.

102 OCA M.B. at 35; OCA St. 2-R at 9-10.

that ADSP would be responsible for serving all EGS customers that return to the DSP[104] and would comply with default service procurement requirements of Act 129 (as spelled out by Direct Energy).[105] But, the EDCs would continue to have the legal responsibility to meet the sales and demand reduction requirements of Act 129 just as it has today, to administer universal service programs and continue to recover the costs of doing so.[106]

C. The Criticisms of Direct Energy's Proposed Customer Account Auction Are Meritless

The Joint Applicants', OCA's and OSBA's criticism of the "opt out" mechanism proposed by Direct Energy for the customer auction is misplaced. They have all expressed concern over the opt-out mechanism, which is part of the proposed auction of customer accounts. The OCA asserts that Section 2807(d)(1) and the Commission's Regulations (52 Pa. Code §§ 57.171 to 57.179)[107] precludes an "opt-out" mechanism, and characterizes such mechanisms as "slamming."[108] In a similar fashion, the OSBA reads those provisions (together with Section 2803 and 2807(e)(3.1) as precluding an "opt-out" mechanism.[109]

But the Commission has approved "opt out" approval processes in several instances.[110] The auction process would not represent unauthorized switching, but rather the lawful exercise of the Commission's express authority to mitigate anticompetitive and discriminatory conduct.

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103 OCA M.B. at 41-42.

104 Tr. 998-99.

105 *See* Section IV.D of this Reply Brief.

106 Tr. 786-90; Tr. 1013-14.

107 OCA M.B. at 11, 17, 22-26.

108 OCA M.B. at 11, 17, 22-26.

109 OSBA M.B. at 48-49. The OSBA contends that a customer must "affirmatively" choose an EGS.

110 *See, e.g., Petition of Direct Energy Services, LLC for Issuance of an Emergency Order*, Docket No. P-00062205, Final Opinion and Order entered April 20, 2006 ("Pike County"); *PECO MST, supra*; *George v. Pa. PUC,* 735 A.2d 1282 (Pa.Cmwlth. 1999). The Commission has long held that customer information will be released to EGSs unless a customer affirmatively opts out of such a release. 52 Pa. Code § 54.8(a). That an opt out constitutes acceptable consent was affirmed by the Commission in its "Eligible Customer List Policy Statement, issued just last week. *Interim Guidelines For Eligible Customer Lists,* M-2010-

The OCA and OSBA attempts to distinguish Pike County and other examples of opt-out mechanisms are without merit. In Pike County, customers of Pike County Light & Power Company ("PCL&P") were offered an "opt-out" aggregation opportunity in which, absent a choice to remove themselves from the aggregation group, customers were included and received a materially lower rate than the customers who remained on default service. The OCA and OSBA place undue emphasis on these facts and that the aggregation customers were subject to a very high generation rate increase in Pike County.[111] The mechanisms used in Pike County were indeed the solution to a unique problem involving default service. However, the Commission's conclusion was that a properly noticed and structured opt-out approval process is legal under the Public Utility Code, and is not slamming. The unique circumstances at play in Pike County could not have made an illegal process into a legal one.

The OSBA further contends that Direct Energy cannot place any reliance on the Commission's prior approval of PECO's market threshold (MST) program.[112] It is true that PECO's MST program is structurally different from Direct Energy's proposal. But, the MST program is relevant because it serves as another example of a Commission determination that a PUC-approved "opt-out" mechanism does not constitute "slamming" under the Public Utility Code.

Moreover, it is clear that the lack of price caps here and the existence of price caps when the PECO MST took place does not undermine the legality of the "opt-out" mechanism. In both

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2183412 (Opinion and Order entered November 12, 2010) at 8 ("In addressing this issue in both the PPL Order and the Duquesne Order, we continued our policy that restriction of information would occur through affirmative customer action, such as through a postal card check-off which clearly identified the information a customer wished to have restricted. We find that the same result set forth in the Duquesne Order should prevail for ECLs maintained by the other EDCs.").

111 OCA M.B. at 24-25; OSBA M.B. at 49-50.

112 OSBA M.B. at 50-51.

cases, the opt-out mechanisms provide for the initial assignments. Under the PECO MST program (and rate caps), customer could leave the MST program and return to the EDC's default service. Here, customers could leave their auction winner and go to the ADSP's default service or to a different EGS. Thus, contrary to OSBA's claim about the auction, the opt-out feature is not affected by whether rate caps have expired.[113]

The Joint Applicants, OCA, OSBA and EAPA all claim that opt-out mechanisms are involuntary.[114] This claim is contradicted by the Joint Applicants themselves. FE's CEO, Tony Alexander, acknowledged that participation by "not opting out" of the municipal aggregation pools represents a voluntary choice.[115] He further testified that an opt-out mechanism could not be called "slamming."[116] Such testimony is consistent with the Commission's treatment of opt-out mechanisms and contradicts the rhetoric of the OCA, OSBA and EAPA. The Joint Applicants cannot have it both ways, embracing opt-out programs when it suits their retail marketing strategy, and rejecting them when they do not.

EAPA broadly contends that an auction is not consistent with the "end state" envisioned by the Choice Act.[117] In doing so, EAPA notes that the Choice Act does not mention the provision of default service by "auctioning default service customers."[118] But, the Choice Act does not preclude a customer auction and, as noted above, the Commission has previously authorized similar albeit less comprehensive mechanisms. EAPA's main objection to the auction

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113 *See* OSBA M.B. at 51.

114 *See, e.g.,* Joint Applicants M.B. at 52; OCA M.B. at 3, 17-18, 39; OSBA M.B. at 47; EAPA M.B. at 5.

115 Tr. 277-278.

116 Tr. 278.

117 EAPA M.B. at 4-5.

118 EAPA M.B. at 5.

is its fear that it will interfere with default service supply procurements.[119] But, as explained in more detail in Section IV.C, a customer auction would not impact the procurement of default service supplies because Direct Energy has specifically proposed that it go into effect only after the current default service plans are completed.[120]

The Joint Applicants, EAPA and OCA also contend that a customer auction would eliminate a customer's choice of receiving service from the EDC.[121] But, as noted above, this contention fails to recognize that no customer has a "right" to be served by a particular entity for default service and the Commission could remove an EDC from this role at any time. Moreover, any customer's desire to be so served must stem from a misapprehension of the service the customer is actually receiving.[122] This kind of misapprehension is a perfect illustration of the structural barriers the proposed post-merger default service structure would allow to remain in place, to the detriment of customers. Given that the Choice Act already provides that an alternative default service provider may provide default service,[123] it is clear that the Legislature did not mandate (or otherwise create) a right to remain on default service offered by an EDC. Moreover, a customer would always be free to seek out the affiliate of the EDC for generation service if he or she had some reason to only deal with the company affiliated with the distribution company.

The Joint Applicants further contend that the customers "would have no say" in the terms of the winning alternative DSP.[124] But, customers could participate in the ADSP selection

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119 EAPA M.B. at 5.

