COMMONWEALTH OF PENNSYLVANIA
PENNSYLVANIA PUBLIC UTILITY COMMISSION
P.O. BOX 3265, HARRISBURG, PA 17105-3265

ISSUED: March 25, 1998

IN REPLY PLEASE
REFER TO OUR FILE
R-00974104 &
R-00974104C0001-C0004

LARRY R CRAYNE
RICHARD S HERSKOVITZ
DUQUESNE LIGHT COMPANY
411 SEVENTH AVENUE 16-006
PITTSBURGH PA 15230-1930

REP

APPLICATION OF DUQUESNE LIGHT COMPANY FOR APPROVAL OF ITS RESTRUCTURING PLAN UNDER SECTION 2806 OF THE PUBLIC UTILITY CODE

TO WHOM IT MAY CONCERN:

Enclosed is a copy of the Recommended Decision of Administrative Law Judge John H. Corbett, Jr.

An original and nine (9) copies of signed exceptions to the decision, if any, MUST BE FILED WITH THE SECRETARY OF THE COMMISSION IN ROOM B-20, NORTH OFFICE BUILDING, NORTH STREET AND COMMONWEALTH AVENUE, HARRISBURG, PA OR MAILED TO P.O. BOX 3265, HARRISBURG, PA 17105-3265; a copy in the hands of the Office of Special Assistants, Room 210; and a copy in the hands of each party of record no later than April 14, 1998 by 4:30 P.M. 52 Pa. Code §1.56(b) cannot be used to extend the prescribed period for the filing of exceptions or reply exceptions.

Replies to exceptions, if any, must be served on the Secretary of the Commission, in the manner described above, no later than April 24, 1998 by 4:30 P.M. as well as served upon the parties. A certificate of service shall be attached to the filed exceptions.

Exceptions and reply exceptions shall obey 52 Pa. Code 5.533 and 5.535, particularly the 40-page limit for exceptions and the 25-page limit for replies to exceptions. Exceptions should be clearly labeled as "EXCEPTIONS OF (name of party) - (protestant, complainant, staff, etc.)".

Any reference to specific sections of the Administrative Law Judge's Recommended Decision shall include the page number(s) of the cited section of the decision.

PLEASE NOTE: All parties, if possible, should provide the Commission with appropriate tables incorporating the adjustments contained in the Recommended Decision. Any tables should be prepared using the ENPRO computer model. Any tables and associated disscussion are exempt from the page limitations for exceptions and /or reply exceptions.

Parties are also requested to provide the Commission's Office of Special Assistants with a copy of exceptions/reply exceptions on a computer disk, 3 1/2" in size, in Microsoft Word 6.0 format. If Word 6.0 is not available, either WordPerfect 5.1 or ASCII format is acceptable.

Very truly yours,

James J. McNulty
Secretary

law
Encls.
Certified Mail
Receipt Requested

DOCUMENT
FOLDER

cc: ALJ CORBETT/ OFFICE OF ALJ/ OSA/ BFUS-TARIFF/ OTS/ OCA/ LAW/ BFUS/ PIO/ OUR FILE/ NEW FILING/ CHAIRMAN/ COMMISSIONERS
See attached or additional parties of record

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Application of Duquesne Light Company	:	
for Approval of Its Restructuring Plan Under	:	Docket Nos. R-00974104 &
Section 2806 of the Public Utility Code	:	R-00974104C0001-C0004

RECOMMENDED DECISION

Before
John H. Corbett, Jr.
Administrative Law Judge

TABLE OF CONTENTS

I. HISTORY OF THE PROCEEDING

On August 1, 1997, Duquesne Light Company ("Duquesne" or the "Company") filed with the Pennsylvania Public Utility Commission ("Commission") a restructuring plan to implement direct access to a competitive market for the generation of electricity pursuant to Section 2806(d) of the Electricity Generation, Customer Choice and Competition Act (the "Competition Act" or "Act"). 66 Pa. C.S. §§2801, et seq. With the appearance of the Commission's Office of Trial Staff ("OTS"), the following parties petitioned to intervene in this proceeding: the Office of Consumer Advocate ("OCA"); the Office of Small Business Advocate ("OSBA"); Allegheny County; the City of Pittsburgh (the "City"); the School District of Pittsburgh; Jim Ferlo, pro se; David Hughes, pro se; Allegheny Electric Cooperative, Inc.; System Council U-10 of the International Brotherhood of Electrical Workers ("IBEW"); PECO Energy Company ("PECO"); Pennsylvania Power Company; Armco, Inc.; NorAm Energy Management, Inc.; Duke Energy Trading & Marketing, LLC; the Pennsylvania Retailers' Association ("PRA"); Electric Clearinghouse, Inc.; Enron Power Marketing, Inc. ("Enron"); QST Energy, Inc.; The Environmentalists ("Env.");[1] Low Income Advocate Parties ("LIAP"); MidCon Gas Services Corporation; mc^2, Inc.; Allegheny Teledyne, Inc.; The Peoples Natural Gas Company; Hospital Shared Services and Administrative Resources, Inc. ("HSS/ARI");[2]

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[1] The Environmentalists' coalition consists of the following organizations: Citizen Power, Inc.; Citizens' Organization on Utility Policies; Clean Water Action; The Group Against Smog and Pollution; The Pennsylvania Public Interest Research Group; and The Sierra Club.

[2] HSS/ARI, together, represent the following entities: Allegheny General Hospital, Children's Home of Pittsburgh, Forbes Metropolitan Hospital, Forbes Nursing Center, Forbes Regional Hospital, Gateway Rehabilitation Center, Healthsouth Harmarville, LGAR Health & Rehabilitation Center, Ohio Valley General Hospital, Presby Senior Care/Allegheny, Riverview Center for Jewish Seniors, St. Clair Hospital, Vincentian Home, South Hills Health System, and the University of Pittsburgh Medical Center. HSS/ARI M.B. at 1-2, fn. 1.

CNG Energy Services Corporation; New Energy Ventures East, LLC ("NEV"); Duquesne Industrial Intervenors ("DII");[3] Metropolitan Edison Company and Pennsylvania Electric Company, individually and collectively trading as GPU Energy ("GPU"); Mid-Atlantic Power Supply Association ("MAPSA"); the Skipping Stone;[4] Pennsylvania Power & Light Company; Wheeled Electric Power Company; Dollar Energy Fund; The Eastern Group; the Pittsburgh Chapter of the NAACP; and the IBEW, Local 2357. No objection was raised to any of these requests to intervene. Motions for admission, pro hac vice, of counsel for various parties were granted without objection as well.

The OCA (at Docket No. R-00974104C0001), the City (at Docket No. R-00974104C0002), the Community Action Association of Pennsylvania ("CAAP")[5] (at Docket No. R-00974104C0003), the DII (at Docket No. R-00974104C0004), the LIAP, the Environmentalists, and the Pittsburgh Chapter of the NAACP filed complaints against the restructuring plan. Answers thereto were waived by the presiding Administrative Law Judge ("ALJ") with the consent of the parties.

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[3] DII is an ad hoc association of Duquesne's large industrial and institutional customers including: BOC Gases, General Motors Corporation; J&L Specialty Steel Company, Inc.; LTV Steel Company, Inc.; Nabisco, Inc.; Nova Chemicals, Inc.; and U.S. Steel Group, a unit of USX Corporation.

[4] The Skipping Stone describes itself as an energy consulting firm specializing in the deregulation of the electric industry. It represents a number of power marketers and aggregators who plan to do business in Pennsylvania.

[5] CAAP is a statewide association of local community action agencies in Pennsylvania whose primary mission is to serve the needs and represent the interests of low income citizens.

A prehearing conference was held on September 4, 1997.[6] Duquesne Light, the OTS and the OCA submitted prehearing memoranda. When agreement could not be reached at the prehearing conference, the parties held an informal telephonic conference on September 10, 1997 to discuss a litigation schedule.[7] On this latter date, I issued a Prehearing Order which, inter alia, established a litigation schedule for this proceeding. All parties agreed they would not object to the Commission issuing its final Order and Opinion on this application by May 29, 1998, which is more than nine months after filing the application as directed in the Competition Act.[8] Altogether, a total of ten Prehearing and Interim Orders were issued in this case concerning various matters. In addition, a Protective Order for proprietary material applying to all parties in this proceeding was issued on October 1, 1997. Further prehearing conferences scheduled for October 21, 1997 and December 9, 1997 were canceled.

As discussed infra, hearings to receive public comment upon the proposed restructuring plan were held on November 12, 1997 in Beaver Falls and on November 13, 1997 in Pittsburgh, Pennsylvania. The prehearing conference and the public input hearings in this case generated 383 pages of notes of testimony.

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[6] This conference was held jointly with the restructuring application of West Penn Power Company ("West Penn") at Docket No. R-00973981 with ALJ Larry Gesoff co-presiding.

[7] These conferences were held jointly with the West Penn restructuring proceeding at Docket No. R-00973981, because Duquesne Light and West Penn filed their restructuring plans on the same date and, as a result, both proceedings are on the same statutory timetable. Also, the parent companies of Duquesne Light and West Penn filed a merger application at Docket No. A-110150F0015. The two restructuring proceedings are not consolidated nor is either restructuring proceeding consolidated with the merger application. ALJ Gesoff is presiding over West Penn's restructuring filing and he and I, together, are presiding over the merger application.

[8] 66 Pa. C.S. §2806(f). Without the waiver, the run date for a Commission Opinion and Order on this application will expire April 30, 1998.

In addition to Duquesne, the following parties filed statements of prepared testimony, together with numerous supporting exhibits: the OTS, the OCA, the OSBA, the City, DII, Enron, the Environmentalists, HSS/ARI, IBEW, MAPSA, NEV, the PRA, the CAAP[9] and David Hughes. Evidentiary hearings to cross-examine witnesses supporting prefiled prepared written testimony for Duquesne were held in the Commission's offices in Pittsburgh on December 15-18, 1997. These hearings generated an additional 1,075 pages of notes of testimony. Further evidentiary hearings scheduled for January 5-9, 1998 to cross-examine witnesses supporting prefiled prepared written testimony for the aforementioned intervenors were canceled when Duquesne, together with all of the active intervenors, agreed to allow this testimony to be moved into the record without objection while waiving cross-examination. All active parties filed first and second stipulations evidencing their agreement with this procedure.

The record in this proceeding closed on January 23, 1998. The following parties filed both main and reply briefs: Duquesne, the OTS, the OCA, the OSBA, DII, HSS/ARI, the PRA, the IBEW, Enron, and MAPSA. The following parties filed main briefs only: the City, the Environmentalists and LIAP (jointly), CAAP, Mr. Hughes, NEV, GPU and PECO.

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[9] The CAAP, a corporation, is not represented by counsel. Corporations must be represented by an attorney-at-law in adversary proceedings before the Commission. See, 52 Pa. Code §1.22 and Lestat Corp. v. PP&L, Docket No. C-00946284 (Opinion and Order entered August 30, 1995). It is a misdemeanor of the third degree to practice law without being an attorney-at-law. 42 Pa. C.S. §2524. The prohibition against the practice of law by a lay person applies to proceedings before this Commission. Walacavage v. Excell 2000, Inc., — Pa. Superior Ct. —, 480 A.2d 281 (1984). However, all active parties have stipulated to the introduction of CAAP's and other intervening parties' prepared written testimony because no party wished to cross-examine the witnesses sponsoring the testimony. Since no party objected, I permitted the CAAP's witnesses to introduce their statements into the record.

II. INTRODUCTION

The issues presented in this proceeding are "both controversial and important," requiring consideration of the most effective means to introduce competition into the market for electric generation services while, at the same time, ensuring that the competitive market brings with it real, informed choices to consumers, ensures that customers who are unable to, or choose not to, obtain competitive services continue to receive generation services at just and reasonable rates, and balances ratepayer and shareholder interests with respect to sharing the costs and benefits of restructuring the role of the utility as a provider of generation services. OCA M.B. at 1. Any plan introducing direct access to a competitive electric generation market must ensure, as well, safe and affordable transmission and distribution service at levels of reliability that the citizens and businesses of this Commonwealth currently enjoy. These considerations underlie the declaration of policy, which the General Assembly found so important in enacting the Competition Act. 66 Pa. C.S. §2802. With this policy in mind, the following decision attempts to balance these various competing interests, while seeking compliance with the specific provisions of the statute.

III. PUBLIC INPUT TESTIMONY

Pursuant to public notice, three hearings were held at two locations in southwestern Pennsylvania to receive public comment upon the proposed restructuring plan.[10] This testimony may be summarized as follows:

A. November 12, 1997, 7:00 p.m., Beaver Falls, Pennsylvania

Peggy W. Betlyn, President, Community College of Beaver County, presented a resolution as President of the Beaver County Chamber of Commerce in support of the proposed restructuring plan, N.T. 100-102.[11]

Bob Dismukes, a retired industrial engineer in the steel mills and purchasing manager for Babcock & Wilcox opposed the proposed restructuring plan. N.T. 115-116.

B. November 13, 1997, 1:00 p.m., Pittsburgh, Pennsylvania

The following persons appeared at this hearing and testified in support of the proposed restructuring plan: Robert Nicklos, Principal, Schenley High School, N.T. 156-158; Jacqueline Perhach, Facilitator, High Technology Magnet, Schenley High School, N.T. 158-162; John Eismont, retired employee of Westinghouse Corporation and a Duquesne Light stockholder,

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[10] These hearings were also held to receive public comment upon the proposed merger of Duquesne Light Company and West Penn Power Company in the Joint Application of DQE, Inc., Allegheny Power System, Inc., et al., at Docket No. A-110150F0015. The majority of the people appearing at these hearings testified about their concerns relating to the proposed merger plan.

[11] Pursuant to Section 331(d) of the Public Utility Code, 66 Pa. C.S. §331(d), persons testifying at a public input hearing must state their name, occupation and place of employment for the record.

N.T. 190-194; Dewitt Peart, Vice-president, Value Properties, Inc., which owns an industrial park in Harmony Township, Beaver County, N.T. 194-198; Victor Fiore, Officer, IBEW, N.T. 240-254; and Patricia Lovelace Wright, an employee of Conservation Consultants, Inc., N.T. 258-262.

The following persons appeared at this hearing and testified against the proposed restructuring plan: Ray Glatz, a retired operator of a state liquor store in the State of Ohio and a current member of the Advocacy Council for the City Parks Senior Citizens' Program, N.T. 141-143; Dave Price, an unemployed community activist with Tri-Valley Energy Center, N.T. 203-215; Bill Cross, building manager, N.T. 236-237; William H. Carlson, a college business finance teacher and member of Citizens Power, N.T. 262-270; Jack Kalen, a resident of McKeesport, N.T. 270-275; and Myron Arnowitt, Western Pennsylvania Director, Clean Water Action, N.T. 275-279.

Cindy Datig, Administrator for the Dollar Energy Fund, Inc., and a member of the Department of Pubic Welfare LIHEAP Advisory Council and the Pennsylvania Public Utility Commission's Advisory Council, testified about her concerns for adequate provisions in any final restructuring plan for universal service and low income customers. N.T. 180-189.

C. <u>November 13, 1997, 7:00 p.m., Pittsburgh, Pennsylvania</u>

Rebecca Hebert, Director of Financial Development, YWCA of Greater Pittsburgh, testified in support of the proposed restructuring plan. N.T. 327-331.

The following persons appeared at this hearing and testified against the proposed restructuring plan: Jim Ferlo, City Council President and City Council Representative for

District 7, City of Pittsburgh, N.T. 312-320; G.A. Gilpin, retired former research engineer with Westinghouse and TRW, presently Energy Chair, Sierra Club, Allegheny Group, N.T. 341-344; Arlene Mercurio, a community representative for Welcome Wagon International, N.T. 345-349; Edward Bortz, a self-employed control systems engineer and a member of The Greens of Southwestern Pennsylvania, N.T. 349-352; Joe Panzino, a self-employed contractor, N.T. 358-364; Marie Kocoshis, retired former kindergarten teacher, N.T. 364-368; Suzanne Sippi, Education Project Manager, Group Against Smog and Pollution, N.T. 368-371; Harry Heenan, owner of an ice cream, cake and candy supply store, N.T. 371-373; Christina Barry, homemaker, N.T. 373-377; Liz Hughes, a worker with East End Cooperative Ministries, N.T. 377-379; and Peter Glose, a self-employed general contractor, N.T. 379-381.

IV. PHASE-IN OF CUSTOMER CHOICE

A. Method of Customer Selection

1. Duquesne's Proposal

Pursuant to Section 2806(b) of the Competition Act, 66 Pa. C.S. §2806(b), Duquesne proposes to phase-in direct retail access in three equal increments of one-third of the peak load of each customer class annually starting January 1, 1999, so that all customers will be eligible for direct retail access by January 1, 2001. Duquesne St. 6 at 3. Residential and small commercial customers will be selected for phase-in to customer choice by zip code-based geographic areas of choice ("GACs") based on interest in its pilot program. Duquesne St. 6 at 3; Duquesne St. 6R at 9. Within those areas, customers will have first-come, first-served rights when their area is phased-in. Duquesne M.B. at 6; Duquesne St. 6R at 9. Other commercial and all industrial customers will be selected based on SIC code-based "market segments," with the order based on the percentage response of customers within the segments to the Company's pilot solicitation. Duquesne M.B. at 6; Duquesne St. 6 at 4; Duquesne Exh. FAH-1.

Duquesne notes three main disputes exist regarding its customer selection plan. The first dispute concerns the OCA and DII assertions that it should have adopted a "first-come, first-served" approach. OCA St. 5 at 57; DII St. 1 at 60. Duquesne contends it has used first-come, first-served principles; it simply has not adopted a pure first-come, first-served approach. It argues its plan for residential and small commercial customers promotes an orderly, rather than a random, transition to customer choice for small customers, while also using the first-come, first-served method. Duquesne M.B. at 6; Duquesne St. 6-R at 7-8. As to its plan for

industrial and larger commercial customers, Duquesne claims two key benefits. First, it uses the results of the first-come, first-served pilot enrollment, so the market segments that demonstrated the most interest in choice will have the first opportunity for it during the transition period. Duquesne St. 6 at 4. Second, it eliminates potential disadvantages within market segments that an open enrollment will create, with certain competitors having choice and others not (because of oversubscription). Duquesne M.B. at 6-7; Duquesne St. 6R at 8. Duquesne argues its proposal is superior to a pure "first-come, first-served" method because it: (i) "prevent[s] competitive disadvantages among similarly situated customers within a customer class," 66 Pa. C.S. § 2806(b)(4), rather than assuming a pure first-come, first-served approach will do that, and (ii) builds on the experience gained from the pilot program, Duquesne St. 6 at 4, rather than establishing a selection process that ignores those results.[12] Duquesne M.B. at 7.

Duquesne discerns a second issue relates to the PRA's proposal that 33% of the load of all "large commercial" customers receive access during all three years of the transition period. PRA St. 1 at 6. Duquesne characterizes this proposal as a special "deal" for large commercial customers that is incompatible with the Act. The Act orders a phase-in of customer choice; for Duquesne, that suggests a concern over the administrability of an immediate phase-in of all customers. Duquesne submits the PRA's proposal plainly "present[s] excessive difficulties

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[12] Duquesne notes that, while the Commission in Application of PECO Energy, Docket No. R-00973953 (Opinion and Order entered December 23, 1997), "PECO Energy," as modified on reconsideration (Opinion and Order entered January 16, 1998), "PECO Reconsideration Order," adopts a pure first-come, first-served approach, Slip Op. at 47, no similar proposal was made in that case. Rather, PECO had proposed random selection for residential customers and first-come, first-served for commercial and industrial customers. Id.

in account administration and billing, triggering extraordinary volumes of customer contacts and imposing unnecessary complexity and inconvenience on those customers." Duquesne St. 6 at 5. Duquesne finds it is not any different from an immediate phase-in, which the Act proscribes. Duquesne M.B. at 7.

Duquesne relates a third dispute concerns suggestions that the enrollment process be structured to ensure that 33% of customers switch suppliers during each phase. MAPSA St. 1 at 62. Duquesne argues this proposal is contrary to Section 2806(b)(1)-(3) of the Act, 66 Pa. C.S. §2806(b)(1)-(3), which provides that a "maximum of 33% . . . shall have the opportunity for direct access" during each phase-in period. (Emphasis added.) Duquesne claims nothing in the Act or PECO Energy suggests enrollment must be structured, and continue, "until" 33% select another supplier. See, PECO Energy, Slip Op. at 47-48. Duquesne submits its proposal to offer choice to 33% of its customers should be accepted. Duquesne M.B. at 8.

2. The OCA's Position

The OCA urges rejection of Duquesne's proposal for selection of residential customers; instead, it recommends adoption of a first-come, first-served approach. OCA M.B. at 4-6; OCA R.B. at 3. The OCA finds no compelling reason to phase-in customer choice for residential customers by geographic area. First, it argues suppliers will typically market throughout an entire service territory, as opposed to the smaller zip code-based areas that Duquesne proposes. OCA M.B. at 5; OCA St. 5 at 56. Second, the OCA claims Duquesne has not shown its proposal is fairer to lower socioeconomic classes, as the Company asserts. Id.

If a problem exists reaching lower socioeconomic classes, more appropriate remedies exist, e.g., targeted customer education programs. Id.

Further, the OCA challenges the equity of Duquesne's selection of geographic areas based on interest in the pilot program. OCA witness Alexander explains:

> These communities vary greatly in population density and a quick review of the list of communities recommended for Phases I, II, and III in Mr. Hoffman's Exhibit FAH-3 shows that some communities with over 15,000 volunteers for the pilot are relegated to Phase III because the volunteers are a relatively small percentage of the community's population, while some communities with less than 100 pilot volunteers are recommended for Phase I because these customers represent a large percentage of a very small population. It is not fair for those larger communities to be relegated to a later phase because their population base is large and it would have required a very large group of volunteers to trigger a higher percentage and so qualify for an earlier phase. It is more equitable to allow customers motivated to participate in customer choice to be selected without regard to their geographic location.

OCA M.B. at 5; OCA St. 5S at 1-2.

The OCA explains the residential customers selected for Duquesne's pilot program will be phased into the first phase of retail access on January 1, 1999. These customers are not concentrated in GACs. OCA M.B. at 5-6. Instead, they are located throughout Duquesne's service territory. Thus, by limiting other customers to inclusion based on the Company's proposed GAC method, these customers will enjoy the benefits of retail access for as much as two years before their neighbors who may have attempted to enroll in the pilot program but were not selected due to space constraints. The OCA submits this result is not an equitable outcome for residential customers. Adoption of a first-come, first-served approach, where motivated

residentials can choose to participate in the competitive market, will create the robust market that the General Assembly intended. OCA R.B. at 3.

The OCA also notes the Environmentalists propose a "Better Choice Plan,"[13] which will supplement the phase-in process. Env. St. 2 at 42-58. In PECO Energy, Slip Op. at 135, the Commission stated it would "further consider the proposal of the Environmentalists when it promulgates regulations required by Sections 2807(e)(2) and (3)." The OCA agrees the Better Choice Plan should be revisited at that time. OCA M.B. at 6.

3. The OSBA's Position

The OSBA conditionally accepts Duquesne's phase-in proposal. First, the Company indicates it will favorably treat a complainant within the dispute resolution process if a customer shows: "a) their business has been misclassified or b) other businesses with the same product or service have received a competitive advantage." OSBA St. 1 at 16. The OSBA cautions the public must be adequately informed of the dispute resolution process and the potential benefits it affords them. Consequently, the OSBA recommends that if Duquesne's phase-in plan is approved, the Commission should order the Company to include an explanation of the dispute resolution process in Duquesne's consumer education plan. OSBA M.B. at 9.

Second, the OSBA seeks to ensure that Duquesne's phase-in plan permits small business customers are fairly represented in the first two stages of the phase-in. "[A]s long as smaller (non-SIC code) customers are phased-in up to the limits of their own peak load levels and all customers within a given SIC code are made eligible at the same time," the OSBA agrees

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[13] The "Better Choice Plan" is described, infra.

Duquesne's phase-in plan will treat small business customers fairly. OSBA M.B. at 9-10; OSBA R.B. at 2-3; OSBA St. 1 at 17.

The OSBA expresses concern if the Commission adopts a pure first-come, first-served phase-in approach as other intervenors suggest. OSBA M.B. at 10-12. The OSBA claims a first-come, first-served approach will likely result in an under-representation of small business customers in the first two steps of the phase-in. OSBA St. 1R at 12. Duquesne's small business customers receive service via Rate GS/GM, which is available to all non-residential customers whose billing demands do not exceed 300 kW. Rate GS/GM is not homogeneous in nature, but rather contains customers with inherently diverse billing demands, usage patterns and physical size. Id. at 12-13.

The OSBA claims the larger a customer's electric bill, the greater the potential savings associated with direct access. Id. at 13. The greater the potential savings that may be obtained, so the OSBA argues, the more of a priority direct retail access becomes for a customer. Thus, there is a greater incentive to obtain, evaluate, and process information concerning direct retail access in a timely fashion for larger electric consuming customers than for smaller customers. Therefore, the OSBA contends larger volume customers will respond more promptly to a first-come, first-served phase-in program. OSBA M.B. at 10-11.

Given the wide diversity that exists within the Company's Rate GS/GM class, the OSBA argues the high end, large account customer within the GS/GM class will be over-represented in the first two steps of the phase-in under the first-come, first-served system. In contrast, the small account customers will be under-represented under this same system. OSBA M.B. at 11; OSBA St. 1R at 13.

The OSBA notes the Competition Act prohibits the Commission from adopting a restructuring plan that unreasonably discriminates against one customer class to the benefit of another. 66 Pa. C.S. §2804(7). For the aforementioned reasons, the OSBA argues a straight first-come, first served phase-in can result in discrimination against the interests of Duquesne's small commercial customers. The OSBA recommends, if the Commission adopts a first-come, first served procedure, that the Rate GS/GM class group be segmented into "Small Rate GS/GM" and "Large Rate GS/GM." OSBA St. 1R at 14. The OSBA suggests a segment limitation for the Small Rate GS/GM at a 40-kilowatt load; however, it recognizes the Company can determine a different breakpoint from a detailed bill frequency analysis of all Rate GS/GM accounts. Id. The OSBA recommends that the Company, based on its load research, designate progressively, one-third of the peak load of the Small Rate GS/GM segment over the phase-in period and the same for the Large Rate GS/GM segment, with the total of the segmented load levels eligible for a given year equal to that allowed for Rate GS/GM as a whole. Id. at 15. The OSBA claims this segmentation process, working within a first-come, first-served phase-in methodology, will provide small business customers with the same level of opportunity for direct retail access that would otherwise be forthcoming from within a more homogeneous rate schedule. OSBA M.B. at 11; OSBA St. 1R at 15.

Lastly, the OSBA notes the legislature has provided separate representation for the small business class by the enactment of the Small Business Advocate Act, 73 P.S. §§399.41 et seq. Additionally, the Commission has traditionally provided similar segmentation to the small business customer class from the business class at-large in recognition of the problem of homogeneity. See, In Re: Bell Atlantic Pennsylvania Inc. Petition and Plan for Alternative For

of Regulation Under Chapter 30, et al., Docket No. P-00930715, et al., (Order entered June 28, 1994) at 178 (stating that only small businesses receive the same protections in local service as residential customers with respect to increases under the price stability mechanism). This comparable procedure was utilized when transitioning from a regulated environment to an unregulated environment in the telecommunications industry and the OSBA infers it should be done here as well. OSBA M.B. at 11-12; OSBA R.B. at 2-3.

4. DII's Position

DII finds Duquesne's customer selection proposal inappropriate under the Act. DII M.B. at 5-8; DII R.B. at 1-4. First, the Act directs the percentage of participation be determined based on "the peak load of each customer class." 66 Pa. C.S. §2802(b)(1) & (2). DII argues Duquesne's proposal merges the commercial and industrial customer classes, and does not treat each customer class separately as required by the Act. DII claims the Act's clear language mandates consideration of each class separately. In addition, the Company admits phasing an entire segment, as a group, may cause it to exceed the maximum participation levels in the Act. N.T. 1027. Although DII agrees allowing as many customers access to the competitive market as soon as possible may be desirable, it asserts the incongruity of Duquesne's phase-in proposal with the Act's requirements illustrates the proposal is inappropriate, unwarranted and not contemplated under the Act. DII M.B. at 5-6.

Second, DII argues Duquesne's rationale for using pilot enrollment to determine the order for phase-in is flawed. Duquesne uses the pilot enrollment solicitation response as a proxy for customer interest in participating in the competitive market during the transition

period. The Company states: "Duquesne did not control which segments were in the first phase - the customers within those segments did." Duquesne St. 6R at 10. The Company concedes a customer's desire to participate in the pilot may have been influenced by factors other than a bona fide interest to obtain competitive supply. N.T. 1021. DII contends this admission undermines Duquesne's assertion that its phase-in proposal is based on customer interest and choice. DII M.B. at 6.

Third, DII suggests Duquesne's willingness to rely on customer response during a truncated solicitation period is inconsistent with its general aversion to a "first-come, first-served" approach to phase-in. DII notes the Company objects to a first-come, first-served approach as inequitable, because customers may be unequally informed about benefits of accessing competitive supply and the procedural aspects of enrolling in the program. Duquesne St. 6R at 7. According to DII, the SIC market segment ranking is essentially a first-come, first-served methodology in which the opportunity to become informed and decide to participate is limited in time. Under Duquesne's phase-in proposal, market segments with businesses more informed of the pilot solicitation benefit for the entire phase-in period. Instead of conducting a phase-in solicitation to determine which customers want to participate in the first two stages of phase-in, DII claims Duquesne is willing to rely on a snap-shot of interest based on the pilot solicitation, which the Company admits may be distorted by factors other than a bona fide interest in accessing competitive supply. N.T. 1021. This may result in a customer having no interest in accessing competitive supply and not responding to the pilot solicitation being permitted access in Phase I, because other members of the SIC segment responded to the pilot solicitation; while a customer having great interest in accessing competitive supply and

responding to the pilot solicitation is denied access until the final stage. N.T. 1017-1019. DII submits this illogical result must be avoided. DII M.B. at 6-7.

DII proposes an alternative phase-in method that it claims will accord fair treatment of all customers with less competitive disadvantage situations. Under the DII proposal, subscription for each stage of phase-in will occur on a first-come, first-served basis, unless a class is oversubscribed. In such event, each customer nominating a portion of load in the oversubscribed class will experience a pro-rata reduction in their nominated load, such that the total load available for direct access in that class meets the Act's requirements. DII St. 1 at 60-61. DII notes the Commission adopted an identical proposal for the phase-in of industrial customers in PECO's service territory. PECO Reconsideration Order, Slip Op. at 22. DII claims its method has two distinct advantages. DII M.B. at 7.

First, the DII method eliminates possible competitive distortions that can occur if some industrial or commercial customers are permitted to participate in alternative access for their full load, while other similarly situated customers are denied participation because of the load cap. Under the DII proposal, all customers will have an equal percentage of load provided by a competitive supplier. DII St. 1 at 60-61. DII claims its method is fair to all customers. DII M.B. at 7.

Second, DII contends its method maximizes the number of participants in the first two stages of phase-in. All customers desiring to participate in the first two stages and requesting to be included are assured at least one-third of their load will be competitively provided on January 1, 1999, and at least two-thirds in the next stage. Id.

DII notes the Company will agree to adopt the DII pro-rata approach if customers indicate a preference for the DII method. N.T. 1049-1050. DII submits support of its proposal by the large industrial customers participating in this proceeding, and the Pennsylvania Retailers' Association is sufficient indication of support for the pro-rata approach. PRA St. 1 at 6-9. Since the interested parties in this proceeding support use of its pro-rata approach, DII submits its proposal should be adopted because customers want it and the Commission has already approved it for PECO. DII M.B. at 8.

DII notes Duquesne describes the PRA pro-rata selection approach as "a special 'deal' to large commercial customers that is incompatible with the Act." Duquesne M.B at 7. Duquesne then attempts to distinguish the Commission's adoption of an identical approach in PECO Energy. Duquesne M.B. at 7, fn. 1. Contrary to Company assertions, DII asserts a proposal similar to the DII first-come, first-served approach with a pro-rata reduction for oversubscribed commercial and industrial classes was proposed and adopted in PECO Energy. PECO Reconsideration Order, Slip Op. at 22. DII declares this approach is clearly appropriate under the Competition Act, which provides that "as of January 1, 1999, a maximum of 33% of the peak load of each customer class shall have the opportunity to direct access." 66 Pa. C.S. §2806(b)(1) (emphasis added). The Act does not specify that the 33% requirement must be filled customer by customer; rather, DII claims as long as only 33% of the class peak load has direct access on that date, the dictates of the Act are satisfied, regardless of how many customers within that class are provided direct access. DII R.B. at 3.

DII also finds Duquesne faults the PRA proposal (and by extension the DII proposal) by stating that it presents administrative and billing complexity. Duquesne M.B. at 7-

8. DII suggests the Company misperceives its actual administrative responsibilities. The limitations on individual customer loads in the pilot program already result in customer loads supplied both competitively and noncompetitively. In addition, PECO will face the same situation. With respect to the inconvenience of customers, DII submits the commercial and industrial customers involved in the instant proceeding have made it abundantly clear the pro-rata approach is worth any purported inconvenience. Duquesne itself states it will introduce the pro-rata approach if sufficient customer interest is expressed. N.T. 1049-50. Therefore, the DII urges adoption of its recommendation. DII R.B. at 4.

5. The PRA's Position

The PRA also urges rejection of Duquesne's proposal and, instead, recommends adoption of a phase-in methodology that the DII favors. PRA M.B. at 6-12; PRA R.B at 1-3. The PRA interprets the Competition Act and the Commission's decision in PECO Energy as requiring acceleration toward a competitive retail generation market and not maintenance of the status quo. The PRA requests adoption of a phase-in process which will allow customer access for one-third of the load in the first phase, two-thirds of the load in the second phase and all of the load in the third and final phase. The PRA notes Duquesne rejected this approach:

> As presenting excessive difficulties in account administration and billing, triggering extraordinary volumes of customer contact and imposing unnecessary complexity and inconvenience on those customers.

Duquesne St. 6 at 5. The PRA suggests these reasons are inadequate to justify the inequities of the Company's proposal. PRA M.B. at 7-8.

First, the PRA claims Duquesne's proposal lacks specificity as to the SIC codes that will be utilized. PRA St. 1 at 4. It is unclear how broadly or narrowly Duquesne defines the codes. Id. Also, some market segments may compete with each other. Id. Duquesne indicates its selection of the SIC market codes was based upon initial customer contacts which may have occurred many years ago. N.T. 1037. As a result, Duquesne agrees certain customers may be in different SIC codes which may compete with each other. N.T. 1039-1041. Duquesne only assumes SIC market code segments do not compete across codes, but only within codes. Consequently, the PRA argues competitive disadvantages will be administratively created under Duquesne's proposal. PRA M.B. at 8.

The PRA also takes issue with Duquesne's proposal to determine the order of phase-in through the results of its pilot program. Duquesne proposes that the largest percentage of total accounts nominated by customers for participation in the pilot program, by segment, will be included in the first year of the phase-in period. Duquesne St. 6 at 4. The PRA is unclear whether this proposal means the entire load or any part of a customer's load. PRA St. 1 at 5. In either case, the PRA objects to tying access to a competitive retail generation market to customer actions during the pilot program initiation period. PRA M.B. at 8-9; PRA R.B at 1-2.

The PRA suggests a variety of reasons may exist why individual market segments failed to participate or nominate their loads in the pilot program. PRA St. 1 at 5. One of these reasons may have been the short time period between Commission approval of pilots and commencement of enrollment. Id. Another apparent reason may be the general lack of alternate supplier information available to the public and the fact that only 5% of class loads would be available during the pilot. Id. The PRA argues it is inappropriate to presume the interest of

parties in the pilot program replicates their interest in access to a competitive generation market. It contends large commercial customers operate in a highly competitive market, where any phase-in procedure should not create competitive disadvantages. Id. at 6. It submits Duquesne's proposal will create competitive disadvantages. PRA M.B. at 9; PRA St. 1 at 5-6; N.T. 1038-1041.

Since Duquesne intends to "grandfather" those customers participating in its pilot program, the PRA suggests the proposal will guarantee extension of a competitive advantage pilot program participants have over their competitors that were not chosen, by lottery, for participation in either the pilot program or the initial phase-in to a competitive retail generation market. PRA St. 1 at 9. The PRA urges adoption of its proposal to ensure all customers will be able to participate in a transition to a fully competitive retail market. PRA M.B. at 10.

The PRA also expresses concern regarding an exception Duquesne anticipates utilizing in its phase-in proposal. This exception provides that all customers taking service at a premise previously unserved by Duquesne will be allowed direct access upon commencement of the service. PRA St. 1 at 9. The PRA terms this provision an unfair competitive advantage. Id. While new job growth is a laudable goal, the PRA argues expansion of existing businesses should also be given equal consideration. Id. It contends defining economic development as solely creating new businesses is short-sighted. PRA M.B. at 10-11; PRA St. 1 at 9-10.

The PRA claims it is unfair to limit access to the competitive market to existing businesses that have been subjected to the high cost of electricity in Pennsylvania to benefit new businesses locating in Pennsylvania. Id. at 10. While Duquesne's proposal creates a competitive disadvantage for competitors of new businesses, the PRA submits its proposal will

allow a new business locating in Duquesne's service territory to increases the peak load amount, thus allowing the participation of a new business on an equal basis with existing competitors. PRA M.B. at 11.

