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January 10, 2011

Via Electronic Filing
Rosemary Chiavetta, Secretary
PA Public Utility Commission
PO Box 3265
Harrisburg, PA 17105-3265

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

Dear Secretary Chiavetta:

On behalf of Direct Energy Services, LLC, enclosed for filing please find the original of its Exceptions PUBLIC VERSION 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. Please note the parties who are being served a hard copy of the Highly Confidential version will be served the public version only via email unless otherwise requested.

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 Exceptions PUBLIC VERSION 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: January 10, 2011

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

EXCEPTIONS OF DIRECT ENERGY SERVICES, LLC

PUBLIC VERSION

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I. INTRODUCTION

> We'll have 6.1 million customers, which we'll actually be larger than any other utility in the country. We'll have 2 million in Pennsylvania. We'll cover over 70% of the land mass in the state of Pennsylvania. But we'll be the largest company in the state. And I always think it's good to be a large player in a state. . . . [S]o, we like to be in a dominant position in a state and I think we will be that in Pennsylvania.
>
> Allegheny Energy Chairman Paul Evanson.[1]

In its Main Brief, Direct Energy presented this quote from Mr. Evanson, made at an investor conference, to make clear what is at stake in this proceeding. The proposed combination of West Penn Power Company d/b/a Allegheny Power ("Allegheny Power"), Trans-Allegheny Interstate Line Company ("TrAILCo") and FirstEnergy Corp. ("FirstEnergy") (collectively, "Joint Applicants"), as recommended by Administrative Law Judges Wayne L. Weismandel and Mary D. Long ("ALJs") in their Initial Decision would merge four of the seven major electric utilities in this Commonwealth, create the largest utility in the jurisdiction, eliminate a current wholesale and retail competitor (Allegheny Energy Supply) and facilitate the full introduction into Pennsylvania of an aggressive marketing strategy whose avowed goal is to lock up the vast majority of the residential and small business customers in its service territory. Or, as Mr. Evanson put it, to make FE "dominant" with the result that customers will not receive the benefits of a truly competitive market. They will instead face a future where, to paraphrase Henry Ford (with only slight overstatement), they will be able to choose any electric supplier they want – as long as it's FirstEnergy-affiliated.

Notwithstanding the reams of testimony submitted by Direct Energy documenting the likely failure of real competition to materialize in the post-merger FE service territory, the Initial Decision rejects (or, in many cases simply ignores) all of this evidence, as well as the carefully

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[1] Direct Energy St. 3-SR, at Exhibit FL-1, at p. 5.

crafted remedial plan proposed by Direct Energy to ameliorate the merger's anti-competitive effects. The ALJs' complete rejection of Direct Energy's position arises from two fundamental errors, either of which is sufficient to require a rejection of the Initial Decision.

First, as a result of the post-hearing filing of a Proposed Partial Settlement of the proceeding (the "Non-Unanimous Settlement" or "Settlement") filed by FirstEnergy and many (but not all) active parties, the Initial Decision explicitly framed the issue as whether the package of "concessions" in the Settlement, without modification, was in the public interest or whether instead the Settlement should be rejected in its entirety. The ALJ considered the evidence submitted by Direct Energy (and the other non-settling parties) showing that the Joint Applicants had not satisfied the statutory merger standards, but only in the context of whether or not to approve the Non-Unanimous Settlement. The ALJs presumably approached the issue in this way because the Settlement Agreement explicitly makes the Settlement contingent upon the PUC accepting it in its entirety and without modification.[2] As a result, the Initial Decision rejected every single argument and proposal raised by the non-settling parties, including those of OSBA and RESA, as well as Direct Energy.

Such an approach plainly robs Direct Energy (and the other non-settling parties) of their right to a fair administrative tribunal. It is also beyond the PUC's legal authority. As a unanimous Commonwealth Court decision authored by Judge Pellegrini intimated in a prior proceeding involving FirstEnergy, an administrative agency such as the PUC has the legal authority to adjudicate a case or accept a unanimous settlement – but cannot transform the proceeding into one about whether a partial settlement must be accepted without modification.

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2 PS at ¶ 62.

Second, and undoubtedly influenced by the ALJs' desire to approve the Settlement unchanged, the Initial Decision fails properly to apply the special competitive standard imposed by Section 2811(e) of the Public Utility Code. First, it fails to recognize that, in addition to the affirmative public benefits test mandated by Section 1102 of the Code and the *City of York* case, Section 2811(e) requires that the merger proponents show that the proposed combination is not likely to result in anticompetitive or discriminatory conduct such that customers will be denied the benefits of a fully functioning and workable competitive market, regardless of whether the merger will otherwise produce net benefits.

The Initial Decision failed to even discuss the extensive evidence found in both the public and the highly confidential record (there is no confidential evidence referenced in the entire Initial Decision) showing that the merger does not meet the Section 2811(e) standard. This record shows that by acquiring Allegheny's generation fleet FirstEnergy will be able to bring to Pennsylvania its aggressive and anticompetitive three-pronged "retail marketing strategy." FirstEnergy's own documents predict that the result will be a post-merger retail market in which a majority of residential and small commercial customers will remain customers of FE, either as default service customers or as customers of FirstEnergy Solutions Corp. ("FES"), FE's competitive subsidiary. Using its name recognition and brand loyalty obtained through its affiliation with the EDC, FES is likely to be able to lock up the overwhelming majority of shopping customers – either directly through one-on-one sales or through opt-out municipal aggregation, the latter of which (municipal aggregation) it already tried to use in Pennsylvania even before the merger, and without legislative or PUC authorization. In Ohio, this strategy has allowed FirstEnergy to serve *over 80%* of the retail load in its own service territory, and FE has

confidently predicted that it will be just as successful in Pennsylvania.[3]

FE's retail marketing strategy is "aided and abetted" by the existing default service structure that discriminates in a multitude of operational ways in favor of customers staying on default service and relies on customers' natural reluctance to switch from "what they know." The result will be a market that could not possibly be characterized as "properly functioning and workabl[y] competitive," as Section 2811(e) requires.

But this does not have to be the result. Direct Energy is not opposed to the merger being approved – but only with additional conditions in order to prevent the elimination of any real competition in the FE service territory. The Commission has the power – indeed the duty – to order that, in addition to the merger conditions set forth in the Settlement, the Joint Applicants should be required to adopt Direct Energy's multi-step plan to create a fully workable competitive market. The key provisions of that plan include: a) transferring the default service role to a separate entity not affiliated with FE (and having the alternative provider provide default service to all customers on a quarterly adjusted, spot market-priced basis); b) conducting a retail account auction that would permit participating EGSs to serve residential and small business customers who agree to participate and pay customers a significant amount ($150-$500) for doing so; and c) having FE create a separate FE-owned subsidiary for billing so that EGSs can have bills that clearly identify them as providing service to customers and value-added billing services can be provided.

While these steps will not address <u>all</u> the anticompetitive and discriminatory affects of the merger (and Direct Energy has proposed additional remedies to address those not ameliorated by its alternative default service/retail auction plan), they will address the most crucial threats to

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[3] To make matters worse, FES's wholesale generation arm will have wholesale market power that will enable it to raise wholesale prices, which, in turn, will affect retail prices in its affiliated service territories.

robust retail competition, which is the statutory policy of the Commonwealth. The Joint Applicants call these steps "radical," and the Initial Decision repeats that characterization.[4] But is it any wonder that FE has so characterized Direct Energy's Plan and opposes it so vigorously? If adopted, Direct Energy's proposal would prevent FE from effectively implementing the goal of its "retail marketing strategy" which, as noted, is to do in the post-merger market in Pennsylvania what FE has done in Ohio – dominate the market.

The Initial Decision characterizes all of these remedial steps as addressing problems that are unconnected to the merger (an obviously incorrect conclusion) and as even being inconsistent with Act 129 (again, incorrect). The steps Direct recommends are, in fact, tailored carefully to address the specific anti-competitive conditions that would result from the merger. Most critically, removing the utility from the role of the default service provider breaks the stranglehold on the mass market that has allowed FirstEnergy to obtain an 81 percent market share in its Ohio service territories (which they would claim are "fully competitive"), and which the merged company hopes to apply to its Pennsylvania markets to similar effect. The record establishes that this is the single most important step the Commission can take in applying the standard for merger review appropriately and fairly, for the benefit of customers in the service territories of the merged company. In conjunction with removal of the utility from the default service provider role, Direct Energy's auction proposal would establish the territories of the merged company as competitively robust, while also delivering hundreds of millions of dollars of value to customers in those areas. Even in the absence of removal of the utility from the default function, the auction would bring competitors into the territories of the merged company at scale, making them far more competitive than they would otherwise be, while still delivering

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4 ID at 69.

substantial, immediate value to customers through the auction proceeds. Combined with removal of the utility from the default function and the auction proposal, establishing a "BillCo" to serve the competitors retailers and non-utility DSP would appropriately recognize the utility's exit from the customer-facing functions in those areas, creating opportunities for job creation and the offering of advanced services from competitors in the market.