120 Direct Energy M.B. at 53-53 (Section VI.A.4).

121 Joint Applicants M.B. at 52; EAPA M.B. at 5.

122 See, Direct Energy St. 2 at 12-13 and Section IV.H of this Reply Brief.

123 See, 66 Pa. C.S. § 2807(e).

124 Joint Applicants M.B. at 52.

process (if the Commission authorized same) and the customer would be free to leave the winning bidder at any time without penalty.[125] Because they can leave the winning bidder, the customers have the ability to reject the terms of the winning bidder. Moreover, the customers never had a "say" in the entity that has been providing them with default service since unbundling.

OCA also contends that low-income customers face additional risks from the auction.[126] Direct Energy proposed bundling low-income customers together to maximize the efficiencies of the assistance programs.[127] Without any explanation, the OCA rejects this concept. In its place, the OCA creates a "strawman." According to the OCA, low-income customers must only be bundled together so that low-income customers can receive higher prices (or less benefit from the retail auction) than other residential customers.[128] Based on this premise, the OCA than "faults" Direct Energy for not "proving" that low-income customers will be charged less than other residential customers.[129] There is no valid basis for accepting the OCA's premise. Under Direct Energy's proposal, low-income customers will still receive the benefits of assistance programs. They will not be negatively or disproportionately impacted by the auction. They will receive a check of exactly the same amount as any other customer.[130]

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125 Direct Energy St. 3 at 13-14.

126 OCA M.B. at 38-40.

127 Direct Energy St. 3 at 10-11.

128 OCA M.B. at 39-39; OCA St. 2-R at 16-17.

129 OCA M.B. at 39-39; OCA St. 2-R at 16-17.

130 Moreover, Direct Energy has made clear from the moment that OCA raised issues about the treatment of low-income customers that it is open to suggested revisions to its plan that would ensure proper treatment of vulnerable customers. Rather than seeking to improve the position of those it claims to represent, the OCA has set about trying to ensure that low-income customers get nothing from the proposed merger, other than whatever the Joint Applicants deign to cast in their direction.

D. The Direct Energy Proposal Satisfies All Applicable Portions Of Act 129

The Joint Applicants, the OCA, the OSBA and now EAPA contend that Direct Energy's proposal generally conflicts with the Commission's Default Service Regulations and the Policy Statement on Default Service.[131] They claim as well that the proposal for the alternative default service provider to price the default option on a quarterly average of electricity procured in the hourly spot market violates various provisions of Act 129. These arguments are not correct.

In fact, Direct Energy's proposal is consistent with the Commission's Policy Statement.[132] The Policy Statement states that for residential customers, "[i]n subsequent programs, the percentage of supply acquired through shorter duration full requirements contracts and spot market purchases should be gradually increased, depending on development in retail and wholesale energy markets."[133] Accordingly, the Policy Statement recognizes that procurement "mix" may change with circumstances and may consist solely of spot market purchases if the circumstances are appropriate.

Importantly, nothing in the Direct Energy proposal is intended to, or will actually, deprive customers of the benefits and protections afforded by Act 129. Contrary to the contentions of the Joint Applicants, the OCA[134] and the OSBA,[135] procurement under the Direct

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131 OCA M.B. at 15-17; OSBA M.B. at 55-58; EAPA M.B. at 5.

132 Direct Energy St. 3-SR at 14. The Commission obviously is not bound by its generic rules or policy statements in the context of a merger and is free to waive generic rules in order to structure a merger that satisfies the statutory standards. Direct Energy St. 3-SR at 14.

133 Default Service and Retail Electric Markets, Docket No. M-00072009, Final Policy Statement entered May 10, 2007 at 5.

134 OCA M.B. at 11-21. OCA suggests that Commission should not restructure the retail market because Act 129 was passed in 2008. OCA M.B. at 30-31. But, the Commission should not be constrained by the passage of Act 129 in remedying the anticompetitive and discriminatory effects caused by the merger. Moreover, Act 129 changed the method of procurement of electricity for default service. Act 129 did not change the structure of the default service markets. Nor did it repeal Section 2811 or the policy of the Commonwealth that "[c]ompetitive market forces are more effective than economic regulation in controlling costs of generating electricity." (66 Pa. C.S. 2802(5)) Thus, there is no reason to wait to observe the impacts of Act 129. This is especially true because the record shows unequivocally that a workable competitive market will not exist *after* the merger is consummated, presumably sometime in

Energy proposal will satisfy all applicable requirements of Act 129. As explained by Direct Energy's witnesses, the alternative DSP will procure through a competitive process (the PJM spot market) the most prudent mix of contracts that meet the least cost over time standard and take into account the benefits of price stability in this context.

1. Prudent Mix[136]

The OCA and OSBA boldly contend that Direct Energy fails to satisfy the "prudent mix" requirement of Act 129[137] But they are wrong. The Direct Energy proposal has as the basic underlying assumption that most, if not all, customers will be served by competitive electric generation suppliers.[138] In that instance, the only "prudent" or "wise or judicious" mix of supply for those few customers who likely will remain on default service would be real-time spot market procurement.[139] It would be unwise, frivolous and very expensive to procure what would effectively be long-term options at a fixed price for such a small number of customers.[140]

Interestingly, the OCA characterizes Mr. Lacey's assumption that only a few customers will remain on default service as "self-serving."[141] But, OCA does not challenge the assumption itself and implicitly agrees that if the auction were conducted, few customers would remain on

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2011, even though the generation rate caps will have been removed starting in January 2011. *See* Direct Energy M.B. at 16-39 (Section IV.B.2). If the OCA's contention is really that, in passing Act 129, the Legislature abandoned its support for and policy of encouraging competitive electric market, it is demonstrably false. Act 129 did not alter the basic policy of the Commonwealth – one that OCA clearly does not share – that competition is better than regulation in producing the lowest prices and best outcomes for consumers. 66 Pa. C.S. § 2802(5). Nor did it rescind section 2811(e).

135 OSBA M.B. at 53-62.

136 Act 129 requires that default service be provided from a "prudent mix" of short, long and spot market contracts. 66 Pa. C.S. § 2807(e)(3.2).

137 OCA M.B. at 21; OSBA M.B. at 53-62.

138 Direct Energy St. 3-SR at 16.

139 Direct Energy St. 3-SR at 16.

140 Direct Energy St. 3-SR at 16-17.

141 OCA M.B. at 20-21.

default service. OCA also does not challenge Mr. Lacey's logic that – with so few customers on default service – the use of the spot market would provide the least cost over time for those customers remaining on default service.

Further, both the OCA and the OSBA contend that Act 129 mandates a "mix" that must include spot-market purchases, short-term contracts and long-term contracts.[142] The OSBA further contends that if the Legislature had intend default service to be spot- market-based, it could have mandated that result.[143] However, these contention fail to recognize that the Commission has already found that default service for a particular class, or for all default service customers may consist solely of spot market purchases and still satisfy Act 129's "prudent mix" requirement. For example, MetEd, Penelec, PennPower and West Penn customers require default service which is priced on an hourly spot market basis.[144] Moreover, in Pike County all default customers are served via the spot market.[145] Again, these PUC orders are irreconcilable with the statements of Direct Energy's opponents that a "prudent mix" of spot, long term or short term products means that all the products are legally required to be used. The correct interpretation of the law is that the type (or types) of products included in a prudent mix is a matter of discretion for the Commission to determine; a mix of various products is certainly not

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142 OCA M.B. at 12-15; OSBA M.B. at 54-55.