Finally, the PRA claims any customer with multiple business sites in Duquesne's service territory should be permitted an opportunity to assign awarded participation levels in the manner of its choosing. PRA St. at 11. For example, if a customer has three locations of equal size and is allowed to phase-in one-third of each location in the first year, that customer should have the opportunity to place all its awarded load at one location. Id. at 11. The PRA asserts such a policy may not only benefit the customer, but it may relieve Duquesne of administrative costs of dealing with access at several locations. Those costs, PRA notes, were never quantified. PRA M.B. at 11-12; PRA R.B. at 3.

6. The Environmentalists' Position

The Environmentalists also object to Duquesne's proposal. Env. M.B. at 9-10. They prefer a first-come, first-served approach, which allows customers to volunteer to shop. If too many residential and small commercial customers sign up for one phase, they suggest a lottery should be held to determine who is able to join. For large commercial and industrial customers, if the number of customers signing up exceeds the allowance, then each volunteering customer should be allowed to participate with a pro-rata share of their load. The Environmentalists note the Commission adopted this approach in PECO Energy, which they support. Id. They further note the Commission adopted the principle of customer self-selection

in the Retail Access Pilots proceeding[14] and recommend it as sound policy for this proceeding as well. Id.

7. Enron's Position

Enron also urges rejection of Duquesne's proposal. Enron M.B. at 6-8; Enron R.B. at 3-4. It argues Duquesne's proposed method of customer selection is inconsistent with Commission policy and will introduce an unfair entry process. It suggests several reasons exist to reject Duquesne's proposal.

First, Enron submits a variety of problems will result if phase-in is based upon geographic criteria. Chief among them is the probability that Duquesne's process will result in far less than 33% of its customers (or 66% if the first two phase-in steps are conducted more or less simultaneously, as discussed below) having access to customer choice. Enron St. 4.1 at 11-12. Moreover, a first-come, first-served approach will assure all customers an equal and fair ability to participate in direct access and guarantee the entire initial 33% (or 66%) of Duquesne's load will be subject to choice. Enron St. 4.0 at 20-21. Enron contends the GAC and SIC method Duquesne advances will indiscriminately prevent customers who desire to participate in the competitive market place from attempting to take advantage of competition. Small commercial customers will also be disadvantaged from one neighborhood to another. Id. at 20. Moreover, prioritizing customers on the basis of their participation in the pilot program, Enron submits, does not eliminate any possible "unfairness" caused by a disparity in information

[14] Petition for Approval of Retail Access Pilot Programs, Docket Nos. P-00971168, et al., (Opinion and Order on Pilot Program Implementation entered August 21, 1997).

or opportunity to participate. For some of these reasons, Enron declares the Commission rejected the "GAC/SIC process" as Duquesne proposed in the Pilot proceeding.[15] Enron M.B. at 6-7.

Enron urges adoption of the procedure the Commission established in PECO Energy as the most reasonable method of customer selection. The PECO Restructuring Order adopts the method used for the pilot to allow customers to include themselves in direct access. If more than the number of its residential and small commercial customers initially permitted (two-thirds) of Duquesne's load requests eligibility, a lottery will select the customers who will be eligible for the first phase (66% as described below). Id. For industrial customers, the Commission mandated that 66% of each customer's load be eligible for the first combined phase-in. Id. If more than 66% of industrial customer load volunteers for the first two phases, 66% of the load of all industrial customers volunteering will be included. Id. Enron submits this customer selection process is the fairest approach to this issue, is consistent with the Act and will promote the full and expeditious development of a competitive market. Enron M.B. at 7-8.

Enron also finds persuasive the fact that the two most active groups of customers participating in this proceeding, the DII and the PRA, both oppose the Duquesne "market segment" methodology for selecting customers to participate in the first phases of direct access clearly belies the notion that Duquesne's proposal will be more likely to avoid creating competitive disadvantages among its commercial and industrial customers. Moreover, most groups commenting on the Duquesne proposal pointed out that the fundamental premise of

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[15] Re: Petition for Approval of Retail Access Pilot Program Pursuant to 66 Pa. C.S. §2806(g) (Duquesne Pilot Order) P-00971175 (Opinion and Order entered Aug. 29, 1997) at 25-28.

Duquesne's approach – i.e., that the selection process should mirror the degree to which a geographic area or industrial commercial market segment responded to the opportunity to participate in the pilot because this response somehow created an appropriate priority for participation in the phase-in of direct access – is illogical and irrelevant. Indeed, as most of the parties point out, participation of customer segments or geographic areas in the pilot may have little to do with their present interest, desire or level of information about participation in direct access. Enron R.B. at 3-4; OCA M.B. at 5; DII M.B. at 7.

Enron's overriding concern about Duquesne's proposal is that it increases the chances that less than the permitted amount of customers will actually participate in direct access when they have the opportunity to do so. Such a result is neither consistent with the desires of customers or suppliers, nor the Commission's determination in PECO Energy. Accordingly, Enron urges rejection of Duquesne's proposal. Enron R.B. at 4.

8. MAPSA's Position

Likewise, MAPSA urges rejection of Duquesne's proposal as the Commission did with a substantially similar approach in the Opinion and Order entered in Duquesne's pilot program.[16] MAPSA M.B. at 8-9; MAPSA R.B. at 6. MAPSA states the Competition Act, while not requiring first-come, first-served methodology for customer selection, expresses a decided preference for it. 66 Pa. C.S. §2806(b)(4). The Act recognizes that competition among providers for electric generation supply necessarily requires, during the phase-in, some degree of competition between customers to become enrolled in the various phase-in periods. However,

[16] See, footnote 15, supra.

MAPSA claims Duquesne's artificial imposition of constraints upon the process will restrict the amount of load purchased from alternative suppliers and unnecessarily complicate the enrollment process. MAPSA M.B. at 8-9; MAPSA St. 1 at 59.

Also, MAPSA agrees with the PRA that small differences in pilot participation, where customer sophistication was quite limited, could have dramatic impacts upon members of a certain market segment's ability to engage in the competitive market, and thus create competitive disadvantages. MAPSA St. 1 at 59-61. MAPSA notes the Commission has expressed a decided preference for not using geographic areas of concentration. In PECO Energy, the Commission expressed its preference for eliminating competitive disadvantage among similarly-situated customers by accelerating the phase-in period, rather than imposing artificial constraints upon the selection process; it rejected PECO's proposal for a random selection process. MAPSA M.B. at 9.

MAPSA argues Duquesne's unsubstantiated attempt to justify its proposal on the basis that it will eliminate competitive disadvantage falls short of the mark. MAPSA submits Duquesne's proposal will still allow for competitive disadvantage, but will give Duquesne control over which segment of the population is disadvantaged. Likewise, Duquesne's arguments regarding building on experience gained from the Pilot Program are irrelevant. During the Pilot Program, MAPSA notes Duquesne did not employ the process it proposes to employ following restructuring. Therefore, no party has experience with the methodology Duquesne proposes. Rather, the parties have had experience with the first-come, first-served methodology and are more likely to be better prepared to deal with that methodology than with Duquesne's proposal. Accordingly, MAPSA urges rejection of Duquesne's enrollment proposal. MAPSA R.B. at 6.

9. Recommendation

For the reasons the intervenors advance, supra, the Commission should reject Duquesne's proposed method to select customers for phase-in to direct retail access to the competitive generation market. In moving toward this market, the Legislature in the Competition Act directed ". . . the Commonwealth must resolve certain transitional issues in a manner that is fair to customers, electric utilities, investors, the employees of electric utilities, local communities, . . . and other affected parties." 66 Pa. C.S. §2802(8). Further, "[t]he procedures under this chapter provide for a fair and orderly transition from the current regulated structure to a structure under which retail customers will have direct access to a competitive market for the generation and sale or purchase of electricity." 66 Pa. C.S. §2802(13). Therefore, whatever method is determined to be appropriate for customer selection must assure a fair and orderly transition.

The Commission has already determined a pure "first-come, first-served" selection process is the fairest and most orderly process for customer selection. PECO Energy, Slip Op. at 47-49. Accordingly, the Commission should first direct Duquesne to implement this approach for residential customers. Beginning July 1, 1998, Duquesne should conduct an open enrollment period for residential customers on a "first-come, first-served" basis. If less than 33% of the customer load for that tariff class enrolls as of September 30, 1998, Duquesne shall notify all customers who have volunteered as of that date that they can participate in the phase-in beginning January 1, 1999. Id. at 48. If more than 33% of the customer load for that tariff class enrolls as of September 30, 1998, Duquesne shall have an independent party conduct a

lottery to determine which customers may participate in the phase-in beginning January 2, 1999. Id.; See, also, PECO Energy Restructuring Order, Slip Op. at 22

In the PECO Energy Restructuring Order, Slip Op. at 22, the Commission departed from the pure "first-come, first-served" selection process for large industrial customers. Instead, subscription for large industrial customers for each stage of phase-in will occur on a first-come, first-served basis, unless a class load is oversubscribed. In such event, each customer nominating a portion of load in the oversubscribed class will experience a pro-rata reduction in their nominated load, so the total load available for direct access in that class meets the Act's 33% requirements for that phase. 66 Pa. C.S. §2806(b). This adjustment apparently reflects the concern for competitive disadvantages this class may otherwise face, as the intervenors in this application so eloquently argue, supra. Since no apparent reason exists for a less than uniform statewide approach to this issue, the Commission should adopt the same method here for the large industrial customers.

The Commission apparently did not address the same competitive concerns of smaller commercial customers in PECO Energy. For that reason, I recommend for adoption the proposal of the OSBA as herein modified and as it relates to small business customers receiving service from Duquesne via Rate GS/GM, which is available to all non-residential customers whose billing demands do not exceed 300 kW. However, as the OSBA explains, Rate GS/GM is not homogeneous, but contains customers with inherently diverse billing demands, usage patterns and physical size. OSBA St. 1R at 12-13. Thus, Duquesne should segment the Rate GS/GM class group into "Small Rate GS/GM" and "Large Rate GS/GM." Id. at 14. The OSBA suggests a segment limitation for the Small Rate GS/GM at a 40-kilowatt load; however,

the Company may determine a more appropriate breakpoint after a detailed billing frequency analysis of all Rate GS/GM accounts. Id. Thereafter, customers within each class may designate their loads in the same manner described above for large industrial customers until one-third of the peak load of each class for that phase-in period is reached.

For all other customers, the pure "first-come, first-served" approach described above for residential customers should apply.

Finally, the Environmentalists propose the same "Better Choice Plan," which they claim will supplement the phase-in process, as they apparently did in PECO Energy. Env. St. 2 at 42-58. In PECO Energy, Slip Op. at 135, the Commission stated it would "further consider the proposal of the Environmentalists when it promulgates regulations required by Sections 2807(e)(2) and (3)." No justification appears in this record to deviate from that strategy. Therefore, the Commission should consider the Environmentalists proposal at a later date.

B. Timetable for Phase-In

1. Duquesne's Proposal

Duquesne proposes that customer choice be phase-in over a three-year period commencing January 1, 1999, in successive 33% increments - recognizing that approximately 5% of its customers currently are enrolled in its Retail Access Pilot Program and will be enrolled in the first phase to full competition - with the last 33% being phased-in on January 1, 2001. Duquesne St. 6 at 3; 66 Pa. C.S. §2806(b). Duquesne notes several witnesses contend the timetable for customer choice should be as follows: (i) 33% of customers receive choice on January 1, 1999, (ii) 33% of customers receive choice on January 2, 1999, and (iii) 33% of

customers receive choice on January 2, 2000. DII St. 1 at 61; Env. St. 2 at 44. The Commission adopted this approach in PECO Energy. Slip Op. at 48. Duquesne opposes this proposal as based on a "distorted interpretation of the [Act]." Duquesne St. 6R at 10. Nevertheless, Duquesne recognizes PECO Energy may control this issue. Duquesne M.B. at 8-9.

2. The OSBA's Position

The OSBA also recognizes the precedent established in PECO Energy. It claims a more rapid phase-in of customer choice effectively makes the potential for competitive disadvantages to small business customers a one-year rather than a two-year problem. OSBA agrees accelerating the phase-in to customer choice in this manner is a way to address the statutory mandates of Section 2806(b) of the Competition Act and to minimize potential competitive problems of small business customers. OSBA M.B. at 12.

3. DII's Position

DII also proposes an accelerated phase-in timetable that eliminates the perceived competitive disadvantages of Duquesne's proposal. DII M.B. at 8-9; DII R.B. at 4-5; DII St. 1 at 60-63. DII proposes that Duquesne offer one-third of its load to direct access on January 1, 1999, the second one-third on January 2, 1999, and the final third on January 2, 2000. Id. at 61-62. The Act establishes annual maximum participation targets for January 1, 1999, January 1, 2000, and January 1, 2001. The day after each target date, the next participation limit becomes effective. DII argues the Act does not establish a one-year period in which only

the minimum amount of load can have direct access; rather, the Act simply establishes the next target and a maximum level that cannot be exceeded on that date. The Commission adopted this accelerated phase-in methodology in PECO Energy in order to "provide the benefits of competition and complete the transition process as early as possible." Slip Op. at 48. DII finds this interpretation of the Act consistent with the goal of maximizing customer access to the competitive market. DII M.B. at 9; DII R.B. at 4.

DII claims the accelerated phase-in also eliminates many potential competitive disputes. Two years is a lengthy period for commercial and industrial customers to be denied access to the competitive generation supply market, when competitors have such access. Compressing this period to one year will significantly lessen any negative effect. The Commission cited the minimization of competitive disadvantages as an additional reason supporting adoption of the accelerated phase-in in PECO Energy, Slip Op. at 49. DII argues customers in the Duquesne territory deserve the same accelerated access as the Commission provided to customers in PECO's service territory. DII M.B. at 9; DII R.B. at 5.

4. The PRA's Position

The PRA echoes the position of DII. PRA M.B. at 12-15; PRA R.B. at 4. It argues large commercial customers should be permitted to participate in the deregulated generation market for a minimum of one-third of their customer load during each year of the three-year phase-in periods contemplated by the Act. PRA St. 1 at 11. Each customer should nominate initially up to two-thirds of their load with the assurance of receiving access for at least one-third of their load. Id. If the nomination process for the first year produces an

undersubscription of the total peak capacity subject to the Act, then those who initially nominated should be permitted to increase their nominated amount proportionately to the undersubscription level, up to a maximum of two-thirds of their individual peak load amount. Id. The intent of the maximum two-thirds participation level is to avoid the potential need for decreasing a customer's participation in the second year of the transition period. PRA M.B. at 12.

In addition, since it is unlikely that all customers in each class will participate in the phase-in period, the PRA asserts a procedure must ensure the customer classes, as a whole, reach the statutory objective of one-third of each customer class' peak load. PRA St. 1 at 11. The PRA believes failure to adopt such a procedure will not achieve a rapid development of a competitive generation market. This will frustrate the legislative intent to make the benefits of generation competition as widely available as possible during the transition period. Id. at 7. The PRA submits Duquesne's concerns regarding excessive difficulties in account administration and billing, and imposition of unnecessary complexities and inconvenience on customers is misperceived. The PRA finds it troublesome that Duquesne is more concerned about increased administration, rather than maximizing the amount of customer benefits that can be achieved through a more robust phase-in. PRA M.B. at 12-13.

Accordingly, the PRA reasons the Commission should establish a phase-in timetable for direct access in this case in the same manner as PECO Energy. All commercial customers should be permitted to nominate one-third of their load by January 1, 1999 and two-thirds of their load by January 2, 1999 with full retail access by January 1, 2000. In this fashion, the PRA claims all of Duquesne's customers will experience a rapid transition to a

competitive generation market, while avoiding competitive disadvantages. PRA M.B. at 13-15; PRA R.B. at 4.

5. The Environmentalists' Position

The Environmentalists prefer the accelerated schedule nominated by the OSBA, DII and the PRA, where two-thirds of the customers will be able to choose their supplier on January 2, 1999 and the final one-third are able to choose on January 2, 2000. The Environmentalists note the Commission ruled this phase-in timetable consistent with the Act in PECO Energy. The Environmentalists argue this timetable ensures a larger number of market participants in the critical first few years of the transition. Env. M.B. at 10-11.

6. Enron's Position

Enron concurs with the foregoing intervenors in finding the Commission's ruling in PECO Energy determinative on this issue. In reaching its determination, the Commission stated, Slip Op. at 47-48:

> The language in the Act quoted above permits the Commission to adopt a more rapid phase-in schedule than proposed by PECO. We conclude that the most rapid phase-in permitted under the Act is in the public interest and should be adopted. PECO is directed to conduct an open enrollment period beginning March 1, 1998. The first 33% of customers to volunteer from each tariff class may shop on January 1, 1999. PECO shall notify such customers through a Commission approved letter. Up to 66% may volunteer to shop as of January 2, 1999. . . . All customers will have the opportunity to shop as of January 2, 2000.

While noting not every resolution of every issue in PECO Energy applies to this case, Enron suggests the length of the phase-in period should apply consistently to each electric

distribution company ("EDC") service territory throughout the Commonwealth to avoid public confusion. Enron submits an accelerated phase-in is in the public interest, permitted by the clear language in the Act, and will bring the benefits of competition to more customers sooner. Enron M.B. at 9-10; Enron R.B. at 4-9.

Enron recognizes GPU, joined by PECO, claims acceleration of the phase-in is "contrary to the plain language of Section 2806(b) of the Competition Act" and should not be applied in this case. GPU M.B. at 7; PECO M.B. at 2. Duquesne appears to join in these arguments. Duquesne M.B. at 8-9. Enron argues all of these parties are wrong. Enron R.B. at 4-5.

While Section 2806(b) restricts the Commission's implementation of direct access, Enron finds the plain language of the subsection provides the Commission with discretion to both accelerate the phase-in or extend the phase-in under certain circumstances. As to acceleration of the phase-in, Section 2806(b), by its express terms, establishes the maximum "peak load of each customer class," which can be provided the opportunity for direct access "as of" or, in other words, not later than January 1, 2001. Enron argues a plain meaning of the statute does not state that 33% of the peak load of each customer class be provided the opportunity for direct access beginning on, or "no sooner than" January 1, 1999 or 66% beginning on January 1, 2000.[17] Instead, the plain language states that "as of" a date certain, the maximum penetration

[17] If the General Assembly had intended to preclude Commission discretion to accelerate the phase-in, Enron argues it could have easily adopted language for Section 2807(c) that "Beginning on January 1, 1999, 33% of the peak load of each customer class shall be provided the opportunity for direct access," or "Beginning on January 1, 2000, 66% of the peak load of each customer class shall be provided the opportunity for direct access." Enron R.B. at 5, fn. 11.

of direct access shall not exceed a certain level. Enron submits that by any reasonably reading, at any time after that date certain, the Commission has discretion to increase the penetration, as long as it does not exceed the next cap. Enron R.B. at 4-5.

Enron argues any claim that the phrase "as of" should be interpreted as meaning "beginning on" is completely inconsistent with the plain language of the Act, since the phrase "as of" is normally understood.[18] Furthermore, Enron suggests GPU's claim that Section 2807(c) establishes the implementation date for direct access as January 1, 1999 and precludes the Commission from advancing the January 1, 1999 date reads meaning into Section 2807(c), which is not supported by the statutory language. Section 2807(c) allows the Commission to extend the initiation date for customer choice and has no bearing on the clear language of Section 2807(a), which provides the Commission with clear discretion to accelerate the January 1, 1999 date. Enron states Section 2807(c)(1) merely requires the first phase of direct access be implemented by January 1, 1999, unless the Commission extends that date for a "six month transition period" for the reasons set forth in the subsection.[19] Enron urges the Commission to expand its phase-in policy to all EDC service territories. Enron R.B. at 6-9.

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[18] Enron notes Webster's II New Collegiate Dictionary defines the term "as of" as "on" not as "beginning on." Accordingly, Enron claims the plain language of Section 2807(a) establishes the maximum penetration for direct access "on" January 1, 1999 and does not affect the Commission's discretion to advance the initiation of direct access or to accelerate the phase-in. Enron R.B. at 6, fn. 12.

[19] Enron notes postponement of implementation of direct access until after January 1, 1999 can only occur if the Commission makes such a determination by no later than November 16, 1998. Technically, the Commission can still postpone the date for implementation of the phase-in, if circumstances so dictate. Enron R.B. at 6, fn. 14.

7. MAPSA's Position

MAPSA joins the foregoing intervenors in objecting to Duquesne's proposal. MAPSA notes Duquesne concedes a phased-in approach to customer choice may cause similarly-situated customers to be treated differently. Duquesne St. 6 at 5. MAPSA claims Duquesne addresses this concern by manipulating the ability of certain classes of customers to engage in specific phases of competition. MAPSA also points to the accelerated phase-in approved in PECO Energy as the most appropriate method for eliminating the potential for discrimination and competitive disadvantages between similarly-situated customers. MAPSA M.B. at 10.

8. GPU's Position

GPU supports Duquesne's initial proposal on this issue. GPU M.B. at 2-9. It argues the Competition Act does not authorize the Commission to order an electric utility to deviate from the phase-in schedule in the Act. The phase-in schedule the Commission adopted in PECO Energy, and other intervenors advocate in this proceeding, is contrary to the plain language of Section 2806(b) of the Act. 66 Pa. C.S. §2806(b).

On its face, GPU asserts, the statute expressly establishes a mandatory schedule in which one-third of the peak load of each customer class is given the opportunity for direct access in January of three successive years - 1999, 2000, and 2001.[20] GPU submits the purpose of such a phase-in is to introduce competition gradually to minimize the impact of any

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[20] When the language of a statute is unambiguous, any further deliberation regarding its meaning is unwarranted. 1 Pa. C.S. §1921(b); Meier v. Maleski, 670 A.2d 755 (Pa. Commonwealth Ct. 1996).

unforeseen problems when direct access is implemented, and to minimize the administrative burdens and any financial impacts on EDCs. GPU M.B. at 4.

GPU contends the accelerated phase-in schedule that the Commission adopted in PECO Energy, and others here advocate, cuts one full year (minus one day) out of the phase-in schedule established in Section 2806(b). GPU notes the Commission did not provide the rationale for its accelerated phase-in in PECO Energy. To GPU, it appears the Commission may have adopted this schedule based on an interpretation of the words "as of," which appear at the beginning of subparagraphs (b)(1), (2), and (3) to mean "at the latest," rather than "beginning on." Under this interpretation, the Commission could order an EDC to phase-in direct access to the second one-third of the peak load of each customer class on January 2, 1999, and the final one-third on January 2, 2000. GPU M.B. at 4.

GPU argues this interpretation of Section 2806(b)of the Act is erroneous. Section 2806(b) establishes a three-step phase-in, beginning in January 1999 and ending January 1, 2001. While an EDC and its customers may settle upon an expedited phase-in of direct access, thereby waiving the EDCs right under the Act to a more gradual phase-in, GPU claims the Commission may not unilaterally cut a year out of the process. GPU M.B. at 5.

GPU posits one must read subsections (b) and (c) of Section 2806 together. Section 2806(c) states:

> (c) **Additional time.** -
> (1) The Commission may determine that an additional six-month transition period is necessary prior to the January 1, 1999 implementation date. A determination under this subsection must be made at least 45 days in advance of the scheduled date for implementation and must be based on one or more of the following considerations:

* * *

> (2) Consistent with the considerations listed in paragraph (1), the Commission may determine that an additional six-month transition period is necessary. This determination must be made by the Commission by May 15, 1999.

66 Pa. C.S. §2806(c) (Emphasis supplied).

GPU claims the language of Section 2806(c) supports its argument for two reasons. First, Section 2806(c) establishes January 1, 1999 as the "implementation date." In other words, January 1, 1999 is the date upon which the phase-in to direct access begins. No one disputes this point.[21] Thus, the words "as of" at the beginning of Section 2806(b)(1) can only mean "beginning on." GPU M.B. at 5-6.

If the words "as of" in Section 2806(b)(1) mean "beginning on," then, GPU continues, one must give these words the same meaning in subsections (b)(2) and (3). Commonwealth v. Maloney, 365 Pa.1, 73 A.2d 707, 712 (1950). "The rule is well established that a word or phrase, the meaning of which is clear when used in one section of an Act, will be construed to mean the same thing in another section of the same Act." Id. GPU applies this interpretation to Section 2806(b), to mean that beginning on January 1, 1999, a maximum of 33% of the peak load of each customer class must be given the opportunity for direct access (subsection (b)(1)); beginning on January 1, 2000, a maximum of 66% of the peak load of each

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[21] The Commission's Opinion and Order in PECO Energy refers to the phase-in schedule ordered therein as "the most rigid phase-in permitted under the Act . . . ." Slip Op. at 45. While GPU disagrees that this schedule is permitted under the Act, it submits this statement shows the Commission treats January 1, 1999 as the earliest date for beginning the phase-in. GPU M.B. at 6, fn. 4.

customer class must be given the opportunity for direct access (subsection (b)(2)); and beginning on January 1, 2001, all customers must be given the opportunity for direct access (subsection (b)(3)). GPU M.B. at 6.

Second, GPU argues the Legislature does not delegate discretion to the Commission in Section 2806 to adopt an accelerated phase-in schedule. The introduction to subsection (b) states clearly that ". . . the following schedule for phased implementation of retail access shall be adhered to unless a determination is made by the Commission under subsection (c)." (Emphasis supplied). GPU contends use of the word "shall" indicates the Legislature intended the schedule to be mandatory, not discretionary. See, Commonwealth v. Baker, 547 Pa. 214, 690 A.2d 164, 167 (1997). GPU M.B. at 6-7.

GPU posits the only possible exception to a mandatory three-year phase-in schedule is under subsection (c) of Section 2806, which authorizes the Commission to delay implementation of direct access phase-in by two separate six-month periods. Thus, while the General Assembly expressly authorized the Commission to delay phase-in, GPU argues it did not authorize the Commission to accelerate phase-in. GPU submits the express inclusion of this one exception to the phase-in schedule set forth in Section 2806(b) indicates other exceptions were not intended. See, Andrus v. Glover Construction Co., 446 U.S. 608, 617-618 (1980). GPU M.B. at 7.

GPU notes additional evidence of legislative intent regarding the phase-in schedule appears in subsection (a) of Section 2806, which reads:

> **(a) General rule.** - The generation of electricity shall no longer be regulated as a public utility service or function except as otherwise provided for in this chapter at the conclusion of a transition and phase-in period beginning on the effective date of this chapter and

> ending, consistent with the Commission's discretion under this section, January 1, 2001. As of January 1, 2001, consistent with the Commission's discretion under this section, all customers of electric distribution companies in this Commonwealth shall have the opportunity to purchase electricity from their choice of electric generation suppliers. The ultimate choice of electric generation supplier is to rest with the customer. (Emphasis supplied).

This language leaves no doubt, GPU claims, that the General Assembly intended the phase-in schedule to end on January 1, 2001 (not January 2, 2000). The language "consistent with the Commission's discretion" refers only to the explicit authorization the Legislature granted to the Commission in Section 2806(c) to delay phase-in; the Legislature did not authorize the Commission to accelerate phase-in. Accordingly, subsection (a) of Section 2806 reinforces the view that any accelerated phase-in schedule violates the Competition Act. GPU M.B. at 7-8.

Finally, GPU notes the Commission itself, prior to PECO Energy, had interpreted Section 2806(b) in the manner GPU urges. In its Order directing jurisdictional electric utilities to submit transition plans at Docket No. M-00960890, F.0003 (Order entered February 13, 1997), 176 PUR 4th 45, the Commission stated:

> We are mindful that the Act itself requires the restructuring of the Commonwealth's electric utilities in three phases, 66 Pa. C.S. §2806(b)(1)-(3) [footnote deleted], culminating in a fully restructured industry with full customer access to competitive sources of electric energy beginning January 1, 2001. 66 Pa. C.S. §2806(b)(3). (Emphasis supplied).

GPU submits the Commission previously interpreted Section 2806(b) as providing for full customer access to competitive energy on January 1, 2001, not January 2, 2000, as in PECO Energy.[22] Thus, GPU urges the Commission to reconsider the phase-in timetable issue here and

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[22] GPU notes the statutory construction the Commission used to resolve the phase-in (continued...)

resolve it in a manner commensurate with the express language of the statute. GPU M.B. at 8-9.

9. PECO's Position

PECO expressly concurs with the position of GPU that the Legislature adopted a series of provisions in the Competition Act which contemplate customer choice will be phased in gradually over a three-year period. 66 Pa. C.S. §2806(b). PECO strongly disagrees with the Commission's decision in PECO Energy to accelerate the phase-in timetable and notes it has appealed that decision to the Commonwealth Court of Pennsylvania. However, if an accelerated phase-in timetable is upheld, PECO claims fairness dictates that similar phase-in schemes be imposed on all jurisdictional electric utilities in Pennsylvania. Otherwise, PECO submits the spirit, and arguably the letter, of the Act's reciprocity feature will be violated. PECO M.B. at 1-2; 66 Pa. C.S. §2805(b)(2).

10. Recommendation

For the reasons GPU and PECO advance concerning proper statutory construction, I urge the Commission to reconsider the accelerated phase-in schedule for customer choice that it favored in PECO Energy, Slip Op. at 47-49. The confusion on this issue arises from the question of how to interpret the words "as of," which appear at the beginning of subparagraphs

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[22](...continued)
issue in PECO Energy was not briefed by the parties in that case. Since the issue has not been fully briefed before, GPU urges the Commission to reconsider the matter in this case. GPU M.B. at 9, fn. 5.

(b)(1), (2), and (3) of Section 2806 of the Act. 66 Pa. C.S. §2806(b)(1), (2) & (3). As the record in this case demonstrates, the term "as of" can have two distinctly different meanings. "As of" may mean "at the latest," which the Commission apparently attributed to the phase-in schedule in PECO Energy. On the other hand, an equally reasonable interpretation for "as of" may mean "beginning on." GPU points out this latter interpretation is the only reasonable one, if one accepts the premise that Section 2806(c) establishes January 1, 1999 as the "implementation date" for the commencement of phase-in to direct access. Given that premise, all of the remaining portions of the statute must be read "in pari materia," pursuant to Section 1932 of the Statutory Construction Act, 1 Pa. C.S. §1932, and for the reasons GPU advances. Accordingly, each of the subsections of Section 2806(b) must be interpreted to mean "beginning on" January 1, 1999, etc.

For these reasons, I recommend the Commission adopt the phase-in schedule favored by GPU and PECO.

V. TRANSMISSION AND DISTRIBUTION RATES; UNBUNDLING ISSUES

A. Introduction

Several interdependent standards of the Competition Act and the Code apply to transmission and distribution rates of an EDC undergoing restructuring for entry into the competitive generation market. The Act requires electric utilities to unbundle their "rates and services . . . to allow competitive suppliers to generate and sell electricity directly to consumers in this Commonwealth." 66 Pa. C.S. §2802(14). Section 2804(3) of the Act, 66 Pa. C.S. §2804(3), provides:

> The [C]ommission shall require the unbundling of electric utility services, tariffs and customer bills to separate the charges for generation, transmission and distribution. The [C]ommission may require the unbundling of other services.

On the subject of rates, Section 2804(4) of the Act, 66 Pa. C.S. §2804(4), states:

> The following caps on electric utility rates shall apply:
>
> (i) For a period of 54 months from the effective date of this chapter or until an electric distribution utility is no longer recovering its transition or stranded costs through a competitive transition charge or intangible transition charges and all the customers of an electric distribution utility can choose an alternate provider of electric generation, whichever is shorter:
>
> (A) The total charges of an electric distribution utility for services to any customer who purchases generation from that utility shall not exceed the total charges that have been approved by the [C]ommission for such services as of the effective date of this chapter; and
>
> (B) For customers who purchase generation from a supplier other than the electric distribution utility, the charges of the utility for non-generation services that are regulated as of the effective date of this

> chapter, exclusive of the competitive transition charge and intangible transition charge, shall not exceed the non-generation charges that have been approved by the [C]ommission for such service as of the effective date of this chapter.

Section 2804(6) of the Act, 66 Pa. C.S. §2804(6), states:

> Consistent with the provision of [S]ection 2806, the [C]ommission shall require that a public utility that owns or operates jurisdictional transmission and distribution facilities shall provide transmission and distribution service to all retail electric customers in their service territory and to electric cooperative corporations and electric generation suppliers, affiliated or nonaffiliated, on rates, terms of access and conditions that are comparable to the utility's own use of its system.

Finally, Section 2804(10) of the Act, 66 Pa. C.S. §2804(10), declares:

> The [C]ommission shall establish rates for jurisdictional transmission and distribution services and shall continue to regulate distribution services for new and existing customers in accordance with this chapter and Chapter 13 (relating to rates and rate making).

Since the transmission and distribution components of a utility's rates will continue to be regulated under Chapter 13 of the Code, the rates for these components must be just and reasonable. PECO Energy, Slip Op. at 61; See, also, 66 Pa. C.S. §1301. With this background, we turn now to review the transmission and distribution issues which this application presents.

B. 1996 Test Year Cost of Service

1. Duquesne's Proposal

The starting point for identifying appropriate non-generation rates for Duquesne is the Company's 1996 cost of service study, which it uses as the basis for allocating all of its costs between generation, transmission and distribution. The study can also be used to separate wire from "non-wire" services. Duquesne proposes a test year ending December 31, 1996 for its costs of these services, and sponsors pro forma adjustments to these amounts. Duquesne M.B. at 9-11; Duquesne St. 3. Duquesne submits the only disputes to its proposal relate to the functionalization of these costs among generation, transmission and distribution. It claims the proposals of others in this case move costs out of transmission/distribution and into the generation function, thereby reducing the regulated rates paid by the constituents of the intervenors. Duquesne M.B. at 9.

Duquesne points to Enron, which takes issue with several discrete items, suggesting they be allocated to the generation function. The first is FERC Accounts 908 (customer assistance expense) and 909 (informational and instructional expense). Enron St. 2 at 8-9. Yet, Enron's own exhibit shows these accounts relate to "providing instruction or assistance to customers, the object of which is to encourage safe, efficient and economic use of the utility's service" and further "to utilize their electric equipment safely and economically." Enron Cross. Exh. 1. Duquesne claims these are functions an EDC must continue to provide its customers. Duquesne St. 5R at 27-28. A large portion of the costs in Account 908 is included in the rates for universal service. Duquesne M.B. at 10; N.T. 799.

Enron proposes a second adjustment for a portion of uncollectible accounts expense to be allocated to generation. Enron St. 2 at 9-10. Duquesne calls this criticism unfair and notes its witness, Mr. Lahtinen, explains:

> [Enron's witness, Mr. Reising's] analysis is flawed because he ignores the fact that under the Competition Act, Duquesne continues to be the supplier of last resort during the transition period while competing suppliers can choose who they serve. This means Enron and other suppliers are likely to serve those customers with a much lower risk of payment default, leaving them to be served by Duquesne. Duquesne St. 5R at 29.

Further, Duquesne suggests both of Enron's proposed adjustments were rejected in PECO Energy, Slip Op. at 61. Duquesne M.B. at 10.

Duquesne notes Enron submits a four-page alternative cost of service "study" to replace Duquesne's study. Enron Exh. PDR-3. But the Company insists the "study" is seriously flawed. First, Enron's cost of service spreadsheet is riddled with "circular references," which standard computer manuals state are "almost always an error, and you should correct it immediately." Duquesne St. 5R at 30-31 (quoting Windows manual). Instead of correcting it, Enron claims it is an "issue that could have been dealt with through discovery or other protocol." Enron St. 2.1 at 3. Duquesne disclaims any responsibility to do so. Duquesne M.B. at 11.

Second, Duquesne contends Enron's study contains other errors, such as over-allocating costs to Duquesne's only wholesale customer by more than 2,500% ($25 million instead of $900,000) and omitting $29 million in revenue from rate class GL. Duquesne St. 5R at 31. Finally, Duquesne notes Enron apparently submitted the same cost of service methodology in PECO Energy, Enron St. 2.1 at 3, where the Commission declined to adopt it.

PECO Energy, Slip Op. at 59-61. Duquesne urges its rejection here as well. Duquesne M.B. at 11.

Lastly, Duquesne notes HSS/ARI request that 50% of all Duquesne's capital expenditures (transmission and distribution) - both past (since 1987) and projected - be disallowed. HSS/ARI M.B. at 10-15. HSS claims that Duquesne did not rebut HSS "directly" on this request. Id. at 11. Duquesne asserts there was nothing to rebut. HSS/ARI do not identify a single expenditure that was imprudent and do not compare these expenditures to the depreciation of those assets over the same time period. HSS/ARI St. 1 at 54-56. Duquesne suggests transmission and distribution systems must be maintained and upgraded; they do not simply "depreciate" away. In short, Duquesne argues HSS/ARI fail to meet their own test: that an intervenor must raise "credible issues" regarding an expenditure to overcome its "presumption of reasonableness." Duquesne R.B. at 14, fn. 19; HSS/ARI M.B. at 11; Citing, Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C. 423, 444 fn. 37 (1983).

2. DII's Position

DII provisionally accepts the Company's 1996 test year Cost of Service, with certain adjustments as discussed below, as the rate unbundling starting point. DII M.B. at 10; DII St. 1 at 36; DII R.B. at 5.

3. HSS/ARI's Position

HSS/ARI object to Duquesne's proposal. HSS/ARI M.B. at 9-12; HSS/ARI R.B. at 19-20. HSS/ARI note Duquesne has not filed a rate case since 1986. Duquesne St. 4 at 22.