Thus, the three parts of Direct Energy's plan have been crafted to address, in order of importance, the three anti-competitive characteristics of the post-merger market that should be of most concern to the Commission: the utility's ability to leverage its default role to establish a dominant position in the market; the absence of opportunities for scale entry by competitors , especially should the utility retain its role as default provider; and the operational barriers to the further development of the market that exist in the current system. In order to substantially address the anticompetitive effects of the proposed merger, and thus allow the merger to go forward with appropriate conditions, however, the Commission need not order all aspects of the Direct Energy plan to be implemented at once. As discussed above, designation of a non-utility default service provider is the most critical step in mitigating the potential anti-competitive effects of the merger, and it should be ordered in as many service territories as allowed under Pennsylvania law. To have a positive effect on the markets in the service territories of the merged company, the retail auction, however, need not necessarily be implemented across all four service territories at the same time. In order to gain further experience with auctions in such a setting and satisfy itself that they are bringing about the desired results, the Commission could order an auction of a subset of the customers in each of the service territories, or all of the customers in one or more of the service territories, on a "pilot" basis, with further auctions coming only after a full evaluation of the results by the Commission. Even partial

implementation of the Direct Energy plan in this manner, if thoughtfully done, could mitigate the potential anti-competitive aspects of the proposed merger that should be of most concern to the Commission.

Most importantly, however, the Commission should not allow itself to accept the Hobson's choice of either accepting the Non-Unanimous Settlement, with the result that competition will be stymied, or worry that customers will get nothing. FirstEnergy should not be permitted to commandeer the Commission and the public interest. If the Commission adopts some or all of Direct Energy's proposals, the Joint Applicants may "withdraw" the Settlement. The Commission's only option would be to then reject the Application outright. We suspect that an "amended" application containing all of the Settlement's benefits, as well as the additional pro-competitive steps urged by Direct Energy and, by then, adopted by the Commission, will be quickly forthcoming.

The choice for the Commission is plain. It may either approve the merger with only the competitive conditions set out in the Non-Unanimous Settlement, thus consigning 70% of Pennsylvania to a dysfunctional competitive market that will be subject to domination by FirstEnergy. Or it can recognize that an unprecedented merger such as this one requires innovative (even "radical") solutions to comply with the Legislature's directive, and fulfill the vision of a truly workable competitive electricity market. Considered in this way, the misnamed "radical" choice is anything but and is, instead, the proper approach.

II. EXCEPTIONS OF DIRECT ENERGY

A. Exception 1: The Initial Decision Is Erroneous Because the PUC Does Not Have The Legal Authority To Issue An Order Approving A Non-Unanimous Settlement. (COL ## 6, 12-15, 23-26; ID at 39-75).

The Initial Decision does not actually adjudicate whether the Joint Applicants' Application for a certificate of public convenience under Section 1102 of the Public Utility Code

should be granted. Instead, it determines that that the Non-Unanimous Settlement submitted by FirstEnergy and many (but not all) of the active parties to the proceeding is in the public interest and, for that reason, concludes that the Merger Application, as modified by the Settlement, should be approved.[5] The ALJs even state that their task was to determine whether there is "substantial evidence consistent with the statutory requirements [to] support the proposed settlement."[6] This was error.

The Commission has stated on numerous occasions that the standards for reviewing a non-unanimous settlement, are the same as those for deciding a fully contested case.[7] In other words, the Commission is required to adjudicate the claims of the remaining active parties exactly as if no settlement had been submitted. But the Initial Decision did not do this.

A cursory review of the Initial Decision shows that its principal focus is whether the Application and Merger Agreement, as modified by the Non-Unanimous Settlement, as a whole is in the "public interest." While the Initial Decision summarily rejects all of Direct Energy's positions (for the most part simply by copying the Joint Applicants' proposed findings),[8] the most revealing portion of the Initial Decision is the Conclusion, in which the ALJs make plain the real basis for their recommendation. There they state that, consistent with the Commission's encouragement of settlements, it was approving this Settlement because "in its totality, the

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5 ID at 38, 75 ("When parties in a proceeding reach a settlement, the principal issue for Commission consideration is whether the agreement reached suits the public interest.") (citation omitted).

6 *Id.*, at 38 (citations omitted, emphasis added).

7 *Application of PECO Energy Company for Approval of its Restructuring Plan Under Section 2806 of the Public Utility Code*, Docket No. R-00973953, et seq., 1997 Pa. P.U.C. LEXIS 51 at 17-18; 181 P.U.R. 4th 517 (Order entered December 23, 1997).

8 This one-sided view of the merger is evident in the fact 87 of the 90 Findings of Fact (96%) in the Initial Decision are nearly verbatim in the submittals of the Joint Applicants (67 of 90, with only minor changes to a few) and the OCA (20 of 90, with only minor changes to a few) – both settling parties. None of the Findings of Fact were derived from submittals by any of the non-settling parties (i.e., Direct Energy, RESA, Citizens Power and the OSBA). Accordingly, the Initial Decision does not describe any of the evidence presented by Direct Energy. Thus, it is impossible to determine (based on the Initial Decision) whether (or not) the conclusions reached in the Initial Decision actually follow from the facts.

benefits of the proposed merger, as modified by the settlement agreement, outweigh the negative impacts."[9]

This discussion in the Decision reveals plainly that the ALJs, in fact, were focused on the purported overall benefits of the Settlement and did not adjudicate the original Application (or even an amended version containing the "concessions" set forth in the Non-Unanimous Settlement). Indeed, the ALJs explicitly admitted that they undertook this overall analysis, stating that "not every consequence of the proposed merger is necessarily a benefit."[10] Nonetheless, they recommended approval of the Application, as "amended," without modification of the Settlement (to, at least, eliminate those unnamed detriments).

The ALJs were undoubtedly influenced to review the reasonableness of the settlement as a whole, and to discount Direct Energy's contrary arguments, by the Settlement term stating that if any provision were altered or modified by the Commission, the Settlement could be withdrawn and be "of no force and effect."[11] Thus, the ALJs were barred from accepting any of the non-settling parties positions for fear of undoing "the deal" and having FE renege on its promises.

Thus, the ALJs have done just what the Commonwealth Court (per Judge Pellegrini) in the 2003 *ARIPPA* decision warned against: they have failed to adjudicate the case and instead have decided whether to accept or reject the Non-Unanimous Settlement. As Judge Pellegrini intimated, there is, at a minimum, serious question whether the Commission has the legal ability to approve such a settlement:

> The danger of such an approach is obvious. Parties with a substantial interest in a utility proceeding can be left out of the decision-making process. . . . Furthermore,

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9 ID at 74-75 (footnotes omitted).

10 *Id.*

11 "This Settlement is conditioned upon the Commission's approval of the terms and conditions contained herein without modification. If the Commission should disapprove the Settlement and modify the terms and conditions herein, this Settlement may be withdrawn upon written notice to the Commission and all active parties within five business days following entry and service, whichever is later, of the Commission's Order by any of the Joint Petitioners and, in such event, shall be of no force and effect." PS ¶ 62.

> in their zeal to reap the benefits of the non-unanimous settlement process, commissions shift the burden of proof to the non-consenting parties by forcing them to prove the unreasonableness of the settlement. While both traditional regulatory hearings and the unanimous settlement process provide protection for all parties, the non-unanimous settlement process places some parties at a severe disadvantage....[12]

While the Court in *ARIPPA* did not resolve the question because it was not raised,[13] the Court questioned "the ability of the Commission to approve [a non-unanimous] settlement."[14]

Direct Energy respectfully suggests that the answer to the question posed by the Court in *ARIPPA* is that the PUC does not have the authority to approve a settlement as presented here. Under the Administrative Agency Law, the PUC is required to issue an adjudication in any contested proceeding *with findings of fact and conclusions of law that support that decision.*[15] The Public Utility Code likewise requires the Commission to make findings "in sufficient detail to enable the court on appeal, to determine the controverted question presented by the proceeding, and whether proper weight was given to the evidence."[16]

An adjudication must rule on the matter before the agency – in this case whether the Application should be approved and a certificate of public convenience and necessity issued pursuant to Sections 1102, 1103 and 2811(e) of the Public Utility Code. Just as the PUC is required to do these things, aggrieved parties are entitled to have those same things done. An entity that is opposed to the Application and has standing to participate is entitled to a fair determination on each major issue, to have its objections reviewed by a neutral fact finder,

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12 *ARIPPA v. PA PUC,* 792 A.2d 636, 659 (Pa. Cmwlth. 2002) *appeal denied,* 815 A.2d 634 (Pa. 2003) (quoting *Krieger,* Problems for Captive Ratepayers in Non-unanimous Settlements of Public Utility Rate Cases, 12 Yale J. on Reg. 257, 265 (1995)).