143 OSBA M.B. at 55.

144 *See, e.g., Petitions of Metropolitan Edison Company and Pennsylvania Electric Company for approval of their default service programs*, Docket No. P-2009-2093053 and P-2009-2093054 (Order entered November 6, 2009) (The Companies will offer industrial class customers an Hourly Pricing Service ("HPS") priced to the PJM real-time hourly market); *Petition of Pennsylvania Power Company for approval of its default service programs*, Docket No. P-2010-2157862 (Order adopted October 21, 2010) (same); *Petition of the West Penn Power Company d/b/a Allegheny Power for Approval of its retail Electric Default Service Program and Competitive Procurement Plan for Service at the Conclusion of the Restructuring Transition Period*, Docket No. P-00072342 (Order entered July 28, 2008) (ST 40 customers will be charged based upon hourly locational marginal price (LMP)).

145 *See, Petition of Pike County Power and Light for Expedited Approval of its Default Service Implementation Plan*, Docket No. P-2008-2044561, (Opinion and Order entered March 23, 2009).

legally mandated.[146] In this case, one type of power procured in the hourly spot market would be most prudent.

2. Direct Energy's Plan Reflects Least Cost Over Time

The OSBA and OCA contend that Direct Energy presented no evidence that using spot market purchases for default service will produce the least cost over time.[147] Apparently, neither reviewed the testimony in the record because this is not the case. Direct Energy's witness Frank Lacey testified that:

> Dr. Morey shows how the structure Direct Energy is proposing will produce the lowest prices for default service over time. In the shorter term, the default service product should be an hourly procured electricity product. Direct Energy has shown in prior proceedings (in Pennsylvania and in other states) and in Pennsylvania's POLR and Default Service rulemaking dockets that short-term prices, over time, yield lower prices than longer-term contracts. The conclusions reached then are still true today.[148]

No witness challenged this testimony and no party disputed that in this scenario, a product secured in the real-time market is the most efficient, and least cost, for those customers.[149] Indeed, when it was pointed out that in similar circumstances, Pike County,

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146 *See, Petition of Pike County Power and Light for Expedited Approval of its Default Service Implementation Plan*, Docket No. P-2008-2044561, (Opinion and Order entered March 23, 2009).

147 OSBA M.B. at 55; OCA M.B. 11-20.

148 Direct Energy St. 1 at 8. In surrebuttal, Mr. Lacey expounded upon the reasons short-term market prices reflected "least cost" in this instance:

> It would be extremely imprudent to procure long-term contracts for default service customers when there are very few customers on default service following an auction. The few customers on default service after the auction would effectively be subsidizing the migration risk for the entire market, or at least an amount of the market that would be served by the long-term contract. Additionally, Pike County demonstrated well that RFPs for long-term default contracts for small volumes of customers are not a reasonable approach. I raise Pike County not because of the price that resulted from the auction, but because only one supplier, Pike County's affiliate supplier, bid for that small default load, which is hardly the kind of robust wholesale auction that would result in least-cost over time.

Direct Energy St. 3-SR at 15.

149 Direct Energy St. 3-SR at 16.

default customers had been subject to hourly market pricing and have seen prices lower than the fixed rate, the Joint Applicants' witness Mr. Schnitzer admitted that "this wouldn't surprise me."[150]

In the longer term, it is well accepted that a fully competitive and robust electricity market will provide service to customers at the least cost over time.[151] In a fully competitive market, prices are driven down to incremental cost, as firms compete to win customers.[152] As Direct Energy's default service pricing proposal is an integral part of its overall plan to create a workably competitive market, it will produce the "least cost over time."

3. Direct Energy's Plan Properly Takes Into Account the Benefits of Price Stability

The quarterly pricing for DSP customers[153] proposed by Direct Energy strikes a fair balance between the competing goals of stability, demand response and least-cost over time.[154] This approach offers price stability and price certainty and is completely consistent with the default service regulations; it is also consistent with the pricing mechanism used for natural gas customers receiving supplier of last resort service.[155]

Yet, the Joint Applicants continue to insist, falsely, that default service customers would be subject to an "unhedged hourly priced product" even though Direct Energy's actual proposal is that the default price would be the projected average of the spot market hourly prices for a three month period.[156] Notwithstanding, that the price will be the average for a three month

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150 Tr. 942.

151 Direct Energy St. 3-SR at 16.

152 Direct Energy St. 1 at 21.

153 Direct Energy St. 1 at 14; Direct Energy St. 3 at 8; Direct Energy St. 3-SR at 12.

154 Direct Energy St. 3-SR at 14-15.

155 Direct Energy St. 3-SR at 12.

156 Direct Energy M.B. at 42-43.

period, thereby smoothing any price spikes or drops,[157] the Joint Applicants claim that the "true-up" could nonetheless inject extreme volatility into the price.[158] The problem is that the Joint Applicants did not produce one whit of evidence for this allegation. A "true up" provision not only adjusts for differences in price between the projected and the actual price but also reflects differences in projected number of customers and sales volumes. One cannot reasonably leap from speculation about the effect of a "true up" to the conclusion that the price will be volatile, and then that the Commission must conclude that the resulting prices will not be properly stable.

The best evidence that a short-term pricing mechanism will, in fact, be sufficiently stable for customers is the results in Pike County, where default customers have been taking default service using the same pricing scheme as that recommended here – three month average spot market prices with a true up – for some time.[159] Notwithstanding this pricing, the load on this hourly priced default service has grown from virtually nothing to 40%.[160] Moreover, Direct Energy is not aware of any complaints about this pricing approach and its various opponents presented none. If hourly priced spot market prices were really so "unpleasant,"[161] how does one explain Pike County?

E. The Commission Has Authority To Order The "BillCo" Structural Separation.

Direct Energy's proposal that, as a condition of the merger, the Joint Applicants agree to create a separate billing subsidiary (a "BillCo") to ameliorate the competitive concerns created by the proposed combination is plainly within the Commission's authority. Essentially, the

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157 Tr. 803.