HSS/ARI claim Duquesne's decision not to file a rate case was a purposeful corporate strategy. See, e.g., Exh. RBW-28, P-0059146 ("No base rate cases anticipated"); HSS/ARI St. 1 at 80. Thus, the Commission has not reviewed any of the capital or other expenditures associated with Duquesne's distribution cost of service for more than a ten-year period. Consequently, HSS/ARI argue, Duquesne must establish its expenditures over that ten-year period were just and reasonable to the extent those costs are subsumed within its current distribution rate structure. 66 Pa. C.S. §315(a). As the Commission has held, "[i]f and when [a utility] seeks recognition of [capital expenditures], it will then be required to support the prudence of those expenditures." Pa. P.U.C. v. Philadelphia Electric Co., Docket No. R-00891364, et al., 1990 Pa PUC Lexis 155 at 54-57 (1990). Additionally, a utility has the burden of proof with respect "to the total amount of the claimed costs." Id. at 57. Notwithstanding these evidentiary burdens, HSS/ARI contend Duquesne produces no evidence to support its past capital expenditures. Therefore, HSS/ARI declare Duquesne's distribution rates should be reduced from current levels to eliminate the impact of unjustified costs. HSS/ARI M.B. at 9-10.

As of December 31, 1996, Duquesne's total investment in distribution plant was $1,233,255,730. Duquesne Exh. MKO-1A at 7. Also, at the end of test year 1996, Duquesne had accumulated depreciation of $372,851,189. Id. at 10. As a result, Duquesne claims net book value of distribution plant in the amount of $860,374,541. Id. at 13. HSS/ARI note that net book value is the major component of Duquesne's distribution-related rate base for purposes of deriving unbundled distribution rates. Duquesne Exh. MKO-1C at 1. HSS/ARI argue that net book value includes substantial costs of capital additions that Duquesne has never shown to be just and reasonable. HSS/ARI M.B. at 10.

Between 1987 and 1996, Duquesne's FERC Form 1 reports show it made distribution-related capital expenditures of approximately $473 million. HSS/ARI St. 1 at 55-56. HSS/ARI's witness, Dr. Weisenmiller, sets forth those data and states that "Duquesne's past capital expenditures obviously must be considered in the context of determining whether Duquesne's proposed rates are reasonable." Id. at 57. HSS/ARI note that neither in its rebuttal testimony nor at any other time does Duquesne rebut this testimony nor does it introduce any evidence to suggest its past capital expenditures were just and reasonable. HSS/ARI M.B. at 10-11.

Section 1301 of the Code provides that "[e]very rate made, demanded, or received by any public utility . . . shall be just and reasonable . . . ." 66 Pa. C.S. §1301. Further, the Commission has held that:

> [t]here is no presumption of reasonableness which attaches to a utility's claims, at least none which survives the raising of credible issues regarding a utility's claims. A utility's burden is to affirmatively establish the reasonableness of its claim. It is not the burden of the other party to disprove the reasonableness of the utility's claims.

Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C. 423, 444 fn.37 (1983). Thus, HSS/ARI argue no basis exists to assume the reasonableness of Duquesne's past expenditures, when Duquesne itself never addressed the issue. Given this circumstance, the Commission could disallow the entirety of Duquesne's 1987-96 distribution-related capital expenditures. However, HSS/ARI concede that would be a harsh result because, presumably, some of Duquesne's expenditures were reasonable. HSS/ARI M.B. at 11.

Nonetheless, HSS/ARI warn the Commission should not assume Duquesne's total expenditures were reasonable in the absence of any record support for that conclusion. Further,

Duquesne should not be rewarded for an apparent corporate strategy of precluding the scrutiny of its rates as would have occurred had Duquesne filed a rate case during the last 10 years. Thus, to balance the interests of all concerned, HSS/ARI recommend that the Commission disallow 50% of the $473 million in distribution-related capital expenditures that Duquesne apparently made between 1986 and the present, and order the rate reduction that will result from that disallowance.[23] HSS/ARI M.B. at 11-12; HSS/ARI R.B. at 19-20.

4. The PRA's Position

The PRA finds it difficult to accept Duquesne's 1996 cost of services levels since the Commission last approved base rates in 1986. "This militates against acceptance of many of Duquesne's recommendations in this proceeding." However, the PRA offers no specific criticisms of the test year proposal. PRA M.B. at 19; PRA R.B. at 5.

5. Enron's Position

According to Enron, Duquesne's methodology contains a number of errors. Enron M.B. at 12-18; Enron R.B. at 10-11.

(a) Functionalization

Enron explains Duquesne utilizes a surrogate to assign the bulk of its administrative and general expenses and general plant to the three categories: generation, transmission and distribution. The surrogate uses the percentage of labor expenses associated

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[23] Of course, HSS/ARI recognize it also is within the Commission's authority to order a greater disallowance if it believes such action is appropriate under the circumstances. HSS/ARI M.B. at 12, fn. 5.

with each of the three categories. Enron suggests, while this proxy method is minimally adequate, a detailed functional cost study[24] should be performed to determine the precise association of Duquesne's costs with the three functional categories. Enron St. 2.0 at 6-7. Enron recommends the Commission direct Duquesne to conduct such a study and submit it at a later date so distribution rates may be revised accordingly. Enron M.B. at 12.

(b) Allocation of Sales, Customer Information and Assistance and Uncollectibles

Notwithstanding the above, Enron contends Duquesne's cost of service study inappropriately assigns several cost of service elements entirely to the "distribution" function, even though the costs are obviously associated with all aspects of Duquesne's service. Enron finds the cost elements inappropriately assigned are: (i) sales expense; (ii) customer information and assistance expense; and (iii) uncollectible accounts expense. Enron M.B. at 13.

Enron finds the first category relates to sales expenses which are incurred to promote the sale of additional energy to retail customers. Such costs must be assigned to the generation portion of Duquesne's operations to avoid cross-subsidies. Enron St. 2.0 at 8. Enron claims Duquesne's attempt to charge 100% of these costs - some $4.5 million[25] - via its distribution rates not only unfairly charges distribution customers for costs for which they are not responsible, but also provides an unfair advantage to Duquesne's generation supply activities. By allocating its sales expenses to distribution customers, Duquesne will be able to sell energy

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[24] A functional cost study is a detailed analysis of cost categories to determine whether the cost category is associated with the generation, transmission or distribution functions. Such a detailed study would also examine whether a particular cost category could be reduced or transferred to an unregulated subsidiary. Enron M.B. at 12, fn.23.

[25] Duquesne Exh. JAL-1B at 16.

services in the market without having to recover these costs in the rates it charges to customers. Duquesne admits all participants in the market, including Duquesne's competitors, must recover all costs (including a profit) associated with providing retail generation services in the charges they make to customers. N.T. 526-27. Enron asserts such a cross-subsidy cannot be condoned under either general ratemaking principles or the Competition Act.[26] It finds Duquesne's contentions unpersuasive.[27] Enron M.B. at 13-14.

Enron claims a second category of misallocated expenses are those included in USOA Accounts 908 and 909: Customer Assistance, and Informational and Instructional Advertising Expenses. Duquesne includes 100% of these costs as distribution related costs.

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[26] Under traditional cost of service principles, Enron notes costs have been allocated to classes or functions on a cost causation basis. The Commission has regularly insisted that if a class is not responsible for a particular cost, it should not be included in determining the rates for that class. Similarly, the Competition Act states that distribution must be unbundled on "rates, terms of access and conditions that are comparable to the utility's own use of its system." 66 Pa. C.S. §2804(6). Enron argues assigning 100% of these costs to the distribution system means that Duquesne's implicit cost of using its distribution system to deliver power to customers will not contain any of these costs and its use will not be "comparable." Enron M.B. at 14, fn.28.

[27] Enron also finds it difficult to understand how Duquesne's sales expense can be reasonably related to any portion of the T&D function; distribution service is completely exempt from competition: no sales expenses will be incurred to sign up a customer – beyond that necessary to "sell" the energy itself – which is a generation-related cost, not a cost associated with distribution. More importantly, it remains Duquesne's obligation to support its claim that a sales expense will be associated with T&D "sales," but it did not. Enron suggests these costs will be associated with Duquesne's continued provision of regulated generation services (as provider of last resort) or will be eliminated (as no longer necessary) or will be assigned to non-regulated business units, for example, appliance sales, repair or retail energy sales. Enron St. 2.1 at 2. Enron insists the "avoidable" nature of sales, as well as customer assistance expense, is supported by the fact that Duquesne itself recognizes its Administrative and General expenses support all three of the Company's present functions, N.T. 625, and it will be able to avoid an allocated share of these expenses, if it closes any of its power plants. Enron M.B. at 14, fn. 29; N.T. 599.

Enron St. 2.0 at 8-9. Enron claims these costs relate to promoting and encouraging the use of electric energy, either generally or from a safety or conservation standpoint. For example, they include expenses for activities associated with "advice regarding the most efficient use of electric equipment, demonstrations of the economical and efficient use of electric service, and engineering and technical advice to promote efficient and economical use of utility services." Id. Review of the accounts associated with these expenses does not indicate any of the costs are directly associated with distribution-related delivery system activities. Id. While some of the costs booked into either of these accounts may be associated with such items as distribution safety matters or other system-wide activities, Enron insists Duquesne does not demonstrate what portion of its customer information and assistance expenses are properly associated with delivery system issues, as opposed to issues associated with the use of energy itself. Id. By allocating 100% of these costs to the distribution function, Enron claims Duquesne allows its generation activities to receive a "free ride" and avoid expenses other competitors must bear. Stated otherwise, Duquesne's generation energy services will receive the benefit of these expenses without having to incorporate them into the prices it charges its customers.[28] Enron M.B. at 15-16.

In the final category, Enron notes Duquesne includes 100% of its uncollectible expense, more than $11 million – almost one-third of its total customer accounts expense – as

[28] Enron notes Duquesne's response to this allocation issue is to suggest that some part of customer assistance and information probably is associated with its delivery system. Duquesne St. 5R at 28. Yet, Enron finds no record support for Duquesne's claims. Since Duquesne bears the burden of proving its proposed T&D allocation is reasonable and having failed to do so, Enron claims 100% of these costs should be allocated to the generation function. Enron M.B. at 16, fn. 34; Enron St. 2.1 at 2.

a distribution-related cost, even though it is associated with uncollectibles for its entire retail operation. Enron claims uncollectible expenses are obviously associated with all services, including generation services, and should have been allocated on the basis of the percentage that the production, transmission, distribution revenue requirements bear to total Company revenue requirements. Enron St. 2.0 at 10. Enron asserts Duquesne's failure to do so provides an unwarranted and illegal subsidy to Duquesne's generation sales operations. Enron M.B. at 16.

Enron recognizes uncollectibles are legitimate expenses of doing business, and all marketers and suppliers will incur them and attempt to recover these expenses in the rates they charge to customers. If Duquesne's position is accepted, Enron posits Duquesne alone in its service territory will have its entire uncollectibles expense repaid through non-bypassable charges for monopoly services and will not have to recover this amount in the prices it charges for generation. Enron M.B. at 16-17.

Enron notes Duquesne responds to this issue by asserting it is "reasonable" to allocate 100% of its uncollectible expense to the distribution function because, in its role as "Provider of Last Resort" ("PLR"), it will likely end up with a far greater level of bad debt expense than suppliers. Duquesne St. 5R at 29. While it disputes this fact, Enron insists a share of uncollectibles should be assigned to Duquesne's PLR generation service, but not solely to its distribution service. It asserts customers purchasing only distribution services from Duquesne (and receiving generation services from a competitive supplier) should not be forced to subsidize uncollectible expenses associated with Duquesne's electric generation service, whether it is PLR service or not. Enron M.B. at 17, fn. 36.

In response to Duquesne's criticism that Enron's cost of service study contains errors and "circular references" which make its recommended cost allocations unreliable, Enron answers the criticism is based upon a failure to understand the material and work papers provided. Enron St. 2.1 at 3. Enron insists it identified a few minor calculation errors, which it corrected in surrebuttal testimony. Id. at 4. Enron M.B. at 17, fn.36.

For these reasons, Enron argues, sales and customer assistance and informational advertising expenses should be allocated 100% to the generation function of Duquesne's functional separation study. Uncollectibles should either be allocated to each of the functional categories or, to the extent energy suppliers or third parties other than Duquesne provide billing services and take credit risks (for example, if the Commission permits suppliers to act as agents for customers and provide a single bill with all charges included), uncollectible accounts expense should be unbundled and removed and not be charged in Duquesne's distribution rate for these customers at all. Enron M.B. at 17-18; Enron St. 2.0 at 10.

Further, Enron claims it is entirely inappropriate once these costs are allocated to the generation portion of Duquesne's functional unbundled rates to simultaneously add them to the Company's stranded cost recovery allowance. Such costs, Enron insists, will be incurred by all suppliers, who will try to recover them in a competitive environment. Therefore, these costs do not satisfy the definition of "stranded costs" in the Competition Act. See, 66 Pa. C.S. §§2804(15), 2803. Moreover, allowing Duquesne to add to its stranded cost recovery the costs removed from its transmission and distribution ("T&D") assignment will perpetuate the unfair competitive marketing advantage that Duquesne seeks to obtain by assigning these costs to T&D. Finally, Enron argues such a reallocation does not satisfy the Competition Act's requirement that

distribution and transmission rates be established justly, reasonably and non-discriminatorily and charged in a manner comparable to the charges that Duquesne will incur in providing generation services. Enron M.B. at 18.

6. Recommendation

Because the Commission has apparently denied the same objections of Enron in PECO Energy, Slip Op. at 59-61, to that utility's proposed allocations for uncollectibles, customer accounts, customer service and sales, the same treatment should be accorded Duquesne in this application. In reaching this result, the Commission noted the subject utility's T&D rates continued to be subject to Chapter 13 of the Code and, subject to the Act's rate caps, parties may challenge existing rates in future proceedings. Further, the Commission noted that as functions continue to be unbundled, a utility's rates may be reexamined to determine if they provide for charges which encompass generation or other unbundled services. Id. at 61. Since PECO Energy appears to control this issue, the Commission should reject Enron's position.

Furthermore, I agree with Duquesne that the Commission should reject, as well, the position of HSS/ARI on this issue. An intervenor must raise "credible issues" regarding an expenditure to overcome its "presumption of reasonableness." Equitable Gas Co., supra. The HSS/ARI have failed to do so. Therefore, the Commission should accept Duquesne's 1996 cost of service study, subject to the adjustments denoted below.

C. Required v. Realized Rate of Return

1. Duquesne's Proposal

Duquesne proposes establishing transmission and distribution rates on a traditional cost-of-service basis, using the traditional three steps. Duquesne M.B. at 11-14. First, Duquesne computes a functionalized revenue requirement for the transmission and distribution functions using its calculated rate of return. Duquesne St. 2; Duquesne St. 4; Duquesne St. 12. Second, it allocates the functionalized revenue requirements to customer classes as follows. For distribution, it allocates demand costs to classes on the basis of non-coincident peak demands and it allocates customer costs on the basis of the number of customers. Duquesne St. 5 at 17. Duquesne claims this methodology is "consistent with the approach taken by Duquesne in its most recent base rate proceeding." Id. For transmission, it allocates costs to classes on the basis of coincident peak demands, which is consistent with the Federal Energy Regulatory Commission ("FERC") policy. Id. at 16. Third, using these allocated revenue requirements, Duquesne then designs transmission and distribution rates for each class. Id. at 47-51; Duquesne M.B. at 11-12.

Duquesne notes several parties object to this approach because it sets transmission and distribution rates on the basis of "required" returns. OSBA St. 1 at 6-7; OCA St. 4S at 6; DII St. 1 at 42; Enron St. 2.1 at 6. The problem, according to these parties, is that this method effectively "shifts costs" in violation of the Act or is a "request for a rate increase." DII St. 1 at 42; Enron St. 2.1 at 6. These parties propose, instead, to calculate transmission and distribution rates using a "realized" rate of return, which means the return that Duquesne is

presently earning from each rate class will be used to set transmission and distribution rates. Duquesne M.B. at 12.

Duquesne suggests the purpose of these proposals is to shift costs away from transmission and distribution, thereby lowering rates for these services. Shifting occurs because Duquesne's total revenue requirement cannot fit within the rate cap established by the Act and, hence, the "realized" rates of return for each class are less than the required rates of return. Duquesne St. 5 at 29-30. Consequently, Duquesne relates these parties can lower transmission and distribution rates by using realized, rather than required, rates of return. Duquesne M.B. at 12-13; Duquesne St. 5R at 35.

Duquesne argues these proposals must fail because this is not how regulated rates are set. Duquesne insists regulated rates are set to recover the required rate of return. That is how transmission and distribution costs were allocated and recovered in Duquesne's last rate case. Duquesne St. 5R at 37. That is how transmission and distribution rates were set in Duquesne's pilot proceeding. Id. at 36. That is how transmission rates were set in Duquesne's FERC filing. Id.[29] Finally, Duquesne contends no party suggests, much less demonstrates, that the T&D revenue requirements Duquesne proposes are higher than the T&D revenue requirements the Commission approved in Duquesne's last rate case (1987); hence, no basis exists for the claim that the Act is violated. Duquesne M.B. at 13.

Finally, contrary to the intervenors' arguments, Duquesne states no possibility of cost-shifting exists under its proposal. Under its approach, "total unbundled charges will exactly

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[29] Duquesne notes the Commission is precluded by federal law from setting rates that fail to recover the FERC-prescribed transmission rates. Mississippi Power & Light Co. v. Mississippi ex rel. Moore, 487 U.S. 354 (1988). Duquesne M.B. at 13, fn. 2.

equal bundled charges at current rates based on 1996 sales." Duquesne St. 5 at 30. Duquesne posits its Exhibit No. JAL-9 demonstrates this fact for every class and no party disputes this fact. Duquesne characterizes the "cost shifting" argument as a smoke screen. It contends the intervenor proposals have nothing to do with a concern over shifts between classes; their key objective is to shift costs between functions. If successful, their constituents will have the best of both worlds: market rates for power and noncompensatory transmission and distribution rates.[30] Duquesne urges rejection of the intervenors' proposals and requests permission to set T&D rates on a traditional cost of service basis. Duquesne M.B. at 13-14.

2. The OCA's Position

The OCA explains the problem with Duquesne's approach to rate unbundling is that by developing T&D rates based upon the full cost of service for transmission and distribution charges, including the full rate of return, the Company improperly assumes transmission and distribution services have been earning a higher rate of return than generation services. OCA M.B. at 8-9; OCA R.B. at 4-5. The OCA declares such an approach is inconsistent with establishing the rate cap for "non-generation charges" at the same level, which the Commission previously approved for such services:

> In the most recent rate case, the Commission approved a system rate of return and also class rates of return, which applied to the Company's entire rate base. Since the rate of return applies

[30] On this latter point, Duquesne notes other companies may have designed T&D rates on the basis of realized, rather than required, returns because, unlike Duquesne, they had recent base rate proceedings and thus the difference between realized and required rates of return may be small, if any. By contrast, Duquesne has not had a base rate proceeding since 1987. N.T. 715; Duquesne M.B. at 14, fn. 3.

> equally to all types of plant, there was no distinction in the rate of return by function. Thus, for purposes of unbundled rates, return by function should be determined by applying the same rate of return to all plant. This will produce appropriate functional rates by class, even though they were not previously unbundled. The Act clearly specifies that overall non-generation charges will be capped at "the non-generation charges that have been approved by the Commission for such service . . . ."

OCA St. 4R at 6. Consequently, the OCA adjusts the Company's T&D rates to reflect the achieved return, rather than the claimed return. Id. By adopting this approach in PECO Energy, Slip Op. at 59, the OCA submits the Commission implicitly adopted its position on this issue. OCA M.B. at 8-9.

The OCA notes Duquesne defends its development of T&D rates based on the claimed rate of return, rather than the earned rate of return, on the basis that it used this approach in developing rates for its pilot program and in developing rates for transmission and ancillary services on file with the FERC. Duquesne St. 5R at 36. Because the Commission did not allow an equity return on certain generating plants in its last base rate case, Duquesne claims the Commission implicitly provided a lower rate of return on generation, which justifies the differential allocation. Id. at 36-37.

The OCA submits neither of these reasons stand scrutiny. The fact that Duquesne filed rates on this basis in other proceedings does not justify the unbundling of rates on that basis in this proceeding. Second, with respect to the Commission's denial of an equity return on Beaver Valley 2 and the full return on a portion of the Elrama units in the 1987 base rate proceeding, Pa. P.U.C. v. Duquesne Light Co., 66 Pa. P.U.C. 518, 651-52 (1988), the OCA finds the Company's arguments inconsistent. On the one hand, Duquesne argues rates were not unbundled and the rates of return, therefore, are indistinguishable. Duquesne St. 5R at 36. On

the other hand, Duquesne argues the Commission implicitly provided for a different rate of return on generation because of the disallowance on this investment. Id. at 37. The OCA suggests the Company fails to make a critical distinction: the Commission's disallowance of an equity return on Beaver Valley 2 and the full return on a portion of Elrama was clearly based on the view that those units were not excess capacity. The OCA contends the issue of the return on that investment should be addressed in the context of a determination of stranded costs, not in the context of functionalizing costs between T&D and generation. The OCA recommends rejection of Duquesne's proposal and adoption of the approach of the OCA, the OSBA and the DII. OCA M.B. at 9; OCA R.B. at 5; OSBA St. 1 at 3-10; DII St. 1 at 41-42.

3. DII's Position

DII objects to Duquesne's proposal, as well. DII M.B. at 10-12; DII R.B. at 5-7. DII argues use of a "required" rate of return constitutes an inappropriate cost-shift and a violation of the Act's rate cap. 66 Pa. C.S. §§2808(a), 2804(7) & 2804(4)(i). DII submits Duquesne must use the realized rate of return for each class as established in its last base rate case. DII St. 1 at 41-42.

DII notes Duquesne requests a rate of return of 9.61%. Duquesne St. 4R at 35. Duquesne's current bundled rates, however, do not reflect a uniform compensation by rate schedules based on this required rate of return. DII St. 1 at 41-42. Instead, the current bundled rates reflect the earned rate of return produced by each rate class as established in Duquesne's last base rate proceeding. Id. DII claims use of a rate of return either above or below the rate of return embedded in bundled rates creates cost shifting, which is prohibited under the Act, and

violates the rate cap on the components of transmission and distribution rates as of January 1, 1997. 66 Pa. C.S. §§2808(a), 2804(7) & 2804(4)(i); DII M.B. at 10-11.

First, DII asserts the use of required rate of return, rather than earned rate of return, shifts costs between the distribution function and the generation function of the unbundled rates. DII St. 1 at 41-42. "Any rate of return excess or deficiency (above or below the equal rate of return value) shows up in the generation component of each class's unbundled rate under the Company's analysis." Id. at 42.[31] Although moving class rates of return closer to system average may be appropriate in other contexts, the Act requires that, in order to prevent cost shifting, individual components of distribution rates must be capped at the January 1, 1997 levels until July 2001, or the time when the utility is no longer collecting a competitive transition charge ("CTC"), whichever is shorter. 66 Pa. C.S. §2804(i). When costs are shifted from the generation component to the distribution rates, the distribution rate will exceed the rate authorized as of January 1, 1997. Because the rate cap will be violated by using the Company's "required" rate of return, Duquesne's unbundling analysis must employ the rate of return currently embedded in each class' distribution rates. DII M.B. at 11; DII St. 1 at 41-42.

Second, DII suggests by changing the size of the generation component, use of the required rate of return in the unbundling analysis shifts responsibility for the recovery of stranded costs through the CTC under the DII and Duquesne approaches to CTC calculation. DII St. 1 at 41-42. Both DII and Duquesne use a "CTC residual" methodology in which the yearly CTC is determined by subtracting the anticipated market price for that year from the total

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[31] DII states all parties agree the generation component of the rate is determined by taking the bundled capped rate and subtracting transmission and distribution charges. DII St. 1 at 36; Duquesne St. 5 at 47-69; OCA St. 4 at 13-15.

generation component of the unbundled rate. DII St. 1 at 36; Duquesne St. 5 at 56-68. The Company's use of required rate of return shifts the costs from distribution to generation (or vice-versa), either raising or deflating the generation component of the class's rate. DII St. 1 at 42. Because the market price will be established separately from the unbundling analysis and will not be influenced by whether required or realized rate of return is used in the unbundling analysis, a change in the total generation component of the unbundled rate changes the residual portion of that generation component - the CTC. Thus, a higher (or lower) CTC may be charged to some classes based on whether Duquesne is currently earning its "required" rate of return. DII claims this result violates the Act's mandate that stranded costs be recovered in a manner that does not affect an inter- or intra-class cost shift. DII M.B. at 11-12; 66 Pa. C.S. §2808(a).

DII argues Duquesne's analysis also inappropriately employs a "required" rate of return in establishing distribution rates. The Duquesne proposal to use its required rate of return in the unbundling of rates is a cost-shift, resulting in both a shift of costs between the distribution and generation functions and a shift of stranded cost liability (if the CTC residual methodology is used). DII contends the Act prohibits both types of cost shifting. DII M.B. at 12; 66 Pa. C.S. §§2808(a) & 2804(7).

In addition, DII posits use of the "required" rate of return violates the rate cap on distribution rates. 66 Pa. C.S. §2804(4)(i). Through its proposal, Duquesne ensures recovery of excessive costs in its monopoly rates, which no customer can avoid. If these costs are not shifted to the monopoly function, the costs will remain in the generation component of

rates and Duquesne will potentially lose them in the competitive market. Duquesne's proposal attempts to shelter these costs from competition. DII M.B. at 12.

DII notes Duquesne's argument that proposals to use a realized rate of return ". . . must fail because this is not how regulated rates are set. They are set to recover the required rate of return." (Emphasis in original). Duquesne M.B. at 13. DII finds the Company misguided. In a general ratemaking proceeding, DII agrees it would be appropriate to move all classes toward a system-wide average rate of return; DII disagrees that it is appropriate in this proceeding. DII R.B. at 5-6.

> Although such an approach might be appropriate in a rate proceeding in which class rates are going to be adjusted towards cost of service, it is not appropriate to use these results in this proceeding, since the current bundled rates reflect the earned rate of return produced by the rate class, and not DLC's desired rate of return. As such, I have utilized the earned rate of return for each rate class to compute the distribution revenue requirements for each rate schedule in my unbundling analysis. This is consistent with the approach that other electric utilities in Pennsylvania have used. In general, I support the concept that rates should be based on costs and that each customer class (and therefore cost function within the class) should pay a rate of return based on the system average rate of return. However, since this is not a rate case and rates cannot actually be adjusted, the Company's proposal is not appropriate. In fact, it effectively results in a cost-shifting in violation of the Competition Act since the generation component of the unbundled rate for each rate schedule is computed as a residual.

DII St. 1 at 41-42.

DII posits the purpose of this proceeding is not to set new transmission and distribution rates for Duquesne; the purpose is to unbundle existing rates in a manner that does not shift costs or violate the rate caps. 66 Pa. C.S. §§2802(14), 2804(3), 2804(7) & 2808(a). Duquesne will have an opportunity to adjust its rates (and possibly move the class rate of return

towards system average) after the transmission and distribution rate cap mandated in Section 2804(4)(i), 66 Pa. C.S. §2804(4)(i), expires. DII suggests Duquesne's use of the required rate of return in unbundling its transmission and distribution rates is inconsistent with this purpose. DII R.B. at 6.

DII also responds to Duquesne's claim that use of the required rate of return does not shift costs because total unbundled charges exactly equal bundled charges at current rates. Duquesne M.B. at 13-14. DII reiterates its claim that use of the required rate of return shifts costs between the generation function and the transmission and distribution functions in violation of the Act for the reasons stated above. DII urges the Commission to reject the Company's proposal to use the required rate of return, as opposed to the realized rate of return, in unbundling its transmission and distribution rates.[32] DII M.B. at 12; DII R.B. at 6-7.

4. Enron's Position

Enron also objects to Duquesne using a "required" rate of return, rather than its realized rate of return, on its T&D costs as of January 1, 1997. Enron M.B. at 17-19; Enron R.B. at 10-11. Enron claims Duquesne's proposal amounts to a de facto attempt to secure a rate increase for this portion of its operations. Enron contends stating the cost of T&D at

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[32] DII notes Duquesne's claim that it should be treated differently from other companies on this issue because it has not had a base rate proceeding since 1987. Duquesne M.B. at 14, fn. 3. DII finds the timing of Duquesne's last base rate proceeding irrelevant. DII explains the Act requires that Duquesne's rates in effect as of January 1, 1997 to be capped and must be unbundled according to those capped rates. The Act creates no special exceptions according to the timing of a company's last base rate proceeding. DII suggests Duquesne will have the opportunity after the transmission and distribution rate cap expires to request that any rate of return allocation be changed. DII R.B. at 7, fn. 2.

Duquesne's "pro forma" or claimed "required" rate of return increases those costs above the level actually incurred in the 1996 test year, because the return level included in Duquesne's study is the level the Company claims it should be earning, not the amount it actually earned. The "required" return included in its study is precisely the type of return that would be included traditionally in a cost of service study allocating costs and revenues after accounting for a proposed rate increase (or an approved rate increase as reflected in a compliance cost of service filing). Duquesne provides no testimony or evidence to justify an increase for capital costs generally or for its T&D costs in particular. Because Duquesne's present rates are capped at January 1997 levels, the Company's proposal will mean the total T&D rates will be set at a level higher than the rate level implicit in Duquesne's rates as of that date. Enron argues this result contravenes the Competition Act. Enron M.B. at 17-18; 66 Pa. C.S. §2804(4)(i)(B).

Enron discounts Duquesne's arguments as to why it should be permitted to utilize a "required" rate of return, as opposed to the return it actually earned on the T&D portion of its rates. Enron R.B. 10-11. Duquesne admits its calculation method, unique among utilities submitting restructuring plans,[33] restates the T&D portion of its rates at levels higher than those that were in place as of January 1, 1997 because, as of that date, Duquesne was obviously earning its realized return, as opposed to the return claimed to be "required" here. In effect, Enron argues Duquesne awards itself a rate increase for the T&D portion of its business.

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[33] Enron notes Duquesne claims its "required" rate of return methodology is appropriate, notwithstanding the fact that no other electric utility adopted it, because of the time that has passed since Duquesne's last base rate proceeding in 1987. But PECO's last base rate proceeding had been in 1990 (PECO Restructuring Order, at Slip Op. at 60), and, nevertheless, it utilized its actual rate of return in calculating T&D rates. Enron R.B. at 10, fn. 22.

Unfortunately, Duquesne failed to file for a rate increase and has failed to comply with any of the requirements in Chapter 13 of the Code associated with such a hike. Enron R.B. at 10.

Enron relates Duquesne's assertion that the rate cap justifies the Company's approach. Duquesne restates all of the various portions of its rates to reflect its claimed "required" rate of return. The T&D rates that it proposes are the only rates that it proposes to establish using this required rate of return because, as it admits, if it restated all of its rates, including the generation portions of its rates, at the higher "rate increase" levels, its rates will exceed its rate cap. Duquesne M.B. at 12-13. Enron asserts Duquesne's methodology allocates its claimed higher cost of capital (i.e., its required verses realized rate of return) to each of the three functional parts of its rates, but in recognition of the restraints of the Act's rate cap, allocates the decrease necessary to comply with the cap only to the generation portion of its total rate. Enron concurs with DII that Duquesne's proposal shifts costs between customer classes and functions, thus violating the Act's prohibition against inter-class costs shifts. 66 Pa. C.S. §2808(a). Enron also urges the Commission to reject Duquesne's proposal. Enron R.B. at 11.

5. Recommendation

I agree with the OCA, DII and Enron that the Company's use of a "required" rate of return to develop T&D rates constitutes an inappropriate cost-shift and a violation of the Act's rate cap. 66 Pa. C.S. §§2808(a), 2804(7) & 2804(4)(i). Duquesne is correct when asserting that development of a "required" rate of return follows traditional rate-making principles. However, the purpose of this proceeding is not to set new T&D rates for Duquesne; the purpose is to unbundle existing rates in a manner that does not shift costs or violate the rate caps. See,

66 Pa. C.S. §§2802(14), 2804(3), 2804(7) & 2808(a). One day after implementation of new rates as approved by this Commission, a utility begins earning a "realized" or "earned" rate of return and not a "required" rate of return. Duquesne will have an opportunity to adjust its rates (and possibly move the class rate of return toward system average) after the T&D rate cap mandated in Section 2804(4)(i), 66 Pa. C.S. §2804(4)(i), expires.

Since I find the arguments of DII, supra, persuasive on this issue, I recommend the Commission direct Duquesne to use the "realized" rate of return for each class, as established in its last base rate case, to develop rates.

D. Distribution Losses

1. Duquesne's Proposal

Compensation is embedded in current bundled rates for electricity losses experienced as electricity moves along distribution lines. These losses are commonly referred to as "distribution losses"; however, the actual costs embedded in rates are for extra generation that must be reserved to compensate for the lost electricity. In effect, more energy must be produced by a generator than will actually be needed by the end-user because some electricity will be lost as it moves along the distribution path. DII M.B.at 12-13.

Duquesne asserts no dispute any longer exists regarding distribution losses. Duquesne M.B. at 14. The Company initially included the costs associated with distribution losses in its T&D rates. Duquesne St. 5 at 12. Duquesne now agrees to "unbundle" losses so customers can procure them from alternate suppliers. Duquesne St. 5R at 21-22. Consequently, a portion of the embedded costs allocated to losses will become potentially stranded and, hence,

must be included in the CTC. Id. at 22. The OCA agrees that stranded costs associated with distribution losses should be included in the CTC. OCA M.B. at 9-10; OCA R.B. at 5; OCA St. 4S at 3-4. DII agrees. DII M.B. at 12-14; DII R.B. at 7.

2. Recommendation

Only the PRA and Enron seem to disagree that the issue of distribution losses appears to be settled. PRA M.B. at 21-24; PRA R.B. at 6; Enron M.B. at 19-20. However, both urge the Commission to require distribution losses to be removed from Duquesne's distribution rates, so alternative suppliers may bid competitively for such losses. Since Duquesne has already agreed to do so, no perceptible issue any longer exists. For this reason, I recommend that the Commission accept Duquesne's proposal to allow customers to procure distribution losses from alternate suppliers. To the extent a portion of the embedded costs allocated to distribution losses will become potentially stranded, I also recommend they be included in the CTC.

E. Ancillary Services

1. Duquesne's Proposal

The Company incurs costs to provide certain services which may be referred to as "ancillary." As the FERC denotes, these ancillary services include: scheduling, dispatch and control service, energy imbalance service, reactive power and voltage control service, regulation and frequency control service, operating reserves-spinning, and operating reserves-supplemental. Duquesne St. 5 at 18-19; OCA St. 4 at 3. While generating units provide a number of these

services, Duquesne made a number of adjustments to functionalize some of these costs as transmission and distribution costs. Id.; Duquesne Exh. JAL-1C at 3. Specifically, Duquesne made adjustments to functionalize as transmission costs $4,021,675 for reactive power, $5,187,040 for regulation and frequency control and $8,913,265 for operating spinning reserve, for a total of $18,121,980. Id.

Duquesne notes the treatment of ancillary services has created a great deal of confusion. Duquesne M.B. at 15-17. With one exception,[34] Duquesne explains all ancillary services are provided by generating units and each is "necessary to maintain the integrity of the transmission system" in an open access regime. Order No. 888, FERC Stats. & Regs. [Regulations and Preambles 1991-1996] ¶31,036, at 31,703 (1996). In Order No. 888, the FERC ruled that all public utilities must offer these services to direct access customers at regulated rates. Id. The FERC also distinguished between services that can only be offered by the host public utility and others that can be competitively procured, assuming that prevailing regional reliability rules permit it. Id. at 31,715-716; Duquesne St. 7 at 13-14. Duquesne contends it has complied with FERC Order 888 ("Order 888") by filing cost-based ancillary services rates with the FERC. Duquesne M.B. at 15; Duquesne Light Co., FERC Docket No. OA96-56-000.[35]

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[34] The exception is "scheduling" service, which is the function of programming an energy management system to accept the projected deliveries by suppliers of generation to the Duquesne control area; the costs associated with this service are primarily labor and control center facilities. Duquesne M.B. at 15, fn. 4; Duquesne St. 5 at 20.

[35] Duquesne explains it has out these rates in effect on an interim basis pending approval by FERC of a settlement. The settlement is on the FERC agenda for February 11, 1998. Duquesne M.B. at 15, fn. 5.

Duquesne discerns two main questions regarding ancillary services. The first is whether Duquesne should allow its customers to procure all these services from alternative suppliers. Duquesne submits that issue is not a question for this Commission. The FERC has determined which services Duquesne must provide and which services can, consistent with regional rules, be supplied by others. Order No. 888 at 31,715-716; Duquesne St. 7 at 13-14. At present, Duquesne's regional reliability council, ECAR, imposes significant restrictions on when many of these services can be competitively procured, if at all. Duquesne St. 7 at 13-14; Duquesne St. 5R at 19. Thus, Duquesne explains, the intervenors' "complaints are with ECAR, not with Duquesne. Duquesne does not set the rules; it follows them." Duquesne St. 5R at 19. Duquesne suggests the issue, therefore, must be addressed by FERC or ECAR, not by this Commission. Duquesne M.B. at 15-16.

The second question is whether, for ratemaking purposes, these services should be: (i) treated like transmission and distribution, and thereby purchased from Duquesne at regulated rates, or (ii) treated like generation, and thereby competitively procured in the market, with the stranded portion being recovered through the CTC. Duquesne suggests the answer depends on the service. If, as discussed above, the FERC and ECAR permit suppliers to provide a service themselves, Duquesne submits it should be treated just like generation and any stranded costs associated therewith should be recovered in the CTC. Duquesne St. 5R at 19. If these bodies require that only Duquesne provide a service, it should be treated the same as transmission/distribution and customers will pay Duquesne a FERC-approved, cost-based rate

for the service. Id.[36] Duquesne submits all the arguments to the contrary either (i) inadvertently confuse the issue by treating all such services homogeneously, or (ii) intentionally do so with the clear, and unlawful, purpose of eliminating Duquesne's ability to recover the stranded portion of these costs in the CTC. Duquesne urges acceptance of its treatment of ancillary services. Duquesne M.B. at 17.