13 *ARIPPA v. PA PUC,* 792 A.2d at 660.

14 *Id.*

15 2 Pa. C.S. § 507.

16 66 Pa. C.S. § 703(e) (emphasis added).

uninfluenced by extraneous and impertinent concerns.[17] Most importantly, an objecting party is entitled to findings and conclusions adjudicating its claims – not findings to support why a settlement it did not agree to should be adopted.

The ALJs' Initial Decision, however, does not meet those standards. Instead, the Initial Decision's discussion section describes the provisions of the Non-Unanimous Settlement as establishing sufficient benefits to satisfy the public interest requirement and then rejects each and every objection of the non-settling parties. The Initial Decision's analysis is whether any positions raised by the non-settling parties are serious enough to cause the ALJs to reject the overall result reached in the Settlement Agreement.[18] Similarly, the Initial Decision's "findings" are all geared around accepting the Settlement and not at adjudicating the actual issues in the case. As the *ARRIPA* decision implies, the Commission simply has no statutory authority to proceed as the Initial Decision has done. The Initial Decision, therefore, is fatally flawed and must be rejected and the case remanded to the ALJs.

The lack of an adjudication of the actual issues presented by the Application is apparent by the absence of any discussion in the Initial Decision explaining how it came to the conclusion that the concessions were sufficient to create a public benefit or how the ALJs had weighed the various factors to come to the ultimate conclusion that the benefits outweighed the detriments. The Initial Decision reviews and relies upon the evidence submitted by the Joint Applicants. However, it does not fully review or rely upon the evidence submitted by the other settling parties (such as the OCA). Nor does it fully review, weigh or consider any of the evidence submitted by the non-settling parties (such as Direct Energy, RESA and the OSBA). Indeed, in

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17 The often-cited statement that the Commission is not required to consider expressly and at length each and every contention of a party does not apply to contentions that go to the heart of the matter before the Commission. *See University of Pennsylvania v. PA PUC*, 485 A.2d 1217, 1222 (Pa. Cmwlth. 1984) (referring to "every minor allegation of a party").

18 ID at 39, 74-75.

coming to the conclusion that each of the various "concessions" constitutes an affirmative benefit, the Initial Decision simply refers to the term of the Settlement and the fact that certain parties were willing to accept the particular term as sufficient.[19] This lack of discussion or analysis shows that evidence presented by parties other than the Joint Applicants was not actually considered or weighed as part of any adjudication on the merits. And, it further shows that the ALJs reached the conclusion that the Non-Unanimous Settlement was reasonable simply because many of the parties had agreed to it.

It is important to understand what procedure the ALJs should have followed because that is the procedure they must follow on remand. First, the Joint Applicants must present to the ALJs an Amended Application reflecting the agreements reached between the Joint Applicants and certain parties. Each of the commitments in the Amended Application should stand or fall on its own merit and not be subject to withdrawal if additional commitments or conditions are ordered, just as do components of an Application. The ALJs should reopen the record to receive such additional testimony as deemed appropriate given the amended Application. The ALJs should then issue an Initial Decision that rules on whether the amended Application meets the applicable requirements of the Public Utility Code.

B. Exception 2: The Initial Decision Is Erroneous Because It Is Tainted By The ALJ's Desire to Adopt the Non-Unanimous Settlement. (COL ## 6, 12-15, 23-26; ID at 60-75).

A related error in the Initial Decision is that the ALJs gave the Non-Unanimous Settlement special and unwarranted significance and plainly weighed whether the positions of the non-settling parties were significant enough to derail the Settlement. As noted above, the

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19 For example, several parties raised concerns about job loss. *See, e.g.*, OTS St. 1 at 4-5, OCA St. 1 at 37-38, WPPSEF St. 1 at 13. But the Initial Decision does not attempt to reconcile that evidence with the employment "protections" in the Non-Unanimous Settlement in determining that those concessions are sufficient. The same can be said about rate reductions to customers. The Initial Decision simply assumes that since several of the public parties agreed to them, they must be sufficient. The same clearly can be said about the alleged "competitive benefits" included in the settlement.

Initial Decision explicitly admits that, consistent with the PUC's policy of encouraging settlements, "[w]hen parties in a proceeding reach a settlement, the principal issue for Commission consideration is whether the agreement reached suits the public interest." But that can only apply when a unanimous settlement is at issue. Applying this standard to a non-unanimous settlement irremediably alters the burden of proof against the non-settling parties and creates a non-level playing field on which objectors cannot reasonably prevail.

It is not merely that all courts, and all hearing examiners or ALJs, prefer settlements for many reasons, principally that a result crafted by the parties with the greatest interest in the matter may well produce the best result. But that logic completely fails when the settlement pointedly excludes the interests of major parties, as is the case here.

Again, the ALJs must have been aware that the Settlement contains a provision stating that if any provision were altered or modified by the Commission the Settlement could be withdrawn and be "of no force and effect [20] Thus, the ALJs were undoubtedly reluctant to reject any portion of the Non-Unanimous Settlement or to add or modify any of its terms for fear of nullifying the entire agreement. That knowledge and inevitable resultant pressure, in turn, deprived the objectors of a fair and impartial determination of their claims. That term all but explicitly guaranteed that the objections needed to meet an unwritten but unduly high standard – were the objections valid enough to nullify the Settlement, with knowledge of all that would follow. Indeed, the Initial Decision clearly shows this analysis when it states that it is approving the settlement as in the public interest "in its totality."[21]

Moreover, the fact that the Initial Decision does not make a single modification to the terms of the Non-Unanimous Settlement nor accept any part of the contentions of any of the non-

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20 PS ¶ 62.

21 ID at 75.

settling parties is powerful circumstantial evidence that the ALJs felt constrained not to seriously consider Direct Energy's evidence of the anticompetitive and discriminatory effects of the merger. Similarly, it suggests that the ALJs did not seriously consider any of the benefits of Direct Energy's proposed remedial plan.[22] As a result, the ALJs violated Direct Energy's due process and Administrative Agency Law rights to a fair and non-biased decision.[23]

To be sure, the Commission has encouraged settlements, but has done so in the context of *unanimous* settlements. As the Commonwealth Court aptly noted in *ARRIPA*, a partial settlement is an "oxymoron" and is not a case settlement at all; it is instead merely a stipulation among the Applicant and some objectors that if the Applicant makes certain changes, the objectors will no longer actively oppose the filing. Indeed, at noted, the only guidance that the PUC has issued with respect to non-unanimous settlements is that they should be treated like any other contested proceeding.[24]

An applicant for a certificate of public convenience is free to make agreements with parties that buy a measure of peace. However, unless all parties agree to the modified application, the original application should have been formally modified – akin to filing an Amended Complaint in court – to include the Joint Applicants' additional commitments. Additional hearings should then have been held to develop a record on which an adjudication on

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22 For example, Direct Energy presented evidence that a retail auction of FE residential and small commercial customers who choose to participate would create a robust retail market and would generate acquisition payments to customers of up to $500 per customer. Direct Energy M.B. at 43-44. As noted, FE/Allegheny customers overwhelmingly endorsed Direct Energy's plan (Direct Energy M.B. at 25-26); yet the ID never even mentions this evidence in the record. Yet, incredibly, the ALJs "found" that Direct Energy provided no "convincing evidence" of "any discernible benefits to customers" from its proposal nor that its proposal was in the best interests of consumers. FOF # 75; ID at 72. No objective observer could possibly characterize this evidence as producing absolutely no "discernible benefit." To the contrary, no fact finder would do so unless the overriding goal was to reinforce the decision to accept the Non-Unanimous Settlement, without modification.

23 Due process entitles parties in a Commission proceeding to a decision by an impartial decision-maker based upon the evidence. *ARIPPA, supra.* In the absence of specific findings of fact, discussion and conclusions of law, the appellate courts cannot infer that the Commission actually and properly determined the contested issues. *See* 2 Pa. C.S. § 507, 66 Pa. C.S. § 703(e).

24 *See, PECO Energy Co., supra.*

the modified Application could have been issued by a fair and unbiased tribunal. This process would also eliminate the "no change permitted" provision, which is a key impediment to a fair determination in the context of a non-unanimous settlement. That the Joint Applicants did not request this process in their haste to obtain PUC approval is not the fault of Direct Energy. It is the Joint Applicants that have the burden of proof in the case to present evidence in accordance with law that supports their Application. They have failed as a matter of law.