158 Joint Applicants' M.B. at 43-44.

159 *Pike County, supra.*

160 Tr. 941; Direct Energy Cross-Exam Exhibit 8.

161 Joint Applicants' M.B. at 44.

proposal is a structural version of the unbundling that the Commission has ordered in many other instances.[162]

Contrary to the opponents' contentions, this proposal is completely within the PUC's authority. The Commission may utilize divestiture, and other structural remedies, whenever it deems appropriate pursuant to its authority under Section 2811.[163] The Commission has plenary authority to regulate the activities of public utilities in the Commonwealth,[164] and divestiture is a remedy which has its basis in express and implied provisions of the Public Utility Code.[165] Moreover, the Commission has indicated that it has a preference for and the authority to order structural remedies for violation of the merger standards[166] and in fact has done so, for example, ordering the structural remedy of Duquesne joining an independent system operator as a condition of approving a proposed merger between that utility and Allegheny Power.[167]

The Joint Applicants and EAPA claim that the billing function is inextricably intertwined with the distribution function, such that Section 2802(16) precludes the Commission from making an "involuntary re-assignment of [an] EDCs' public service obligation to furnish bills for distribution service."[168] Section 2802(16) does contain a statement indicating that, "[i]t is in the public interest for the transmission and distribution of electricity to continue to be regulated as a

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162 It should be noted that BillCo is part of Direct Energy's proposed remedies, but it is not critical remedy. Mr. Lacey recognized that the Commission could adopt the alternative DSP and auction proposals, but decline to order the creation of BillCo. Direct Energy St. 3 at 21, fn 4. In that scenario, Mr. Lacey recommended that the Commission order the implementation of a purchase of receivables ("POR") plan throughout the merged territory of FE. Id.

163 *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998 (April 30, 1998).

164 66 Pa. C.S. § 501, 1501.

165 *See, generally Joint Application of SBC Communications, Inc., and AT&T Corp.*, 2005 Pa. COMMISSION LEXIS 37 (Order entered October 6, 2005); *Re: Structural Separation of Bell Atlantic-Pennsylvania, Inc. Retail and Wholesale Operations*, Docket No. M-00001353 (Order entered April 11, 2001).

166 *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998.

167 *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998 *at * 76-*83 (1998).* The merger was never consummated.

natural monopoly subject to the jurisdiction and active supervision of the commission."[169] But once again however, Direct Energy's opponents have mischaracterized its proposal. Direct Energy is not suggesting an "involuntary re-assignment," nor is it suggesting that an entity other than the EDC would be responsible for billing and collection services, or that the service provided would not continue to be regulated by the Commission. Direct Energy's actual proposal – extricating the billing function from the other EDC functions – is completely consistent with Section 2802(16) because it merely requires FE to "unbundle" its billing functions, a power that the Commission has regularly exercised. The only difference here is that FE would be further required to perform these tasks from a separate affiliated company.[170] This affiliate would perform the service on behalf of the EDC affiliate, much like a service company does for general administrative functions. A regulated utility is free to contract with affiliates to provide billing (or other) services, assuming of course that the affiliate adheres to all applicable Commission rules and regulations.

The OCA and EAPA further contend[171] that the creation of BillCo is contrary to the provisions of Section 2804(5) of the Public Utility Code,[172] which states that the Commission shall not *require* an electric company to reorganize its corporate structure. First, Section 2804(5) applies to "each public utility's restructuring plan, oversight of the transition process and regulation of the restructured electric industry," presumably with respect to implementation of the utility's restructuring plan.[173] But, even if this section were deemed to have continued

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168 Joint Applicants' Motion *In Limine* at 11; EAPA M.B. at 6.

169 66 Pa. C.S. § 2802(16).

170 Tr. 1007-1008, 1046.

171 OCA M.B. at 11-12, 28-29; EAPA M.B. at 6.

172 66 Pa. C.S. § 2804(5).

173 66 Pa. C.S. § 2804.

viability, Direct Energy's proposed BillCo does not violate this provision because the Commission would not be requiring an electric utility to "reorganize its corporate activities." Under Direct Energy proposal, if FE wishes its merger to be approved, it must voluntarily agree to unbundle its billing and customer care functions and move them to a separate affiliated entity. Thus, no coercion is involved. Moreover, Section 2804(5) cannot be read to constrict the Commission's authority to remedy a merger that is fundamentally anticompetitive and discriminatory under Section 2811(e).[174] Read in that way, the Commission would be precluded from conditioning a merger on structural changes or asset divestiture. The Commission has found just the opposite in the Duquesne/Allegheny merger proceeding.

OCA and EAPA also contend that the EDC has a statutory "right" to provide the customer service functions (such as billing and collection).[175] No such right exists. Section 2807(c) provides that an EDC "may be responsible for billing customers for all electric services."[176] But Direct Energy is not suggesting that the EDC would not still be responsible for its billing – only that an affiliate would do the billing on its own behalf. If the statute is applicable at all, certainly does not mandate that only the employees of the EDC may actually do the billing for customers for all electric services. Such a holding would lead to absurd results, such as precluding the Joint Applicants' from consolidating billing and collections of their EDCs after the merger (which the Joint Applicants are, indeed planning) providing for EGS consolidated billing, or precluding an EDC from using billing services provided by an affiliate.

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174 "As divestiture of assets has long been accepted by the courts and enforcement agencies as an effective means to address market power concerns in merger cases, this Commission may utilize this remedy (and other structural remedies as well) whenever it deems appropriate pursuant to its authority under section 2811 of the Electric Competition Act." *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998 at 72 (1998).

175 OCA M.B. at 28-29; EAPA M.B. at 6.

176 66 Pa. C.S. § 2807(c).

OCA further submits that there is no evidentiary basis for concluding that the Billco would result in any benefits to customers.[177] However, the record shows that the Billco would facilitate the efficient functioning of a workable competitive retail electricity market in the Commonwealth and would, most likely, help the Commonwealth become the most effectively competitive retail electricity market in the country.[178] In turn, as envisioned by the General Assembly,[179] customers will benefit from a robust, efficient and sustainably competitive market.

Finally, Contrary to EAPA's claim,[180] nothing in Direct Energy's proposal would "strand" billing system costs or prevent the adequate recovery of such costs. First, neither EAPA nor any other party ever alleged this in the proceeding or submitted any evidence to support this claim, and it should be precluded from doing so now. Further it is clear that EAPA does not understand the Direct Energy proposal. As Mr. Lacey explained, the Billco would conduct all the present billing/collection/customer care functions that are presently being provided by the EDC, plus, it would provide branded bills for EGSs serving customers in the FE affiliated service territories.[181] Those customers are now receiving default service and receiving bills from the EDC, thus, the level of billing activity would not change. Nor would the utility's level of cost recovery change. In addition, the Billco would be free to offer unregulated value-added billing services for EGSs – or others, thus potentially expanding its operations and increasing its revenues.[182] Nothing in the proposal would create "stranded" billing system costs – in fact, just the opposite. Moreover, as Direct Energy has stated over and over, costs of revising the billing

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177 OCA M.B. at 41.

178 *See* Direct Energy M.B. at 49-52 (Section IV.A.3); Direct Energy St. 3 at 4, 19-20.

179 66 Pa. C.S. § 2802(5) ("Competitive market forces are more effective than economic regulation in controlling the cost of generating electricity.").