2. The OCA's Position

The OCA disagrees with Duquesne's proposed adjustment to shift these costs from generation to transmission. OCA M.B. at 10-12; OCA R.B. at 5-6. The costs associated with these adjustments were estimated as portions of the revenue requirement associated with generating units estimated to be required to provide these services. OCA St. 4 at 4. The OCA explains:

> . . . 43 MW of fossil-fuel generating capacity was assumed to be necessary to provide regulation and frequency control response for the Duquesne control area, so the equivalent percentage of fossil plant was determined and this percentage of the fossil plant revenue requirement was defined as the cost of this ancillary service.

Id.

Since these costs are associated with generating units, the OCA removes the Company's adjustment for these costs from the generation function to the T&D functions. Thus,

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[36] The FERC has jurisdiction over unbundled retail transmission and ancillary services rates. Order No. 888 at 31,781. Consistent therewith, Duquesne's rates for pilot customers were filed with, and accepted by, the FERC. Duquesne M.B. at 17, fn.6; Allegheny Power Serv. Corp., 81 FERC ¶61, 271 (1997).

the OCA shows T&D costs of $285,417,000 before Duquesne's adjustments for ancillary services. OCA M.B. at 11; OCA Exh. LS-4.

In rebuttal, Company witness Lahtinen testifies that to the extent these services can be competitively procured, the costs should be reflected in the generation function and proposes a market-based credit to be added to the CGC. Duquesne St. 5R at 18-20. To the OCA, it is unclear to what extent, if any, the Company has modified its adjustment to T&D rates to reflect the procurement of these services on a competitive basis. The OCA states most of these services can be purchased competitively:

> Competitive suppliers could provide most ancillary services. The Company's own testimony states that energy imbalance service and regulation and frequency control can be provided by other suppliers through dynamic scheduling; essentially by running an alternative control area. Currently ECAR requires that spinning reserves be provided from within the control area. That rule is subject to change, and spinning reserves could be provided within the control area by either purchasing existing generation or by building new generation within the area. Thus, it appears that only scheduling and reactive power services are unlikely to be provided through the competitive market.

OCA St. 4S at 2. The OCA disagrees with Duquesne that these costs should be reflected in T&D rates. It asserts the Company's T&D costs should be adjusted as the OCA proposes to reflect these amounts in generation. OCA M.B. at 11-12; OCA R.B. at 5-6.

3. DII's Position

The DII also objects to Duquesne's treatment of ancillary services. DII M.B. at 14-17; DII R.B. at 7-8. DII argues inclusion of generation-related ancillary services in the Company's unbundled transmission rates is inappropriate because it shifts costs between

functional categories. DII St. 1 at 37. Generation-related ancillary services costs are not included in Duquesne's current transmission rates. DII St. 1S at 15. Consequently, DII claims these costs cannot properly be assigned to the transmission function in unbundling Duquesne's rates. DII M.B. at 14-15; 66 Pa. C.S. §2804(3).

DII suggests, as electric industry restructuring develops, many ancillary services, including the ones at issue in this proceeding, can be provided by alternative suppliers in a competitive market. DII St. 1S at 15. DII contends customers must be given options to purchase such competitive ancillary services from alternative suppliers. Concurrent with the emergence of customer options to procure alternatively supplied ancillary services, ancillary services costs must be removed from Duquesne's transmission rate to avoid double payment for these costs. Id. If the ancillary services costs are not removed from transmission rates, DII asserts Duquesne's customers will be forced to pay twice for these services - once to the alternative supplier from whom customers nominally procure ancillary services and once to Duquesne as part of the regulated transmission rate. Id. To prevent inappropriate double payment, DII recommends moving $18 million of ancillary services costs from the transmission rates into the market price component of unbundled generation rates. DII M.B. at 15; DII St. 1 at 37.

DII makes two adjustments to the Company's unbundling analysis to account for generation-related ancillary services. The first adjustment involves the reactive supply and voltage control ancillary service. The second adjustment involves the remaining generation-related ancillary services. DII M.B. at 15.

First, to adjust Duquesne's unbundling analysis for reactive supply and voltage control ancillary service, DII removes the proposed cost from transmission rates and adds the Company's proposed reactive supply and voltage control cost to the market price for each year. DII St. 1 at 37-38. DII claims its adjustment ensures that customers will not pay twice for reactive supply and voltage control ancillary service. DII M.B. at 15; DII St. 1 at 37.

Second, DII adjusts Duquesne's unbundling analysis to account for other generation-related ancillary services. DII insists other ancillary services must be procured as a percentage of the customer's load. Id. at 38. Consequently, DII employs a 15% reserve margin adder to the market capacity prices that DII calculates for each customer class. Id. DII reasons:

> Since these generation related ancillary services are determined as a percentage of load, [DII has] included the cost of all of these services through the application of a 15% reserve margin adder to the market capacity prices calculated for each customer class. Essentially, by applying a 15% reserve margin adder, [DII has] accounted for generation related ancillary service charges (other than reactive supply and voltage control) at market-based prices. This is also consistent with the assumption that [DII] made in our stranded cost quantification; i.e., that all generating capacity would receive market-based capacity revenues. Furthermore, since all electric generation suppliers service firm load will carry a reserve margin for reliability purposes, the reserve margin adder must be included in market prices for generation and not in the transmission component.

Id. The DII claims its adjustments to Duquesne's unbundling analysis will ensure generation-related ancillary services costs will be assigned to the generation function. DII M.B. at 16; DII St. 1S at 15.

The Company agrees generation-related ancillary services that can be competitively supplied should be removed from the transmission rate. N.T. 720-721. Because

all generation-related ancillary services are not currently subject to competition, the Company's adjustment will result in only a partial removal of ancillary services costs from the transmission rate. Presumably, as more ancillary services are competitively provided, DII surmises Duquesne will remove such costs from its transmission rate. DII believes this piecemeal approach to unbundling is unsatisfactory. DII offers that all generation-related ancillary services be removed from the transmission rate and the Company may charge customers for any generation-related ancillary service not competitively procured. DII M.B. at 16; DII St. 1S at 15.

In the event the Commission does not accept its proposed treatment of ancillary services costs, DII argues other changes must be made to Duquesne's Restructuring Plan. First, the Company's unbundling analysis includes generation-related ancillary services at embedded costs. DII St. 1S at 15. To the extent the Company's proposal is accepted and Duquesne continues to receive compensation for competitive ancillary services at the embedded costs, DII claims ratepayers must receive a credit toward stranded costs for those services. Id. If the embedded costs of these generation-related ancillary services exceed market revenues, the difference between the embedded cost and the market price must be credited against any stranded cost liability that the Company imposes on its customers. Id. Second, DII includes generation-related ancillary services in its market price analysis at the market price for procuring those services. To the extent Duquesne's proposal to include any or all of these costs in the transmission rate at embedded cost is accepted by the Commission, the DII suggest its market price forecast and stranded cost calculation should be adjusted to reflect the Company's ability to receive greater compensation for these services (at embedded costs as opposed to market price). DII M.B. at 17; DII R.B. at 7-8; DII St. 1S at 15-16.

4. The PRA's Position

The PRA agrees with the assessment of the OCA and DII concerning Duquesne's proposal for the costs of ancillary services, but concurs with the treatment DII proffers on this issue. PRA M.B. at 24-25; PRA R.B. at 6-7.

5. Enron's Position

Enron finds Duquesne will allow suppliers to competitively procure ancillary services pursuant to standards and restrictions contained in FERC Order 888. Duquesne St. 7R at 3. Order 888 requires transmission providers to permit their customers to self-provide ancillary services to the extent it is technically feasible under applicable regional reliability council standards. Enron agrees this position is correct and commends Duquesne for its willingness to follow the FERC approach. Enron M.B. at 20.

Enron also finds Duquesne recognizes the necessity to ensure retail choice customers are not charged twice for ancillary services they choose to purchase from an alternative supplier. To ensure this result will not occur, Duquesne proposes that customers will receive an annual credit for revenues collected from suppliers, net of any additional expenses incurred. Duquesne St. 5R at 19. Enron agrees it is important to assure customers are not charged twice for the same service and thereby penalized for choosing an alternative supplier. However, Enron disagrees that the appropriate mechanism is through an end-of-the-year "market based" credit. Rather, Enron suggests the transmission-related portion of the rate should be unbundled to recognize the delivery of those services by an alternative supplier. The credit

should be based upon the embedded cost of the ancillary service as established by Duquesne's cost of service study. Enron M.B. at 20-21.

To ensure implementation of its proposal, Enron urges the Commission to direct Duquesne to calculate the embedded generation cost of ancillary services; this value should then be deducted from the Company's generation revenue requirement.[37] Enron M.B. at 21.

In addition, Enron agrees with MAPSA's arguments on imbalance charges and scheduling charges. Enron submits these costs are already contained within the FERC tariffs and Duquesne should not reapply them to suppliers in an attempt to limit market opportunities. Id.

6. MAPSA's Position

MAPSA argues Duquesne's proposal to provide a "market-based" credit for ancillary services capable of competitive provision must be modified to ensure the credit represents the fully-allocated cost of providing those services. MAPSA M.B. at 11-14; MAPSA R.B. at 7. MAPSA finds Duquesne's proposal includes the partial unbundling of ancillary services and allows for competitive provision of only one of them. The services of reactive power control, frequency regulation, scheduling, energy imbalance, and spinning reserve will not be unbundled, and Duquesne proposes to collect the cost of these services in its transmission

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[37] Enron notes this will be important if a "merger" based calculation of stranded costs (such as the OCA methodology) is utilized. The OCA calculation determines stranded costs by comparing the revenues that plant is predicted to generate compared to the revenue requirement, if ancillary services are included in the generation revenue requirement. If these costs are removed, the generation revenue requirement will be reduced and stranded costs will be reduced as well. Enron submits Duquesne should be required to reflect this change in its compliance tariff filing. Enron M.B. at 21, fn. 49.

rates, because Duquesne proposes to continue monopoly provision of these services. Duquesne initially proposed to unbundle the ancillary service of supplemental reserves and to charge suppliers per unit charges for those services. Duquesne St. 5 at 55. Duquesne subsequently modified its proposal to provide for a "market-based" credit for those ancillary services that can be purchased from an entity other than Duquesne (currently only supplemental reserves) and to add that credit to its CGC. MAPSA M.B. at 11; Duquesne St. 5R at 2.

MAPSA submits Duquesne should be required to unbundle all ancillary services and provide a separate, fully-allocated credit for each of those services, which should be added to the CGC to compensate customers if they choose to have these services competitively provided. MAPSA explains suppliers will be required to purchase, at a minimum; scheduling, energy imbalance and supplemental reserves. MAPSA St. 1 at 20. To ensure there will be no double collection and to gain the best value for customers by allowing suppliers to provide these services from the most economical source, MAPSA finds an additional credit to the CGC is required. MAPSA M.B. at 11-12.

(a) **Imbalance Charges**

MAPSA argues Duquesne's proposal contains imbalance charges which are not cost justified, are otherwise unreasonable, and should be rejected. Energy imbalance charges are intended to compensate for differences in the amount of energy a customer is scheduled to use (and what a supplier must deliver into the system) and what the customer actually uses. Duquesne proposes to charge each supplier for imbalances that fall outside of a 1.5% "dead-band": during off-peak periods at the higher of 110% of Duquesne's out of pocket costs, or

$50/mwh, and during on-peak periods, the higher of 110% of Duquesne's out of pocket costs or $100/mwh. MAPSA contends Duquesne has failed to provide any cost justification for these charges; the charges are unreasonable and excessive, and Duquesne's proposal should be rejected. MAPSA M.B. at 12.

MAPSA suggests Duquesne's proposed imbalance charges are intended to create an incentive for suppliers to schedule with a high degree of accuracy. MAPSA St. 1 at 56. Duquesne will provide class-average load data for customers with specific meter types to suppliers, who will then have to match the load shape. Suppliers are penalized if the supply does not match the usage, but not if the supply does not match the load data. In actually scheduling the load, suppliers will be forced to rely on load data which Duquesne provides and which is likely to be highly inaccurate for any particular supplier. Id. MAPSA agrees penalties are not inherently dangerous, but when the data on which a supplier must rely is not accurate, MAPSA argues the penalties should be adjusted or eliminated because of the potential for abuse. MAPSA proffers a reasonable change should be 100% of Duquesne's out-of-pocket expenses. MAPSA M.B. at 12; MAPSA St. 1 at 57.

MAPSA proposes that the Commission allow imbalances to be traded among competitive suppliers. Trading imbalances will allow a supplier, who over-delivers in one hour, to trade that oversupply to another supplier who may have under-supplied in that particular hour. Both suppliers will then be considered to be in balance, and Duquesne will not collect imbalance penalties from both. MAPSA St. 1 at 58. MAPSA also suggests that the Commission allow imbalances to be resolved in-kind, at a time, and in a manner agreed upon by Duquesne and the suppliers. MAPSA M.B. at 13.

b. Scheduling Charge

MAPSA claims Duquesne's proposed $100 scheduling charge is unreasonable, anti-competitive, not cost justified and should be rejected. Duquesne proposes to charge suppliers $100 for each schedule and each change in schedule which is submitted to Duquesne. Scheduling is a service which Duquesne proposes to continue providing as a monopoly service. MAPSA asserts the charge "bears no rational relationship to the service." MAPSA St. 1 at 41. It notes the Company derives the fee by dividing the adjusted labor expense of Account. No. 556 by the number of hours in a year. Id. MAPSA contends this analysis merely yields a result establishing the hourly cost of scheduling. MAPSA suggests Duquesne has not established the actual transactional cost incurred in providing the service. Id. at 42. The fee is so high, MAPSA submits, it is likely to hinder the development of a robust competitive market because it will discourage suppliers with small loads – and thus fewer kWh's over which to spread their fixed costs - from participating in the market. MAPSA M.B. at 13-14; MAPSA St. 1 at 42.

When utilities impose charges which are anti-competitive, MAPSA argues those charges: (i) must be proved to be necessary and not speculative, See, Pa. P.U.C. v. The Peoples Natural Gas Company, 83 Pa. P.U.C. 22 (1994) (rejecting an OTS proposal to impose exit fees where the need for the fee was speculative); (ii) must be specifically quantified, See, Pa. P.U.C. v. UGI Utilities, Inc., 1994 Pa. P.U.C. Lexis 9 (1994) (rejecting unquantified and discriminatory exit fees which had the effect of shielding the utility from competition); and (iii) must be supported by adequate cost justification, See, Re: PECO Energy Company, 180 P.U.R. 4th 125 (1997) (striking a switching fee that was not adequately cost justified). Where the utility fails to meet its burden of providing substantial evidence, its proposed rate must be denied in

its entirety. Lower Frederick Township Water Company v. Pa. P.U.C., 409 A.2d 505, 507 (1980) (affirming the Commission's denial of all elements of a proposed rate increase where the utility did not meet its burden of proof). MAPSA M.B. at 14.

MAPSA argues the record evidence is clear; Duquesne's scheduling fee is, on its face, anti-competitive. Duquesne has not proved the charge is necessary (it currently is being fully recovered in rates) and has not submitted any cost justification on a transactional basis. MAPSA submits Duquesne's proposal inhibits the development of competition by imposing an excessive fee for a service for which there currently is no alternative. MAPSA seeks to have the Commission strike Duquesne's scheduling fee proposal, at least until such time that it offers appropriate cost-justification. Id.

In response to Duquesne's argument that it is ECAR, not the Company, which prevents Duquesne from offering ancillary services on a competitive, unbundled basis, MAPSA notes Company witness Mr. Lahtinen admits this may not be the case. MAPSA R.B. at 7; N.T. 772.

7. Recommendation

The traditional rate making principle is that assignment of costs follows function. Since Duquesne admits generating units provide the ancillary services, Duquesne M.B. at 15, and the costs associated with the challenged adjustments to transmission were estimated as portions of the revenue requirement associated with generating units estimated to be required to provide these services, OCA St. 4 at 4, then it naturally follows that the costs of ancillary services should be attributed to the generation function, if the particular service can be

competitively procured, and any stranded costs associated therewith should be recovered in the CTC. Duquesne and the intervenors apparently agree on this general principle.

However, the catch arrives with determining what ancillary services can be competitively procured. The FERC Order 888 has ruled that all public utilities must offer these services to direct access customers at regulated rates. Yet, the FERC distinguishes between services that can only be offered by the host public utility and others that can be competitively procured, assuming that regional reliability rules permit it. The picture becomes murkier when Duquesne explains its regional reliability council, ECAR, imposes significant restrictions on when many of these services can be competitively procured. Duquesne St. 7 at 13-14; Duquesne St. 5R at 19. Yet, Duquesne's own witness admits this may not be the case. N.T. 772. Since it is not at all clear that ECAR imposes significant restrictions on the competitive procurement of these services, Duquesne has not affirmatively proven this fact to be true. Consequently, I recommend the following amounts be removed from T&D rates and moved into generation costs: $4,021,675 for reactive power, $5,187,040 for regulation and frequency control and $8,913,265 for operating spinning reserve, for a total of $18,121,980.

Further, I recommend the Commission disallow Duquesne's proposed imbalance charges and the $100 scheduling charge, since the Company has not provided sufficient evidence to justify them and for the reasons MAPSA explains, supra.

F. Voltage-Differentiated Rates

1. Duquesne's Position

Duquesne argues Enron's proposal should be rejected because it shifts costs between classes, which Enron does not dispute. Duquesne M.B. at 17; Duquesne St. 5R at 32-34; Enron St. 2.1 at 5.

3. DII's Position

DII concurs with the Company. DII urges the Commission to reject Enron's proposal because Enron has not sufficiently demonstrated that implementation of its voltage differentiated rates will not shift costs between classes. DII R.B. at 8.

3. Enron's Proposal

Enron proposes a Distribution Services Tariff ("DST") which, it claims, will apply to suppliers who will be responsible for making all the necessary arrangement (acting as agent) for individual or aggregated end-user customers. Enron M.B. at 21-23; Enron R.B. at 11-12; Enron St. 2.0, Exh. PDR-6. In conjunction with the DST, Enron proposes that applicable rates be designed so as to reflect the characteristics of a customer's service, including voltage level, rather than historical identification by traditional "class" of service.[38] In the restructured industry, Enron suggests the important pricing distinctions between customers will be the timing of electricity consumption, the voltage level at which customers take service and

[38] Enron's proposed voltage based rates are reflected in Enron St. 2.1, Exh. PDR-10.

whether that service entails single-phase or poly-phase facilities. Enron finds this approach posses a number of advantages, including:

- It results in a simplification of rates which better enables the customer to determine the basis for the charges imposed.
- It results in a more direct attribution of costs to the type of facilities actually used by the customer instead of the traditional class-differentiated rates.
- Most of the motivation for class rates has to do with generation-related costs, which will now be provided via a competitive market through which suppliers will be free to establish energy pricing mechanisms to meet specific customer needs and desires.

Enron M.B. at 21-22; Enron St. 2.0 at 25.

To demonstrate its proposal, Enron provides a sample rate design calculation for Energy Delivery Services. Enron St. 2.0 at 26, Exh. 2, PDR-7. Revenue requirements attributable to Energy Delivery Services are summarized into customer- and demand-related categories, and are then further segregated by customer voltage level. In that example, the demand charge component for service at secondary voltage is cumulative in that it covers demand-related costs of transmission and primary and secondary voltage facilities. Enron M.B. at 22.

Enron declares Duquesne incorrectly contends the rates proposed to be used in conjunction with the DST will cause cost-shifting. Duquesne St. 5R at 33-34. Under the DST, Enron responds the Supplier - acting as agent for end-users - is the customer. In that circumstance, historic customer class distinctions have little meaning. Where the Supplier is not acting as agent for the end-user and for default customers, Duquesne's class-based unbundled tariff will apply. Where the DST applies, Enron submits Duquesne is appropriately compensated

in aggregate by the Supplier for distribution services rendered. The voltage-differentiated rate mechanism presented in Enron Exhibit 2, PDR-7 (revised in Exhibit 2.1, PDR-10) is a simple straightforward means to accomplish that objective. Enron M.B. at 23.

In further response to the cost-shifting argument, Enron demonstrates the examples Duquesne presents purporting to show the voltage-differentiated rate proposal will cause cost shifting presumes Duquesne's present rates by customer class already allocate costs to certain classes for which they are not responsible and for which they should not bear responsibility. Enron St. 2.1 at 5. If customers who only take service at the transmission level are today being allocated costs for secondary and primary voltage, Enron submits such an allocation is a cross-subsidy already built into rates. Enron suggests either that kind of cross-subsidy is unlikely to exist in Duquesne's rates (since unreasonable cross-subsidies have always been violative of the Public Utility Code)[39] or, if they exist, will not cause a cost shifting but eliminate one. Enron R.B. at 12.

4. Recommendation

I agree with Duquesne and the DII on this issue. The Competition Act prohibits cost shifting in the unbundling process and mandates a rate cap on non-generation rates through mid-2001. See, 66 Pa. C.S. §§2804(4)(i) & 2804(7). The fact that the cost shifting may affect the supplier, who is the "agent" for the end-user customer, is irrelevant. Since insufficient evidence exists in this record to show that Enron's voltage-differentiated rates will not violate

[39] See, 66 Pa. C.S. §1304.

the Act's prohibition against cost shifting or exceeding the rate cap on non-generation rates, I recommend the Commission reject Enron's proposal.

G. Other Issues

Several parties present miscellaneous issues concerning transmission and distribution rates. These issues may be summarized as follows.

1. HSS/ARI's Position

HSS/ARI argue Duquesne makes no attempt to demonstrate its projected capital expenditures for distribution-related service are just and reasonable. HSS/ARI M.B. at 12-15. HSS/ARI note Duquesne's cost of service study does not assume an adjustment to 1996 test year data with respect to distribution plant. Duquesne Exh. MKO-1B at 6. However, HSS/ARI find that cost of service study misleading in the context of Duquesne's overall rate proposal. HSS/ARI M.B. at 13.

In Duquesne Exhibit DJC-3, the Company sets forth, inter alia, a revenue requirement forecast for generation, transmission and distribution. On each page with revenue requirement forecasts for the years 1997 through 2005, Duquesne assumes a return on equity of 11.5% consistent with its proposal in this case. Duquesne Exh. DJC-3 at 2-22. HSS/ARI presumes Duquesne intends to show in this Exhibit that through 2005, Duquesne likely will not earn more than its requested return on equity of 11.5% if it is permitted to continue to charge its current rates. HSS/ARI M.B. at 13.

However, HSS/ARI claims, specifically with respect to distribution-related capital expenditures, that Duquesne Exhibit DJC-3 reveals that between 1997 and 2005 Duquesne will have to make capital additions of $532 million (more than one-half of its current net plant investment) to provide a cost basis that will allow it to back-in to an 11.5% return on equity. HSS/ARI St. 1 at 58; Duquesne Exh. DJC-3 at 22 & 28. On its face, that level of projected capital additions appears excessive. Nonetheless, HSS/ARI contend Duquesne offers no explanation for the expenditures. Thus, HSS/ARI ask: how excessive will Duquesne's return on equity be if Duquesne does not expend the forecasted amounts? Also, HSS/ARI ask: is there evidence to suggest just how excessive Duquesne's forecasted expenditures might be? HSS/ARI M.B. at 13-14.

HSS/ARI find the answer to the first question concerning Duquesne's potential returns on equity in materials Duquesne presented in an August 1996 rating agency presentation. In those materials, Duquesne projected returns on average common equity of 14.6%, 15.4%, 14.9%, 14.3% and 14% for the years 1996 through 2000, respectively. HSS/ARI St. 1 at 78; HSS/ARI Exh. RBW-28, p. 0059280. Those projections are consistent with Duquesne's recent financial performance. For instance, in a September 23, 1997 presentation to NatWest Securities, Duquesne boasted that its earnings per share as of the 12 months ending June 30, 1997 were up by 8.4% from the prior 12-month period. HSS/ARI Exh. RBW-29 at 2. Duquesne also boasted of annual compound growth rates in earnings per share and dividends of 8.0% and 6.2%, respectively. Id. at 3. Further still, Duquesne gloated that its five-year growth rates in earnings per share was sixth highest of all ranked utilities; its five-year growth in dividends per share was second highest of the ranked utilities; and, its payout ratio was lowest

of all utilities. Id. at 4. Thus, HSS/ARI argue Duquesne's projections of distribution-related capital expenditure appear to be designed to help Duquesne maintain its substantial financial achievements for its shareholders, with no commensurate benefit for its ratepayers. HSS/ARI M.B. at 14.

Concerning the question of just how excessive Duquesne's projected capital expenditures may be, HSS/ARI point out Duquesne has a history, dating back to 1987, of forecasting distribution-related capital additions of approximately 10% more than actual expenditures. HSS/ARI St. 1 at 59 & 61. As a result, HSS/ARI seek an adjustment to Duquesne's proposed distribution rates to assume future capital additions of 10% less than Duquesne forecasts. HSS/ARI M.B. at 14-15; Citing, PECO Energy, Slip Op. at 82.

In Pa. P.U.C. v. Pennsylvania Power & Light Co., 67 PUR 4th 30, 50-51 (1985), the Commission disallowed expenses projected more than 12 months after a rate case test year. Given the lack of any evidence to support Duquesne's projected expenditures, HSS/ARI urge the Commission to disregard Duquesne's distribution related projections in their entirety and assume a declining rate base that will result from straight line depreciation. To do otherwise, HSS/ARI assert, will assume without foundation that Duquesne will make certain expenditures that it has not shown are known and measurable. It also will place Duquesne in a position (particularly in the out years as it depreciates existing plant) to extract a return on equity well in excess of the 11.5% return it claims to be requesting. HSS/ARI M.B. at 15.

(a) **Recommendation**

So far as I can determine, no other party voices a position on this issue. Duquesne does not respond to the HSS/ARI claim. Section 2808(c)(4) of the Competition Act, 66 Pa. C.S. §2808(c)(4), imposes a duty upon every electric utility, during the transition period, to mitigate generation-related transition or stranded costs to the extent practicable. These efforts may include minimization of new capital spending for existing rate base generation assets. 66 Pa. C.S. §2808(c)(4)(ii). Giving affect to these provisions, the Commission in PECO Energy, Slip Op. at 81-82, disallowed 5% of the budgeted capital additions to generating plant because PECO had a ten-year history of over-budgeting future capital improvements and the Commission determined permitting full recovery would constitute an anti-competitive subsidy of PECO's future competitiveness in the generation market.

Here, HSS/ARI cite the holding in PECO Energy for the proposition that the Commission should disallow 10% of Duquesne's projected distribution-related capital additions because the Company has a history of over-budgeting future capital improvements. Nowhere does the Act compel such a result. HSS/ARI overlook the fact that transmission and distribution rates will still remain regulated after implementation of this restructuring plan. If they believe T&D rates are still unreasonable at that time, HSS/ARI can challenge those rates in a future proceeding before this Commission. For these reasons, I recommend the Commission deny the proposal of HSS/ARI on this issue.

2. The Environmentalists' Position

The Environmentalists term their proposal "Targeted Area Planning." Env. M.B. at 11-12. As load grows, the Environmentalists posit EDCs will come under increasing pressure to upgrade transmission and distribution lines. However, before an EDC invests ratepayer money in such actions, the Environmentalists suggest it should first evaluate the life-cycle costs of a number of alternatives, including energy conservation and efficiency, load management and distributed energy generation. Integrated resource planning should be an important tool in the distribution segment of the electric industry. Env. M.B. at 11.

The Environmentalists recommend an "integrated" approach to distribution system planning that encourages the utility to identify and implement the least-cost option in meeting system requirements by finding the least expensive solution to distribution system needs or problems. Env. St. 1 at 16-18. The Environmentalists suggest sometimes the least-cost way to solve a distribution problem is not by building new distribution facilities, but rather by targeting demand-side management approaches or by siting generation in local areas to avoid or reduce the need for distribution system upgrades. In other situations, the lowest cost method may be to reconfigure existing distribution facilities rather than build new ones. Automatically picking distribution system upgrades may well lead to higher costs to customers and negative environmental impacts. Env. M.B. at 11-12.

The Environmentalists recommend a process for turning this common sense principle into a workable system for minimizing distribution system costs and environmental impacts. The Environmentalists insist the Company should begin a systematic collection of data to support a thorough understanding of its distribution capabilities and limitations, forecasted

needs and capital additions, area-specific avoided costs, and the costs and characteristics of a range of alternatives to traditional system reinforcements. Env. M.B. at 12.

The Environmentalists also propose that this planning process be open to meaningful public review and input, including the right of discovery, technical meetings, hearings and a publicly published final plan. Such a planning process will facilitate distribution system investments which are good for the system, the economy and the environment. Env. M.B. at 12.

(a) Recommendation

So far as I can determine, no other party voices a position on this issue. Duquesne does not respond to the Environmentalists' proposal. The Commission already requires jurisdictional electric utilities to file annual integrated resource plans. Presumably, this practice will continue for that portion of the electric utility industry still regulated by this Commission after implementation of direct access to the electric generation market, i.e., transmission and distribution. So far as public input into the EDC filings of integrated resource plans in the future, the Commission may want to consider this proposal at a later time in a generic proceeding. For purposes of this application, I recommend the Commission need undertake no further action on the Environmentalists' proposal.

VI. TRANSITION OR STRANDED COSTS

A. Overview of Stranded Cost Valuation and Recovery Approaches

1. Introduction

Duquesne correctly notes the pivotal issue in this application is whether to accept its offer to auction its generating assets today. That offer, if accepted, should resolve most disputes regarding the quantification of stranded costs and the methodology for recovering them. If that offer is not accepted, the Commission must choose between sharply different market valuation and stranded cost recovery proposals. Duquesne M.B. at 18.

Pursuant to Sections 2808(a) and 2804(13) of the Competition Act, 66 Pa. C.S. §§2808(a) & 2804(13), electric companies are provided the opportunity to recover transition or stranded costs, as defined in the Act, through a CTC assessed upon every customer accessing the electric company's T&D network. The Act defines "transition or stranded costs" as:

> An electric utility's known and measurable net electric generation-related costs, determined on a net present value basis over the life of the asset or liability as part of its restructuring plan, which traditionally would be recoverable under a regulated environment but which may not be recoverable in a competitive electric generation market and which the [C]ommission determines will remain following mitigation by the electric utility. (Emphasis added).

In accordance with the Competition Act, the term "transition or stranded costs" includes: (i) regulatory assets and other deferred charges typically recoverable under current regulatory practice, the unfunded portion of the utility's projected nuclear generating plant decommissioning costs and cost obligations under contracts with nonutility generating ("NUG") projects which have received a Commission Order, the recoverability of which is to be determined pursuant to 66 Pa. C.S. §2808(c)(1); (ii) prudently incurred costs related to

cancellation, buyout, buydown or renegotiation of NUG projects, subject to statutory conditions, the recoverability of which is to be determined pursuant to 66 Pa. C.S. §2808(c)(2); and (iii) net plant investments and costs attributable to the utility's existing generation plants and facilities, and certain other enumerated costs, the recoverability of which is to be determined pursuant to 66 Pa. C.S. §2808(c)(3).

2. Duquesne's Proposal

In its direct case, Duquesne claimed regulatory assets and decommissioning expenses under 66 Pa. C.S. §2808(c)(1). Duquesne St. 4 at 7-8. Duquesne generally has no NUG project exposure; so, stranded costs under 66 Pa. C.S. §2808(c)(2) are not an issue. OTS M.B. at 7.

With respect to its generation plant-related stranded costs under 66 Pa. C.S. §2808(c)(3), Duquesne proposes, in its direct case, a market-based valuation approach which will defer until 2003 a final valuation of its generation plant-related stranded costs as of December 31, 2005. Duquesne St. 2 at 2; Duquesne St. 3 at 5. The Company contends that, by this time, a competitive generation market will likely have developed so as to permit a stranded cost determination based upon actual market data. Id. at 52. According to Duquesne, only a market-based determination of stranded costs can reasonably satisfy the "known and measurable" criteria set forth in the Competition Act. Administrative determinations, which rely upon market price projections, are inherently inferior to valuations based on actual market data. OTS M.B. at 7-8; Duquesne St. 3 at 6-7.

Duquesne proposes this final market valuation in 2003 to be calculated by a three-member arbitration panel using objective market data such as forward contracts, future contracts, and/or comparable generating unit asset sales. Duquesne St. 1 at 14-15. The panel's recommendation will be subject to Commission review and the Commission is not bound by the panel's findings on market value. OTS M.B. at 8; Duquesne St. 3 at 49.

Until the final valuation occurs, Duquesne proposes to set annual CTCs on the basis of an annual Request For Proposal ("RFP") to sell a substantial block of power for a one-year term. Customer-specific CTCs will be set using the market prices established by the RFP, information about each customer's consumption and information on class load shapes. Duquesne St. 1 at 17. The CTC, based on these annual RFPs, will collect a pool of money that will be compared to the book value of generation-related assets (net of amortization) as of December 31, 2005 in the final valuation process. In the final valuation, the panel will recommend a CTC that will recover any remaining level of stranded costs. If no stranded costs associated with generating plants exist at that time, there will be no CTC. OTS St. 4 at 11. If stranded costs are projected to extend beyond 2005, given Duquesne's rate cap under Section 2804(4) of the Act, 66 Pa. C.S. §2804(4), Duquesne will propose to extend the rate cap beyond 2005. OTS M.B. at 8-9; Duquesne St. 2 at 41.

Duquesne performed a stranded cost projection based upon a range of costs, solely to determine whether it will likely have stranded costs remaining as of the end of the transition period. It deemed this study necessary to support its proposal to charge its capped rates through the transition period. Duquesne St. 2 at 28-29; 66 Pa. C.S. §2804(4)(v). Duquesne commits

to an amortization and depreciation of at least $1.7 billion in stranded costs during the transition period, through charging its capped rates. OTS M.B. at 9; Duquesne St. 1 at 5.

Duquesne proposes two mechanisms during the transition period which can trigger an earlier final valuation of stranded costs and an earlier end to the CTC. First, Duquesne states if market prices rise sufficiently prior to 2003, it is possible an overrecovery of stranded costs can occur, unless safeguards are provided. The Company proposes to trigger an early market valuation based on established price triggers for the years 2001 and 2002. Duquesne's calculated trigger price in its direct case was $28.5/mwh for the year 2001 and $29.2/mwh for the year 2002. The early trigger price is that market price that will likely produce a high enough residual value so as to allow an early end to the rate cap and further collection of the CTC. The Company proposes to use the annual RFP solicitation for 2000 and 2001 as market evidence of whether the trigger prices are exceeded. If the market price determined in these solicitations exceeds the values set forth above, the final market-based valuation will be accelerated. OTS M.B. at 9-10; Duquesne St. 2 at 41.

The second trigger Duquesne proposes in its direct case relates to its "ROE spill over" adjustment. The Company proposes to establish a collar on its earnings of plus or minus .5% around its claimed return on equity ("ROE") of 11.5%. If its earnings exceed the upper collar of 12%, it will establish a deferred revenue account, which will be used to fund accelerated depreciation and amortization of stranded costs. However, if earnings fall below 11%, an adjustment to the deferred revenue account will occur to increase the Company's earnings to the 11% level or to eliminate the credit and balance in the account, whichever is smaller. If at any time during the transition period the balance in the deferred revenue credit

account, when netted against Duquesne's net book value of generating and regulatory assets, equals Duquesne's estimated net book value as of December 31, 2005, the final market-based valuation will be triggered. OTS M.B. at 10-11; Duquesne St. 2 at 42.

In the rebuttal phase of this case, Duquesne modifies its original stranded cost valuation proposal in three ways. First, the Company will provide the Commission[40] an option, in addition to the market-based valuation in 2003 described previously, whereby the Commission can order Duquesne to divest its generating assets in 2003 (or sooner if there is an early trigger of the final valuation).[41] Duquesne proffers this option in response to the positions of several parties that divestiture is the only way to determine a definitive market value for its generation assets. OTS M.B. at 11; Duquesne St. 2R at 3.

At that stage of the case, the Company declined to offer an immediate generation auction due to concerns about its continuing obligation to serve and its risk, during the transition period, that market prices may rise above the level implicit in the auction price. Duquesne T&D customers may then return to Duquesne as generation customers due to lower generation rates established at the time of the auction, when market prices were lower. Duquesne would be required to provide generation to these customers within capped rates, regardless of whether its market purchases to serve these returning customers were higher. OTS M.B. at 11-12; Duquesne St. 1R at 14.

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[40] Since 66 Pa. C.S. §2804(5) precludes the Commission from ordering an involuntary divestiture, Duquesne frames its divestiture proposal as an agreement by the Company to provide the Commission an option for divestiture. Duquesne St. 1R at 11.

[41] This divestiture proposal relates to Duquesne's "stand-alone" restructuring and Duquesne only offers this proposal, if the proposed merger with APS is not consummated. N.T. 178-179.

Second, the Company agrees in rebuttal to revise its market price trigger to reflect the OCA market price line. This revision will lower the trigger price in 2001 from $28.5/mwh to $24.9/mwh and in 2002 from $29.2/mwh to $25.6/mwh. Duquesne characterizes this modification as adding conservatism to its stranded cost recovery proposal, since it will make an early valuation more likely. OTS M.B. at 12; Duquesne St. 2R at 3, 6.