C. Exception 3: The Initial Decision Erroneously Found That The Merger Satisfies The Requirements Of Section 2811(e) Of The Code. (FOF ## 58, 59, 69, 79; COL # 24; ID At 37-39, 60-74).

In its haste to bless the Non-Unanimous Settlement and reject any contrary arguments, the Initial Decision simply brushed aside or completely ignored Direct Energy's extensive evidence demonstrating that the merger does not satisfy one of the merger standards: Section 2811(e) of the Code.[25] The Initial Decision does this by misinterpreting the standard and failing properly to weigh the record evidence.

First, the Initial Decision wrongly describes the Section 2811 standard as being merely one part of the analysis in determining whether a merger will produce "affirmative benefits," as required under Chapter 11 of the Code and *York/Popowsky*.[26] It then goes on to mischaracterize the Section 2811(e) standard as whether the merger "will have an adverse impact upon retail markets,"[27] and implies that if any competition is likely to exist then the standard is satisfied.[28] Next, the Initial Decision misconstrues the evidence of anticompetitive and discriminatory

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25 66 Pa C. S. § 2811(e). As the Commission is undoubtedly aware, under Section 2811(e), the Commission is required to "consider whether a proposed merger, consolidation, acquisition or disposition is likely to result in anticompetitive or discriminatory conduct, including the unlawful exercise of market power, which will prevent retail electricity customers in this Commonwealth from obtaining the benefits of a properly functioning and workable competitive electricity market." *Id.* Moreover, if the Commission finds that the proposed merger is likely to result in such conduct, the Commission may not approve the merger "except upon such terms and conditions as it finds necessary to preserve the benefits of a properly functioning and workable competitive retail electricity market." 66 Pa. C.S. § 2811(e)(2).

26 *Id.*, at 64-65; *Popowsky v. PUC*, 937 A.2d 1040 (Pa. 2007).

27 *Id.*, at 65-66.

28 *Id.*, at 65-67 (emphasis added).

conduct that is likely to occur, claiming that this evidence merely shows that the acquisition of Allegheny Energy's generation assets "may provide [FirstEnergy] with some competitive advantage" and that FES "intends to be an aggressive marketer of retail electricity products."[29] The Initial Decision concludes, however, that Direct Energy's real complaint is about the generic structure of the default service market, an issue that the ALJs' incorrectly conclude "has no real nexus to the merger."[30]

These errors and misinterpretations, heaped one upon the other, show a complete failure to grasp or to deal with the extensive record. That record shows that, because of the merger, the retail competitive market in the Joint Applicants' service territories will be dominated by FirstEnergy, which will serve the overwhelming portion of retail and small business customers. If the Commission approves the Initial Decision without modification, FirstEnergy, either through is default service or through its "aggressive" marketing subsidiary, FES, will likely serve 80% or more of the residential and small business customers in the merged service territory. This will rob those customers of the extensive benefits of a robust competitive market: lower prices and innovative products, promotions that, among other things, advance the efficient use of energy, that result when a market contains a number of viable competitors.[31]

1. The Initial Decision Erred in Interpreting the Requirements of Section 2811(e).

The Initial Decision fundamentally misinterprets Section 2811 as requiring the proof that retail markets will be adversely impacted. They also suggest that the loss of one competitor – Allegheny Energy – is the only "harm" that will occur to competition as a result of the merger and that, since some competition will exist in the post-merger market the statutory requirement

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29 *Id.*, at 67, 74.

30 *Id.*, at 67-69.

31 *See* Direct Energy M.B. at 16-39.

of a "workable competitive market" is achieved.[32] These conclusions are plainly wrong. But even accepting this interpretation of the statute, the evidence shows that the post-market WILL be adversely affected by the merger, and will be worse off than it would be without the merger and, therefore, cannot be approved.

As noted, the Initial Decision dismisses the requirements of Section 2811 by insisting that they only come into play when there is evidence that the post-merger market will be worse off than before the merger.[33] While conduct that is harmful to competition is certainly covered by Section 2811, the plain language of the statute also invalidates a merger which *perpetuates* circumstances are likely to prevent retail electricity customers … from obtaining the benefits of a properly functioning and workable competitive retail electricity market."[34] Nowhere does the statutory language require that the "result" be specifically caused by the merger; or that the post-merger market be less competitive than the existing market. This "do no harm" standard would always allow the pre-merger competitive conditions to continue – even if those conditions lead to a nonfunctioning and unworkable competitive retail electricity market. Such an exceedingly narrow interpretation of the statute is particularly insidious now because it would essentially bless the total lack of competition that exists in most of the FirstEnergy service territories, a condition driven by the existence of generation rate caps for the last decade and more.[35] Preserving a completely non-competitive market cannot possibly be what the General Assembly intended when it added this special standard for electric utility mergers, and the ALJs' interpretation of Section 2811(e) would essentially read that standard out of the law.

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32 *Id. See also* FOF ## 53-58.

33 ID at 65-66 (requiring a showing that the merger "will have an adverse impact upon retail markets").

34 66 Pa. C.S. § 2811(e)(1).

35 *See* Direct Energy M.B. at 16-39, which discusses the lack of pre-merger and post-merger competition.

2. The Initial Decision Erred In Ignoring Evidence Of Ant-Competitive And Discriminatory Conduct Likely To Result From The Merger.

A more egregious error in the Initial Decision is its total failure to recognize the extensive evidence – supported by highly confidential merger documents that the Joint Applicants tried to keep from releasing to Direct Energy[36] – showing that, indeed, the merger will likely have an adverse effect on competition and that the market will likely be worse than it would have been if the merger did not occur.

In summary, the evidence shows the following: Enabled by the existing default service structure, which makes it very difficult for suppliers to move small customers to competitive supply, or to keep them there once they do switch,[37] the evidence shows that *as a result of the merger* FE will be able to fully implement its "retail marketing strategy" that has been so successful in Ohio.

Implementing this strategy in Pennsylvania will result in FE similarly achieving a dominant position in its Pennsylvania retail markets, to the detriment of competition and customers.[38]

The Joint Applicants' public documents reveal a retail marketing strategy focused on dominating FE's and AP's EDC service territories.[39] That strategy seeks to utilize Allegheny's generation fleet (which currently serves default service customers but will be freed up starting in 2011, when Allegheny implements a wholesale procurement auction to provide default service)[40] to aggressively market at the retail level through three sales channels: direct sales; municipal

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36 *Id.*,. at 8-9.

37 The evidence demonstrated that a variety of factors conspire to make it extremely difficult to wrest small customers away from default service, such as (1) status quo bias, (2) current operational rules, which are biased in favor of default service, (3) characterizations of default service as a service of the EDC, rather than as simply a pass through and (4) the structure of the generation billing. These factors are discussed in great detail in Direct Energy's M.B. at 22-34, 39-58.

38 *Id.*, at 16-39.

39 FE's public marketing strategy was described in Direct Energy's M.B. at 26-34.

40 Direct Energy M.B. at 26-30.

aggregation; and (indirectly) wholesale sales for default or POLR retail customers in Pennsylvania. FE's CEO, Tony Alexander, acknowledged that the merger, with the acquisition of Allegheny's generation fleet, would enable FE to fully implement this generation-backed strategy in its Pennsylvania service territories, including the newly acquired West Penn Power service territory.[41] He also acknowledged that this three-pronged strategy has proven successful in Ohio with FE and FES making approximately 80% of all retail sales in its Ohio franchise service territory.[42]

The highly confidential HSR documents confirm and further explain that strategy.[43] **BEGIN HIGHLY CONFIDENTIAL** [redacted] **END HIGHLY CONFIDENTIAL** A market dominant position of this sort will result in FES having considerable market power, *i.e.*, the

41 *Id.*; Tr. 260-66.

42 *See* Direct Energy M.B. at 26-34; Tr. 263-266; Direct Energy Cross-Exam Exhibit 3. FE's Third Quarter results show FE's retail strategy to be even more successful, now accounting for 81% of sales in FE's franchised service territory. The reasons? "[T]he biggest driver of our strong quarter was the success of our retail strategy, as we continue to move customers away from POLR into direct sales and government aggregation channels. We are not just selling more megawatt-hours but reducing shopping risk, as well as enhancing our flexibility to structure favorable contracts and our opportunity to maximize our margins," said Mark Clark, FirstEnergy Corp. CFO. "FirstEnergy Solutions Supplied Nearly 81% of Sales in Affiliated Ohio Territories in Third Quarter," Energy Choice Matters, October 27, 2010. http:/www.energychoicematters.com/stories/20101027a.html

43 FE's confidential marketing strategy was described in great detail in Direct Energy's M.B. at 26-34.

44 Direct Energy M.B. at 27 at fn 104, 33; Direct Energy Cross Exam Exhibit (Confidential) 1 at 39.

45 *Id.*

46 Tr. 218 (Confidential).

ability to impose prices that are higher than they would be in a fully competitive market, with many buyers and sellers.[47] This result, thus, is anticompetitive and discriminatory and not consistent with a workable competitive market.[48]

Importantly, this strategy could not be implemented in the Allegheny service territory, and could not be implemented to the same extent throughout the Pennsylvania FE service territory without FE's acquisition of Allegheny's generation capacity.[49] **BEGIN HIGHLY CONFIDENTIAL** [redacted] **END HIGHLY CONFIDENTIAL**

As noted, the record also shows that FE's retail marketing strategy and its goal of dominating the market will be enhanced and enabled by the existing default service structure and

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47 Direct Energy St. 1 at 21-22 (Without a structure that will result in a workable competitive market, customers will undoubtedly not "enjoy the benefits of a fully competitive market, which includes prices that are driven down to incremental cost, as firms compete to win customers."); Direct Energy St. 2 at 20 ("Economists will attest that a fully competitive market will drive prices to incremental cost.").