180 EAPA M.B. at 7.

181 Direct Energy St. 3 at 21; Direct Energy M.B. at 49-52.

systems to accommodate the creation of Billco would come from the acquisition payment pool that EGSs would offer in return for the ability to serve tranches of customers. Direct Energy witness Morey estimated that the total pool could be as high as $1 billion. Thus, EAPA's claim that the Billco proposal creates "concerns" about cost recovery is misplaced.[183]

F. Direct Energy's Proposal Is Consistent With Public Policy

OCA and OSBA broadly argue that Direct Energy's proposal would be a poor public policy because it would expose default service customers to "risks." But what Direct Energy's proposal would really do is reduce the risk to customers of allowing a single entity to dominate the retail and wholesale markets in the manner that the Joint Applicants clearly intend to do by creating a robustly competitive market (while still assuring the existence of a default service backup). Customers are not being exposed to any risk, other than the risk of receiving a check for up to $500 for essentially doing nothing, subsequently receiving a competitive and probably lower price (due to vigorous competition) from an EGS and receiving better and more innovative services. It should be noted that, in their Main Briefs, neither the OCA nor the OSBA contends that a remedy is not warranted because post-merger markets will be "properly functioning and workably competitive." Instead, they merely contend that Direct Energy's proposal is not the

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182 Direct Energy M.B. at 49-52 (Section VI.A.3).

183 The Joint Applicants also claim incorrectly that Direct Energy's Billco proposal is somehow barred by the settlement of MetEd and Penelec's last default service procurement proceeding because, in that Settlement, Direct Energy (and RESA) agreed not to "seek further unbundling of MetEd and Penelec's distribution rates" until those companies next base rate case. Joint Applicants' M.B. at 45. First, Direct Energy's proposal does request or require "unbundling of [MetEd and Penelec's] distribution rates. It would require those companies to unbundle activities and functions by creating a structurally separate billing subsidiary, but MetEd and Penelec's rates would not have to change. In any event, the proposal does not constitute a "petition seeking the unbundling" of anything – the proposal is submitted as a remedy to address the lack of a workably competitive market in the Joint Applicants' service territory and, if the Joint Applicants do not want to undertake that step, they do not have to – they can cancel their merger plans.

solution.[184] It is quite clear, however, that these parties' claims about the customers' risks allegedly created by Direct Energy's proposal are wrong and should be rejected.

1. Customer Benefits from Auction

OCA suggests that Direct Energy's proposal is a mere tactic to procure large groups of customers.[185] The record does not support this conclusion, and OCA ignores ample evidence showing how the Direct Energy proposal would be implemented and why it is far more than a mere "tactic" to acquire customers. Every EGS does not participate in every EDC service territory. Given that EGSs obtain customers one at a time,[186] care must be taken before entering a new service territory.[187] An EGS will only enter a market if it believes it can obtain a sufficient and sustainable customer base (i.e., scale) to support itself in that territory.[188] An auction process would enable an EGS to efficiently gain a large number of customers and obtain the necessary scale to sustain competition.[189] The auction will enable customers to receive proceeds from the auction (estimated at $150-$500 per customer) and obtain the benefits of shopping – without limiting their ability to choose another EGS.[190] Moreover, as stated previously, Direct Energy is not guaranteed to obtain a single customer if its proposal is implemented. It must bid for customers just like any other EGS and could come away from the those auctions having "won" no customers at all. What Direct Energy would have "won" however, is a fully competitive

184 *See*, e.g., OCA M.B. at 31-42.

185 OCA M.B. at 32-34.

186 Tr. 813-814.

187 Tr. 1055-1056.

188 Tr. 1055-1056; Direct Energy St. 1-SR at 39-40.

189 Tr. 814.

190 Direct Energy St. 3 at 13-14.

market in these service territories, which would be far more beneficial to both customers and EGSs in the long run than any number of customers acquired as a result of the auction.

2. Customer Education

Based on the testimony of their witness, Barbara Alexander, the OCA suggests that customers may not "adequately prepared" to participate in the competitive market envisioned by Direct Energy's proposal.[191] OCA further suggests that customers who participate in the auction process may need more than one year to make informed choices.[192] To the extent that confusion may exist concerning the auction, Direct Energy has proposed an extensive education program be conducted (paid for by auction proceeds) to advise customers of their options.[193] Participation in the auction will give customers experience in the competitive market, making subsequent buying decisions easier, and ongoing education efforts would continue to keep customers informed.

Moreover, the OCA's opinion is not shared by customers. Direct Energy commissioned Zogby International to conduct a customer poll of the customers in the Joint Applicants' service territories [194] to assess the validity of Ms. Alexander's broad statements about consumer attitudes and concerns.[195] The poll shows that when customers received information about their choices, an overwhelming number of them supported the proposed plan, as well as having an alternative default service provider. These results directly refute Ms. Alexander's claim that customers would not want to be part of this plan.[196] In fact, Commissioner Brownell believes that this poll

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191 OCA M.B. at 34, 42.

192 OCA M.B. at 42.

193 Direct Energy M.B. at 43-49 (Section VI.A.2); Direct Energy St. 1 at 19-20; Direct Energy St. 3 at 12.

194 Direct Energy St. 3-SR at 24, n. 10.

195 Direct Energy St. 2-SR at 8-9; Direct Energy St. 3-SR, Exhibit FL-4.

196 Direct Energy St. 2-SR at 8-9.

shows that "when customers are provided information that permits them to understand their competitive alternatives and the amount of savings they could experience, customers overwhelmingly support choice."[197] Frankly, there is no reason to even consider Ms. Alexander's claims about what customers want or understand, as they are based on nothing more than her speculative opinions.

3. Customer Pricing

The OCA contends that customers will face pricing risks if the retail auction takes place.[198] Specifically, OCA states that Direct Energy's proposal will result in customers being assigned to "unregulated marketers, who after the introductory period can charge what they want."[199] The OSBA echoes this concern about "unregulated" rates.[200]

These statements are patently false and betray a misunderstanding or a refusal to accept the workings of a competitive market. In the first year following the auction, customers would be charged a market price established by a consultant retained by the Commission.[201] They will also enjoy a substantial "acquisition payment" which could be as much as their electric bill for several months. Beginning in the second year following the auction, the prices for the auctioned customers will be driven by market forces, just as EGSs make price offers today.[202] However, after the auction, customers inertia will not enable EGSs to charge customers "whatever price it chose" after the first year because those customers who were auctioned will have access to, and

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197 Direct Energy St. 2-SR at 9.

198 OCA M.B. at 35-36.

199 OCA M.B. at 34, 36.

200 OSBA M.B. at 52-53.

201 This would not establish a "regulated" rate pursuant to Chapter 13, but the rate established under Direct Energy's proposal would carry the approval of the Commission as compliant with an established process.