Third, the Company eliminates its .5% collar on its 11.5% ROE spill-over proposal. This adjustment responds to criticisms that Duquesne was trying to gain approval of a 12% ROE. Thus, the Company agrees to record all entries to the deferred revenue account based on an 11.5% ROE. OTS M.B. at 12; Duquesne St. 2R at 6-7.

Since it posits a final stranded cost valuation should be deferred until 2003, the Company did not propose a one-time administrative valuation of generation plant-related stranded costs in its direct case. OTS St. 4SR at 4. However, in rebuttal, in response to OCA's and DII's contentions that its market valuation proposal is deficient because it does not include a one-time quantification of stranded costs as of January 1, 1999, Duquesne presents evidence to support a total stranded cost determination of $1,916 million, including regulatory assets of $374.45 million. Duquesne St. 3R at 4, 9, 15. The stranded generation plant component of the $1,916 million is $1,542 million, including a first-time claim of approximately $208 million, relating purportedly to unavoidable sunk costs incurred regardless of whether plants are operating (PV of Costs Independent of Operation), and approximately $41 million claimed as M&S and Fuel-Related Sunk Costs. OTS M.B. at 12-13; Duquesne St. 2R at 13-14; Duquesne St. 3R at 11; Duquesne Exh. DJC-10.

In a fax memo to the ALJ and all parties dated February 6, 1998, the Company revises its regulatory assets claim downward, so that its total one-time quantification of stranded costs as of January 1, 1999 is now $1,898.96 million, including regulatory assets of $357.28 million. The stranded generation plant component of the $1,898.96 million remains at $1,542 million. OTS M.B. at 13; See, Appendix, Table 1.

In rejoinder, Duquesne declares it is willing to advance the date for the optional asset auction. Instead of the 2003 date for the auction referenced in rebuttal, the Company will, in its stand-alone restructuring case, agree to an immediate auction, if the Commission determines it cannot accept Duquesne's auction offer due to the delay. Duquesne, however, reserves its right to submit a proposal for addressing its continuing obligation to serve under the rate cap, if and when the Commission orders an immediate auction. OTS M.B. at 13-14; Duquesne St. 1R at 1-2.

3. Duquesne's Position

(a) Market-Based Valuation

Duquesne posits the fundamental premise of its approach to stranded cost recovery is that the market, not career forecasters, should set the value of its generating assets. The Company claims no party presents a compelling argument to rebut this premise and, indeed, most parties agree with it. Duquesne M.B. at 18; Duquesne St. 1R at 7-11; OTS St. 4 at 15-16; City St. 1 at 6; MAPSA St. 1 at 6; HSS/ARI St. 1 at 118.

Duquesne suggests the principal dispute is not over the premise that administrative "forecasts" are inherently unreliable.[42] Instead, the disputes center on the market valuation method and the timing of that valuation. In particular, the essential criticism of Duquesne's initial plan was that (i) an auction of generation is the best, and perhaps only, market-based mechanism that can satisfy the known and measurable standard, HSS St. 1-S at 3, and (ii) whatever valuation method is used, it must be employed today, not in 2001-2003 (as proposed by Duquesne). OCA St. 1 at 7; DII St. 1 at 26; HSS/ARI St. 1S at 4. Duquesne asserts its rebuttal testimony eliminates the first dispute by offering to auction all its generation, although it continues to assert such a valuation need not, and should not, be conducted today. Duquesne St. 1S at 2. Thus, the second dispute still remains; some intervenors contend in surrebuttal testimony that any such auction must be held today. OCA St. 1S at 5; HSS/ARI St. 1S at 4. In rejoinder testimony, Duquesne agrees to eliminate that dispute through its offer to auction generation today. Duquesne M.B. at 19-20; Duquesne St. 1R.[43]

Duquesne notes only the IBEW opposes an auction, asserting the Commission has no authority to order it. IBEW M.B. at 4-7. Duquesne recognizes the Commission does not

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[42] Duquesne notes even the OCA and DII, who sponsor computer simulations, do not claim those methods can reliably predict market prices. Rather, as OCA witness Kahal stated, "I concur with Company witnesses that performing market valuations on long-lived plants is a difficult undertaking." OCA St. 1 at 12; See, also, DII St. 1 at 26 ("I recognize that there is uncertainty with respect to future market prices"). Duquesne insists both witnesses concede an auction is superior to a computer forecast. Duquesne M.B. at 19, fn. 7; Duquesne Exh. DDM-1 at 2, 5.

[43] Duquesne continues to believe: (i) market methods other than an auction can meet the known and measurable standard; and (ii) it is preferable to conduct a final valuation in 2001-2003, when markets are more fully developed. Duquesne St. 1R at 1-2; Duquesne St. 3R at 16-18. Duquesne notes other parties concur that the valuation should be deferred until later in the transition period. Duquesne M.B. at 20, fn. 8; Duquesne Exh. DDM-1 at 14.

have authority to compel Duquesne to sell its assets. 66 Pa. C.S. §2804(5) ("[t]he Commission may permit, but shall not require, an electric utility to divest itself of facilities . . ."). But, Duquesne submits that issue is not present here. Duquesne proposes to exercise its right to auction its generating assets should the Commission find a final stranded cost determination must be made today. Duquesne St. 1R at 11 ("Duquesne is willing to commit to such an auction to narrow or eliminate unproductive disputes in this case over market valuation."). To be sure, the auction will be precipitated by a Commission finding on a related issue (i.e., the permissibility of Duquesne's final valuation proposal); but the choice of whether to auction the assets in the face of such a finding is Duquesne's. Thus, the Company argues no conflict with Section 2804(5) or any other law exists. Duquesne R.B. at 1-2.

While the auction is "perhaps the best means of establishing the market value of the plants," Duquesne notes the OCA finds it "impractical" to address the issue here because the offer "is made only in the context of non-consummation of the merger." OCA M.B. at 14. Duquesne responds the Company and its customers do not have the luxury of sidestepping the issue. Rather, Duquesne explains:

> Duquesne fully expects that the merger will be approved by all necessary regulatory agencies, and that it will thereafter be consummated; however, it is critical that the Presiding Judge make findings here regarding Duquesne's stand alone proposal that would survive should the merger not occur. This will ensure that a customer choice plan is in place for Duquesne's customers under all circumstances.

Duquesne M.B. at 3-4. The Company asserts its position is consistent with the OCA's position that "the purpose of this proceeding [is] to resolve stranded costs and its recovery, not to defer it to a future proceeding." OCA St. 1 at 12. Duquesne urges the Commission to "resolve" the

matter by finding an auction provides the best valuation method.[44] Duquesne submits any necessary findings regarding competing valuation methods presented in the merger case should be made in that case, not here. Duquesne R.B. at 2-3.

(b) Auction Implementation Issues

If its auction offer is accepted, Duquesne claims three main implementation issues must be addressed. The first is the process and rules by which the auction is conducted. Duquesne commits to file proposed procedures and rules within 90 days of the date of entry of a Commission Order accepting its auction proposal. All interested parties may comment on them at that time. Duquesne M.B. at 20.

The second issue is the establishment of an "interim" CTC to take effect January 1, 1999. Duquesne submits an interim CTC is necessary because it is unlikely the auction will be completed by that time. To simplify the issue, Duquesne proposes to apply the same rates (and credits) approved in the pilot program for customers electing direct access during this interim period.[45] Duquesne M.B. at 21.

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[44] Duquesne claims DII mistakenly asserts "the Company requests a rate cap waiver" as part of its auction proposal. DII M.B. at 43; Citing N.T. 55. The Company claims it has not "requested a rate cap waiver;" rather, it has stated: (i) a legitimate concern regarding the rate cap, Duquesne St. 1R at 13-17; (ii) there are a range of methods for addressing that concern, Id. at 16; (iii) removing the rate cap is "one way" to do so, N.T. 56; and (iv) it commits to file a proposal addressing this concern should its auction proposal be adopted. Duquesne M.B. at 21; Duquesne R.B. at 3, fn. 1.

[45] Also consistent with the pilot program, Duquesne will defer revenue losses associated with the market and customer participation credits for collection in the final CTC. Duquesne M.B. at 21, fn. 9.

The third concerns the method for calculating a "permanent" CTC using market values produced by the auction. If an immediate auction is ordered, Duquesne will waive application of Section 2804(4)(v) and adopt the general approach used in PECO Energy, provided the following two conditions are met. First, Duquesne is permitted to fully recover (e.g., with no "sharing" and a compensatory return on equity) its stranded costs, as established by the market values produced by the auction. Second, Duquesne's continuing obligation to serve at capped rates must be addressed. (Duquesne's concerns on this issue are discussed at Duquesne St. 1R at 13-17.) Duquesne commits to submit a proposal to address its continuing obligation to serve at the same time that it files a final CTC calculation, using market values produced by the auction. Duquesne M.B. at 21.

Duquesne finds the intervenor approaches differ in two main respects from its proposals. The first difference proposes to calculate market value using computer simulations, which the OCA and DII advocate. Duquesne strongly objects to this approach for the reasons explained above; however, if the Commission believes a finding is required for market forecasts, Duquesne contends the Commission should adopt the Company's forecast, which relies on market data to the maximum extent possible. The second difference relates to proposals for immediate rate reductions (OCA and HSS). These rate reductions may be attractive for the OCA and HSS/ARI, but Duquesne claims they are proscribed by Section 2804(4)(v), which states "the utility shall not be required to reduce its capped rates below the capped level upon the complaint of any party if the [C]ommission determines that any excess earnings achieved under the cap are being utilized to mitigate transition or stranded costs. . . ." (Emphasis added). Duquesne M.B. at 21-22; 66 Pa.C.S. §2804(4)(v).

Duquesne concludes many of the key disputed issues will be eliminated if its offer of an immediate auction is accepted, which all parties agree is the best valuation method. If this offer is not accepted, Duquesne submits the Commission should accept its proposal to conduct a final valuation in 2001-2003 and approve a stranded cost recovery plan pursuant to Section 2804(4)(v). Duquesne M.B. at 22.

4. The OTS' Position

The OTS does not oppose Duquesne's auction/divestiture option, which Duquesne agreed in rebuttal and rejoinder testimony to provide to the Commission. Likewise, the OTS does not oppose the Company's claim for regulatory assets, with the exception of deferred caretaker costs and decommissioning, infra. The OTS supports, with two modifications, the Company's direct case proposal to defer a final valuation of generation plant-related stranded costs until 2003, and to base the valuation on objective market data in 2003 rather than today's projections. OTS M.B. at 14-19; OTS St. 4 at 15-17. The OTS opines the market value approach is superior to a "regulator-administered approach," which would be involved in the one-time administrative quantification of stranded costs as of January 1, 1999 sought by DII and the OCA. OTS witness Mr. Metro explains:

> In a regulator administered approach, the projection of market rates over a 30 year period would be necessary to attempt to determine the net present value of the company's stranded costs. The regulator administered approach is not accurate by any account. . . . I believe that any utility's stranded costs claim is in error if it is based on 30 year market rate projections. In my opinion, the utilities will err in their favor in the calculation of the stranded cost.

OTS St. 4 at 15-16.

The OTS provides an exhibit which compares expert market rate projections from, inter alia, PJM-member electric utility restructurings in Pennsylvania. The exhibit demonstrates a wide disparity in market rates. Thus, the electric utilities cannot even agree to the same market rate within the PJM service territory, wherein the OTS claims the market rates should be identical. OTS M.B. at 15; OTS St. 4 at 17; OTS Exh. 4, Sch. 1.

In the OTS' view, the Competition Act does not bar the Company's proposal to conduct a final valuation of generation plant-related stranded costs in 2003, at a time when a competitive generation market is likely to be flourishing and sufficiently objective market data can be obtained. In fact, the OTS finds the statutory definition of stranded costs invites such deferred approaches due to the requirement that stranded costs be "known and measurable." It posits a one-time administrative evaluation of stranded costs in this proceeding, as of January 1, 1999, cannot be accurate by any account. OTS M.B. at 15; OTS St. 4 at 15.

If the "known and measurable" standard must be satisfied now in this restructuring proceeding, then the OTS submits no electric utility can substantiate any generation plant-related stranded costs at this time, absent an immediate auction. Since the Legislature clearly stated auctions/divestitures can only be voluntary, 66 Pa. C.S. §2804(5), and if one interprets the Competition Act as requiring stranded cost levels to be definitively determined now, then, absent an agreement to at least a partial divesture/auction, the OTS suggests the generation plant-related stranded cost in all restructurings would have been preordained to be zero. Given the intent of the Act to provide at least an opportunity for stranded cost recovery, 66 Pa. C.S. §2808(a), the OTS finds this result absurd and not in accord with principles of statutory construction. See, 1 Pa. C.S. §1922 (1); Pa. P.U.C. v. Commonwealth, 353 A. 2d

887 (Pa. Commonwealth Ct. 1976). Accordingly, the OTS urges rejection of this interpretation in favor of allowing a delayed valuation in 2003. OTS M.B. at 16.

The OTS proposes two modifications to Duquesne's deferred valuation proposal. First, the OTS proposes the rate cap under 66 Pa. C.S. §2804(4) and the CTC collection period be extended if the final valuation in 2003 determines a stranded cost level which will produce CTC "rate shock." The OTS notes the Company apparently intends to begin collecting stranded costs determined by the panel pursuant to the 2003 valuation on January 1, 2004 and to collect these costs over the two remaining transition years. If the valuation at that time results in stranded costs which exceed the upper level of Duquesne's projections of remaining stranded costs (approximately $423 million), then the OTS recommends the CTC and rate cap period be extended for whatever time is necessary to recover the additional stranded costs at the then current recovery rate. OTS M.B. at 16-17; OTS St. 4 at 13-14; Duquesne St. 2 at 11; Duquesne Exh. DJC-3 (Revised) at 1.

The OTS notes the Competition Act specifically permits extensions to the CTC collection period if the Commission so orders for good cause shown. 66 Pa. C.S. §2808(b). Duquesne does not oppose the OTS' rate cap/CTC extension proposal. In fact, Company witness Clayton indicates Duquesne will extend the rate cap for CTC recovery beyond 2005.[46] OTS M.B. at 17; Duquesne St. 2 at 41.

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[46] In Application of PECO Energy Company for Issuance of a Qualified Rate Order Under Sections 2808 and 2812 of the Public Utility Code, at Docket No. R-00973877, (Opinion and Qualified Rate Order entered May 22, 1997), Slip Op. at 22-25, the OTS notes the Commission apparently questions its authority to direct a utility to extend the rate cap beyond the end of the transition period. However, in the instant case, Duquesne has voluntarily agreed to extend the rate cap. OTS M.B. at 17, fn. 3.

The OTS' second modification concerns the Company's ROE spill-over proposal. Duquesne posits 11.5% is a reasonable rate of return on equity and links its "ROE spill-over" trigger to 11.5% in earnings. Also, Duquesne originally proposed a .5% collar around the 11.5% so the deferred revenue account will not be triggered until its earnings exceeded 12%. However, the OTS establishes a reasonable rate of return on equity for Duquesne is 10.50%. OTS St. 1 at 8. Consequently, the OTS originally recommended that 10.50% be used for the "ROE spill-over" trigger with a .5% dead band from 10% to 11%. OTS St. 4 at 14. However, when the Company modified its ROE spill-over proposal in rebuttal to eliminate the .5% dead band, Duquesne St. 2R at 6-7, the OTS also removed the .5% dead band from its recommendation. OTS M.B. at 18.

In the event the Commission rejects Duquesne's deferral of final valuation and decides it must render a one-time administrative determination of stranded costs in this proceeding, without benefit of an auction, then the OTS proposes a stranded generation plant cost projection of $1,025.32 million and a total stranded cost of $1,378.68 million, as set forth in OTS Exh. 4SR, Sch. 1, as revised by Duquesne's February 6, 1998 fax memo, in comparison to the Company's $1,898.96 million. See, also, OTS M.B. at Appendix, Table 1. The components of this estimate will be discussed, infra. The OTS notes the Phillips and Brunot Island generating plant disallowance, together with its decommissioning adjustments included in OTS Exh. 4SR, Sch. 1, should also be incorporated in the delayed panel valuation process in 2003. OTS M.B. at 18-19.

5. The OCA's Position

(a) Duquesne's Approach

The OCA opposes Duquesne's final valuation and rate cap/ROE spill-over proposals and submits the Commission should reject them in favor of a one-time determination of stranded costs in this proceeding, a sharing of stranded costs by amortizing stranded costs over a seven-year period without allowing a return on the unamortized balance of the Company-owned generating assets. The OCA argues Duquesne's proposals should be rejected because they are inconsistent with the Act, provide no near-term rate relief to consumers, are administratively burdensome, will interfere with the competitive market, will interfere with the Company's incentive to mitigate stranded costs, and will require ratepayers to bear the entire stranded cost burden of the significant amount of uneconomic excess capacity currently held by the Company. The OCA emphasizes the 11.5% ROE is far too high and it will be practically impossible to determine earnings as part of its ROE spill-over proposal when the Company has one foot in the competitive market. OCA M.B. at 13-14.

With respect to the Company's alternative divestiture proposal, while the OCA agrees a divestiture provides the best means of establishing the market value of plants and the stranded costs associated with them, it finds Duquesne's proposal is made only in the context of non-consummation of the merger. Without a final decision on the merger, the OCA submits it is impractical to further consider this alternative. Id. at 14.

The OCA explains two key principles underlie Duquesne's approach. First, Duquesne's proposal for continuation of the current level of rates until the final valuation is based on its interpretation of Section 2804(4)(v) of the Act, which it interprets as allowing

electric utilities to charge rates up to current levels provided "any excess earnings achieved under the cap are being utilized to mitigate transition or stranded costs for the benefit of ratepayers." Id. Since Duquesne's calculations indicate that if rates are maintained at current levels and all revenues that are not utilized to cover transmission and distribution costs and generation costs at market prices are utilized to mitigate (or amortize) stranded costs, it will still have stranded costs at the end of the transition period, it contends that it meets the requirements for continuation of rates at their current levels. Second, Duquesne's approach is in accordance with its view that a final valuation in 2003 will result in stranded costs being based on "objective" market evidence, rather than on market price forecasts. The OCA submits that, for a number of reasons, Duquesne's approach must be rejected in favor of the one the Commission used in PECO Energy. OCA M.B. at 14-15.

(i) Consistency with the Act

The OCA finds the first problem with Duquesne's approach is a legal one. The OCA submits the Act requires stranded costs to be determined in this restructuring proceeding. Thus, a future valuation of stranded costs is inconsistent with the Act. This conclusion proceeds from the definitional section of the Act where "transition or stranded costs" are defined as the utility's net electric generation-related costs "determined on a net present value basis . . . as part of its restructuring plan." 66 Pa.C.S. §2803. The OCA submits the Act's requirement for a determination of stranded costs in the restructuring plan on a net present value basis is a clear requirement for a one-time determination of stranded costs in this proceeding. OCA M.B. at 15.

(1) Duquesne's Response

Duquesne disagrees with the OCA and DII contentions that its final valuation plan cannot be accepted because the Act requires a final stranded cost determination be made today. OCA M.B. at 15; DII M.B. at 31-33.[47] Several supposed statutory barriers are raised, but the Company only responds to three. The first issue is the Act's reference to stranded costs as being stated on a "net present value" basis. 66 Pa.C.S. § 2803; OCA M.B. at 15. Duquesne claims this is a calculational issue, not a timing issue: whether stranded costs are determined today or in 2003, they can, and should, be calculated on a net present value basis.[48] Duquesne R.B. at 5.

The second issue concerns the Act's reference to stranded costs as being determined "as part of [the utility's] restructuring plan." 66 Pa.C.S. §2803; DII M.B. at 31. Duquesne submits this language does not require that stranded costs be determined today; it requires that they be determined "as part of [Duquesne's] restructuring plan." Duquesne's plan is that market methods be used in a final valuation in 2001-2003. Duquesne R.B. at 5; Duquesne St. 2 at 28, 40.

The third issue is that Section 2808(f) requires an annual CTC true-up for changes in sales levels. DII M.B. at 32-33. Duquesne claims its proposal does this and more. Duquesne's ROE spill-over provides a true-up for sales levels and for changes in other factors

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[47] Duquesne notes the OTS and the Environmentalists support deferring a final valuation of its generation assets. Duquesne R.B. at 5, fn. 5; OTS M.B. at 15; Env. M.B. at 14.

[48] Duquesne witness Mr. Clayton provides a net present value calculation of Duquesne's stranded costs as of December 31, 2005. Duquesne R.B. at 5, fn. 6; Duquesne St. 2 at 30; Duquesne Exh. DJC-3.

that affect earnings, such as operating costs. Duquesne St. 1 at 9; Duquesne St. 2 at 42-44; Duquesne St. 3 at 24. Moreover, given Duquesne's $1.7 billion minimum amortization commitment, there is no guarantee Duquesne will even earn its required return. Duquesne St. 1 at 22. Duquesne asserts its ROE spill-over proposal adds to the consumer protections embodied in Section 2808(f). Duquesne R.B. at 6; Duquesne St. 1 at 23.

Duquesne argues the viability of its final valuation proposal should not turn on such semantic debates, but rather its fidelity to the substantive requirement that it provide a "known and measurable" quantification of stranded costs. OTS M.B. at 15. It claims it does. Duquesne R.B. at 6.

(ii) The "Known and Measurable" Standard

The OCA claims the Company's argument that the Act requires the Commission to determine the "known and measurable" level of stranded costs, and that such a determination cannot be made in this proceeding, is simply wrong and suggests the Commission's PECO Energy decision contravenes the law. Duquesne St. 1 at 14. The OCA explains, while performing market valuations on long-lived plants is a difficult undertaking, the same will be true in 2003, when Duquesne proposes that such a valuation be made. OCA St. 1 at 12. Thus, in PECO Energy, Slip Op. at 100, the Commission found its stranded cost determination was known and measurable. OCA M.B. at 15.

(iii) Section 2804(4)(v)

The OCA also submits Duquesne misinterprets Section 2804(4)(v) of the Act, 66 Pa. C.S. §2804(4)(v), to allow the Company to maintain its rates at the level in effect at the effective date of the Act if the Commission determines excess earnings are being utilized to mitigate stranded costs or to offset other known and measurable cost increases that would be recoverable under traditional ratemaking and are not included within the capped rates. The OCA submits the legislative intent of this section, which is included in the rate cap provisions of the Act, was to preempt complaints against current rates after the Company's restructuring had been completed, not to prevent rates from being lowered in the Company's restructuring case. The Company's interpretation of this provision stands the entire restructuring proceeding on its head and will defeat one of the primary goals of the Act, i.e., to provide needed rate relief for Pennsylvania consumers. The OCA demonstrates, even after amortizing an appropriate amount of stranded cost, the Company's rates require adjustment to reflect savings to all customers. OCA M.B. at 16.

(1) Duquesne's Response

Duquesne notes several parties object to its proposal to charge capped rates pursuant to Section 2804(4)(v),[49] but only the OCA contends the Company's proposal rests on a mistaken "interpretation" of Section 2804(4)(v). But, Duquesne insists there is no "interpretation" at all in the passage quoted. The OCA quotes directly from Section 2804(4)(v)

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[49] Duquesne notes, however, neither the OTS nor DII object to the proposal to continue charging capped rates. Duquesne R.B. at 3, fn. 2; OTS M.B. at 49; DII M.B. at 72.

itself, not from Duquesne's interpretation of those words.[50] Duquesne disagrees with the OCA's interpretation that the intent of this Section ". . . was to preent [sic] complaints against current rates after the Company's restructuring had been completed, not to prevent rates from being lowered in the Company's restructuring case." OCA M.B. at 16; (emphasis in original). Duquesne finds the plain language of Section 2804(4)(v) does not permit such a distinction. The only "temporal" dimension of that Section is the requirement that capped rates not exceed those "approved by the [C]ommission as of the effective date of this chapter." Duquesne argues that is precisely its proposal. Duquesne St. 2 at 35-36. The Company contends the OCA's interpretation, by contrast, rewrites the Section to say: capped rates shall not exceed those "approved by the [C]ommission as of the effective date of the utility's restructuring plan."[51] Duquesne R.B. at 3-4.

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[50] If it is necessary to discern a legislative "intent" for Section 2804(4)(v), Duquesne suggests it is quite obvious the Section mirrors Duquesne's "Ft. Martin Plan," which froze current rates while using excess earnings to accelerate the amortization of stranded costs and the Commission approved shortly before passage of the Act. Duquesne R.B. at 4, fn. 3; Duquesne St. 1 at 9.

[51] Duquesne finds the OCA's interpretation contradicts its own case. To explain, the OCA calculates a fixed CTC based on a one-time forecast of market prices and operating costs. OCA St. 4 at 15; OCA Exh. LS-4. Duquesne bears the risk that market prices may turn out lower, or operating costs higher, than forecast by the OCA; however, Duquesne also has the theoretical opportunity, if the converse is true (i.e., market prices turn out higher or operating costs lower than forecast by the OCA) to earn higher returns. OCA St. 1 at 43. The OCA considers this a key aspect of its plan, providing Duquesne a purported opportunity to mitigate the severe impacts of the "sharing" disallowance. Id; OCA M.B. at 60. Under the OCA's interpretation of Section 2804(4)(v), Duquesne submits this becomes an empty promise: if it achieves "excess earnings" (through, for example, more aggressive cost reductions), the OCA or any customer group can force Duquesne to reduce its rates even further by filing a complaint "after the Company's restructuring had been completed." OCA M.B. at 16; (emphasis in original). Duquesne contends such a one-sided CTC recovery plan is punitive. Duquesne R.B. at 4-5, fn.4.

(iv) Deferring Final Valuation of Stranded Costs

The OCA also finds the Company's proposal suffers from a number of other problems. OCA M.B. at 16-18. First, while the primary reason for the Company's proposal is that there is too much uncertainty to reliably estimate stranded costs, the OCA argues it is inappropriate to assume this uncertainty will be dispelled over the next several years and an "unbiased" arbitration panel will be able to reach a better valuation of stranded costs. OCA St. 1 at 12. As Duquesne recognizes, even if the arbitration panel makes its decision on the basis of market evidence in 2003, such as forward contracts, that decision will still be based on estimates - except that they will be investor estimates, rather than market analyst estimates. N.T. at 29-30. Moreover, there is no guarantee that a futures market will develop by 2003 that will provide market data throughout the life of asset period for which market price projections must be made in this case. OCA M.B. at 16-17.

While the Company expects a market will exist for futures contracts at that time that will provide what the Company believes to be "real" market evidence, the OCA suggests such market evidence, based as it is on investors' (rather than experts') forecasts of prices, may turn out to be just as accurate or inaccurate as experts' forecasts of market prices today. N.T. 28-30. Thus, even if a developed futures market exists at that time, the prices utilized in a final valuation may be more "inaccurate" than the prices established in the expert valuations being made in this proceeding. The Company admits investors make bad decisions, i.e., they buy or sell based on mistaken forecasts of market prices or market values of assets, harming their bottom line. N.T. 86-87. Thus, the OCA emphasizes Duquesne's sale of its 50% ownership interest in Ft. Martin at four times its book value indicates either the market forecast for that

sale was seriously in error or Duquesne's market valuation in this case is seriously in error. OCA R.B. at 8.

Second, the interim establishment of the market price through an auction process may result in a depressed market price proxy, leading to overstated CTC charges at ratepayers' expense and to Duquesne's benefit. The OCA explains a "passive wholesale auction, with no price negotiation is hardly consistent with the aggressive marketing and revenue maximization" that can be expected in a genuine competitive market. OCA St. at 13. Especially if Duquesne's retail customers are unable to purchase their power supply at these auction prices, then the auction pricing procedure is of questionable merit in establishing market price. Id. The OCA finds it difficult to believe, for example, that retail customers will be able to purchase electricity at the 1.856¢/kWh that is reflected in Duquesne witness Mr. Lahtinen's Customer Generation Credit. OCA M.B. at 17; Duquesne Exh. JAL-11.

Third, the OCA contends Duquesne's proposal eliminates the possibility of any rate savings for customers during the CTC recovery period, a fact which is extremely problematic given Duquesne's very high rates and its own recognition that rates during this period will exceed its standard cost of service by a substantial amount. OCA St. 1 at 13. More specifically, Duquesne forecasts the need for $259 million of accelerated depreciation and $175 million for acceleration of the Beaver Valley 2 lease in order to reduce the return on equity to 11.5% during this period. Id. at 14. This accelerated depreciation is on top of $180 million in accelerated depreciation of the Perry nuclear plant resulting from the 1996 Ft. Martin settlement and another 1995 initiative. Id. at 14-15. The OCA claims to reduce the return on equity to 10.0% as the OCA will increase the need for accelerated depreciation by $136 million.

Id. Finally, the OCA points out the Company's financial forecast assumes three apparently uneconomic plants will continue to operate during the transition period. Id. at 15. If these plants do not continue to run, the Company will save more than $200 million in net operating expenses, after accounting for the added cost of purchasing replacement power. Id. Thus, the OCA concludes these various items suggest the capped rates exceed the "standard" cost of service (i.e., no acceleration, a 10.0% ROE and no uneconomic operating costs) by more than $1 billion during the transition period. Given that Duquesne's rates are the second highest in the state to PECO's, with an average residential rate of 12.2 cents per kWh - approximately 50% above the national average - the OCA submits the Company's proposal to not include a rate reduction is simply the wrong approach to restructuring rates under the Act. Id. The OCA submits its approach of reflecting the savings of competition to all customers is a fundamentally more sound approach. OCA M.B. at 17-18.

Fourth, the OCA contends a final valuation in 2003 will weaken Duquesne's incentives to mitigate stranded costs and maximize asset value. OCA St. 1 at 15. "Poor cost control performance during the intervening years will show up as reduced market value of its power plants in 2003. Ratepayers will incur at least some of that risk under Duquesne's plan." Id. The OCA finds the intended division between that portion of Duquesne's operations which are regulated and that which is unregulated will not occur since performance at the Company's generating units will affect the final valuation of stranded costs. This possibility concerns the OCA, since continued operation of a number of Duquesne's generating units appears to be uneconomic. Since the final stranded cost valuation will depend on whether the Company retires or continues to operate its generating units and the efforts that it makes to control costs, the

OCA submits the Commission needs to be particularly wary of a final valuation approach, since it will require the Commission to determine the prudence of the Company's management of generating facilities during this period. OCA M.B. at 18.

(v) The Company's ROE Proposed Spill-Over Mechanism

The OCA notes Duquesne's proposal is premised on its proposed "ROE spill-over mechanism" ensuring that all "excess earnings" will be utilized to mitigate stranded costs. Under this proposal, as revised in its rebuttal case, the Company will flow to ratepayers any earnings in excess of its authorized rate of return. Despite the importance of this mechanism from the Company's perspective, N.T. 212, the OCA finds the specific operation of this mechanism was not delineated anywhere in the Company's direct or rebuttal testimony. On cross-examination, Company witness Clayton envisions a once-a-year true-up of the Company's earnings based on its quarterly financial report filings pursuant to Chapter 71 of the Commission's regulations. N.T. 209-11. He further testifies that while he envisions a review and comment process, it will be appropriate to allow parties to perform discovery and cross-examine witnesses for purposes of determining the earnings subject to the ROE spill-over mechanism, and that it will be appropriate for the Company to bear the burden of proof to justify its numbers. OCA M.B. at 18-119; N.T. 365-66.

The OCA finds numerous problems with Duquesne's entire approach to valuation and recovery of stranded costs. First, Duquesne's proposal will require annual reexamination of the Company's returns on capital. N.T. 209-11. In OCA's view, this will, for all practical purposes, require a ratemaking review of the Company's earnings on an annual basis, with

provision for discovery and hearings to examine Duquesne's numbers. While one hopes this review can be limited in nature, the OCA posits the need to preserve parties' due process rights may result in substantial differences of opinion over the Company's earnings and require substantial expenditure of administrative resources. OCA M.B. at 19.

Second, the OCA suggests Duquesne's proposal contemplates review of its earnings on a total company basis, including a review of its generation earnings, which will be subject to the competitive market. N.T. 212-13. The OCA submits the Act intends to establish market-based generation rates, subject only to the limitations of the generation rate cap and provider of last resort service. The Company's ROE spill-over proposal, however, will require a continued regulatory return review. OCA M.B. at 19.

In this respect, the OCA insists Duquesne's performance in the competitive generation market will directly impact on the Company's earnings. If, for example, the Company operates generating plants which are uneconomic to operate, Duquesne's imprudence will impact on its level of earnings and its imprudence in the generation market will have to be reviewed. N.T. 213-14. The OCA finds this prospect very real in light of the uneconomic state of a number of the Company's plants, including its nuclear units. OCA M.B. at 19-20.

Third, the OCA suggests the Company can effectively evade an over-earnings finding by using such "excess earnings" to fund marketing efforts or offer rate discounts associated with unregulated market transactions. OCA St. 1 at 12. In light of these considerations, the OCA submits the Company's proposed ROE spill-over mechanism is inconsistent with the Act's objectives of reducing regulation and raises more problems than it resolves. OCA M.B. at 20.

(vi) The Company's Divestiture Proposal

In its rebuttal case, Duquesne proposes as an alternative to its final valuation proposal that, if directed to do so by the Commission, it will divest its generating assets in 2003. The OCA points out this proposal retains the shortcomings of the Company's original proposal since it rules out any rate relief for retail customers for six years or longer and delays the quantification of stranded costs. OCA M.B. at 20; OCA St. 1-S at 5.

In its rejoinder testimony, Duquesne indicates it will agree to an immediate auction of the Company's generating assets in order to determine their market value as of January 1, 1999. Duquesne St. 1R at 1-2. The OCA generally agrees immediate divestiture will provide an appropriate valuation method. However, Duquesne's proposal is limited to its stand-alone restructuring plan and it will not pursue this course of action if the merger with Allegheny Power Systems ("APS") is completed. N.T. 24. Thus, the OCA submits this course of action can only be considered in the context of the non-consummation of the merger transaction. OCA M.B. at 20.

The OCA insists the effects of merger consummation on Duquesne's restructuring plan and its stranded costs need to be considered in the context of this case. OCA M.B. at 47-48; OCA St. 1 at 38-40; N.T. 43-45, 47. The option to value Duquesne's stranded costs through a sale of its generating assets is only a real option if the Commission determines to reject the merger with APS. Consequently, the OCA suggests the Commission must carefully review the evidence of other valuation approaches as a means to determine stranded costs if the merger is not consummated. OCA R.B. at 6-7

(b) **OCA's Approach**

The OCA proposes a current valuation of stranded costs and recovery of these costs over the seven-year CTC recovery period, except the Company should not be permitted to recover a return on the unamortized balance of its owned-generation assets as discussed, infra. With that adjustment, the OCA claims its proposal will reduce rates to a just and reasonable level. OCA St. 1 at 14-16. As discussed above, the OCA contends Duquesne's capped rates exceed its "standard" cost of service by more than $1 billion during the CTC recovery period, even before consideration of merger savings. OCA M.B. at 21-22; OCA St. 1 at 15.

6. The City's Position

(a) **Duquesne's Approach**

The City maintains the Company manipulates its stranded cost claim in an attempt to thwart the goals of the Competition Act. Rather than promoting competition and making its service area more attractive for business development, it asserts Duquesne's stranded cost claim virtually assures there will not be any competition with Duquesne in the generation marketplace for many years to come and Duquesne's ratepayers will continue to pay some of the highest rates in the United States for at least the next eight years. City M.B. at 1-2.

The City identifies a number of serious flaws in Duquesne's proposed stranded cost claim. It asserts Duquesne's stranded cost valuation approach is rife with errors that seriously inflate Duquesne's claim and provide an incentive to maximize, rather than minimize, stranded costs. Contrary to the purpose of the Act, the City contends Duquesne's stranded cost calculation methodology impairs formation of a competitive market and minimizes traditional

risk faced by utility investors. The City finds the admitted lack of any meaningful mitigation efforts by Duquesne significant in light of the level of Duquesne's stranded cost claim and its lack of competitive rates for its customers. Because Duquesne fails to carry its burden of proof as to the fair and reasonable amount of its stranded costs, the City argues Duquesne's stranded cost claim must be denied in its entirety, unless Duquesne commits to divest itself of its generating assets. Divestiture will not only result in an immediate transition to a competitive market, but is a more credible method of valuing assets than merely ascertaining stranded costs. Id. at 2.

The City characterizes the divestiture proposal in its rebuttal case as a ploy by Duquesne and APS to garner support for the proposed merger. The City finds the proposed divestiture set to occur in 2003 much too late to promote industry and jobs in Pittsburgh, and to correct the economic damage done to the region by Duquesne's historic unjustifiably high rates and consequent obstacle to competition. The City insists no reason exists to wait until 2003. A vibrant market now awaits generation assets. The City terms Duquesne's offer to refund overrecovery of stranded costs after 2003 inadequate. The rebuttal proposal to conduct a shutdown study constitutes an admission by Duquesne that it has not taken its duty to mitigate stranded costs seriously. Id. at 6.

(b) <u>The City's Approach</u>

The City believes the approach that will produce the greatest benefits is for the Commission to require - regardless of whether a merger is approved - Duquesne to divest itself of a substantial portion of its generating assets, as soon as possible, in order for Duquesne to

have the opportunity to recover stranded costs, if any. This approach, the City believes, will reflect the most accurate and highest market value, and will mitigate against the continued operation of uneconomic units, thus lowering stranded costs significantly. Divestiture will also have the benefit of creating generation competition in Pittsburgh. The market is fully capable of valuing assets now as is evidenced by the numerous asset sales that have occurred and are expected in the near future. Id. at 6-7.