48 Direct Energy M.B. at 19-39.

49 *See* Direct Energy M.B. at 26-39.

50 *Id.*

51 Direct Energy M.B. at 18; Direct Energy Cross-Exam Exhibit 2 (Confidential).

52 *Id.*, Tr. 227-230 (Confidential).

53 Direct Energy St. 1-Supp. (Confidential) at 6-7; **BEGIN HIGHLY CONFIDENTIAL** [redacted] **END HIGHLY CONFIDENTIAL**; Tr. 227-230.

the fact that a majority of customers will continue to be served by the EDC-provided default option. For example, one prong of FE's retail marketing strategy is to provide generation service to default customers by being a winning bidder in the FE-affiliated EDC default service auctions.[54] Obviously the success of this prong entirely depends upon there being a significant number of "non-shopping customers" on default service.

The success of the second part of FE's marketing strategy – municipal aggregation – also depends upon a majority of customers being served by default service as well as FE's continued role as the default service provider under the present structure.[55] FE has described municipal aggregation as an alternative to default service, "not much different than the structure already in place today in Pennsylvania," and as a way for small customers to obtain the "benefits of a competitive market."[56] However, if most customers were already shopping for electric service, and a fully competitive market existed, customers would be less interested in this "surrogate" for a fully competitive market. Moreover, in many cases, customers who had already switched and have entered into contracts for a term of years presumably could not be part of a municipal aggregation scheme without violating those previous contractual arrangements.

Perhaps most importantly, FE's municipal aggregation strategy benefits from its "brand identification" and its relationship as the customer's present electric service provider.[57] FE takes every opportunity to associate the FirstEnergy name with the local utilities: MetEd, Penelec, etc.,

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54 Direct Energy M.B. at 30.

55 *Id.*, at 30-34. FOF #79 is wrong. FE's explicit intention to rely on municipal aggregation clearly brings that strategy within the scope of this proceeding. The requested investigations do not obviate any of the concerns about FES's long term use of municipal aggregation to achieve a dominant market share in its affiliated service territories as efforts to enact specific statutory authority for municipal aggregation in Pennsylvania are continuing. However, the Initial Decision's "conclusion of law" that the "opt-out portion of FES's municipal aggregation program is illegal "slamming. COL 16,18. The Commission has found on numerous occasions that an "opt out" program, when properly structured and approved by the Commission, does not in any way violate the Public Utility Code. See Direct energy R.B. at 31-35. Therefore Direct Energy specifically excepts.

56 Direct Energy Cross Exam Exhibit 9 at 2.

57 FE's plans to leverage its EDC brand are comprehensively reviewed in Direct Energy's M.B. at 30-33.

and, in fact, touts its "local brand" as a competitive advantage in making aggregation sales. For example, FirstEnergy associates its name with the local utility in such crucial functions as beginning or changing electric distribution service. The evidence supports the conclusion that FES's relationship to the default service provider gives it "name recognition" that makes possible its municipal aggregation strategy.[58]

Similarly FE's role as the default service provider facilitates FE's "direct sales." FE's own documents indicate that FES' competitive advantage in making direct sales is "[l]ong term customer relationships [and] local brand."[59] Since that same document points out that FES has only been in existence since 1997 (and presumably has relatively few customers in Pennsylvania) it is obvious that the "local brand" and "long term relationship" it is attempting to leverage is the EDC's local brand and long term relationship as the customer's distribution and default service provider.

The net result is that FE's leveraging its role as EDC/default service provider will result in the majority of residential and small business customers continuing to take service from FE, either via default service or from FES. When one entity is likely to have such a dominant share of the retail market, the result will be higher prices than would occur from a workable competitive market.[60]

The Initial Decision simply ignores all of this evidence, dismissing these claims by observing that although FirstEnergy will be an "aggressive" competitor, a market dominated by one entity is not sufficient to fail the statutory test. From the ALJs' perspective, the fact that a handful of smaller suppliers likely will attempt to compete with the much larger FirstEnergy

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58 Tr. 562.

59 *See* Direct Energy's M.B. at 30-33.

60 *Id.*

means that the market will not be sufficiently "harmed" to constitute a violation of Section 2811. The Initial Decision is wrong on both counts.

First, the standard mandated by Section 2811(e) is whether anticompetitive or discriminatory conduct will result in the prevention of a workable competitive market. This Commission has defined the equivalent term in the Gas Choice Act[61] – "effective competition" – as requiring:

- Participation in the market by many sellers so that an individual seller is not able to influence significantly the price of the commodity.
- Participation in the market by many buyers.
- Lack of substantial barriers to supplier entry and participation in the market.
- Lack of substantial barriers that may discourage customer participation in the market.
- Sellers are offering buyers a variety of products and services.[62]

Direct Energy used a similar definition to describe a workable competitive electric market.[63]

The evidence makes clear that the post-merger market will not in any way resemble the "effectively" or "workably" competitive market envisioned by the PUC's definition. Indeed, and contrary to the Initial Decision's suggestion,[64] the post-merger market will not even resemble the current PPL market, which has a modicum of competition. Instead, it will likely have the following characteristics:

- Few Sellers: In light of FES's dominance through direct and aggregation sales, there will likely be just a handful of suppliers making offers in the post-merger market. Realistically, the number of separate sellers will be smaller yet. In contrast, in PPL's territory there are over 19 suppliers competing for residential and small commercial business and there is no one dominant supplier providing serving most of the customers.
- Few Buyers: Most importantly, only a minority of residential and small business customers are likely to shop. Even without FE's aggressive marketing strategy, no FE

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61 66 Pa. C.S. § 2204 (g).

62 *Investigation into the Natural Gas Supply Market: Report on Stakeholders' Working Group (SEARCH)*, Docket No. I-00040103F0002, 2008 Pa. PUC LEXIS 31 (Order entered September 11, 2008), at p. 2 (emphasis added).

63 Direct Energy M.B. at 20-22.

64 ID at 60-69; FOF ##53-58.

market has even a quarter of residential or small business customers shopping. Penn Power's market has been open since 2006, after the lifting of rate caps, and only 20% of residential customers are shopping. The percentage of shopping customers will likely be even lower in the FE service territory, when the customers being served by FES are excluded. Even if the PPL market were used as the guide, there is little likelihood that 35-40% of the residential customers will be shopping and the actual percentage will be even smaller if the customers served by FES are excluded.

- Existence of Barriers to Entry and Lack of Variety of Products and Services in the Market. With FE locking up most of the customers via default service or their own competitive service, EGSs will likely be extremely reluctant to enter and stay in the post-merger FE market. Direct Energy witness Morey explained that a key requirement for sustained competition is the marketer's ability to achieve economies of scale and scope, thereby allowing it to offer a variety of products and services.[65] With FE having such a dominant position, other EGSs will have little hope of achieving such economies and will be reluctant to invest in the market; thus sustainable competition will be impossible.
- Perpetuation of barriers that will discourage customer participation in the market. As noted above, FES affirmatively exploits its relationship with its affiliated EDC as a marketing advantage when selling competitive products, selling its "customer relationships [and] local brand." Thus FE will continue to encourage customers should "stay with FE," either by staying on default service or by switching them to their affiliate. The EDC as well will have an incentive to favor its affiliated supplier in a variety of ways, such as maintaining operational rules that favor default service (e.g., making it easier to implement customer aggregation).

Simply put, the evidence shows that not only will there be no "workable" competition, with 80% or more of the market served by a single provider – but the retail market will clearly be adversely impacted by the merger. Only a minority of customers will get their electricity from a supplier other than FE or an FE affiliate and only a few EGSs will even make offers.[66] At the very least, FE has failed to show that the merger and its retail marketing strategy will not harm the development of a workably competitive market.