202 Direct Energy St. 3 at 14.

experience with the competitive market, and will be free to move to leave their competitive supplier if they are not satisfied with their auction winner's second year price.[203]

Mr. Lacey explained just how wrong it is to suggest that an EGS could charge an existing customer "whatever price it chooses."[204] Moreover, it should be noted that the OSBA's implicitly premise – that the default rate is "better" for customers because the Commission formally "approves or disapproves" that rate – is incorrect.[205] The Commission reviews the "bid results" of a competitive bid solicitation process used by a DSP as part of its procurement plan.[206] In most cases, those results are then blended with the results from other procurements and converted by the DSP into retail prices/rates. The final retail rates are not approved or disapproved by the Commission under 52 Pa. Code § 54.188(d). Thus, the default rates are a product of the electric markets, just as are EGS prices.[207]

4. The "Zogby Survey"

In response to OCA's claims that Direct Energy's proposals would essentially be "too confusing" for customers, Direct Energy commissioned a nationally known polling firm, Zogby International, to conduct a poll of residential and commercial customers in the EDC service territories of the Joint Applicants.[208] The survey found that: a) 15% of FE and Allegheny Power customers surveyed on a random sample basis were not even aware that it was possible to switch

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203 Direct Energy St. 3 at 14; Tr. 1038.

204 Tr. 1037-38 ("Q. But it is correct, I'm understanding your proposal, that after the first year, EGSs would be able to charge market prices or whatever prices that they chose to charge the customer? A. There's a vast difference between market price and any price I choose to charge. The ability to charge any price I wish doesn't exist in a functioning market. We believe this will get Pennsylvania or these service territories to a functioning market. Market forces, we heard Mr. Graves this morning say there's price discipline in the wholesale side. If you get a competitive market, there's price discipline on the retail side as well.").

205 OSBA M.B. at 52.

206 52 Pa. Code § 54.188(d).

207 Tr. 920-922.

his/her electric generation supplier in Pennsylvania; b) 64% had never considered such a switch; c) approximately 90% of the Joint Applicants' customers would prefer to have more options for default service; and d) 84% liked Direct Energy's proposal for restructuring the retail market.[209] As Joint Applicants clearly do not like these results, they embarked upon a campaign to undermine them boldly claiming that the survey first "exploited fears over potential job loss and hunger" and presented "biased" questions to shape the responses.[210] There is no merit to any of these criticisms.

Perhaps the most astounding attack launched by Joint Applicants against the survey is the inflammatory claim that the ordering of the survey questions was intended to "exploit fears over potential job loss and hunger" before then asking whether respondents would react favorably to receiving a check.[211] In fact, the ordering of the questions as set forth in the record clearly shows that questions related to a respondents' employment and economic status were asked **after** questions related to the Direct Energy proposal and, therefore, were not ordered to "exploit fears" as Joint Applicants claim.[212] Further, beyond failing to understand how asking someone if they are out of work would be "attempting to exploit fears," (would the respondent have forgotten this fact when asked about the Direct Energy proposal?), it is important to note that the poll included a little over a dozen other similar questions seeking information about the respondent's age, gender, race, marital status and income.[213] All of these questions were asked to ensure that a reasonably representative sample of customers from across the socio-economic

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208 Direct Energy St. No. 3SR at 24.

209 Tr. 1059; Direct Energy St. 3-SR at 24-25; Exhibit FL-4 (Questions Nos. 2, 4 and 5).

210 Joint Applicants' M.B. at 57-59.

211 Joint Applicants' M.B. at 59.

212 Joint Applicants' Cross Exhibit 15. That exhibit clearly shows that these and other questions designed to obtain socio-economic information were asked after the main questions, not before.

spectrum were polled so as to ensure the validity of the polling which, ironically, is one of the very criticisms of the survey raised by Mr. Graves.[214]

Additionally, Joint Applicants relied upon Mr. Graves to attack the validity of the survey itself. However, Mr. Graves admitted that he is not a "polling expert," that he did not find any "design flaw" in the survey and he did not do any independent research regarding Zogby International's polling methods or reputation.[215] Despite all of these disclaimers, the Joint Applicants still claim – based *solely* on Mr. Graves' opinion – that the use of telephone surveys has "been prone to participation bias" and that "several of the questions were worded in such a way as to shape the responses."[216] Unlike Mr. Graves, Zogby International is a leader in the public opinion field that has been tracking public opinion since 1984 and works with a panel of psychologists, sociologists, computer experts, linguists, political scientists, economists, and mathematicians to explore every nuance in language and test new methods in public opinion research.[217] Even Mr. Graves acknowledged that Zogby is a reputable polling firm.[218] It is for this reason that the ALJs ruled that Mr. Graves had not testified that there was a design flaw in the survey.[219] For this reason, the Joint Applicants' criticisms should be ignored.

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213 Joint Applicants' Cross Exam Exhibit No. 15.

214 Tr. at 882. "There could be biases towards certain income strata, biases against families with two workers, two parents working so they're not as able, or bias against families with children who might not be able to respond."

215 Tr. 903-905, 907.

216 Joint Applicants I.B. at 58-59.

217 See http://www.zogby.com/about/index.cfm.

218 Tr. 904.

219 Tr. 913.

G. The Critical Components Of Direct Energy's Proposal Are Sufficiently Spelled Out And Are Reasonable.

The Joint Applicants, OCA and EAPA submit that Direct Energy has not made the necessary evidentiary showings to support its proposal alternative DSP/retail auction/Billco proposal. Specifically, they allege that many cost and implementation details are missing and that many questions are unanswered.[220] But, as a proponent of a remedy, Direct Energy is not required to produce details on every relevant aspect of proposed merger conditions.[221] And, if it did, these parties undoubtedly would have criticized Direct Energy for being too specific and taking away the PUC's discretion. The fact is that Direct Energy met its burden of production by presenting a prima facie case which suggested a framework for the restructuring of the retail market in the Joint Applicants' post-merger service territory. To establish the final details, Direct Energy proposed that once the Joint Applicants accepted Direct Energy's proposed conditions, the Commission initiate an investigation and workshops to establish the rules and procedures by which the restructuring of default service and the retail markets in the Joint Applicants' post-merger Pennsylvania service territories will be accomplished.[222]

This proposal for an investigation is entirely consistent with EAPA's position. EAPA has stated that "to the extent the Commission wishes to consider the [Direct Energy] proposal, it should only do so in a generic proceeding that is focused specifically on these issues."[223] The Order proposed by Direct Energy would start such an investigation,[224] which is expected to involve all interested stakeholders. But because these proposals are being made to remedy the

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220 Joint Applicants M.B. at 51-57; OCA M.B. at 39-41; EAPA M.B. at 4, 6.

221 *See* Section II of this Reply Brief.

222 *See* Direct Energy's M.B. at Appendix D.

223 EAPA M.B. at 4. See also EAPA M.B. at 3.

224 *See* Direct Energy's M.B. at Appendix D.

competitive deficiencies in the merger, that investigation would not be generic, but confined to the merging companies.

Nevertheless, the Joint Applicants contend that critical components of Direct Energy's proposal are undefined or unsupported (or both). None of these contentions has any merit.

1. The ADSP

Based on the alleged uncertainty of Direct Energy's proposal, the Joint Applicants question the "wisdom of stripping" its EDCs of their DSP responsibilities.[225] But the Joint Applicants' efforts to show uncertainty as to the functions of the alternative DSP are wrong or irrelevant, or both, and should be rejected.