If Duquesne will not agree to divestiture, the City argues the Commission should not permit Duquesne to recover any stranded costs since it has not met its heavy burden of proof in this case and there is a real possibility that Duquesne, even under its own projections, will enjoy a stranded benefit of hundreds of millions of dollars. Id. at 7.

The City urges the Commission to reject Duquesne's plan and adopt a plan where stranded costs are determined by actual market information, obtained preferably by an early divestiture of Duquesne's generation assets, if the Company is allowed to recover any stranded costs. Duquesne should be required to mitigate its stranded costs by shutting down uneconomic units immediately or not be permitted to pass costs related to those units through to ratepayers. The plan ultimately adopted should promote the creation of a competitive market at the soonest point in time. Id.

7. DII's Position

(a) Duquesne's Approach

DII argues the Duquesne proposals that delay asset valuation past the start of direct access phase-in must be rejected. Acceptance of either of the Company's delayed

approaches prevents the Commission from quantifying Duquesne's net transition and stranded costs in this proceeding, which is inconsistent with the provisions of the Act, precedent established in PECO Energy, and the public interest. DII M.B. at 23-24.

If the Commission in this proceeding requests an immediate auction of all of Duquesne's generating assets (as Duquesne has offered), DII agrees this approach will satisfy the need for a definitive level of stranded costs as of the beginning of the transition period. However, DII cautions many additional issues must be addressed associated with the immediate auction that may undercut the viability of this option. DII discusses those issues further, infra. Subject to resolution of those issues, DII supports valuation of Duquesne's assets based on an immediate auction of all of those generating assets. Id. at 24.

One of these issues concerns the Company's claim for future fossil units decommissioning expense, which Duquesne claims as a component of its stranded costs. Duquesne St. 4 at 18-19. For the reasons discussed, infra, DII advocates rejection of this claim. DII M.B. at 22-23.

Duquesne also requests recovery of $374.45 million (after tax) in stranded regulatory assets. Duquesne St. 2R; Duquesne Exh. DJC-10. DII asserts many of these claims are inappropriate under the Act and must be rejected. DII St. 3 at 6-30; DII St. 3S at 6-23. DII discusses specific regulatory asset adjustments, infra. DII M.B. at 24-25.

Concerning the establishment of an interim CTC prior to commencement of the auction, DII recognizes that it may not be possible for the auction of Duquesne's assets to occur prior to January 1, 1999. In such event, DII agrees continuation of the rates and credits in the pilot program may be acceptable. However, if the Commission accepts Duquesne's offer to

conduct an immediate and full auction of its assets, this auction should occur as soon as possible and not be unreasonably delayed.[52] DII R.B. at 10-11.

DII notes the Company discusses the calculation of a permanent CTC using the market value produced by the auction. The Company states it is willing to adopt the approach used in PECO, which provided an allocated levelized CTC, provided two conditions are met. Duquesne M.B. at 21. DII finds both of the Company's "conditions" are clearly contrary to the requirements of the Act. DII R.B. at 11.

The first condition the Company places on its offer is that Duquesne must be permitted to recover fully its stranded costs with no sharing of those costs between shareholders and ratepayers. Duquesne M.B. at 21. DII explains the Commission has a duty to use its regulatory discretion to determine whether sharing is appropriate in this proceeding. DII M.B. at 18-22, 27-28 & 69-70. The Commission cannot shirk this responsibility based on the proposed interim compromise by Duquesne. DII R.B. at 11.

The second condition the Company places on its offer to accept the PECO methodology is that the Commission must address Duquesne's concerns regarding its obligation to serve at capped rates during the transition period. Duquesne M.B. at 21. In rejoinder testimony, the Company states that such a solution:

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[52] DII emphasizes an interim CTC is appropriate only if the Commission orders the immediate and full auction as offered by Duquesne in its rejoinder testimony. The DII comments in this section do not apply if the Commission employs any other valuation methodology (such as delaying divestiture until 2003 or requesting Duquesne to divest only a portion of its assets). In such event, DII will object to the use of the methodology. DII M.B. at 30-33 & 39-45; DII R.B. at 11, fn. 4.

> . . . [C]ould involve an agreement to remove the cap or an arrangement with the purchaser of the assets to sell Duquesne power at a fixed price (a "call option").

Duquesne St. 1R at 16. The Company confirms during cross-examination that it desires to restrict ratepayers' statutory right to return to service from the utility at capped rates during the transition period while the Company is recovering stranded costs from that ratepayer. N.T. at 55. DII contends this condition is clearly unlawful. Ratepayers have a statutory right to return to service at capped levels during the transition period. 66 Pa. C.S. §2804(4). DII explains this right is a quid pro quo for the recovery of stranded costs by the utility and cannot be waived. DII M.B. at 43-44; DII R.B. at 11-12.

Duquesne's choice to auction generating assets is its own; the Act states the Commission cannot require Duquesne to divest assets. 66 Pa. C.S. §2804(5). Only the Company's offer presents the Commission with the option to request divestiture. DII argues the Commission cannot eviscerate one of the central consumer protections contained in the Act based on the Company's offer to voluntarily divest itself of its generating units. Any Duquesne "compromise" that involves a waiver of the rate cap must be rejected. DII R.B. at 12.

(b) <u>DII's Approach</u>

DII proposes to establish the market value of Duquesne's generating assets based on a market price forecast and an asset value methodology of computing stranded costs. DII St. 1 at 29; DII St. 2 at 9-48. The DII methodology predicts the revenues a generating unit will be able to earn in the competitive environment. DII suggests this methodology is a reasonable

compromise of the competing interests and the only method the Act contemplates. DII M.B. at 25.

DII notes the Commission used a determination of stranded generation costs based on application of a market price forecast to the asset value methodology to find the known and measurable level of PECO's total stranded generation costs. PECO Energy, Slip Op. at 80-91. DII contends this precedent, as well as other portions of the Act, requires a similar calculation based on an asset value methodology to establish Duquesne's stranded cost entitlement. DII M.B. at 25.

DII calculates a definitive level of stranded generation costs in this proceeding based on market price projections. DII St. 1 at 29. DII quantifies Duquesne's jurisdictional stranded generation costs at $994.969 million. DII St. 1 at 9; DII Exh. SJB-2. In addition, DII recommends the use of an equity return disallowance to arrive at a level of just and reasonable stranded generation costs to be recovered from ratepayers. DII St. 1 at 15-21. These calculations result in a disallowance of $232.289 million of Duquesne's stranded costs. DII St. 1 at 9; DII Exh. SJB-2. DII finds the total stranded generation costs to be recovered from ratepayers under its proposal to be $712.68 million. DII M.B. at 25.

In addition, DII recommends Duquesne be permitted to recover $574.698 million (jurisdictional pretax) in stranded regulatory assets. DII St. 1 at 9; DII Exh. SJB-2. This recommendation is based on DII's understanding of the standards in the Act for properly claimed, quantified and recoverable regulatory assets. DII also recommends recovery of $9.791 in transition costs. Id. Finally, DII calculates the properly recoverable nuclear decommissioning expenses (net of trust fund earnings) of $42.920 million (jurisdictional). Id.

In total, DII recommends that Duquesne be permitted to recover $1.39 billion in stranded costs from ratepayers. DII M.B. at 25-26, and DII Appendices A, B & C attached thereto, as revised in DII R.B. at 12-13, and DII Appendices A, B & C attached thereto.

8. HSS/ARI's Position

(a) Duquesne's Approach

HSS/ARI contend Duquesne has not proven, even on a preliminary basis, that it has any stranded costs. Therefore, HSS/ARI assert Duquesne has failed to carry its evidentiary burden to support its request to accelerate amortization and depreciation. HSS/ARI M.B. at 17.

HSS/ARI note Duquesne derives its estimated range of claimed post-2005 remaining stranded costs by relying upon computer-generated market price projections, notwithstanding its own compelling criticisms of those projections. Duquesne's witness Schnitzer calculates future retail market prices in some cases out to the year 2026. To derive those price projections, HSS/ARI suggest Schnitzer inputs unreasonable assumptions into his computer and makes unreasonably modest adjustments to Duquesne's summer 1997 wholesale RFP results, the net effect of which is to produce unreasonably low projections of future retail market prices. Based upon those price projections, Duquesne calculates revenues it claims it will gain (i) through 2005 and (ii) through the retirement dates of its various plants (Schnitzer's projected market prices times projected plant output). Duquesne Exh. DJC-3. Duquesne then calculates its costs of operation assuming acceleration of $1.7 billion in amortization and depreciation. Based upon those cumulative data, Duquesne claims as of 2006 its plants will have a net book value of $535 million, but market value only in a range of a negative $47 million to

a positive $527 million, depending upon whether Schnitzer's low or high price projections are used to determine the future operating margins for Duquesne's plants. Duquesne's comparison of those projected market values to net book investment as of December 31, 2005 serves as the basis for Duquesne's initial claim that, notwithstanding its acceleration of amortization and depreciation, Duquesne likely will have remaining stranded costs ranging from $8 million to $582 million as of January 1, 2006. Duquesne St. 2 at 29:20-22; Duquesne Exh. DJC-3 at 1. Thus, HSS/ARI posit the claimed market values derived principally from Schnitzer's price predictions serve as the basis for Duquesne's initial requests: (i) that it be provided authorization to accelerate depreciation and amortization by $1.7 billion allegedly to mitigate stranded costs that Duquesne claims otherwise will remain in 2006; and (ii) that it be granted authorization to continue to charge its current rates. HSS/ARI M.B. at 18-19.

However, HSS/ARI find Duquesne miscalculates the cost side of its equation. Duquesne admits it overstates its projected costs and as a result, as of January 1, 2006, Duquesne may not have any stranded costs at all. HSS/ARI Exh. RBW-1. Duquesne's corrected calculations show its generation assets may have positive market value of as much as $233 million, assuming Duquesne's high case price projection. Attachment A to HSS/ARI Exh. RBW-1; Duquesne St. 2R at 9:8-10. Thus, HSS/ARI points out Duquesne will have flunked its own test for qualifying for its rate proposals based upon its own revised data, i.e., Duquesne cannot demonstrate it is likely that stranded costs still will remain in 2006 even after the excess earnings mitigation. HSS/ARI M.B. at 19-20; HSS/ARI St. 1 at 6:8-15.

As a consequence, Duquesne modifies its claim in its rebuttal testimony. There, Duquesne claims for the first time that it will have quantifiable stranded costs as of January 1,

1999 in the amount of $1.916 billion. Duquesne St. 2R at 12:18-21; Duquesne St. 3R at 2:12-14. The $1.916 billion claim was derived using a similar formulation to that described above. Again, HSS/ARI contend Duquesne uses unreasonably modest adjustments to wholesale RFP results and computer-generated price projections to calculate plant revenues. Duquesne then uses those unreasonably low price forecasts to calculate projected plant margins, i.e., the difference between projected plant revenues (Schnitzer's projected market prices times projected plant output) and Duquesne's unreasonably high projection of the costs of operating its plants. The Company then nets those plant margins against the net book value of its generation plants, costs Duquesne claims it will experience independent of operation of the plants and decommissioning costs to determine stranded costs of $1.9 billion that Duquesne now claims it will have as of January 1, 1999. HSS/ARI M.B. at 20; Duquesne St. 2R at 12; Exh. DJC-20 at 1.

To understand the significance of these price projections to the Company's claim, HSS/ARI emphasize it is important to understand that Duquesne's $1.916 billion stranded cost claim is based upon the Company's low case price projections. If one adjusts for Duquesne's high case projection (another unreasonably low price forecast), HSS/ARI assert the Company's stranded costs will be $1.537 billion, or $379 million lower than Duquesne's claim. That $379 million reduction does not take into account a host of other adjustments that HSS/ARI submit should be made that will raise the high case price projections or reduce Duquesne's cost projections and claimed regulatory assets. Thus, a $379 million swing is produced by a mere penny per kWh swing in price projections used to determine revenues commencing in 2006. Duquesne St. 2R at 12; Duquesne Exh. DJC-20 at 1. HSS/ARI denote the significance of mere pennies in price projections is the difference between a stranded cost claim of almost $2 billion

and a finding that Duquesne has no stranded costs at all. Thus, the accuracy of Duquesne's price projections is critical in determining whether it has the right to have the Commission approve any of its proposals. More specifically, the accuracy of the Company's price projections is critical in determining whether Duquesne has the right to charge a CTC while deferring an actual stranded cost calculation until some future time date. HSS/ARI M. B. at 20-21.

(b) HSS/ARI's Approach

HSS/ARI examine Duquesne's stranded cost claims in three different ways. As a first step, HSS/ARI examines the evidence Duquesne relies upon as the basis for its stranded cost claim, both in terms of price and cost projections. The purpose of that examination is to determine whether the Company's evidence establishes that Duquesne has stranded costs. The need for that first step evaluation flows directly from the assignment to Duquesne of the evidentiary burden in this case. HSS/ARI M.B. at 21.

Secondly, HSS/ARI examines documents Duquesne produces itself in discovery and circumstances other than those relied upon by Duquesne. The purpose of examining such documents and circumstances is to determine whether there is evidence of the market value of Duquesne's generation assets other than the evidence relied upon by Duquesne. Id.

Third, HSS/ARI examines facts and circumstances concerning Duquesne's mitigation efforts, or lack thereof. Id. at 21.

As a result of its examination, HSS/ARI conclude Duquesne fails to meet its burden and should be denied any stranded cost recovery. Duquesne fails to meet that burden

for two principal reasons. First, its stranded cost claim, in all its variations, depends upon the Company's computer-generated price projections. As HSS/ARI discuss, infra, the evidence shows those price projections are derived in a manner to assure an unreasonably low result, the net effect of which is to maximize and overstate Duquesne's potential stranded costs. Thus, HSS/ARI find the Company's computer-generated price projections inconsistent with the known and measurable standard. N.T. 83-84. The second principal reason Duquesne fails to meet its burden is that it inflates its cost projections. Thus, by understating projected market prices and overstating projected operating costs, HSS/ARI contend Duquesne inappropriately maximizes and grossly overstates its stranded cost claim. N.T. 265-266. HSS/ARI discusses the evidence that purports to demonstrate the flaws in Duquesne's price and cost projections, infra. HSS/ARI M.B. at 22.

HSS/ARI conclude substantial evidence exists relevant to an assessment of the market value of Duquesne's generation assets that the Company did not put in the record in this case. HSS/ARI argue, infra, that actual valuations of Duquesne's assets performed by the Company and its consultants mere months before the filing of this application show Duquesne's assets have positive market value. Those studies, as well as evidence of market value demonstrated by actual market transactions, including, but not limited to, Duquesne's sale of its interest in the Ft. Martin plant, show that Duquesne has no stranded costs at all. Id.

Finally, HSS/ARI discuss evidence, infra, purporting to demonstrate that, notwithstanding Duquesne's claims that it intends to fully mitigate its claimed stranded costs, Duquesne has failed to undertake actions that could have or would have mitigated any stranded costs Duquesne claims to have. Id. at 23.

Since Duquesne fails to establish it has known and measurable stranded costs, HSS/ARI argue substantial evidence shows Duquesne's generation assets have positive market value and Duquesne has failed to properly mitigate any stranded costs it claims to have. Accordingly, HSS/ARI request that the Commission: (i) deny Duquesne's request to accelerate depreciation and amortization; (ii) deny Duquesne recovery of any amount claimed to be a stranded cost; (iii) deny Duquesne the right to charge its customers a CTC; and (iv) deny Duquesne's request to have its potential stranded costs reexamined through a final valuation conducted at some future date. Id. at 23.

HSS/ARI deny Duquesne's assertion that HSS/ARI seek an Order in this case from the Commission requiring the Company to sell its generating assets. Rather, HSS/ARI offer an option for purposes of determining stranded costs that Duquesne claims to have accepted, i.e., an immediate sale of its generation assets. However, HSS/ARI suggest this option is illusory, absent circumstances that Duquesne is quite sure will not occur. HSS/ARI R.B. at 17-18.

In the event the proposed merger of APS and Duquesne is not consummated and Duquesne offers to auction its facilities immediately, HSS/ARI find it necessary to address an argument of the IBEW. The IBEW claims it is not in the public interest for Duquesne to sell or close any of its power plants because of the potential affects on Duquesne's current plant employees and their communities. IBEW M.B. 6-7. However, HSS/ARI show the IBEW's fears are not likely to be realized if Duquesne sells its generating assets. HSS/ARI St. 1 at 57-60. HSS/ARI assert purchasers of Duquesne's plants likely will retain plant employees because of their expertise Id. at 57. HSS/ARI produce evidence to show that actual sales of generation

assets in California and Massachusetts provided continued employment for workers and/or for early retirement, special severance and retraining programs. Id. at 60:4-20; HSS/ARI Exh. RBW-61. Thus, HSS/ARI submit the IBEW's concerns with respect to the displacement of Duquesne's employees are largely unwarranted as the experience of a plant's current employees makes them invaluable assets to the plant's new owners. HSS/ARI R.B. at 18-19.

9. IBEW's Position

The IBEW does not specifically address the valuation method used by Duquesne, except to note that it is unlawful to the extent it gives the Commission the authority to order Duquesne to close or sell a power plant. IBEW M.B. at 7. Likewise, the IBEW does not specifically address the valuation method used by various other parties, except to note they also are unlawful to the extent they give the Commission the authority to order Duquesne to close or sell a power plant. Id.

The IBEW finds the lack of information concerning the proposed sale of Duquesne's power plants striking. Neither Duquesne nor any other party attempts to evaluate the effect of plant sales or closures on the reliability of Duquesne's transmission system, though initial indications of serious reliability problems will occur caused by closing or selling Duquesne's plants. Neither Duquesne nor any other party attempts to evaluate the effect of plant sales or closures on Duquesne's employees. Neither Duquesne nor any other party attempts to evaluate the effect of plant sales or closures on the communities where those plants, and employees, are located. Moreover, none of the parties making these proposals, including

Duquesne in the later stages of this case, recognize the proposed, Commission-ordered sale of these plants contravenes the Code. Id. at 1.

IBEW posits the Commission does not have the legal authority to order the sale or closure of a power plant. Moreover, even if it did, the evidence of record in this case does not establish the need to do so. In fact, the evidence shows Duquesne needs these plants in order to provide safe, adequate, and reliable service to its customers. Therefore, the Commission cannot order Duquesne to sell or close any of its power plants. Id. at 1-2.

IBEW argues Section 2804(5) of the Act, 66 Pa. C.S. §2804(5), specifically prohibits the Commission from ordering a utility to sell any of its facilities, stating: "The [C]ommission may permit, but shall not require, an electric utility to divest itself of facilities or to reorganize its corporate structure." Moreover, even without the express prohibition in Section 2804(5), the Commission does not have the right to order a utility to sell or close a power plant (or any other facility). One of the fundamental principles of utility regulation in this Commonwealth is that the Commission does not sit as a "super board of directors" over a utility and neither owns nor controls a utility's property. As our Supreme Court has stated:

> The Public Utility Commission is not a super board of directors for the public utility companies of the State and it has no right of management of them. Its sole power is to see that in the matter of rates, service and facilities, their treatment of the public is fair. Speaking through the present Chief Justice, we said: "It is not intended by the legislature that the commission should be a board of managers to conduct and control the affairs of public service companies, but it was meant that where certain of their powers and obligations had intimate relation to the public through fairness, accommodation or convenience, the commission should have an inquisitorial and corrective authority to regulate and control the utility in the field specifically brought within the commission's jurisdiction. . . . the company manages its own affairs to the fullest extent consistent with the protection of the public's interest,

> and only as to such matters is the commission authorized to intervene, and then only for the special purposes mentioned in the act": Coplay Cement Mfg. Co. v. Pub. Ser. Com., 271 Pa. 58, 61, 114 A. 649. "It must never be forgotten that while the State may regulate with a view to enforcing reasonable rates and charges, it is not the owner of the property of public utility companies and is not clothed with the general power of management incident to ownership": Southwestern Bell Tel. Co. v. Pub. Ser. Com., 262 U.S. 276, 289.

Northern Pennsylvania Power Co. v. Pa. P.U.C., 333 Pa. 265, 267-68, 5 A.2d 133, 134-35 (1939). IBEW M.B. at 4-5.

IBEW continues the Commission only has such authority as has been delegated to it by the General Assembly. Pa. P.U.C. v. Philadelphia Electric Co., 501 Pa. 153, 460 A.2d 734 (1983); Western Pa. Water Co. v. Pa. P.U.C.. 31 A.2d 370 (Pa. Commonwealth Ct. 1973). The Commission has certain authority regarding the construction, closure, and sale of power plants, but it does not go so far as to allow the Commission to make the decision for the utility. Specifically, the Commission: (i) has the power to order the cancellation or modification of construction of a power plant, 66 Pa. C.S. §520; (ii) must approve the retirement of a power plant, 66 Pa. C.S. §521; (iii) may prohibit a utility from closing a power plant if the Commission finds that the plant, or its output, can be sold to another utility, 66 Pa. C.S. §525; and (iv) must approve the sale of facilities that are in rate base, 66 Pa. C.S. §1102(a)(3). But, the IBEW emphasizes absolutely no statutory or other legal authority exists for the Commission to order a utility to shut down or sell a power plant. Thus, while Duquesne may be willing to give the Commission the authority to order Duquesne to sell its power plants, IBEW argues the Commission is prohibited from exercising that authority. IBEW M.B. at 5.

IBEW posits the provision in Section 2804(5) prohibiting the Commission from ordering the sale of a power plant does not just protect the utility that owns the plant. As the Act recognizes, other interests are involved as well, including the interests of the utility's employees and the communities where the plants are located. Id. at 5-6; 66 Pa. C.S. §2802(18).

Moreover, even if it is lawful for the Commission to order the sale or closure of a power plant, IBEW claims the evidence in this case demonstrates it will not be in the public interest to do so. Neither Duquesne nor any other party proposing the sale or closure of these plants has fully evaluated the transmission constraints that will result. N.T. 950-52. Duquesne's initial review of transmission issues for the Elrama plant shows serious transmission constraints will be created by the unrestricted sale or closure of that plant. N.T. 945. At this time, neither Duquesne nor any other party has a plan for alleviating these serious reliability concerns. N.T. 952. Further, neither Duquesne nor any other party has studied the reliability impacts of closing the Cheswick station or any other Duquesne facility. IBEW M.B. at 6; N.T. 952.

Furthermore, neither Duquesne nor any other party has evaluated the impact of the sale or closure of any facility on Duquesne's employees or on the communities where those plants and employees are located. Indeed, IBEW denotes, Duquesne has not evaluated the impact of plant closures or sales on local communities, N.T. 175-78, 569, or on the employees who work at those facilities. IBEW M.B. at 6; N.T. 175-78, 570-73, 578-79.

Yet, in order for the Commission to evaluate a restructuring plan, IBEW contends one must consider the impact of the plan on the utility's employees and on the communities that may be affected. 66 Pa. C.S. §2802(18). As the Act requires, 66 Pa. C.S. §2806(e), and the Commission's filing guidelines also mandate, Duquesne's original filing contained an evaluation

of its original restructuring plan on its employees and on the local communities. Duquesne Exh. 1, Sch. N-1 to N-4. However, IBEW notes that evaluation does not consider the possibility that any plants will be sold, nor does it consider the possibility that any plants will be closed before 2005. Duquesne Exh. 1, Sch. L-5; N.T. 345-46. Simply, IBEW contends the original evaluation remains valid for a restructuring plan that does not involve the sale or closure of a power plant. But it has no relevance to a revised restructuring plan that involves the sale or premature closure of a power plant. IBEW suggests no other evidence in this case enables the Commission to consider the impact of such a sale or closure on Duquesne's employees or on communities that may be affected. IBEW M.B. at 6-7.

IBEW summarizes this issue as follows:

> [T]he power plants make a major contribution to the local economy, in terms of jobs, wages, and taxes. . . . [I]t's clear to me that they failed to consider the substantial benefits to other area businesses, and the greater Pittsburgh area as a whole, from having these power plants in operation and owned by a local company. They also failed to consider the substantial costs associated with closing or selling those plants.

Id. at 7; IBEW St. 1 at 11..

IBEW summarizes it is not in the public interest for Duquesne to sell or close any of its power plants. Even if it were a good idea to have Duquesne sell or close its power plants – which it is not – the Commission lacks the authority to order Duquesne to do so. Therefore, any stranded cost proposals based on the Commission ordering the sale or closure of a power plant must be rejected. IBEW M.B. at 7.

IBEW notes the City's assertion that the sale of Duquesne's power plants will not lead to a loss of jobs. City M.B. at 14. IBEW finds the evidence on which the City relies does

not support this statement and, in fact, shows precisely the opposite is true. In making this assertion, the City relies on surrebuttal testimony of HSS/ARI, which in turn relies on two events: the sale of one gas-fired plant by an independent power producer in California, with 18 employees; and the proposed sale of power plants by New England Electric System ("NEES"). IBEW R.B. at 2; HSS/ARI St. 1S at 60; HSS/ARI Exh. RBW-61.

IBEW submits nothing in the record shows the sale of one gas-fired power plant in California, with a total of 18 employees, has any relevance whatsoever to Duquesne. Further, the second sale relied upon by the City, the sale by NEES, does not support the City's assertion that such a sale will have no impact on the utility's employees. In fact, the information HSS/ARI supplies in HSS/ARI Exhibit RBW-61 shows the purchaser agreed to pay $85 million "to fund previously announced retraining, early retirement, and special severance programs for its [NEES's] employees who will be affected by electric industry restructuring." IBEW submits if it costs $85 million to compensate the utility's employees, then the sale of NEES's power plants must have had a severe impact on that utility's employees. IBEW R.B. at 2-3.

In addition, IBEW notes HSS/ARI also advocate that Duquesne reduce the staffing levels at its power plants by between 33% and 35%. HSS/ARI St. 1S at 59-60. Without debating the merits of these extreme reductions in staff levels, IBEW finds HSS/ARI's statement clearly shows substantial savings can be realized by cutting employment levels at Duquesne's power plants. Therefore, for the City to use HSS/ARI's testimony to support the notion that selling the Company's power plants will not have a serious impact on Duquesne's employees, IBEW contends the City's position lacks credibility. IBEW R.B. at 3.

10. The PRA's Position

(a) Duquesne's Approach

The PRA urges the Commission to reject any deferral of a determination of the Company's stranded costs. It finds several problems with deferral from both a practical standpoint, as well as a legal one. PRA M.B. at 31-37.

While it may be true that performing market valuations on long lived plants is a difficult undertaking, the PRA submits the same will hold true in the year 2003. OCA St. 2 at 12. The requirement of performing a market valuation and convening a panel of experts will not dispel the uncertainty or controversy, but only delay the undertaking of what will certainly be an uncertain and controversial project. PRA M.B. at 31.

In addition, the PRA argues deferral of the determination of the level of stranded costs recoverable from ratepayers is contrary to the dictates of the Act. The Act requires a rapid deployment of a competitive retail generation market in Pennsylvania. An important component of the development of that market is the recovery of stranded investment by electric utilities. This result is important to both the electric utility, as well as customers, since it ensures: (i) utilities have a fair opportunity to permit their investors to recover their investment in a Pennsylvania plant; and (ii) ratepayers have a complete understanding of the cost of entering the competitive generation market, i.e., the cost of paying for stranded investment in their electric utility. Id. at 32.

While uncertainty may exist with respect to future market prices, the PRA contends that fact is simply a function of the market itself. In order to implement effective retail generation competition in the Commonwealth, it is necessary to develop a fixed level of stranded

cost recovery despite that uncertainty. As DII explains, the type of analysis that must be performed in this proceeding is no different from the analyses Duquesne has traditionally engaged in with respect to generation planning and economic decision making regarding the type of generating unit to add to its system. It has been a fact of life in the electric industry that long-term forecasts are required to make decisions. DII St. 1 at 26. Thus, Duquesne and the Commission must perform a similar function to what has been conducted in the past. It is both contrary to past practices, as well as to the Act, to defer a finding of stranded costs until a future time. PRA M.B. at 32.

The PRA suggests other practical considerations exist to Duquesne's proposal. For example, the OCA indicates there are some questions as to whether the auction method of establishing an annual market price is appropriate. This witness testified:

> My concern is that this will establish a depressed market price proxy, leading to overstated CTC charges at ratepayers' expense and to the benefit of Duquesne. As Duquesne participates in the emerging competitive market, it will be seeking to market its power supply customer groups at the highest possible prices in order to maximize its revenue string. A passive wholesale auction, with no price negotiation, is hardly consistent with the aggressive marketing and revenue maximization we would expect of Duquesne.

OCA St. 2 at 12. Nor is there any assurance such auction prices developed through this annual price benchmark analysis will be available to Duquesne's existing retail customers. As the OCA indicates, there is no guarantee or reason to believe Duquesne's customers will be able to purchase their power supply at these auction prices. PRA M.B. at 32-33.

The PRA contends the auction Duquesne conducted, which forms the basis for a portion of its proposal, is deficient in several respects. In particular, the RFP was designed

to reflect the incremental cost of electricity solely in the Duquesne area. HSS St. 1 at 26. It was not designed to reflect a market price in the entire ECAR region, the likely supply area in a competitive retail generation market. Id. As a consequence of the narrow design of the RFP, it does not reflect the prices outside of Duquesne's service territory nor does it adequately represent the impact of the dynamics of future supply and demand in the region. Id. The terms and conditions of the RFP were prescriptive, which diminished the value to potential buyers. Id. Power was offered for a specific, established time period (one or eight years starting in 1998) with no flexibility for a different start date for power flows or different term lengths. Id. at 30. Thus, the PRA asserts potential buyers were limited to those bidders seeking baseload power. Further, potential buyers were not provided assurances of firm transmission rights over the Duquesne system. Id. at 26. The tested market was for wholesale power and not retail power. Id. at 27. The solicitation was for energy only and did not reflect ancillary services nor transmission services to the customer's location. Id. at 26. Finally, the proposed contract had a take-or-pay provision at relatively high capacity factors. Id. This would have resulted in a high delivered price, when combined with the lack of firm transmission rights. Id. The PRA submits all of these interrelated factors tended to reduce bid prices and understate the cost of power in a future market. Consequently, the Duquesne RFP cannot be utilized in this proceeding as evidence of a future market price since it is a poor predictor of future power prices. PRA M.B. at 33-34.

In addition, the PRA claims Duquesne's proposal to defer calculation of a definitive stranded cost level is primarily one which shifts risk associated with stranded costs from customers to stockholders, as DII indicates:

> Failing to fix the stranded cost level at the beginning of the recovery period leads to substantial uncertainty on the part of [Duquesne's] customers, who will be facing unknown CTC charges in future transition period years, as well as an uncertain length of time in which such charges will actually be collected. This will result, in my opinion, an inappropriate regulatory framework for transitioning to retail competition. The [Duquesne] proposed framework is designed to provide [Duquesne] with a risk-free future with respect to stranded cost recovery while exposing its customers to the maximum risks associated with uncertainty regarding future market prices. This is clearly inappropriate and unfair to customers.

DII St. 1 at 24. It is also clear the Legislature never intended customers to face exposure to uncertainty regarding the CTC. Rather, the Legislature required the CTC to be established during the restructuring period and not at a future date. Customers are entitled to some certainty as to the cost they will pay through the CTC in order to evaluate properly their necessity of accessing a competitive retail generation market. PRA M.B. at 34-35.

The PRA contends Duquesne's proposal also represents a continuation of the current regulatory environment through the year 2003. During that time period, Duquesne collects revenues in the same manner in which it currently collects such revenues from its existing customers. However, if a Duquesne customer desires to purchase from an alternative supplier, there is no certainty as to the level of the CTC charges the customer will face in any given year. DII expounds on this problem:

> The yearly CTC charge would be determined through an automatic process based on Duquesne's yearly RFP process. This is an unacceptable approach for rate making and would severely diminish the process of retail competition for Duquesne's customers. The [Duquesne] methodology would inhibit a customer's ability to enter into a supply contract for a duration of more than one year because that customer cannot know what its CTC responsibility will be for these future years (and the corresponding target market price necessary to realize savings).

DII. St. 1 at 25.

The PRA claims hindering the development of a robust competitive market is contrary to the express desire of the Commission in PECO Energy. Therein, the Commission rejected the Joint Petition for Settlement because it would hinder the development of a competitive market. In a similar fashion, the PRA submits Duquesne's establishment of a CTC and a CGC on an annual basis will not allow for establishment of a robust competitive market. For the reasons DII advocates, customers will not be able to purchase on a long-term basis since the CTC will be unknown for any period longer than one year. This fact creates an artificial infringement on the development of the retail generation market in Pennsylvania and the Commission should reject it. PRA M.B. at 36.

The PRA finds Duquesne's proposal to defer action to calculate stranded cost is contrary to the law since it proposes to have a three-person panel determine such final valuation. This proposal clearly violates the requirement that the Commission, through open evidentiary hearings, establish a stranded investment level for each electric utility in the Commonwealth. It is not clear that the Commission may defer its statutory obligation to a three-person panel created by administrative fiat. As such, this provision also supports rejection of Duquesne's proposal. Id. at 36-37.

The PRA notes the Company's claim that the Commission must deal with Duquesne's obligation to serve at capped rates. Duquesne M.B. at 21. Apparently, Duquesne argues it will be economically disadvantaged if market rates exceed capped rates because it will be required to go to the open market to purchase capacity and energy. The PRA finds Duquesne's analysis misguided. If market rates are higher than those produced by the auction, the PRA asserts it simply means the resulting CTC was incorrectly established, i.e., it was set

too high by the Commission. This result will mean Duquesne will be overrecoverying its stranded cost level because it underestimated the market price. Thus, the PRA argues the amount by which market rates exceed capped rates is the same amount by which Duquesne will be overcollecting stranded costs through an inflated CTC. PRA R.B. at 8-9.

(b) <u>The PRA's Approach</u>

The PRA notes the intervenors, on a mostly consistent basis, contend the Commission must establish the level of recoverable stranded investments in this proceeding as of January 1, 1999, rather than delay it. The OCA states stranded costs:

> . . . refers to those costs which would be recoverable from utility customers under traditional regulation but which the utility will not be able to recover under a competitive industry structure. What gives rise to stranded costs is the expectation that once competition in generation is introduced, competitive forces and efficiencies will lead to market prices which will be lower than the utility's per unit full imbedded cost (computed using traditional regulatory principles). Of course it is also possible that market prices could exceed regulated rates in which case stranded costs would be negative.
>
> There are three concepts regarding stranded costs which must be kept in mind at the present time. First, stranded cost relates only to the power supply (i.e., generation plus purchase power) portion of an electric utility's business since the other functional areas will remain regulated, not subject to direct competition (at least for now). Second, policy makers and regulators normally recognize only those stranded costs net of reasonable mitigation efforts, i.e., net efficiencies and other feasible measures which could reduce imbedded costs and/or enhance asset value. Third, stranded costs must be evaluated on a "net" basis, i.e., the above market and below market value assets should be permitted to offset.

PRA M.B. at 37-38; OCA St. 1 at 4.

The PRA note DII also contends that stranded costs should be established in this proceeding. DII calculates the level of recoverable stranded costs on a residual basis in a manner similar to that proposed by Duquesne. DII St. 1 at 11. In addition, DII suggests there should be a sharing proposal regarding the recoverable level of stranded investment. Under its proposal, the return allowed on stranded investment will exclude the cost of common equity, i.e., the return should only be the weighted cost of debt and preferred stock. Id. at 13. If securitization is used, however, the transition bond cost factor should be the rate of return utilized for recovery of investment in stranded costs. PRA M.B. at 38; DII St. 1 at 13.

The PRA concludes the Commission should reject Duquesne's proposal to forestall the calculation of the CTC in this proceeding and its proposal to rely upon an annual RFP as a method of computing stranded costs. Adoption of either proposal will not lead to an appropriate determination of stranded costs. PRA M.B. at 38-39.

11. The Environmentalists' Position

The Environmentalists take no position on Duquesne's valuation proposal for stranded costs nor the positions of any other intervenor, which will entail divestiture of assets. Instead, the Environmentalists note a higher stranded cost award means a higher CTC in the unbundled rates. Because of the rate cap, a higher CTC means a lower generation or shopping credit, which means less of the bill is subject to competition and customers will have less opportunity to obtain savings from alternate suppliers. This result means alternate suppliers will have a tougher time entering and staying in the market, robust competition will fail to develop and the promise of the Act will remain unfulfilled. Env. M.B. at 13-14.

These issues are important to the Environmentalists because the absence of competition will slow down the introduction of new, clean generating options (both fossil-fueled options and renewable resource options). In addition, a high stranded cost recovery will indirectly subsidize existing generation, including older, inefficient polluting units. These emissions will make it more difficult to maintain air quality at levels sufficient to protect human health and property. This result in turn may impose restrictions on economic development, constraining the siting of manufacturing operations or competitive power producers. How the Commission treats stranded costs will have a very large impact on the fate of the current generation of polluting and unsafe generating plants and whether and when Pennsylvania moves to a new and healthier electric future for our children. Id. at 14.

12. Enron's Position

Enron adopts the position of MAPSA with respect to these issues. Enron M.B. at 24. Further, Enron strongly endorses Duquesne's proposal that its level of stranded costs be determined by auctioning all of its generating assets and that such an auction take place "today." Duquesne M.B. at 18. Enron finds Duquesne's "immediate auction" alternative consistent with the Competition Act because it allows the market to provide evidence of the value of Duquesne's generating assets in a competitive retail marketplace. While no one, including Enron or Duquesne, can be certain of the result if an auction is conducted appropriately, it should produce accurate indications of the value of Duquesne's generating assets and, in turn, an accurate determination of the portion of its net investment which should be considered "stranded" in accordance with the definition in the Act. Enron R.B. at 12-13; 66 Pa. C.S. §2803(14).