The Initial Decision acknowledges that acquisition of Allegheny's generation "may" provide FE with a competitive advantage, and that they will be "aggressive" post-merger participants, but concludes that this does not constitute anticompetitive or discriminatory

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65 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.

66 Direct Energy M.B. at 20-21; Direct Energy Cross-Exam Exhibit 7; Tr. 917 (after four years, there are only two EGSs serving PennPower's service territory), Tr. 919 (after eight years, there are only four EGS serving in the Duquesne Light service territory).

conduct.[67] This is not so. Their aggressive marketing strategy will result in the perpetuation of FE's market dominance and, thus, constitutes anticompetitive conduct.[68] In the anti-trust context, preserving or expanding one's monopoly or dominant market share constitutes anticompetitive conduct.[69] Moreover, FE's market domination efforts will discourage the entry of new EGSs and deter the growth of EGSs already in the market. Such actions clearly constitute conduct that is inherently discriminatory to the retail electric markets.[70] Certainly, the FE strategy's central purpose is to discriminate against non-affiliated suppliers by seizing a dominant position in the retail market.[71]

Therefore, the Initial Decision seriously erred in finding that FE had shown that the merger would not result in anticompetitive or discriminatory conduct violative of Section 2811(e). Accordingly, the merger application should either be rejected or conditioned upon FE's acceptance of Direct Energy's remedial plan (explained *infra* in Exception 5).

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67 ID at 67.

68 By focusing on physical barriers to an EGS entering or existing the market (FOF # 58), the Initial Decision takes a narrow view of anticompetitive or discriminatory conduct. As one court of appeals has stated: "'Anticompetitive conduct' can come in too many different forms, and is too dependent upon context, for any court or commentator ever to have enumerated all the varieties." *Caribbean Broad. Sys., Ltd. v. Cable & Wireless PLC*, 331 U.S. App. D.C. 226, 148 F.3d 1080, 1087 (D.C. Cir. 1998). FOF #58 also suffers from fatal flaws. First, it fails to consider the market share of those EGSs. Second, it fails to consider the barriers to leaving service of the Joint Applicants. Third, it fails to establish the number of active EGSs that are necessary for a "competitive market."

69 The existence of monopoly power may be inferred from a predominant share of the market. *United States v. Grinnell Corp.*, 384 U.S. 563, 571 (1966). Unlawful maintenance of a monopoly is demonstrated by proof that a defendant has engaged in anti-competitive conduct that reasonably appears to be a significant contribution to maintaining monopoly power. *United States v. Microsoft*, 346 U.S. App. D.C. 330, 253 F.3d 34, 79 (D.C. Cir. 2001). Behavior that otherwise might comply with antitrust law may be impermissibly exclusionary when practiced by a monopolist. *United States v. Dentsply Int'l, Inc.*, 399 F.3d 181, 187 (2005).

70 *LePage's, Inc. v. 3M*, 324 F.3d 141, 159-60 (3d Cir. 2003) (The test is not total foreclosure, but whether the challenged practices bar a substantial number of rivals or severely restrict the market's ambit). Dr. Morey explained that scale economies and sunk costs limit the number of firms that can profitably serve a market. Direct Energy St. 1 at 36-38; Direct Energy St. 1-SR at 37-41.

71 The Initial Decision further wrongly concludes that the Joint Applicants will not have "any real incentive" to act upon those opportunities. *See* ID at 67. That conclusion places great weight on the lack of evidence showing past instances of anticompetitive or discriminatory behavior by FirstEnergy or its affiliates. *See* FOF # 69. It is true that Direct Energy's witness 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. Tr. 781-82. But, this observation fails to appreciate that it is the merger itself that will give FE the opportunity to do so as it implements its retail marketing strategy.

D. Exception 4: The Initial Decision Erroneously Found That The Merger Satisfies The Requirements Of Section 1102(a) Of The Code. (COL ## 15, 23-26, ID At 39-74).

In addition to their erroneous conclusions regarding Section 2811(e), the ALJs also erroneously concluded that the merger met the separate standard in Section 1102 of the Public Utility Code.[72] That Section requires the Commission to find that a proposed acquisition will "affirmatively promote the 'service, accommodation, convenience, or safety of the public' in some substantial way."[73] As is well established, this standard requires that the merger produce "affirmative public benefits."[74] Here, the Initial Decision again misinterprets Direct Energy's position as claiming that a merger must confer an affirmative benefit to competitors in order to meet the affirmative public benefits test.[75] But that is not at all what Direct Energy argued.

The *Popowsky* decision makes quite clear that the existence or absence of competitive benefits is one part (albeit an important part) of the analysis of whether the merger will, on net, produce an affirmative public benefit. Here, as described above, the merger will have a negative impact on a properly functioning and workably competitive retail electric market. Any affirmative benefits the merger produces will be far outweighed by the harm to the retail competitive market in Pennsylvania. The Non-Unanimous Settlement does not address any of these negative competitive impacts. And it makes no material effort to ameliorate the effects of FE's retail marketing strategy, nor to ensure or improve competitive conditions in the retail

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72 Pursuant to 66 Pa. C.S. § 1102(a)(3) and 52 Pa. Code § 69.901, the Commission is required to approve mergers that result in a change in the direct or indirect control of a Pennsylvania public utility. In addition, Section 1103(a) allows the Commission to impose upon its issuance of a certificate of public convenience "such conditions as it may deem to be just and reasonable." 66 Pa. C.S. § 1103(a).

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

74 *Id.; Popowsky, supra.*

75 ID at 66.

electric market.[76] Thus, the Non-Unanimous Settlement cannot be found to satisfy the "affirmative public benefit" standard.

To the contrary, the so-called "retail competitive enhancements" the Non-Unanimous Settlement promises are extremely minor, were already going to be done, or have *already* been eviscerated. For example, it is clear that First Energy fully intends to integrate West Penn into FirstEnergy's existing customer billing and collection computer systems,[77] so there is no value being "added" by promises that FE will require West Penn Power to implement supplier interaction and supplier billing steps that MetEd and Penelec have already agreed to implement. Such steps would be required by the integration of the systems! Likewise, the agreement of West Penn to provide budget billing to EGS customers is something it is already obligated to provide by Commission regulation.[78] In a similar fashion, the Joint Applicants agreed not to harmonize their default service procurements until 2013. But, they did not intend to harmonize earlier because they have already begun to purchase generation supply for period from 2011 to 2013. Virtually all of the so-called "competitive benefits" are of a similar "sleeves from the vest" nature.[79]

Moreover, a careful review of the record shows that it does not contain substantial evidence that the "competitive market" portions of the Non-Unanimous Settlement (Paragraphs

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76 The Initial Decision merely regurgitates the list of alleged "benefits" set forth in the Application and Non-Unanimous Settlement in an attempt to demonstrate that they satisfy the competitive merger standards. ID at 39-74. There is no evidence in the record that demonstrates – or even discusses – 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 mere agreement by and between the Settling Parties that net benefits will result – does not mean that such benefits will actually exist. Benefits must be supported by substantial evidence. 2 Pa. C.S. § 704. More required than a mere trace of evidence or a suspicion of the existence of a fact sought to be established.

77 Direct Energy M.B. at 60.

78 *Id.*, at 60-63.

79 *Id.*, at 58-64. In addition, the Settlement provides (only to the Joint Petitioners') information about default service solicitations and bids (PS ¶ 53), as well as a "report" providing information about "wholesale market prices and price trends in ... PJM" (PS ¶ 54). Such information is either publically available or available as part of the default service procurement plans. The Settlement also gives the signatory parties the right to request a Commission investigation into the competitive market (PS ¶ 55), a right that they already have! None of these provisions does anything to address the substantial competitive concerns, that are likely to exist if the merger is approved per the Non-Unanimous Settlement.

53-55) are in the public interest. The Initial Decision relies on these paragraphs to lessen market power concerns.[80] But, these paragraphs do nothing to mitigate or prevent any anticompetitive or discriminatory competitive conduct providing merely "information" and "reports."[81]

Thus, even if the Joint Application, as modified by the Non-Unanimous Settlement, promises some benefits in some areas, such as minimal rate decreases and universal service funding, the lack of competitive benefits from the merger, and indeed the harm to the competitive market, means that, on net, the merger will be a detriment to the public and cannot be approved.

E. Exception 5: The Initial Decision Erroneously Found that Direct Energy's Claims and Proposals Regarding the Default Service Market Have No Nexus to the Merger When They the Evidence Demonstrates That Its Proposals Are Necessary to Remedy the Competitive Harm that the Merger Will Produce. (FOF ## 58-59; ID at 68, 74-75).