- There is no contradiction between Mr. Lacey and Dr. Morey as to whether the alternative DSP will be a public utility. While it is clear that the ADSP would have the same responsibilities as the existing DSP, under the Public Utility Code the ultimate determination of whether the alternative DSP will be a public utility lies with this Commission. Mr. Lacey testified that the Commission would determine that status of the alternative DSP.[226] Dr. Morey gave his opinion that the alternative DSP would a public utility. However, it should go without saying that Dr. Morey's opinion on the legal status of the alternative DSP is not binding on this Commission.

- The alternative DSP would have long-term financial viability. The alternative DSP would be able to recover its costs from default service customers.[227] Moreover, any costs initially expended towards the Billco would be reimbursed by the auction.[228] The cost of electricity is expected to be a "pass-through," and the Commission will set parameters for pricing the non-EDC default service.[229] Nothing in that framework suggests that the alternative DSP would lack the requisite financial fitness.

- There is no conflict between Commissioner Brownell and Mr. Lacey (or Dr. Morey). Commissioner Brownell stated that "the the new DSP would be required to provide

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225 Joint Applicants M.B. at 51. This position implies that FirstEnergy would be willing to allow a customer auction if its EDCs would remain the default service provider. Whether or not FirstEnergy is actually willing to allow a customer auction under such circumstances is not entirely clear based on its Main Brief.

226 Tr. 1045. Mr. Lacey also testified that it did not matter if the alternative DSP was determined to a public utility or not. *Id.*

227 Direct Energy St 3-SR at 20.

228 Tr. 1048.

229 Direct Energy St 3-SR at 20.

service under the same confines as the EDC does today." These confines would the procurement of default service supplies pursuant to the standards in Act 129.[230] In comparison, Mr. Lacey (and Dr. Morey) testified that EDCs would keep the legal responsibility to meet the non-procurement requirements of Act 129, and continue to recover the costs of doing so.[231]

- Mr. Lacey did not reverse course on separation of roles for EGSs and EDCs. He testified that he envisioned the alternative DSP would "be its own stand-alone business entity."[232] And went on to say that "it's the affiliation with the wires service that's the problem, not the corporate general corporate affiliate interest."[233]

2. Level of Proceeds From Auction of Customers

The Joint Applicants' efforts to show uncertainty as to the level of proceeds to be achieved from the customer auction are unfounded and should be rejected.

- Direct Energy estimated that the education and administrative costs would not be more than 5% of the auction proceeds.[234] The Joint Applicants do not contest this estimate. Rather, they complain that it is "just an estimate" and not an accurate quantification of the costs.[235] However, it was explained that costs could not be specifically quantified until the final parameters are known.[236] As explained, the final parameters would be based on input from multiple stakeholders and the EDCs.[237]

- Dr. Morey showed in his testimony that competitive suppliers are willing to pay for customers. The Joint Applicants do not dispute this fundamental point.

- Dr. Morey used publicly available transaction information to determine potential acquisition fee revenue on a per customer account basis.[238] He calculated an average price of $200 per residential account,[239] and estimated that lower end of the auction

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230 See Section IV.D of this Reply Brief.

231 Tr. 786-790; Tr. 1013-14.

232 Tr. 1007.

233 Tr. 1007. Mr. Lacey did not discuss the name of the alternative DSP. Under the appropriate circumstances, the Commission could, of course, prohibit, the alternative DSP from having a name similar to an existing EGS. See Section IV.H of this Reply Brief and Direct Energy M.B. at 56-58 (Section VI.C).

234 Direct Energy St. 3 at 4, 12; Direct Energy St. 1 at 46-47; Tr. 1003-1004, 1057. A portion of the revenue would be retained to fund a customer education program and to fund systems changes to enable "BillCo" to become a fully functioning service company. Direct Energy St. 3 at 12; Tr. 1005.

235 Joint Applicants M.B. at 53-54.

236 Tr. 1006.

237 Tr. 1006.

238 Tr. 793-796.

239 Joint Applicants' Cross-Exam Exhibit 9.

revenues at $150 per account.[240] The Joint Applicants emphasize that the transactions used by Dr. Morey involved more than just the purchase of customer accounts.[241] But, they make no effort to quantity if the other elements of those transactions would impact Dr. Morey's price range beyond Dr. Morey's own downward adjustment. Given that Dr. Morey's testimony already reflects a downward adjustment to the calculated average transaction, there is no reason to doubt his determination of the auction revenue on a per customer account basis. Further, both Mr. Lacey and Commissioner Brownell confirmed the reasonableness of Dr. Morey's projections.[242]

- The Joint Applicants question the equity of the proposed distribution of auction proceeds. As explained, Direct Energy proposed that proceeds would be returned on an equal basis to participating customers (i.e., each customer will receive the same size check).[243] In response, the Joint Applicants cry foul.[244] This will be up to the PUC, but, surely if Direct Energy had proposed to distribute proceeds per tranche, or per customer class, the Joint Applicants would have complained that the proceeds were being inequitably distributed.

3. BillCo

Finally, the Joint Applicants' efforts to show uncertainty as to the functions of the BillCo are flawed and should be rejected.

- There is no contradiction between Mr. Lacey and Dr. Morey as to whether the BillCo will be a public utility. As with the status of the alternative DSP, the Commission will ultimately determine whether the BillCo is a public utility.

- There is no confusion over how the BillCo's rates would be set. Mr. Lacey testified that he did not envision the cost structure of BillCo changing.[245] Commissioner Brownell testified that there were other models that could be used.[246] But, she did not specify that any one of them should be used.

- The existence of the BillCo is not likely to lead to customer confusion. The BillCo could establish a single contact number that could then route calls to the EGS, the distribution

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240 Direct Energy St. 1 at 49-52.

241 Tr. 798-779.

242 Direct Energy St. 3 at 12; Direct Energy St. 2-SR at 7-9. If there is any concern about the level of proceeds, the PUC could set a minimum bid price. See Direct Energy St. 3-SR at 24.

243 Direct Energy St. 3 at 4, 12. A portion of the revenue would be retained to fund a customer education program and to fund systems changes to enable "BillCo" to become a fully functioning service company. Direct Energy St. 3 at 12.

244 Joint Applicants M.B. at 54-55.

245 Tr. 1008.

246 Tr. 983.

company or the default service provider, depending upon the nature of the problem.[247] That would not lead to confusion for customers as to who to contact. A "hot transfer" could be used to insure that customers could directly contact their EGS for EGS related questions or the "wires company" for issues related to regulated distribution service. Mr. Lacey did acknowledge, however, that multiple telephone numbers "could" appear on the bill.[248] The use of multiple numbers, however, would not create confusion as there are already multiple phone numbers on the single bill from the EDC which consolidates charges from the EDC and the EGS.[249]

4. Divestiture of Generation

The issue of divestiture is not moot just because Mr. Lacey stated that the PJM market generally is competitive. Mr. Lacey testified that the wholesale markets are generally competitive.[250] He was obviously not speaking about market power issues created by this specific transaction. However, this does not detract from the fundamental point that the merger would harm the post-merger wholesale markets because, at certain times, FE will have increased wholesale market concentrations that will enable it (along with the existing structural PJM problems) to raise prices.[251]

The details of divestiture would be determined by an analysis (as recommended by Dr. Morey) which would identify the generation assets that should be required to be divested.[252] Dr. Morey explained that he believed it was premature to recommend any specific plant divestitures because the Joint Applicants did not provide any information regarding the retail price impacts of the various wholesale market aspects of the merger.[253] Therefore, it is appropriate for the Commission to order an analysis so these impacts, and the necessary plant divestitures can be

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247 Tr. 1049.