Enron's main concern, however, is that the proposal for an immediate auction is not superseded by other proposals that may be advanced in an extraneous proceeding involving the APS/Duquesne merger. Enron posits Duquesne's offer to be subjected to an immediate auction should be accepted unconditionally, and this offer should be final and not subject to any modification as a result of the merger proceeding. Indeed, based on a careful reading of the Act, such an unconditional acceptance is mandated by the required procedures set forth in the Act,[53] which appears to require a "once and done" determination. Enron R.B. at 12-13.

Assuming the Commission accepts the immediate auction proposal as final regardless of the outcome in the merger, Enron welcomes the opportunity to work with Duquesne and the Commission to establish the appropriate procedures and other criteria to carry out an immediate auction process. Enron suggests the Commission convene a task force to make recommendations to the Commission, which will then be the basis for the auction. Id. at 13.

In the meantime, as the restructuring process goes forward, Enron agrees some interim CTC mechanism needs to be established. Enron submits that, in accordance with PECO Energy, it makes most sense to establish the CTC based on the "model based" approach the OCA recommends. Enron submits PECO Energy mandates the CTC established using the OCA formula be subtracted from current rates and, along with the subtraction for appropriately calculated T&D rates, the remaining portion of Duquesne's rates be established as a generation credit. Future adjustments, once the auction takes place, can be made to that CTC to

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[53] See., 66 Pa. C.S. §2806(f) ("The [C]ommission shall . . . issue an order accepting, modifying or rejecting [a restructuring] plan."). Enron R.B. at 13, fn. 32.

appropriately phase in recovery of any stranded costs determined as a result of the auction. Enron R.B. at 14.

13. MAPSA's Position

(a). Introduction

At the very threshold of the process of reviewing any electric utility's proposal for stranded cost recovery, MAPSA posits the CTC, by its very definition, is a device that allows utilities to recover costs which are not recoverable in the ordinary competitive market.[54] While one may argue that no above-market cost is reasonable for ratepayers to bear, such an argument has been considered and rejected by the Pennsylvania Legislature, which alternatively has determined that it is appropriate for electric utilities to recover their "reasonable" and non-mitigable above-market costs. Thus, MAPSA suggests the CTC, by its very nature of imposing above-market costs on ratepayers, is an anti-competitive device which serves to allow utilities to recover some of their prior investments which now have turned out to be "above-market." As the Commission stated in PECO Energy:

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[54] MAPSA notes the CTC is defined as "[a] nonbypassable charge applied to the bill of every customer accessing the transmission or distribution network which (charge) is designed to recover an electric utility's transition or stranded costs . . . ." 66 Pa. C.S. §2803. And, the "transition or stranded costs" are defined to be "[a]n electric utility's known and measurable net electric generation-related costs, determined on a net present value basis over the life of the asset or liability . . . which may not be recoverable in a competitive electric generation market . . . ." MAPSA M.B. at 15, fn. 6; 66 Pa. C.S. §2803 (emphasis supplied).

> The price caps or the energy and capacity credits ("ECC") [or, in Duquesne's case CGC] are a major government intrusion into the competitive market, just as are the CTCs that recover approved amounts of stranded investment.

MAPSA M.B. at 15; PECO Energy at 15.

On the other hand, while the Competition Act mandates the imposition of "reasonable" anti-competitive charges, MAPSA notes it also establishes, as its dual goal, the promotion of competition. Therefore, the Commission's schizophrenic task in all of these restructuring proceedings is to oversee and direct the development of a competitive market, while still allowing for the existence of an anti-competitive ratemaking device "left-over" from the prior regulatory period. MAPSA M.B. at 15-16.

Looking at the situation from its proper perspective, unless subject to careful and ongoing regulatory scrutiny, MAPSA argues the collection of utility stranded costs through the CTC can and will be used by electric utilities as a cleverly designed device to allow the utilities to charge under-market, and possibly even under-cost prices for generation, and still recover the previously allowed regulatory expenses and profit. For example, it is possible for a utility in the new competitive world to charge an under-market (or even under-cost) generation rate and still recover its full pre-1997 revenue requirement by using the CTC to recover the difference; all that is required to accomplish this result is to convince the Commission, in these restructuring proceedings, that the market price will be lower than it actually turns out to be. The utilities clearly have a tremendous incentive to use the lowest possible number for "market price," where market price is used to calculate stranded costs. Id. at 16.

Of course, MAPSA submits the only true and exact measure of net generation costs "not recoverable in a competitive market" may be found by comparing the book value of

facilities with the sale price obtained through an "open-bid RFP," similar to that proposed by GPU Energy (i.e., Metropolitan Edison Company and Pennsylvania Electric Company). While Duquesne proposes to allow itself to be ordered to undergo an RFP process in this proceeding, MAPSA notes it does not prefer that process and, in fact, Duquesne proposes no auction if its merger with West Penn is consummated. Indeed, Duquesne has made multiple proposals for the quantification of its stranded costs, all of which (except an asset auction in 1989) reflect a bare wholesale market price as a determinant of value. The absence of true market value evidence frustrates the Commission's ability to determine Duquesne's "real" stranded costs, if any, and leaves the Commission with the uncertainty of market price prognostication and speculation. Accordingly, MAPSA suggests Duquesne's decision effectively to forego an "RFP" process must be viewed negatively. Id. at 16-17.

MAPSA submits what Duquesne has done by using a low market price to create a high level of stranded costs, with a resulting low generation credit, is to insulate itself from meaningful competition until at least 2003. MAPSA finds the fact Duquesne's restructuring plan will not allow for competition has been admitted. As Duquesne's policy witness and CEO states:

> Q. And would you agree that it is very unlikely that if suppliers in general can't sell energy [and] capacity at a price that is equal to or less than that competitive generation credit, it is unlikely that they will gain customers.
>
> * * *
>
> A. I would argue that if they can't, you know, if suppliers can't in fact provide benefits above, you know, the wholesale price of power today [i.e., if suppliers can's sell power below the wholesale price], that probably the Competition Act isn't a good idea.

Id. at 17; N.T. 136.

MAPSA suggests Duquesne's understanding of the Competition Act (and its restructuring plan which is the embodiment of its understanding) clearly is contrary to the Commission's understanding. West Penn at 1 (the Legislature intended the creation of a vibrant, competitive retail market in electric generation by January 1, 2001); PECO Energy (rejecting a plan that hindered the development of a competitive retail market until 2003 at the earliest). MAPSA M.B. at 17.

MAPSA asserts without competition, there are no "stranded costs" by definition, under the provisions of the Act, 66 Pa. C.S. §2803; See, also, 66 Pa. C.S. §2811 (regarding the Commission's duty to monitor the "properly functioning and workable competitive electricity market"). Therefore, in the absence of a properly functioning and workable competitive electricity market, there is no need to compensate Duquesne or its shareholders for costs which are "stranded" by competition simply because by definition there are none. MAPSA M.B. at 17-18.

Finally, MAPSA notes that, while the Commission has restricted discretion with regard to allowing stranded cost recovery (namely, it must allow that amount which is found to be reasonable and non-mitigable), it has complete discretion to determine whether that recovery is "front-end" (i.e., more in the early years, and less in the later years), "levelized" (i.e., equal over the years), or "back-end" (i.e., more in the later years). Further, the Commission has complete discretion regarding all other elements that are necessary to establish a competitive market (i.e., the full unbundling of services and the requirement of a pro-competitive supplier tariff). Id. at 18; 66 Pa. C.S. §2802(12) & (14).

(b) Duquesne's Approach

MAPSA argues Duquesne's proposal for calculation of stranded costs fails to meet the known and measurable standard, is based upon faulty market price assumptions and otherwise is contrary to the statute and should be rejected. MAPSA notes Duquesne has made three distinct proposals regarding the calculation of stranded costs. Duquesne's preferred approach appears to be a process where it collects a "target" level of stranded costs of $1.7 billion. While Duquesne has not firmly estimated the $1.7 billion target, the number is based upon the 1997 RFP process. N.T. 344. Under its proposed process, Duquesne will do a final valuation of its generation assets in 2003 and will accordingly adjust the CTC collection mechanism in order to tailor the collection of stranded costs to meet the "now firm" number. The 2003 valuation will be performed on the basis either of an auction of Duquesne's generation assets or, more likely, through some yet undefined market valuation method. MAPSA M.B. at 18-19; Duquesne St. 1R at 2.

The second process proposed will be a one-time administrative determination made in this proceeding based upon market estimates. If the one-time administrative valuation is in fact done – a process which Duquesne does not endorse – Duquesne believes its stranded costs will be approximately $1.9 billion as opposed to the at least $1.7 billion level identified using the "preferred" method. MAPSA notes Duquesne's own witness, however, does not believe the market price estimates used in preparing the latter estimates meet the Commission's known and measurable standard. N.T. 82. The third proposed methodology is for Duquesne to auction its generation assets in 1999. Duquesne St. 1R at 1. However, MAPSA claims this proposal, made in rejoinder testimony, cannot be taken seriously. Duquesne does not propose to engage

in the immediate auction process if the merger with West Penn Power occurs. N.T. 24-25. Moreover, because Duquesne fails to include any specifics as to how the auction will actually take place and because of the uncertainty as whether the Commission can indeed order Duquesne to auction its generation assets, MAPSA submits this proposal must be disregarded. MAPSA M.B. at 19.

In reality, MAPSA contends Duquesne proposes to collect its fully capped rate throughout the period 1999 to 2003. Relying upon the language of 66 Pa. C.S. §2804(4)(v), Duquesne believes it has a right to continue to collect its fully-capped rate so long as it applies any excess earnings to mitigate stranded costs. Duquesne St. 2 at 28. MAPSA finds Duquesne's reliance on §2804(4)(v) as supporting its stranded cost recovery plan contrary to the statute, and Duquesne's overall method for collection of its stranded costs must be rejected. MAPSA claims Duquesne's stranded cost recovery proposal: (i) fails to meet the Commission's known and measurable standard; (ii) does not make a determination of stranded costs according to the methodology this Commission adopted as being the correct methodology in PECO Energy; (iii) is based upon suspect evidence of market price, at best; and, (iv) is otherwise inadequate to form the basis for any level of stranded cost recovery. While MAPSA takes no position as to what level of stranded costs, if any, should be established in this case, it disagrees with the methodology by which Duquesne attempts to calculate and collect stranded costs. MAPSA M.B. at 19-20.

MAPSA notes Section 2804(4)(v) of the Act contains a rate cap provision designed to ensure the Commission does not require a utility to lower the rate cap if a utility rolls into its base rates its current energy cost rate at the time of the enactment of the act. 66 Pa. C.S.

§2804(4)(v). Duquesne relies upon this Section for the proposition that it should be allowed to collect its capped rate throughout the transition period, which Duquesne defines as being from 1999 through 2003. In 2003, Duquesne proposes to perform an evaluation of the market value of its assets, make a final determination of stranded costs, and adjust the CTC accordingly. Duquesne contends it is likely it will seek approval to extend the recovery period for CTC revenues because it contends its level of stranded costs is in fact higher than the $1.7 billion estimate which it placed in its proposal. MAPSA M.B. at 20.

MAPSA finds Section 2804(4)(v) contains no provision which relieves an electric utility from determining a competitive transition charge based upon a "known and measurable" level of stranded costs at the time it files its restructuring plan. Indeed, the Act defines transition or stranded costs as:

> "an electric utility's known and measurable net electric generation-related cost, determined on a net present value basis over the life of the asset or liability as part of its restructuring plan, which traditionally would be recoverable under a regulated environment but which may not be recoverable in a competitive electric generation market . . ."

66 Pa. C.S. §2803 (emphasis added).

The Act requires the Commission, in setting a competitive transition charge, "to provide each electric utility with an opportunity to recover its transition or stranded cost following the Commission's determination under subsection (c), "every customer . . . shall pay a competitive transition charge to the electric distribution company . . ." 66 Pa. C.S. §2808(a). MAPSA submits the statute intends that electric distribution utilities will value the stranded cost level in their restructuring plans and that in determining the appropriate CTC, the Commission

will only allow for the recovery of those "known and measurable" stranded costs. MAPSA M.B. at 21.

MAPSA claims Duquesne's proposal puts off the valuation of its level of stranded costs until the year 2003. Duquesne proposes to collect a level of stranded costs, which is based upon faulty market price assumptions and which Duquesne's own witnesses admit are not reliable. N.T. 82. Therefore, Duquesne proposes to collect a CTC which is targeted to collect a level of stranded costs that is not likely to be accurate. MAPSA M.B. at 21.

MAPSA responds the only accurate method for determining stranded costs is divestiture of generation assets. MAPSA St. 1 at 7. Duquesne's proposal is perhaps most flawed by the fact that it does not propose to do so.[55] In rejoinder testimony, Duquesne indicates it will be willing to waive its statutory right not to be ordered to divest its generation assets and allow the Commission to order it to divest its generation assets through an auction to be held in 1999. Duquesne St. 1R at 1. The market value determination for its generation assets produced by such an auction will be used to determine the actual level of stranded costs for Duquesne. However, as Duquesne admits, N.T. 24-25, if the proposed merger with West Penn Power occurs, Duquesne will not auction any assets. In order to ensure an accurate determination of stranded costs, MAPSA urges the Commission to accept Duquesne's offer to waive its rights under the statute and order Duquesne to divest its generation assets in an "arms' length" auction process, regardless of whether Duquesne merges with West Penn Power or not.

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[55] Without the certainty produced by divestiture, MAPSA suggests one can only guess at the market value of the assets. MAPSA St. 1 at 7. Indeed, in the case of New England Power, which auctioned off its non-nuclear generation assets, it obtained 150% of the book value, thereby reducing its stranded costs substantially. MAPSA M.B. at 21, fn. 7; MAPSA St. 1 at 7.

Otherwise, MAPSA asserts Duquesne's offer to auction its assets is nothing more than an illusory promise. As several intervenors point out, divestiture is the best and most accurate method for determining the level of stranded costs related to generation assets in a competitive market. Duquesne admits to this fact. MAPSA M.B. at 21-22; N.T. 141-42.

MAPSA further notes Duquesne's proposal estimates the initial level of the CTC based upon a 1997 RFP process. N.T. 139. Duquesne proposes to refine the target level of stranded cost recovery based upon an RFP process it proposes to engage in early 1998. Duquesne's RFP process has been criticized for several reasons, not the least of which is the fact that the process appears to have been developed with a goal of producing an unusually low "market price." MAPSA St. 1 at 18. Duquesne admits the RFP result reflects a depressed market. N.T. 495. In fact, the Commission considered Duquesne's market price evidence in the pilot proceedings, which was based upon its RFP results, and found it to be unconvincing. MAPSA M.B. at 22; Pilot Order at 64.

MAPSA finds Duquesne's RFP process incapable of determining an accurate market price. MAPSA St. 1 at 25. MAPSA details several specific facets of the RFP process, which form the basis of this conclusion. First, the RFP approach will not provide prices that are representative of amounts charged on sales by one party to a retail load. Rather, the product sold in the RFP will likely be a product included in a portfolio of generation products that a supplier will need to use in order to serve retail load. Second, the RFP product was not designed to be used directly to serve retail load and is a wholesale product. Third, the RFP offer does not include dynamic scheduling or any other costs associated with following customer load and is not suitable as a proxy for the power required to serve time-varying requirement

customers. Fourth, the RFP had a 75% capacity factor take-or-pay provision, which limits the flexibility of the purchaser. Fifth, the RFP requires a bidder to take point-to-point transmission service with the receipt point at Duquesne's generation units, which will make the power economical only for someone purchasing that power from Duquesne to serve load in Duquesne's service territory. Sixth, the winning RFP bidder is not guaranteed that it will obtain the entire megawatt block of power for which it bids. Rather, the RFP only guarantees a minimum of 10 megawatts for the winning bidder, regardless of the amount sought. Finally, the RFP does not represent the true cost of generation assets in the way that a divestiture will, because it does not include the intangible values of operating a generating plant. MAPSA M.B. at 22-24; MAPSA St. 1 at 25-27.

MAPSA submits Duquesne's RFP merely shows what a single party, in a market with many participants, is willing to pay for a very discrete product under very specific conditions. The additional fact that those conditions are subject to manipulation by Duquesne, the very party with an incentive to produce a low market-price result, and which appears to have done so in the first round of the process, increases MAPSA's concerns with such a proposal. MAPSA St. 1 at 25. MAPSA claims Duquesne's proposed methodologies for determining stranded costs are so seriously flawed that they cannot be adopted by the Commission. Rather, the Commission should adopt a methodology or a combination of methodologies proposed by the other intervenors. MAPSA M.B. at 24.

14. Recommendation

In the purist economic model, the marketplace determines the value of an object. In that marketplace, an actual "arms length" bona fide transaction between a willing seller and a willing buyer determines the value of an asset. Thus, an actual marketplace transaction is clearly superior for the purposes of determining the value of an asset to expert predictions of what that value may be. For this reason, Duquesne's proposal, in the event no merger with APS is consummated, to offer an immediate divestiture of its generating assets to determine the value of its stranded assets appears irresistible. However, any divestiture must occur immediately to avoid the problems which the parties amply demonstrate, supra, will result from delay.

Accordingly, I recommend the Commission accept Duquesne's proposal to offer an immediate divestiture of its generating assets to determine the value of its stranded assets. Within 90 days of entry of the Commission's final Order in this case, Duquesne should file with the Commission a plan of divestiture, together with a proposal for addressing its continuing obligation to serve under the rate cap. All interested parties should have an opportunity to respond to either or both proposals. This divestiture should occur within 18 months of entry of the Commission's final Order disposing of this application in the event the proposed merger is not consummated for any reason whatsoever. Concerning the issue of an interim CTC to take effect January 1, 1999, Duquesne should apply the same rates and credits approved in the pilot program for customers electing direct access during this interim period. Finally, relating to the issue of what method to use for calculating a "permanent" CTC, using market values produced by the auction, the Commission should direct the Company to adopt the general approach used in PECO Energy. Duquesne should be permitted to fully recover (e.g., with no "sharing" and

a compensatory return on equity) its stranded costs as established by the market values produced by the auction. The Company should also submit a proposal to address its continuing obligation to serve at the same time that it files a final CTC calculation, using market values produced by the auction.

In addition, certain claims of the Company for treatment as stranded costs should be disallowed for the reasons discussed, infra. The following sections of this decision address these claims, as well as an appropriate stranded cost recovery method in the event a merger is consummated.

B. Generation-Related Stranded Costs (Recovery Pursuant to Section 2808(3))

1. Net Book Value

(a) Total Net Book Value

(i) Duquesne's Proposal

The Company claims a net book value for its generating plant of $917.61 million. This value is net of claims for M&S and fuel related sunk costs of $41.11 million, the present value of the lease expense for Beaver Valley 2 of $475.57 million, and deferred income taxes of $197.33 million. Duquesne M.B. at 23, Tables at 5. Duquesne Exhibit DJC-10 illustrates general agreement among Duquesne, the OCA and DII on the Net Book Value of Generation Plant. See, also, Duquesne St. 3R at 10-11. The only material difference is with the OTS, which disallows recovery of Phillips and Brunot Island costs. Duquesne M.B. at 23.

(ii) The OTS' Position

The OTS finds the total net book value of Duquesne's fossil generating plants should be reduced by $65.58 million to reflect a disallowance of the stranded cost claim made by Duquesne with respect to Phillips Power Station (Units 1, 2, 3, and 4) and Brunot Island Power Station (Units 3 and 4). OTS M.B. at 21; Appendix, Table 6.

In addition, if a one-time administrative valuation of stranded costs is required as of January 1, 1999, then the OTS asserts the Company's claim for $1,236.95 million in net book value should also be reduced by $41.11 million ($33.40 million nuclear and $7.70 million fossil) for the category "M & S and Fuel-Related Sunk Costs." See, Duquesne Exh. DJC-10; Appendix, Tables 5 and 6. The OTS submits this claim was not included in Duquesne's original filing and consequently was not included in the OTS stranded cost valuation allowance as shown on OTS Exh. 4-SR, Sch. 1. OTS M.B. at 21.

The OTS' resulting net book value is $1,139.22 million ($764.14 million nuclear and $375.08 million fossil). Id.; OTS Exh. 4-SR, Sch. 1; Appendix, Tables 2 and 3.

(iii) The OCA's Position

Initially, the OCA notes the differences between the Company and the OCA concerning the methodologies employed for quantifying stranded costs. OCA M.B. at 21-25. Then, the OCA estimates the total net book Value of the Company's owned generation assets, is $913.02 million, excluding Beaver Valley 2 lease costs and $1,274.91 including those costs (net of tax). As discussed below, the OCA characterizes Beaver Valley 2 lease costs as owned-generation assets and recovered pursuant to Section 2808(c)(3). The OCA's net book value also

reflects an adjustment to remove $5 million associated with Brunot Island, which it claims represents the amount from the Ft. Martin sale proceeds, which should have been used to restore those plants to service. Since those plants are not being returned to service, the OCA contends this amount should be used as a reduction to the value of that plant. Id. at 25-26.

(iv) DII's Position

DII explains the proper standards for recovery of stranded generation costs. DII M.B. at 27-28. Absent an immediate, total and unconditional auction of Duquesne's generating assets, DII asert the proper valuation is obtained by application of the asset value methodology to DII's projection of market prices for the competitive ECAR region. Id. at 27-28. Further, the DII equity return disallowance must subsequently be employed to arrive at the just and reasonable level of stranded generation costs to recover from ratepayers. Id.; DII R.B. at 13.

For purposes of calculating the Company's generation-related stranded costs, DII uses Duquesne's quantification of its net generating plant and CWIP balance at December 31, 1998 of $979.130 million. DII M.B. at 29; DII R.B. at 13; DII St. 1 10; Duquesne St. 2R; Duquesne Exh. DJC-21.

(v) HSS/ARI's Position

The HSS/ARI argue Duquesne fails to demonstrate it will have any generation-related stranded costs as of January 1, 1999, nor does it demonstrate it will have stranded costs as of January 1, 2006. Therefore, HSS/ARI posit it fails to satisfy the "known and measurable"

standard imposed by the Act as a predicate to a utility recovering any stranded costs. HSS/ARI M.B. at 23.

HSS/ARI do not dispute Duquesne's calculation of a net book investment in generation-related assets is $1.236 billion. However, HSS/ARI do object to the use of that net book value for purposes of establishing the generation component of Duquesne's rates or Duquesne's potential stranded costs. Id. at 24.

With respect to Duquesne's generation-related capital additions constructed since 1986, HSS/ARI reiterate that Duquesne has chosen not to file a rate case since 1986. Duquesne St. 4 at 22. Thus, as in the case with Duquesne's distribution-related capital expenditures, HSS/ARI note the Commission has not reviewed any of the capital or other expenditures Duquesne made associated with its generation cost of service for over a ten-year period. As a consequence, Duquesne also has the burden of establishing that generation related capital expenditures over that ten-year period were just and reasonable to the extent those costs are subsumed within Duquesne's current generation rate structure. Pa. P.U.C. v. Philadelphia Electric Co., 1990 Pa. PUC Lexis at p* 54-57; 66 Pa. C.S. §315 (A). However, as in the case of its distribution-related capital expenditures, HSS/ARI assert Duquesne produces no evidence to support its past generation-related capital expenditures. HSS/ARI M.B. at 24-25.

HSS/ARI note Duquesne's FERC Form 1 reports show that between 1987 and 1996, exclusive of expenditures related to Beaver Valley 2 and Duquesne's initial capital expenditure of $743 million for Perry Unit 1, Duquesne made generation-related capital expenditures of approximately $382 million. HSS/ARI St. 1 at 55-56. Again, given that Duquesne made no attempt to introduce any evidence to suggest its past generation-related

capital expenditures were just and reasonable, HSS/ARI claim it is within the Commission's authority to order a total disallowance of the $382 million in claimed generation-related capital expenditures. Pa. P.U.C. v. Equitable Gas Co., 57 Pa. P.U.C. 444, fn.37; 66 Pa. C.S. §1301. Nonetheless, to balance the interests as previously discussed, HSS/ARI recommend a 50% disallowance of that amount. HSS/ARI M.B. at 25; HSS/ARI R.B. at 17-18.

(vi) The PRA's Position

The PRA urges adoption of the OCA's calculation of total net book value to be utilized for calculating the Company's stranded investment in owned-generating plant. PRA M.B. at 40.

(b) Beaver Valley 2 Lease Costs

(i) Duquesne's Proposal

Duquesne claims the present value of its Beaver Valley Unit No. 2 lease expense to be $278.24 million. Duquesne M.B.; Appendix, Tables at 5. The Company notes it, the OTS, the OCA and DII all agree that Duquesne should be permitted to recover the costs of the lease payments for Beaver Valley Unit No. 2. Duquesne Exh. DJC-10.[56] While the parties state

[56] Duquesne entered into a sale-leaseback transaction that removed the Beaver Valley 2 asset from its books. Duquesne M.B. at 24, fn. 10; Duquesne St. 2 at 9; Duquesne St. 2-R at 57.

these costs on differing bases, Duquesne claims Exhibit DJC-10 restates the values on a consistent basis, i.e., present value net of tax.[57] Duquesne M.B. at 23-24.

(ii) The OTS' Position

The OTS includes a nuclear stranded cost allowance of $287.19 million for the present value ("PV") of the Beaver Valley 2 lease expense. OTS Exh. 4SR, Sch. 1; Appendix, Table 5. This allowance slightly exceeds the $278.24 million claim shown by the Company in Duquesne Exh. DJC-10 due to application of the OTS' discount rate of 7.43% which is used to compute present value. OTS M.B. at 22; OTS St. 1 at 8.

(iii) The OCA's Position

The OCA argues because the level of recovery under Section 2808(c)(3) is a discretionary determination and recovery under Section 2808(c)(1) and (c)(2) are not discretionary, characterization of the Company's claims may make a difference in the final stranded cost recovery allowance. One item about which OCA and the Company disagree is the treatment of the Beaver Valley 2 nuclear generating station. Duquesne proposes to treat only $32.48 million associated with Beaver Valley 2 as an "owned-generation" asset and proposes to treat the lease payments as regulatory assets subject to recovery under Section 2808(c)(1).

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[57] Duquesne submits its Exhibit DJC-10 restates the calculations of the OTS, the OCA and DII on a consistent basis using a present value, net of tax calculation. A "net of tax" calculation - which, in effect, calculates the cash that Duquesne would have to receive today to recover its stranded costs, including the related tax effects - is consistent with the method used in PECO Energy, Restructuring Reconsideration Order at 24-25; ("PECO should exclude the tax gross up by multiplying the resulting present value by .587 to reflect PECO's tax rate of 41.3%"). Duquesne M.B. at 24, fn. 11.

OCA submits the entire amount of the Beaver Valley 2 lease should be classified as owned-generation and subject to Section 2808(c)(3) since, the OCA explains, the sale leaseback transaction is merely a "financing vehicle" and Beaver Valley 2 is, in reality, "owned" by Duquesne. OCA M.B. at 26.

In its rebuttal testimony, the OCA finds the Company does not appear to object to reclassification of these costs as owned-generation, but notes this reclassification does not change the Company's claim. Duquesne St. 2R at 18. While OCA agrees this reclassification does not change the Company's claim, reclassification of these assets to Section 2808(c)(3) gives the Commission discretion in providing for recovery of such costs. Consequently, the Beaver Valley 2 lease costs should appropriately be reclassified as owned-generation. OCA M.B. at 26.

(iv) **DII's Position**

DII disputes the Company's treatment of the Beaver Valley 2 lease payments in calculating Duquesne's stranded cost. DII M.B. at 29-30. In its direct case, Duquesne includes the lease payments as part of its stranded generation asset claim and as a regulatory asset. Duquesne St. 2R; Duquesne Exh. DJC-21 at 17, 77. DII submits the Company inappropriately requests recovery for the Beaver Valley 2 lease expenses in two parts of its filing. First, the Company includes the lease expense as a "Non-Production Expense" in its calculation of stranded costs related to the Beaver Valley 2 unit. Duquesne St. 2R; Duquesne Exh. DJC-21 at 17; DII St. 3 at 14. Duquesne also includes the NPV of the lease payments as a regulatory asset entitled "PV Beaver Valley Lease." Duquesne St. 2R; Duquesne Exh. DJC-21 at 77; DII St. 3 at 14. Inclusion of the lease expense in two separate components of stranded cost claim

violates the netting concept that is necessary according to the statutory definition of "stranded costs." DII M.B. at 29; DII St. 3 at 14; 66 Pa. C.S. §2803.

DII includes lease expense in the stranded generation cost calculation for the years 1999-2005 and as a regulatory asset for the remaining years of the lease. DII St. 3 at 14.

> DII witness Falkenberg has incorporated the full Beaver Valley lease expense for the years 1999-2005 in the DII quantification of generation stranded costs. I have included the remaining years costs in the net present value of the Beaver Valley 2 lease payments regulatory asset.

Id. DII claims inclusion of the lease expense in the stranded generation cost claim decreases the market value of the Beaver Valley 2 unit and increases Duquesne's stranded cost associated with that unit. DII finds this approach parallels the Company's approach in its original filing. DII M.B. at 29-30.

DII notes the Company, in its rebuttal case, modifies its stranded cost claim to remove the Beaver Valley lease regulatory asset, although not explicitly acknowledged. Duquesne St. 2R; Duquesne Exh. DJC-10. Also, in its rebuttal filing, DII notes the Company includes the NPV of the 1999-2017 Beaver Valley 2 lease payments as an addition to the net book value of its generation assets. Id. DII does not conceptually disagree with the Company's approach as utilized in its rebuttal testimony because the double recovery issue is eliminated. The DII approach is an equally valid method to achieve the same result. DII recommends that the Commission endorse the DII treatment of the Beaver Valley 2 lease expense. DII M.B. at 30.

DII agrees that Duquesne should be permitted to recover the Beaver Valley 2 lease costs, but seeks to ensure the Company does not recover the costs in two portions of its stranded

cost calculation. The DII maintains its treatment of these costs ensures no double recovery. DII R.B. at 13.

DII agrees with the Company's statement that Duquesne Exhibit DJC-10 illustrates the OCA, Duquesne and DII proposals on a consistent basis. Duquesne M.B. at 23-24. Furthermore, DII accepts the Company's explanation of the PECO Order. Id. at 24, fn. 11. DII does not conceptually disagree with the Company's approach, but prefers utilization of the DII approach. DII R.B. at 13.

(v) The PRA's Position

The PRA concurs with the approach of the OCA on this issue. PRA M.B. at 41; PRA R.B. at 10.

(c) Phillips and Brunot Island Costs

(i) Duquesne's Proposal

Duquesne claims fossil plant stranded costs of $65.58 million net book value[58] for Units 1, 2, 3, and 4 at Phillips Power Station and Units 3 and 4 at Brunot Island Power Station. Duquesne St. 2 at 33; OTS St. 4 at 24; N.T. 303. All of these units were placed in cold reserve in 1986, as approved by Commission Order entered May 2, 1986 at Docket No. P-00860103 with respect to Brunot Island, and by Commission Order entered July 30, 1986 at Docket No. P-00860132 with respect to Phillips. N.T. 194-195. These units were removed from rate base

[58] The OTS notes the $106.8 million claim for the cold reserve units mentioned in OTS witness Mr. Metro's testimony is the $65.58 million rate base amount plus approximately $40 million in deferred taxes. OTS M.B. at 22, fn. 4; OTS Cross Exh. 3.

in the Company's base rate case in 1987. Brunot Island Units 2A and 2B were placed back in service in 1996 as a result of the Ft. Martin agreement, but these units are not included within the $65.58 million net book value claim for the cold reserved units. N.T. 196, 303. The Company presently has no plans to place its cold reserved units back into service. N.T. 201. OTS M.B. at 22; N.T. 196.

Duquesne requests stranded cost recovery for these assets. Duquesne St. 4 at 14-15. The Company notes the OCA and DII do not oppose the request. Duquesne Exh. DJC-10. The OTS, however, argues that since the units were rendered uneconomic in 1986, they were not stranded by the Competition Act; hence, OTS argues, they cannot qualify as stranded costs. OTS St. 4 at 25. HSS also contests recovery of these costs. Duquesne M.B. at 24; HSS St. 1 at 106.

Duquesne finds these arguments uncompelling. Duquesne argues the OTS is mistaken in suggesting the past economics of these units is relevant. Duquesne contends the point is the Act will render them stranded once and for all. The OTS and HSS adjustments also conflict with the past ratemaking treatment of these assets. Over the last ten years, Duquesne has sought to reactivate these plants in a manner that would benefit ratepayers, N.T. 109-112, including reaching an agreement with General Public Utilities ("GPU") to reactivate them in support of a 500 MW, 20-year sale. Duquesne St. 1 at 26. The Commission approved this transaction (over the objection of the OTS), finding that it would produce over $300 million in present value benefits to ratepayers. Id.; N.T. 111; See, also, HSS Exh. RBW-45. While the transaction ultimately fell through, Duquesne St. 1 at 26, Duquesne asserts the point is that the Commission determined that ratepayers, not shareholders, should receive the benefits. Id. It

is, therefore, unfair for these parties now to contend that Duquesne's shareholders, not its ratepayers, should bear the economic detriment now associated with the assets. Duquesne M.B. at 24-25; Duquesne St. 1 at 27; Duquesne St. 2-R at 35.

(ii) The OTS' Position

OTS opposes inclusion of the Phillips and Brunot Island cold reserved units in the Company's stranded cost claim as being contrary to the Act. OTS M.B. at 22-25; OTS St. 4 at 23-25. As stated in 66 Pa. C.S. §2803, the definition section of the Act, "stranded costs" must be costs that are traditionally recoverable under a regulated environment. Costs for generating plants that are not "used and useful" are not traditionally recoverable under a regulated environment.[59] While the Competition Act at 66 Pa. C.S. §2803 provides an exception for costs attributable to physical plants no longer used and useful because of the transition to retail competition, Duquesne acknowledges these units were placed in cold reserve and removed from rate base at a time when there was no competitive electric generation market for Duquesne's end use customers. N.T. 195-196. Furthermore, the Company does not deny the possibility that excess capacity played a role in the decision to "cold reserve" these units. OTS M.B. at 23-24; N.T. 23, 110.

As the Commission stated in the PECO Restructuring Order, Slip Op. at 67-68, the utility bears the burden to prove, by substantial evidence, that its stranded costs claim is within the statutory definition of stranded costs. The Pennsylvania Supreme Court held in

[59] See, e.g., Barasch v. Pa. P.U.C., 516 Pa. 142, 169-170, 532 A. 2d 325, 338-339 (1987), aff'd, 488 U.S. 299, 109 S.Ct. 609 (1989).

Burleson v. Pa. P.U.C., 501 Pa. 433, 437, 461 A.2d 1234, 1236 (1983), when a party bears the burden of proof, that party must, in addition to establishing a prima facie case, establish that:

> . . . the elements of that cause of action are proven with substantial evidence which enables the party asserting the cause of action to prevail, precluding all reasonable inferences to the contrary.

The OTS argues Duquesne has not met its burden of proving the costs relating to its cold reserved units are traditionally recoverable under a regulated environment or these costs are attributable to plants no longer used and useful because of the transition to retail competition. Accordingly, the OTS submits Duquesne's stranded cost claim for the cold reserved units should be rejected. OTS M.B. at 24-25; OTS R.B. at 4-8.

(iii) The OCA's Position

The OCA notes the Company's and the OCA's net book value differ by only $5 million. This difference reflects the OCA's adjustment with respect to treatment of Brunot Island Units 2B and 3, which are currently in cold reserve. OCA St. 1 at 23. The OCA notes $5 million of the Ft. Martin settlement was to be used to reduce the costs of returning those units to service. Id. Since it now appears those units will not be returned to service, the OCA argues the unrecovered net investment in the units should be reduced by this amount. Id. Consequently, the OCA's net book value reflects this reduction. OCA M.B. at 26-27.

In rebuttal testimony, Duquesne contends the OCA's interpretation of the Ft. Martin settlement is "novel" and not supported by the agreement, and the Company does not agree to credit $5 million without recovery of, or return on, such investment. Duquesne St. 1R at 35. The OCA submits it is Duquesne's reading of the Ft. Martin agreement that is novel.

The Company's Declaratory Order Petition in this case clearly spelled out that it would "use the proceeds" from the Ft. Martin transaction "to rehabilitate and restore to service the simple cycle units located at the Company's Brunot Island Power Station." In Re: Petition of Duquesne Light Co. for a Declaratory Order, P-00951001, Petition at 4, ("Ft. Martin Petition"). There is no language in the Petition to indicate any source of funding other than the proceeds of this transaction to fund such costs. Certainly, if such costs were intended to be subsequently included in rates, then the OCA submits the Petition would have made clear that the proceeds of the Ft. Martin sale were being utilized only as an interim funding mechanism. In this regard, the Petition clearly did not provide any quid pro quo that the Company would recover such investment, and a return on such, from ratepayers. To the contrary, the Petition specifically spelled out that Duquesne's rates could not increase through the year 2000. Among other things, the Petition further provided for a one-time reduction in the Company's nuclear plant investment of $130 million; accelerated depreciation and amortization of nuclear plant investment of $25 million in each year 1996-1998; a $5 million increase in Duquesne's contribution to its nuclear plant decommissioning fund without any increase in existing rates; and an annual $5 million credit to the ECR to compensate for reduced off-system sales resulting from the Ft. Martin sales. OCA M.B. at 27.