In response to the extensive evidence of likely anti-competitive and discriminatory post-merger conduct by FE and FES, Direct Energy presented an innovative plan to address the merger's seriously negative consequences. Generally, the plan would revise the retail market structure in the FE service territory, including the following steps:[82] (a) establish a process to select an alternative default service provider, not affiliated with the Joint Applicants, that will provide default service to customers choosing not to participate in a retail customer auction, with default service priced on a quarterly adjusted, spot market basis; (b) conduct a retail auction in which residential and small commercial customers would be assigned to EGSs in return for an

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80 ID at 64.

81 The Settlement provides (and only to the Signatory Parties) information about FE's default service solicitations and bids as well as a "report" about "wholesale market prices and price trends in . . . PJM."[81] PS ¶ 53, 54. The Settlement also "confers" on "Signatory Parties" a right they already have – to request a Commission investigation into the competitive market.[81] PS ¶ 55. Other than the self serving statement of the Settling Parties, the record contains nothing that shows that those provisions provide an affirmative benefit. By merely requiring reporting and allowing after-the-fact investigations, the Settlement follows an "ask for forgiveness" approach and does nothing to actually prevent damage to competitive markets.

82 Importantly, Direct Energy's proposal is not conditioned on Direct Energy either acting as the ADSP or achieving any particular result in the an auction conducted by the DSP. *See* Direct Energy M.B. at 41, fn 164.

acquisition payment to participating customers; and (c) require FE to create a separate, affiliated billing subsidiary to perform all billing and customer care functions with the specific duty to provide EGS-specific billing to those participating in the retail auction.[83]

The Initial Decision dismissed Direct Energy's plan, stating that its proposed modifications to the provision of default service in the FE service territory had "no nexus" to the merger and that, since the suggested changes related to the way in which the default market is generically structured in Pennsylvania, Direct Energy's arguments were "more appropriately addressed by the General Assembly, not by the Commission in a merger proceeding."[84]

But the ALJs' decision that default service modifications are not part of the merger is really part and parcel of their rejection of all of Direct Energy's evidence in their desire to bless the Non-Unanimous Settlement. In fact, and as explained above, Direct Energy showed that the existing default service structure will aid and abet FE's own retail marketing strategy, which utilizes the name recognition and brand loyalty of its affiliated EDC/default service provider to help switch default service customers to products offered by its affiliated EGS. Controlling default service will make FES more successful in switching customers via municipal aggregation (for small customers) and direct sales (for larger ones).[85] Thus, the present default service structure is a key element of this anticompetitive strategy.

While it is true, as the ALJs observed (and Direct Energy's witness admitted), that the default service structure in the FE- and Allegheny-affiliated service territories is the same structure in place in other EDC territories,[86] this fact certainly does not mean that the Commission cannot order modification to the that existing structure as a *remedy* to ameliorate a

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83 Direct Energy M.B. at 39-58.

84 ID at 68.

85 Direct Energy M.B. at 26-35.

86 ID at 68; Joint Applicants M.B. at 37-38.

merger's anticompetitive and discriminatory effects. The Commission has broad powers to order structural remedies in merger cases, as preconditions for merger approval. For example the Commission ordered the companies in the Duquesne/Allegheny proposed merger to join an RTO as a condition to merger approval.[87] In that and other cases, the Commission has also considered divestiture of generation assets. The Commission may not have the authority to order a regulated public utility to take such actions, absent a merger proposal, but Section 2811 gives it the authority (and obligation) to do so as a condition of merger approval. The ALJs' extremely limited view of the PUC's authority in merger cases is simply not correct.

F. Exception 6: The Initial Decision Erroneously Found That The Direct Energy's Proposal Is Inconsistent With The Mandates Of Act 129 And Violates Section 2807(e)(3.1), (3.2), (3.4) And (3.7) Of The Public Utility Code. (COL ## 17, 22; ID at 69-72).

In a single sentence, *without reviewing or discussing any aspect of* Direct Energy's proposal, the Initial Decision concluded[88] that its remedy proposal (specifically, the portion of the proposal that default service would be priced on the basis of quarterly adjusted, spot market prices), is not consistent with the provisions of Act 129.[89] This conclusion is incorrect. Direct Energy's proposed default service pricing is consistent with the plain language of Act 129, Commission precedent and the uncontested testimony presented by Direct Energy's witnesses.

1. Prudent Mix

The Direct Energy proposal assumes that most, if not all, customers will be served by competitive electric generation suppliers. In that instance, the only "prudent" or "wise or

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

88 COL ## 17, 22; ID at 69-72.

89 The Initial Decision never actually explains which aspects of Direct Energy's proposal are inconsistent with Act 129 - because they clearly are not. *See* ID at 69-72. The Commission is empowered to select an alternative DSP. 66 Pa. C.S. § 2807(e); 52 Pa. Code § 54.183. And, nothing in the Public Utility Code prohibits an account auction for retail and small commercial customers. This step has been ordered or agreed to on previous occasions. Moreover, the BillCo proposal is, essentially, a structural version of the unbundling that the Commission has ordered in many other instances. Direct Energy M.B. at 39-55.

judicious" mix of supply for those few customers who likely will remain on default service will be real-time spot market procurement. It would be unwise, frivolous and very expensive for a supplier to procure what would effectively be long-term options at a fixed price for such a small number of customers. The Initial Decision does not challenge Direct Energy witness 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.[90]

It is plainly wrong as a matter of law to suggest that a "mix" must include spot-market purchases, short-term contracts and long-term contracts.[91] 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.[92] For example, in *Pike County*. the Commissioner approved serving all default customers via the spot market.[93] Thus, the correct interpretation of Act 129's "prudent mix" requirement 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 not legally mandated. In this case, one type of power procured in the hourly spot market would be most prudent.

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

The ALJs summarily conclude that Direct Energy's proposal to use spot market pricing for default service (for residential and small commercial customers) would not produce default service at the least cost over time. On the contrary, the direct testimony of Direct Energy's witness Frank Lacey testified that using spot market purchases for default service will, indeed,

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90 Direct Energy St. 3-SR at 16-17; Direct Energy R.B. at 36-41.

91 *See* ID at 69-72.

92 Examples are reviewed in Direct Energy's R.B. at 39-40. Additionally, it should be remembered that the Commission's Policy Statement recognizes that procurement "mix" may change with circumstances and may consist solely of spot market purchases if the circumstances are appropriate. *Default Service and Retail Electric Markets*, Docket No. M-00072009, Final Policy Statement entered May 10, 2007 at 5.

93 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).

do just that. The evidence shows that short-term prices, over time, yield lower prices than longer-term contracts.[94]

No witness challenged this testimony and no party disputed that in this scenario, a product secured in the real-time market is most efficient and least costly.[95] Again, if spot market pricing could not, as a matter of law, constitute the "least cover over time," then the Commission could not have been ordered the use of spot market prices for default service in the *Pike County* case.

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

Finally, the ALJs insist that Direct Energy's default service pricing proposal does not take into account "price stability." In fact, the record shows that the quarterly pricing for DSP customers proposed by Direct Energy strikes a fair balance between the competing goals of stability, demand response and least-cost over time.[96] 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. Yet, the Initial Decision implies, 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.[97] Using a three month average period to set the price will smooth any price spikes or drops.[98]

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94 Direct Energy St. 1 at 8. In surrebuttal, Mr. Lacey expounded upon the reasons short-term market prices reflected "least cost" in this instance. Direct Energy St. 3-SR at 15; at fn 148.

95 Direct Energy R.B at 40-41; Direct Energy St. 3-SR at 16. Indeed, when it was pointed out that in similar circumstances Pike County, default customers had been served via hourly market pricing and had seen prices lower than the fixed rate, the Joint Applicants' witness Mr. Schnitzer admitted that "this wouldn't surprise me." Tr. 942.

96 Direct Energy M.B. at 42-43; Direct Energy R.B. at 41-42.

97 *See* ID at 69-72.

98 Tr. 803.

The best evidence that a short-term pricing mechanism will, in fact, be sufficiently workable and stable for customers is the result in Pike County, where default customers have for some time been taking default service using the same pricing scheme as that recommended here – three month average spot market prices with a true up.[99] Under this pricing mode, the load on this hourly priced default service has grown from virtually nothing to 40%.[100] 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, how does one explain the Pike County results?

G. Exception 7: The Initial Decision Erred by Refusing to Consider Each of the Individual Portions of Direct Energy's Proposed Remedies. (COL ## 15, 23-26; ID at 60-72).

As noted above, the ALJs rejected Direct Energy's proposal to revise the default service provisioning and pricing in the post-merger FE service territory as beyond the scope of the merger and contrary to Act 129.. While both of these conclusions were incorrect, the Initial Decision incorrectly treated these measures as applying to every aspect of Direct Energy's remedial plan.