248 Tr. 1049-1050. Direct Energy proposed that details would be established by a stakeholder group established by the Commission. Direct Energy St. 3 at 21.

249 Tr. 1050.

250 Tr. 793.

251 See Direct Energy's M.B. at 35-39 (Section V.B2.b).

252 Direct Energy St. 1 at 30-32; Direct Energy St. 1-SR at 17-18; Tr. 968.

determined.[254] The fact that a separate analysis would be conducted is not confusing, and does not create confusion as to the fundamental need for divestiture.

Similarly, there is no confusion as to the import of the Commission's Order in the 1997 Allegheny/Duquesne merger.[255] In that case, the Commission did not order a divestiture of assets, but it did order a structural remedy.[256] In doing so, the Commission also clearly stated that it may use the divestiture of assets "to address market power concerns in merger cases."[257] Dr. Morey's understanding of that case[258] is completely consistent with the standard articulated by the Commission.

H. The Joint Applicants' Affiliated EGS Should Be Prohibited From Using the FirstEnergy Name and Logo

The Joint Applicants argue that the proposed ban on the use of the FirstEnergy name or logo by affiliated EGS violates their First Amendment rights.[259] There would not be a violation of the Joint Applicants' First Amendment rights because the proposed ban satisfies all four of the *Hudson* conditions to prohibit commercial speech.[260]

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253 Direct Energy St. 1 at 31.

254 The opponents of the 1997 Allegheny/Duquesne merger generally sought the complete divestiture generation assets. *DQE, supra.*

255 Neither Dr. Morey nor Commissioner Brownell can express legal opinions that are binding on the Commission.

256 *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998 at 82 (1998) (holding that merger should be approved conditioned upon the Applicants joining a FERC approved, fully functioning Midwest ISO or PJM ISO).

257 *Re: DQE, Inc.*, Pa. P.U.C. LEXIS 48, 186 P.U.R. 4th 39, 1998 at 72 (1998). Commissioner Brownell gave her recollection of this Order, but stated "honestly I would have to refresh my memory and re-read that." Tr. 968. She further stated that when the merger was not completed, her focus turned to the restructuring cases in Pennsylvania. Tr. 968. So, her lapse in memory as to the remedies ordered in 1997 are entirely understandable.

258 Direct Energy St. 1 at 32.

259 Joint Applicants M.B. at 45-47.

260 In *Central Hudson Gas & Elec. Corp. v. Public Service Commission of New York*, 447 U.S. 557, 562-564, (U.S. 1980), the United States Supreme Court promulgated a four-part test for determining the constitutionality of restrictions on commercial speech: (1) the speech in question must concern lawful activity and not be misleading, and (2) there must be a substantial governmental interest in restricting the

Importantly, the Joint Applicants fail to even acknowledge that Direct Energy's proposal is that FirstEnergy has a choice: either market in its Pennsylvania-affiliated service territories under a different name or not market in those areas. Thus depending on the election, FirstEnergy's First Amendment argument doesn't even come into play.

Moreover, the Joint Applicants argue that there is no showing that customers are aware of the corporate affiliation between FirstEnergy and FirstEnergy Solutions.[261] This argument is not persuasive. Dr. Morey showed that First Energy "brands" its EDC communications with customers [262] In its Main Brief, FirstEnergy argues that branding "aids customers in differentiating among alternative suppliers."[263] FE further argues that it is important to tie (or link) FES to the EDC – because it is "accurate and factual information."[264] But, customers do not need to understand the companies' legal relationship between a parent company and an EGS in order to chose an alternative supplier. Therefore, by linking the alternative supplier to the EDC, customers may be mislead into believing that they are receiving some "benefits" from using FES that they would not otherwise have with another EGS.[265] Moreover, as demonstrated by the record, the post-merger marketing strategy for FES will attempt unfairly leverage the

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speech. If these first two requirements are met, Hudson next requires that (3) the regulation must directly advance the governmental interest asserted, and (4) the regulation must not be more extensive than needed to serve that interest. *Id.* at 564-566.

261 Joint Applicants M.B. at 46.

262 Direct Energy M.B. at 31-32.; Joint Applicants' 10-R at 10. This is not, however, a "local brand" to FES. FES is based in Ohio. Since less than 6% of FES' total sales are in Pennsylvania (Direct Energy Cross Exam Exhibit 3, p. 15), it is clear that vast majority of FES' employees work at FES' generation facilities, which are primarily located in Ohio. (See Joint Applicants' St. 4-R at 13). Moreover, the only "brand" discussed in the marketing strategy is the "FirstEnergy" brand.

263 Joint Applicants M.B. at 46. Mr. Graves indicated that customers "are likely to be adverse to the EDC's brand name." Joint Applicants' St. 10-R at 10. This testimony is undermined by FES' post-merger marketing strategy, which relies on its "local brand." If the Joint Applicants actually believed that consumers were adverse to FirstEnergy, they should be willing to distance FES from the FirstEnergy brand.

264 Joint Applicants M.B. at 46.

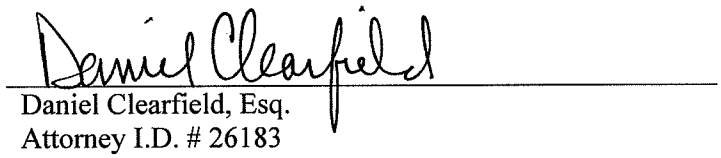
265 Brand identification with the EDC may lead to confusion or a misunderstanding that the service provided by the affiliated DSP is somehow more reliable, economic or safer. See Direct Energy St. 2 at 12-13.

EDC's local brand and the EDC's long term relationship with default service customers to gain market share.[266] As recognized by OSBA witness Wilson, there is a strong possibility that customers will chose FirstEnergy Solutions based on name recognition alone. Thus, a restriction on FirstEnergy's use of its name when marketing electricity in its service areas supports the government's interest in promoting competition among electricity providers. By requiring FirstEnergy to either agree to change the name of its affiliated EGS or refrain from in-affiliated service territory marketing as a condition for the approval of the merger, the Commission will level the playing field and enable non-FirstEnergy affiliated EGSs to fairly compete in FirstEnergy's service areas. This goal cannot be accomplished with a less restrictive condition, and in this context FirstEnergy must agree to the name change to prevent an unfair competitive advantage. Therefore, there would be no violation of FE's First Amendment Rights.

V. CONCLUSION

Direct Energy respectfully requests that the Administrative Law Judges issue a Recommended Decision consistent with the recommendations set forth in this Reply Brief and Direct Energy's Main Brief.

Respectfully submitted,



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266 *See* Direct Energy M.B. at 31-34.