The Initial Decision characterizes all of these remedial steps as addressing problems that are unconnected to the merger (an obviously incorrect conclusion) and as even being inconsistent with Act 129 (again, incorrect). The steps Direct recommends are, in fact, tailored carefully to address the specific anti-competitive conditions that would result from the merger. Most critically, removing the utility from the role of the default service provider breaks the stranglehold on the mass market that has allowed FirstEnergy to obtain an 81 percent market share in its Ohio service territories (which they would claim are "fully competitive"), and which

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99 *Pike County, supra.*

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

the merged company hopes to apply to its Pennsylvania markets to similar effect. The record establishes that this is the single most important step the Commission can take in applying the standard for merger review appropriately and fairly, for the benefit of customers in the service territories of the merged company. In conjunction with removal of the utility from the default service provider role, Direct's auction proposal would establish the territories of the merged company as competitively robust, while also delivering hundreds of millions of dollars of value to customers in those areas. Even in the absence of removal of the utility from the default function, the auction would bring competitors into the territories of the merged company at scale, making them far more competitive than they would otherwise be, while still delivering substantial, immediate value to customers through the auction proceeds. Combined with removal of the utility from the default function and the auction proposal, establishing a "BillCo" to serve the competitors retailers and non-utility DSP would appropriately recognize the utility's exit from the customer-facing functions in those areas, creating opportunities for job creation and the offering of advanced services from competitors in the market.

Thus, the three parts of Direct's plan have been crafted to address, in order of importance, the three anti-competitive characteristics of the post-merger market that should be of most concern to the Commission: the utility's ability to leverage its default role to establish a dominant position in the market; the absence of opportunities for scale entry by competitors , especially should the utility retain its role as default provider; and the operational barriers to the further development of the market that exist in the current system. In order to substantially address the anticompetitive effects of the proposed merger, and thus allow the merger to go forward with appropriate conditions, however, the Commission need not order all aspects of the Direct plan to be implemented at once. As discussed above, designation of a non-utility default

service provider is the most critical step in mitigating the potential anti-competitive effects of the merger, and it should be ordered in as many service territories as allowed under Pennsylvania law. To have a positive effect on the markets in the service territories of the merged company, the retail auction, however, need not necessarily be implemented across all four service territories at the same time. In order to gain further experience with auctions in such a setting and satisfy itself that they are bringing about the desired results, the Commission could order an auction of a subset of the customers in each of the service territories, or all of the customers in one or more of the service territories, on a "pilot" basis, with further auctions coming only after a full evaluation of the results by the Commission. Even partial implementation of the Direct plan in this manner, if thoughtfully done, could mitigate the potential anti-competitive aspects of the proposed merger that should be of most concern to the Commission.

The Initial Decision also erred by ignoring that Direct Energy had, as a condition of merger approval, proposed additional remedies.[101] These remedies include: (1) the divestiture of a portion of FE's generation fleet, with the Commission determining the amount necessary to eliminate FE's wholesale market power; (2) the establishment of an enhanced code of conduct that addresses the relationship between the EDC and FE's EGS affiliate, FES, and prohibits FE from marketing in its affiliated EDC service territories under the FE name; (3) continuous monitoring of cross-subsidies; and (4) the imposition of safeguards to protect consumers from potential abuses and to ensure post-merger compliance. None of these remedies was considered by the Initial Decision. The Commission should order these additional remedies as merger conditions.

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101 Direct Energy M.B. at 39-40, 55-58.

H. Exception 8: The Initial Decision Erred by Rejecting the Evidence that the Post-Merger Wholesale Market in the FE Service Territory Will Not Be Sufficiently Competitive. (FOF ## 49-52; ID at 60-72).

The evidence also showed significant wholesale market concerns resulting from the merger, which, in turn, would adversely affect the retail market. Instead, the ALJs adopted the testimony and conclusions of the Joint Applicants' witness Hieronymus, who applied the "FERC horizontal merger guidelines" to conclude that the proposed merger will not have an adverse effect on the wholesale market, and, as a result will not adversely affect the retail market. That testimony simply applied the FERC regulations and the "delivered price test" as set forth in those regulations. The ALJs incorrectly assert that that this is "[the way it] is done by [the PUC]."[102] The Initial Decision also references the Non-Unanimous Settlement's provisions that give wholesale market information to OTS, OSBA and OCA (but not to competitors like Direct Energy) as an additional reason to reject Direct Energy's claims. This was error.

First, the Initial Decision incorrectly concluded that this Commission applies the same standard as the FERC in considering whether the wholesale market in the merged service territory satisfies the requirements of Section 2811(e). While the Commission has indicated it would follow the "analytical process" used by FERC/FTC/DOJ in the Merger Guidelines, it has never stated it would woodenly accept FERC's conclusions and the Commission has never indicated that it considered itself bound by those Guidelines. For example, in the 1998 proposed merger of Duquesne Light Co. and (ironically) Allegheny Power, the Commission stated it would apply the FERC guidelines, but do so in the context of Section 2811.[103]

In fact, the Commission's legal standard is different than the federal standard. As stated above, the Commission's inquiry is whether the market power concerns constitute

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102 ID at 60.

103 *Re DQE, Inc.*, 1998 Pa. P.U.C. LEXIS 48, at 67-68 (1998).

"anticompetitive or discriminatory conduct," and requires the Commission to take action to "preserve the benefits of a . . . competitive retail electricity market." In contrast, the FERC inquiry is whether the merger will permit the applicants to "have the ability to exercise market power, which is defined as the ability to increase market prices for a sustained period of time."[104] Dr. Hieronymus did agree that there could be examples of markets that passed the FERC market concentration screens but were nonetheless not competitive.[105] Here, the Commission must analyze whether there are any circumstances that, even if not failing the FERC market power test, could nevertheless permit the merged companies to engage in discriminatory or anticompetitive conduct that could prevent the development of a workably competitive market.

Indeed, there is just such evidence in the record, even though the ALJs completely ignored it. Direct Energy presented testimony indicating that because of existing structural problems in the PJM market that the PJM Market Monitor had identified, there was a significant potential that the merged company could be in a position to manipulate wholesale prices in a discriminatory or anti-competitive manner. Direct Energy witness Dr. Morey explained that for many years the PJM Market Monitor has made clear that the market structure in PJM's energy, reserve and capacity markets creates ample opportunity for participants to exercise market power. The PJM Market Monitor has noted potential market power concerns in both the Allegheny Power and the Penelec control zones for the energy, capacity and reserve markets. While the PJM Market Monitor has indicated that market mitigation (in the form of offer capping rules) had been effective "in most cases," the obvious conclusion is that in at least some times these structural issues created undue concentrations and thus gave participants the ability

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104 The FERC standard is explained at footnote 150 of Direct Energy's M.B. and discussed at pages 35 to 39 therein.

105 Direct Energy M.B. at 37.

to exercise their market power and raise prices.[106] Therefore, the structural deficiencies in the PJM market itself will exacerbate the admitted additional market concentration that the Joint Applicants' own study revealed.

The undeniable conclusion is that at several points during the year, the merged company will possess market power that will permit it to raise prices in the wholesale market which, in turn, will lead to higher prices in the retail market. The Joint Applicants never addressed the implications of the PJM Market Monitor's conclusions on the results of its market concentration study. As Dr. Morey concluded, "the Applicants have not demonstrated that they could not profit from withholding in the reserve and capacity markets . . . ."[107] In turn, the Commission cannot conclude, based on the record, that absent mitigation, the post-merger retail markets in the FE service territory will be free of anti-competitive or discriminatory conduct.

Accordingly, the ALJs erred in concluding that the merger would not create the potential for discriminatory or anti-competitive conduct in the wholesale energy market that could prevent the development of a workably competitive retail market. The only way to address this potential is to require the Joint Applicants, as a condition of merger approval, to take action to eliminate the merged company's ability to take advantage of the existing structural deficiencies in the PJM market so as to control or otherwise manipulate prices. This requires FE to either divest a certain percentage of its in-state generation or to offer that generation in a transparent manner to wholesale and retail competitors at the same price it is made available to the FE-affiliated companies. Divestiture should be viewed as a necessary and reasonable means to keep this situation from worsening post-merger.

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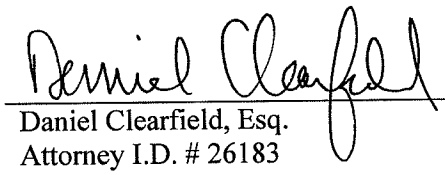
106 *Id.*, at 38, 39, 58.

107 Direct Energy St. 1 at 30. *See also* Direct Energy M.B. at 35-39.

III. CONCLUSION

For the reasons set forth above, Direct Energy respectfully requests that the Commission reverse the Initial Decision regarding the issues set forth herein. More specifically, the Commission should adopt Direct Energy's proposed solutions as conditions to merger approval, to mitigate the anticompetitive and discriminatory effects of the proposed merger.

Respectfully submitted,



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