The OCA contends none of these financial commitments were made contingent upon subsequent compensation by ratepayers. Likewise, the use of Ft. Martin proceeds to restore Brunot Island was not contingent upon subsequent ratepayer financing of this investment. The Commission's approval of the Petition was clearly made with the understanding that at least $5 million of this restoration project would be funded solely with Ft. Martin proceeds and there

is no basis to suggest that ratepayers should now pay these costs. Ft. Martin Petition, Slip Op. at 3 (June 20, 1996). Consequently, the OCA claims its adjustment to remove these costs should be adopted. OCA M.B. at 27-28.

(iv) HSS/ARI's Position

HSS/ARI also oppose the Company's claim relating to stranded costs for Phillips and Brunot Island. For purposes of considering Duquesne's stranded cost claim, HSS/ARI argue its net book investment of $1.236 billion in generation-related assets also should be reduced to eliminate the net book investment associated with the Phillips and Brunot Island cold reserve capacity. That reduction would be in the amount of $106,800,000. Duquesne St. 4 at 12-14. HSS/ARI submit there are three principal reasons why that reduction is appropriate. HSS/ARI M.B. at 25.

HSS/ARI explain:

> Duquesne took the units out of rate base, and placed them in cold reserve, in 1986 for two essential reasons. First, due to a 50 percent loss of its industrial load, Duquesne did not need the units to operate to serve its market. Exh. RBW-60 (p. 3, Paragraph 10). Second, and as a result of the first factor, Duquesne sought authority from the Commission to cold reserve the units, and take them out of rate base, as part of an "overall corporate program to substantially reduce costs and reduce revenue requirements." Id. at 5.

HSS/ARI St. 1S at 24. Therefore, HSS/ARI point out, if the costs of the cold reserved units are stranded, they are not stranded as a result of Pennsylvania's legislation that restructures the electric industry. Rather, to the extent any costs are stranded, they were stranded by Duquesne's loss of its industrial market over ten years ago. Id. In that circumstance, there is no reason

why Duquesne's ratepayers should be forced to pay for Duquesne's investment in facilities due to the passage of legislation that has no impact on Duquesne's use or non-use of the cold reserved plants. HSS/ARI M.B. at 25-26.

HSS/ARI contend a second reason why Duquesne's net book investment should be reduced by the net book investment in Phillips and Brunot Island for purposes of considering Duquesne's stranded cost claim is that Duquesne should be held to the representations it made to the Commission in 1986 when it requested authority to cold reserve the units. As HSS/ARI Exhibit RBW-60 shows, when Duquesne asked to take the units out of rate base, it did so to reduce its costs and its revenue requirement for the benefit of ratepayers. HSS/ARI Exh. RBW-60 at 3. Further, there was a presumption the units would not be brought back into service unless and until there was a need to operate the units to serve Duquesne's market. Id. at 4. As a result, Duquesne should be held to its 1986 promise to reduce costs and not be permitted to shift financial responsibility to Duquesne's 21st century customers for the failure of load growth to materialize after 1979. HSS/ARI St. 1S at 25. Indeed, that result is all the more appropriate given that Duquesne has no plans to return the facilities to utility service. HSS/ARI M.B. at 26-27; Duquesne St. 2R at 32; Duquesne Exh. DJC-21 at 24-26.

For the foregoing reasons, for purposes of considering Duquesne's stranded cost claim, HSS/ARI contend the Company's net book investment should be considered to be $938 million to reflect the elimination of Duquesne's net book investment in the cold reserve portions of the Brunot Island and Phillips facilities and 50% of Duquesne's generation-related capital expenditures between 1986 and the present, none of which ever have been shown to be just and reasonable. HSS/ARI M.B. at 27.

(v) **The PRA's Position**

The PRA agrees with the OCA that the cost of the cold storage units of Phillip and Brunot Island should be included in the net book value. That is, the net book value of Duquesne's generating plant should include $64.06 million for plants in cold reserve. In addition, the stranded cost analysis should include $45.62 million for working capital. PRA M.B. at 41; PRA R.B. at 10-11.

(d) **Recommendation**

If a one-time administrative valuation of stranded costs is required as of January 1, 1999, I recommend the Commission adopt the Company's calculation of net book value for its generation-related stranded costs, with the following adjustments. The Commission should allow Duquesne its claim of $41.11 million ($33.40 million nuclear and $7.70 million fossil) for the category "M & S and Fuel-Related Sunk Costs," since this claim appears reasonable and no substantial reason exists to deny it. The Commission should also allow the Company its stated claim of $475.57 million representing the lease expense for Beaver Valley 2, but, for the reasons the OCA advances, the Commission should treat the lease payments as an "owned-generation" regulatory asset subject to recovery under Section 2808(c)(1).

Finally, The Commission should disallow the Company's claim of fossil plant stranded costs of $65.58 million net book value for Units 1, 2, 3, and 4 at Phillips Power Station and Units 3 and 4 at Brunot Island Power Station. Section 2803 of the Act defines "stranded costs" as costs that are traditionally recoverable under a regulated environment. Costs for generating plants that are not "used and useful" are not traditionally recoverable under a

regulated environment.[60] While the Act provides an exception for costs attributable to physical plants no longer used and useful because of the transition to retail competition, Duquesne acknowledges these units were placed in cold reserve and removed from rate base more than ten years ago, when no competitive electric generation market for Duquesne's end use customers existed. N.T. 195-196. Therefore, the Competition Act and the transition to a competitive generation market played no role in the decision to "cold reserve" these units. Accordingly, the Act precludes the recovery of this claim.

The Commission should also reject the argument of the HSS/ARI concerning how the burden of proof should be applied in this case, specifically as it relates to the valuation of stranded costs. The HSS/ARI stand the process of traditional ratemaking on its head. According to the HSS/ARI, any public utility seeking an adjustment of its rates must prove the reasonableness of each and every claim in its application, even though no party challenges any single item, or risk denial of its request. As the Commission has noted in numerous cases, a utility must, indeed, meet its burden of proving the reasonableness of its claims, but a party must first identify the item it challenges. Otherwise, the utility faces an insurmountable burden. The absurdity of the HSS/ARI's position is clearly revealed by the fact that the HSS/ARI challenge Duquesne's expenditure of hundreds of millions of dollars since the last base rate proceeding, more than ten years ago. Yet, the HSS/ARI fail to identify even a single expenditure as unreasonable. For this reason, the Commission should reject out-of-hand the argument of the HSS/ARI relating to how the burden of proof should be applied in this case.

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[60] See, e.g., Barasch v. Pa. P.U.C., 516 Pa. 142, 169-170, 532 A. 2d 325, 338-339 (1987), aff'd, 488 U.S. 299, 109 S.Ct. 609 (1989).

2. Market Value

(a) Introduction

(i) Duquesne's Proposal

If the Company's offer of an immediate auction is not accepted, Duquesne submits the Commission must address its proposal to conduct a "final valuation"[61] in 2001-2003 using market evidence (including an auction if so ordered by the Commission). Duquesne St. 1-R at 11-12. The foundation of this proposal is that: (i) computer forecasts of market prices are inherently unreliable; (ii) a market valuation in 2001-2003 will be superior because better market evidence will be available as electric markets mature; (iii) a valuation today is not necessary given that, even under the OCA and DII market price forecasts, Duquesne cannot fully recover its stranded costs until at least 2003; and (iv) given the nature of Duquesne's obligations under the rate cap, a final valuation later in the transition is preferable to a one-time valuation today. Duquesne M.B. at 25-26; Duquesne St. 1 at 14-18; Duquesne St. 1R at 11-17; Duquesne St. 3 at 12-20; Duquesne St. 3R at 15-32, 44-48.

Duquesne notes several parties, although not OTS, OTS St. 4 at 12-14, oppose Duquesne's proposal. The OCA and DII urge the Commission to adopt their computer forecasts of market prices. OCA St. 2; DII St. 2. DII rests its claim on the premise that "certainty" – i.e., fixing a total stranded cost number today – is of paramount importance in this case. DII St. 1 at 25. Duquesne finds this position unsustainable. The Act establishes "known and measurable" as the standard that must be met. 66 Pa.C.S. §2803. The Act elevates accuracy

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[61] Duquesne notes this "final" valuation is distinguished from its "interim" valuation, which it performed to determine how long Duquesne could continue changing currently approved rates pursuant to Section 2804(4)(v). Duquesne M.B. at 25-26, fn. 12; Duquesne St. 3 at 23.

over any supposed benefit of "certainty." Duquesne finds the only thing "certain" about the computer simulations the OCA and DII proffer is that they will inaccurately forecast future market prices. Duquesne Exh. 1-R at 7-11. Duquesne notes DII chose not to rebut the evidence Duquesne submits that such forecasts have proven grossly inaccurate, including in Pennsylvania. Duquesne M.B. at 26-27; Duquesne St. 3 at 6-16; DII St. 2 at 14.

Duquesne notes the OCA's principal objection to a final valuation is that it will not produce immediate "rate reductions" because current rates (per Section 2804) are charged in the meantime. OCA St. 1 at 13; OCA St. 1S at 4. Duquesne suggests the OCA has it backwards. The issue here is the soundness of the valuation methodology,[62] not whether it "results" in any particular rate stream. In any event, Duquesne contends the supposed importance of rate reductions, OCA St. 1 at 13 cannot be squared with Section 2804(4)(v), which suggests a legislative preference for accelerating stranded cost amortization to end the CTC recovery period early rather than reducing rates now and lengthening the transition period. Duquesne M.B. at 27; 66 Pa. C.S. §2804(4)(v).

Duquesne notes HSS/ARI oppose the final valuation because, they argue, Duquesne has no stranded costs. HSS/ARI St. 1 at 14. HSS/ARI stands alone on this issue: every other party that considered the matter in detail estimates that Duquesne has at least $1 billion in stranded costs. OCA Exh. MIK-1 at 1; DII Exh. SJB-2; OTS Exh. 4SR, Sch. 1. Using those estimates, Duquesne recalculated the date for its final valuation (Duquesne St. 2-R

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[62] Duquesne notes the OCA, like DII, does not assert that its market price projections are sufficiently reliable to meet that standard. OCA St. 2. Rather, its claim is that the forecasts provide a "consistent set of planning assumptions" for all Pennsylvania utilities. Duquesne M.B. at 27, fn. 13; OCA St. 2S at 1.

at 4-5); hence, it asserts the final valuation is no longer even based on Duquesne's market price projections. Moreover, Duquesne finds the evidentiary presentation supporting HSS/ARI's claim riddled with inconsistencies.[63] Finally, Duquesne contends HSS/ARI really seek a forced divestiture which is proscribed by the Act.[64] Duquesne M.B. at 27-28.

(ii) The OTS' Position

As Duquesne agrees, the OTS posits the difference between net book value, addressed in the previous section, and competitive market value represents that portion of book value stranded by competitive retail access. The competitive market value of electric generation plant is what a willing buyer will pay for the right to receive the net after-tax cash flows from the plant in the future. The level of after-tax cash flows is largely dependent upon the prevailing market price for power. OTS M.B. at 25-27; Duquesne St. 3 at 7.

In its direct case, the OTS notes the Company did not propose a specific market value of its generation plant, as of January 1, 1999, as its approach, supported by the OTS, is

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[63] Duquesne provides two examples. HSS/ARI devote nearly one hundred pages of testimony to attacking Duquesne's market evidence, HSS/ARI St. 1; HSS/ARI St. 1-S, yet fails to spend a single sentence critiquing the OCA's market price forecast, which is nearly identical to Duquesne's. Duquesne St. 3R at 24. HSS/ARI object to deferring the final valuation to a panel of experts, HSS/ARI St. 1 at 3-5, yet propose to defer a determination of nuclear decommissioning costs to an expert "auditor." Duquesne M.B. at 28, fn. 14; HSS/ARI St. 1 at 72-74.

[64] The Company notes HSS/ARI contend Duquesne cannot recover any stranded costs from ratepayers unless it sells all its generating assets today. HSS/ARI St. 1 at 141. Duquesne asserts that relief is proscribed by the Act. 66 Pa.C.S. §2804(5). The City recognizes the Commission cannot order such a sale absent Duquesne's consent, City St. 1 at 18, but suggests the Commission penalize Duquesne if it does not offer an immediate auction. Id. at 18-19. Duquesne urges rejection of this proposal as well. Duquesne M.B. at 28, fn. 15.

to defer final valuation until 2003. However, in rebuttal, in response to criticisms of the OCA and DII, the Company stated that if a one-time administrative quantification was required, its best estimate of generation plant market value, as of January 1, 1999, is $27 million, which results in total stranded costs of $1,916 million, subsequently revised on February 6, 1998 to $1,898.96 million. OTS M.B. at 25-26; Duquesne St. 3R at 4; Duquesne St. 2R at 12; Duquesne Exh. DJC-20 at 1.

The OTS notes the Company's $27 million estimate assumes the low end of market value for Duquesne's generating plants, based upon its market price analysis and the results of the Company's 1997 solicitation to sell firm power. Duquesne St. 2R at 12. There is an inverse relationship between generating plant market values and stranded costs; i.e., as market value decreases, stranded costs increase. OTS M.B. at 25-26; N.T. 395-396.

The OTS uses the Company's market price study, but supports a plant margin determined under the Company's delayed entry portfolio. This is the plant margin result which falls between the Company-supported low market price scenario and the high market price scenario. OTS St. 4-SR at 5. Use of this portfolio accommodates the OTS' assessment that utilities err on the high side with respect to stranded costs (therefore, Duquesne supports low market prices) and that the mid-range portfolio is more likely to be closer to the average of most market price projections. The resulting market value is $159 million ($81.10 million nuclear and $77.90 million fossil), as shown on OTS Exh. 4-SR, Sch. 1; See, also, Appendix, Tables 2 and 3. OTS M.B. at 26-27.

(iii) **The OCA's Position**

The OCA explains the determination of the market value of the Company's generating facilities, in the absence of a sale of those facilities, involves an estimation of the net present value of the net margins to be generated by those facilities. As indicated above, the Company and OCA both utilize a net margin analysis to determine the market value of Duquesne's generating facilities. The difference in results – $272 million – produced by those analyses the OCA attributes to two factors: (i) different market price projections and (ii) assumptions regarding treatment of generating facilities at the end of their useful lives (life extension). OCA M.B. at 28.

The OCA claims its approach to valuing owned-generation stranded costs was specifically endorsed by the Commission in PECO Energy, Slip Op. at 90, finding that the OCA's approach "best balances all of our considerations." In particular, the Commission found OCA witness Smith's analysis of market value the most credible, convincing and reasonable and was truly an "objective" analysis as compared to the other market value witnesses in the case:

> Though there is no single proposal that we find completely convincing on every component of its analysis, we adopt the testimony of OCA witness Smith as the most reasonable determination of future market value in the record and therefore determine a market value of PECO's stranded generation plants of $3.96 billion as of 12/31/98. Witness Smith's testimony is the most credible, and least criticized of any of the other market value witnesses, and produces a result approximately midway between the other two most credible models. We are also convinced that witness Smith performed an objective analysis of the issues in this proceeding, a task that the Commission believes no other party truly performed.

Id. at 88.

The OCA notes the Commission also concluded that the ENPRO model used by Mr. Smith "fairly represents several other important matters such as unit commitment, NUG operations, fuel prices, imports and exports, and heat rates." Id. at 89. The Commission also noted its specific agreement with Mr. Smith's "approach to fuel use by dual fuel units, the cost of new generation, and the use of average heat rates." Id. at 90; OCA M.B. at 29.

Before addressing the specific details of Mr. Smith's market value analysis in this case, the OCA emphasizes Mr. Smith's analysis, after adjusting the model to reflect the market area served by Duquesne and the data available for that market area, is, for all practical purposes, the same as the model utilized in PECO Energy. In light of the Commission's findings as to the credibility and reasonableness of Mr. Smith's analysis and to be consistent with the approach taken in PECO Energy, the OCA submits the Commission should adopt the OCA's analysis of the market value of owned-generation assets in this case. As discussed below, the result produced by this analysis – market value of $299 million compared to adjusted book value of nearly $1.5 billion – is consistent with what one would expect for Duquesne's mix of resources. In particular, the evidence shows that Duquesne's stranded costs are driven almost entirely by its high cost nuclear operations. Duquesne's coal plants, on the other hand, are generally economic, consistent with the market evidence, such as the Ft. Martin sale, which shows market values of coal plants to be well in excess of book value. OCA M.B. at 29; OCA St. 1S at 11.

The OCA notes, consistent with its final valuation proposal, Duquesne, in its direct case, presented an analysis of the market value of its generating assets at January 1, 2006 and compared that projected market value to its projected net book value at that date, net of

committed generation related depreciation and amortization, to determine that stranded costs of between $8 million and $513 million will still exist at that date. Projected market values were based on an analysis of market prices prepared by Duquesne witness Schnitzer and on forecasts of production costs and generation output by unit provided by Duquesne witness Karl. This analysis was brought forward to January 1, 1999 in the Company's Rebuttal case, which reflects a market value as of that date of $27.04 million, based on Mr. Schnitzer's "low" estimate of market value. Duquesne Exh. DJC-10. The Company's high estimate of market value is $278 million. OCA M.B. at 29-30; Duquesne Exh. DJC-20 at 1.

The OCA submits the Company's low market value estimate, based on Mr. Schnitzer's projection of the price of new capacity in 2006, is unreasonably low and fails to reflect the likelihood of life extension of existing units. In its place, the Commission should adopt the OCA's estimate of market value of $299 million, which reflects the results of Mr. Smith's dispatch simulation model for the APS/DQL area and Mr. Kahal's adjustment to life extend the Company's units. Notably, this estimate is not significantly higher than Mr. Schnitzer's high market value estimate, which does not take life extension into consideration. OCA M.B. at 30; OCA R.B. at 9.

(iv) <u>The City's Position</u>

The City concentrates on Duquesne's methodology of arriving at the market value of its generating assets in order to estimate its stranded costs. In estimating the amount of its stranded costs at December 31, 2005, and the present value of its stranded costs as of January 1, 1999, the City notes Duquesne uses an administrative approach and ignores actual market

information in an effort to inflate its claim. The City finds Duquesne embraces this method despite the fact that all parties to this proceeding, including Duquesne, criticize the administrative approach as inherently unreliable and endorse the sale of generating assets as the best method of ascertaining value. The City submits a sale of generating assets will dramatically reduce Duquesne's stranded generation cost claim. The City emphasizes it is extremely significant, in light of Duquesne's heavy burden of proof, that Duquesne admits that under its own administratively determined projections, it may realize no stranded costs, but rather a benefit of $233 million. City M.B. at 8.

(v) DII's Position

DII finds inappropriate Duquesne's proposal to delay market value determination of its generating units until some time during the transition period. Duquesne St. 2 at 40-41; Duquesne St. 2R at 3-4. DII suggests the Commission is obligated (under the Act and relevant Commission precedent) to determine market value of Duquesne's generating units (and the correlating stranded cost total) as a part of this proceeding. DII offers a market value determination based on a market price forecast. DII St. 1 at 9-10. DII claims its forecast, and the resulting stranded cost calculation, are reasonable and should be used by the Commission. Id. According to the DII calculations, Duquesne's stranded generation-related costs are $995.872 million. DII St. 1 at 48, DII Exh. RJF-5a. $994.969 million of this stranded cost is jurisdictional. DII M.B. at 30-31; DII St. 1 at 9; DII Exh. SJB-2.

DII submit the definition of "transition or stranded costs" contained in the Act supports a one-time determination of stranded cost responsibility. Multiple parts of this

definition dictate that the Commission must make a determination of the market value of Duquesne's generating assets and the correlating stranded cost total as part of this restructuring proceeding. First, the definition requires generation-related costs to be netted in determining stranded costs. It is impossible for the Commission, in this proceeding, to net Duquesne's potential stranded costs if one component of those stranded costs is not quantified. DII M.B. at 31.

Second, the definition establishes that a utility's stranded costs are to be determined "as part of its restructuring plan." In 2003, the Commission will no longer be considering Duquesne's "restructuring plan." Rather, the Commission will be fulfilling its duties in the "oversight of the transition process." 66 Pa. C.S. §2804. Stranded cost liability under the Act is intended to be determined as part of the Commission's duties during the first period, "as part of its restructuring plan," prior to the start of the transition process and direct access phase-in. DII M.B. at 31; 66 Pa. C.S. §2803.

Third, the definition of stranded cost under the Act allows recovery for only those costs "which the Commission determines will remain following mitigation by the electric utility." Id. This definition must be read in conjunction with the duties placed on electric utilities by the Act regarding mitigation. Electric utilities have the duty to mitigate generation-related stranded costs under the Act only during the transition period. Id.; 66 Pa. C.S. §2808(c)(4). The definition of stranded costs under the Act clearly contemplates a prospective evaluation of the electric utility's planned mitigation efforts during the transition period in determining the amount of stranded costs properly recoverable from ratepayers. An approach to generation asset valuation such as those offered by the Company in which determination of

market stranded cost is not made until a point substantially into the transition period will clearly not allow the Commission to fulfill its duty to consider the valuation of future mitigation efforts in establishing a just and reasonable level of stranded costs to be recovered from ratepayers. Id.; DII M.B. at 31-32.

DII submit the Act's "just and reasonable" recovery requirements also mandate that a definitive determination of total stranded costs be made as part of the Commission's decision in this restructuring proceeding. As previously explained, many provisions of Chapter 28 and the Code mandate that the Commission's establishment of a CTC meet the just and reasonable requirements. 66 Pa. C.S. §§1301, 2804(13) & 2804(14). To delay the quantification of Duquesne's total stranded costs until sometime in the latter part of the transition period will not allow parties and the courts sufficient information to review whether the Commission's decision in this proceeding will produce just and reasonable rates. DII M.B. at 32.

In addition, the Act also requires a yearly review of Duquesne's CTC revenues to:

> . . . reconcile the annual revenues received from the charge with the annual amortization of transition or stranded costs approved by the commission under this section. The commission shall adjust the competitive transition charge based upon underrecovery or overrecovery of the annual amortization amount.

66 Pa. C.S. §2808(f). The Commission stated: "Section 2808(f) requires annual reconciliation of CTC revenues in order to ensure that CTC revenues are no less nor greater than the authorized amount." PECO Restructuring Order, Slip Op. at 113. The Duquesne proposals to delay stranded generation cost determination will prevent the Commission from fulfilling its duty

under Section 2808(f). In short, if stranded costs are not determined in the instant proceeding, they cannot compare CTC revenues to "the annual amortization of transition or stranded costs approved by the Commission" under Section 2808. DII M.B. at 32-33.

Furthermore, the Commission's decision in PECO Energy incorporates a one-time determination of stranded costs as of December 31, 1998 by comparing the net book value to the projected market value (based on a market price forecast). PECO Restructuring Order, Slip. Op. at 80-91. The Act mandates that the transition be accomplished in a manner that is fair to all ratepayers, utility investors, utilities and competitors. 66 Pa. C.S. §§2802(8), 2804(7) & 2804(14). Fundamental fairness requires that an issue such as whether final determination of stranded costs should be delayed past the end of the restructuring plan litigation and customer choice phase-in must be decided on a statewide basis. It is unfair for Duquesne's ratepayers to bear the heightened risk of stranded cost recovery that is associated with the Company's delayed valuation proposals. It is unfair for Duquesne's ratepayers to not have a definitive establishment of their total stranded cost and competitive transition charge responsibility before the start of direct access phase-in when PECO's ratepayers have such certainty. The balancing and fairness contemplated under the Act mandates that the Commission make a definitive determination of Duquesne's stranded cost as part of this proceeding. DII M.B. at 33.

In contrast to Duquesne's proposals to delay the stranded cost determination, DII offers a definitive calculation of the market value of Duquesne's generating units (and the correlating total stranded cost) as part of this proceeding. DII St. 1 at 9-10; DII St. 2 at 1-48. DII uses the "asset value method" of determining stranded generation costs. The asset value method of stranded cost calculation is a most reasonable balancing of competing interests

involved in this proceeding. 66 Pa. C.S. §2802(8). Adoption of the asset value method for calculation of Duquesne's stranded costs also will result in the consistency of approach necessary by the Commission throughout the state on this issue because the same approach was used in the PECO proceeding. DII M.B. at 33; PECO Restructuring Order, Slip Op. at 80.

DII explains the asset value method essentially determines the loss to Duquesne, if it sells its generating assets at market price, without actually having the Company relinquish the assets and consummate a sale. DII St. 2 at 10-11. The asset value method computes the "loss" experienced by shareholders, because of movement to a competitive market by comparing a market value estimate of Duquesne's assets under competition to the present value of those assets contained on Duquesne's books. Id. at 20; DII St. 1 at 20. DII assert the asset value method is a reasonable proxy for results obtained from a properly implemented divestiture. DII M.B. at 34.

DII asserts the asset value method is fully consistent with the definition of stranded costs in Chapter 28. Duquesne shareholders will be appropriately compensated for any reductions in the value of the property supporting their investment. The difference between the book value of the assets and the revenue the units will earn for the Duquesne shareholders in the competitive market is the "net generation-related cost" of the effect of restructuring on those generation assets. 66 Pa. C.S. §2803. Under regulation, shareholders were given an opportunity to earn a just and reasonable return on the generation-related assets. Investors were guaranteed only a "return of" their investment; investors were not guaranteed a "return on" their investment. Duquesne Light Company v. Barasch, 488 U.S. 299, 109 S.Ct. 609 (1989); Philadelphia Electric Co. v. Pa. P.U.C., 433 A.2d at 623 (Pa. Commonwealth Ct.)(emphasizing

that removal of units from rate base represented a denial of a return on investment, but not a denial of a return of investment). Thus, the asset value method calculates stranded costs based on the return of the shareholders' investment and any diminution in the value of that asset caused by the transition to a deregulated market. This is precisely the type of balancing of shareholder and ratepayer interests that is contemplated under the Act. DII M.B. at 34; 66 Pa. C.S. §§2802(8) & 1301.

Furthermore, DII notes the Commission utilized the asset value method to determine the amount of stranded generation costs that PECO will be permitted to recover. PECO Energy, Slip Op. at 80. Chapter 28 mandates that the transition to a competitive market be accomplished in a manner that is fair to all consumers, utilities and competitors. 66 Pa. C.S. §§2802(8) & 2804(14). Fairness demands that the asset value method be consistently applied in the valuation of stranded generation costs. DII M.B. at 34-35.

DII finds Duquesne's arguments supporting the Company's proposal unpersuasive. According to Duquesne, the Commission should consider the Company's various positions regarding asset market value in the following order:

(1) The Company's offer to divest itself immediately of all generating assets to determine the market value;

(2) The Company's proposal to conduct a "final valuation" in 2001-2003 using market evidence, which could include an auction if ordered by the Commission; and

(3) The Company's stranded cost recommendation based on the range of market prices submitted by Mr. Schnitzer.

DII R.B. at 14; Duquesne M.B. at 18, 22, & 28.

DII argues the only Company-sponsored option that is appropriate for the Commission's use is to accept Duquesne's offer to auction immediately all of the Company's generating assets. DII M.B. at 39-45. This option, however, must not eliminate customers' statutory right to return to service at capped rates. DII R.B. at 14-15.

DII notes Duquesne gives four reasons in support of its second option to conduct the final asset valuation in 2001-2003:

(1) Computer forecast of market prices are inherently unreliable;

(2) The market valuation in 2001-2003 will be superior because better market evidence will be available as electric markets mature;

(3) Evaluation today is not necessary given that Duquesne cannot fully recover its stranded costs until at least 2003; and,

(4) Duquesne's obligations under the rate cap militate in favor of a final valuation later in the transition period.

Duquesne M.B. at 26. DII finds the Company's purported foundation for the delayed valuation is baseless and must be rejected. DII R.B. at 15.

First, although computer forecasts of market prices are not completely accurate, DII asserts computer forecasts are the best evidence the Commission has to fulfill its duty under the Act to value Duquesne's stranded costs (absent an immediate and full auction).

> Duquesne attempts to justify this omission on the basis that market prices are too uncertain to be forecasted. I agree that there are certain difficulties in forecasting market electricity prices. However, as economist William Baumol once stated, "The only thing worse than forecasting the future is <u>not</u> forecasting the future!" Duquesne appears to prefer the "head in the sand" approach to dealing with change. Based on Duquesne's comments, the Company apparently has no idea of what its assets are worth. One wonders how Duquesne was able to decide that the sale of its share of Fort Martin Unit 2 to APS (at a high multiple of book value) was a "good deal."

DII St. 2 at 13. Contrary to the Company's assertion that DII does not "rebut" its evidence of the past inaccuracy of market price forecasts, Duquesne M.B. at 27, DII asserts market price forecasts are the best evidence in this proceeding to balance the need for a definitive determination of asset market value against the Act's known and measurable standards. DII M.B. at 30-35; DII St. 2 at 13.[65] The Commission relied on a market price forecast to determine PECO's stranded generation cost. PECO Energy, Slip Op. at 82-91. Certainly, reliance on a market price forecast is appropriate to determine Duquesne's stranded generation costs. DII R.B. at 15-16.

Second, DII argues delaying the market valuation will not necessarily produce better market evidence upon which to base the valuation in 2003. Under Duquesne's delayed valuation proposal, unless an auction is ordered, an arbitration panel will determine the value of Duquesne's assets. Duquesne St. 2R at 3-4. An arbitration panel must look at evidence such as market price forecasts. The arbitration panel must also review other market price indicia such as comparable sales of generating units. An arbitration panel will not be able to determine administratively, with certainty, the market value of Duquesne's generating assets in 2003. OCA St. 1 at 12. Any level of uncertainty inherent in DII's recommendation will also exist in the arbitration panel's decision in 2003. DII's market price forecasts provide the Commission with information to perform the definitive stranded cost valuation necessitated by the Act, See,

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[65] DII contends it is no more certain the DII market price forecast will "inaccurately forecast future market prices," Duquesne M.B. at 27, than it is certain the Duquesne proposals will result in an accurate market valuation by an arbitration panel in 2003. DII R.B. at 15-16, fn. 6.

66 Pa. C.S. §§2803, 2802(8) & 2808(f); delaying valuation deprives the Commission of this ability. DII R.B. at 16.

Third, DII claims the length of time required for Company recovery of any authorized stranded cost is irrelevant to whether a definitive level of stranded costs must be determined in this proceeding. DII explains the Act clearly contemplates a one-time assessment of the utility's stranded cost as part of this proceeding. DII M.B. at 30-33. The following reasons support DII's assessment of the Act:

- The definition of stranded cost requires generation-related costs to be netted in determining stranded costs. 66 Pa. C.S. §2803. It is impossible to net Duquesne's potential stranded costs if one component of stranded costs is not quantified.

- The definition of stranded cost states that such costs are to be determined "as part of the restructuring plan." Id. The Commission will not be reviewing Duquesne's restructuring plan in 2001-2003.

- The definition of stranded cost requires that such cost be mitigated. Id. The Commission is required to look at both retrospective and prospective mitigation by the Company. Id. §§2808(4) & (5). The Commission cannot fulfill its duty to ensure that such costs are mitigated in order to produce a just and reasonable level to recover from ratepayers unless a definitive level of stranded cost is determined as part of this proceeding.

- The Commission cannot perform its duty to ensure that stranded cost recovery is "just and reasonable" unless a definitive determination of total stranded costs is made as part of the restructuring proceeding. See, id. §§1301, 2802(15), 2804(13), 2804(14) & 2808(c)(3).

- The Commission cannot fulfill its duty under the Act to perform a yearly reconciliation of the CTC revenues, Id. §2808(f), unless a definitive level of stranded cost is established as part of this proceeding.

- Delaying determination of stranded costs does not adequately balance the interests of ratepayers and the Company, in violation of Section 2802(8). Id. §2802(8).

- Delaying determination of a definitive level of stranded cost is unfair and equitable to Duquesne's ratepayers because other ratepayers in the Commonwealth have been granted such certainty as to stranded cost responsibility. Id. §2802(8).

- Delaying determination of Duquesne's stranded cost will hinder the development of the competitive market, in contravention of the goals of the Act. Id. §§2802(4)-(7).

DII R.B. at 16-17. DII illustrates, regardless of how long it will take Duquesne to recover its allowed stranded costs, it is imperative that a definitive level of stranded costs be determined as part of this proceeding. Id. at 17.

Fourth, DII contends Duquesne's concerns about the rate cap are insufficient to deviate from the Act's clear mandate that a definitive level of stranded cost be determined in this proceeding. The Act represents a balancing of ratepayers', shareholders', utilities' and competitors' interests during the transition period. 66 Pa. C.S. §2802(8). Although the Company repeatedly asserts its aversion to rate cap legislation, Duquesne St. 1R at 13-16; N.T. 137 & 163-64, this aversion is irrelevant; the Act requires a rate cap as a necessary consumer protection. Rate cap elimination eviscerates the balancing implicit in the Act. The Company cannot arbitrarily select which portions of the Act it will abide. DII R.B. at 17.

Finally, DII submits the Commission must reject any reliance on Duquesne's range of market prices and stranded costs. DII M.B. at 24. The Duquesne range developed by Duquesne witness Schnitzer does not address a number of relevant factors that must be considered in a market price forecast, including the following:

- The relevant market for the forecast, DII St. 2 at 15;

- An accurate assessment of fuel prices, Id. at 16;

- Consideration of information about the regional fleet of generation resources, such as, generator capacities, heat rates, availability statistics, and maintenance requirements, Id. at 16;

- Customer demands (average energy and usage patterns), Id.;

- Sufficient future capacity additions, Id.; and,

- A realistic assessment of the cost and efficiency of new capacity, Id. at 17-18 & 24-33.

DII finds Duquesne's analysis simply lacks the level of detail necessary for the Commission to determine this important component of the restructuring filing.

> Mr. Schnitzer's approach is unrealistic. Mr. Schnitzer nominates a range of capacity prices, heat rates, carrying costs, and etc. He then selects the low and high end of each variable to derive his low and high prices. There is no reason to assume, however, that there is any realistic chance that all of the "low" or "high" variables will occur simultaneously. For example, it is quite unlikely that both the low heat rate and low capital cost estimates would occur in tandem. In fact, . . . capital costs are inversely related to heat rates: the more efficient plants cost more to build. Thus, the simultaneous selection of all "low" or "high" values is unrealistic. Arbitrarily combining the extreme values of all variables does nothing but produce a meaningless analysis. The wide range of possible prices that Mr. Schnitzer laments stem mostly from the fact that he has "manufactured" much of the claimed uncertainty by his combination of extreme values. In addition, even his so called "high" prices reflect heat rates and capacity cost forecasts that are more properly characterized as "low," "optimistic," or even "wildly optimistic" estimates. In other words, even Mr. Schnitzer's "high" prices reflect unreasonably low capacity costs and exceptionally high efficiency rates for new units.
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> * * *
>
> Mr. Schnitzer shows no evidence to support his conclusion that new combined cycle plants will be the most economic capacity addition. He does not determine where such units will fall into the regional dispatch. He performs no detailed examination of the need for capacity in the region. He assumes all generators will be

> paid the same market prices, regardless of where they appear in the regional dispatch. All of these factors influence market prices and where possible, should be considered in a more detailed analysis.

DII R.B. at 18-19; DII St. 2 at 22-23.

Furthermore, DII suggests the Company's assertion that the Schnitzer forecast is based on market evidence is misleading. Duquesne M.B. at 29. The Schnitzer analysis for 1997-2005 is based on the results of Duquesne's offer to sell a firm block of power for an eight-year period. Id. The results of that reverse-RFP, and the single year reverse-RFP, have been widely criticized in this proceeding as understating the retail price of electricity. HSS/ARI M.B. at 30-36. "Market evidence," such as Duquesne's sale of the Fort Martin Unit 2 for a substantial gain, clearly suggests that Duquesne overstates its stranded costs. DII R.B. at 19; DII St. 2 at 14.

All of the Company's options for asset valuation contain significant flaws. DII submits the DII asset valuation is the most reasonable and accurate assessment of the value of Duquesne's generating assets in the competitive market. DII urges the Commission to accept the DII calculation. DII R.B. at 19.

(vi) HSS/ARI's Position

In considering Duquesne's calculation of market value, i.e., the key component of its stranded cost calculation, HSS/ARI find the testimony of Duquesne's President and CEO critical. Mr. Marshall states that Duquesne believes administrative projections of future market prices are inconsistent with the known and measurable standard. Duquesne St. 1 at 14; N.T.

61. When asked: is it Duquesne's position that it is entitled to $1.9 billion in stranded costs based upon an administrative determination, Mr. Marshall answers:

> We are saying that based on the best information we have today, that we estimate the number at 1.9 billion.
> [However, w]e do not believe that the method is adequate to determine a stranded cost calculation today.

HSS/ARI M.B. at 27; N.T. 75.

> Similarly, Mr. Marshall testifies:
>
> Based on the best information we have, what would the number be, it is 1.9, but when you say, do I support it, I don't support it . . . .

HSS/ARI M.B. at 27-28; N.T. 79.

> And, Mr. Marshall responds as follows, when asked:
>
> Q. [A]re Mr. Schnitzer's price projections - now I'll make it very specific to the period 2006 and beyond - are those price projections consistent with the known and measurable standard?
>
> A. No.

HSS/ARI M.B. at 28; N.T. 82. Given this testimony, HSS/ARI argue the following discussion largely is academic, because there can be no dispute that Duquesne has not submitted a stranded cost calculation that even Duquesne believes satisfies the statutory standard. Nonetheless, it is worthwhile to review the evidence to see how Duquesne determines a market value that by any reasonable assessment must be determined to grossly understate the real value of Duquesne's generation facilities. HSS/ARI M.B. at 28.

(vii) The PRA's Position

The PRA finds this issue to be the most controversial subject in this proceeding. The conclusion reached as to the market value of assets results in a significant swing in the level of stranded costs the parties deem just and reasonable. Obviously, the higher the market value, the lower the stranded investment and vice versa. The PRA argues Duquesne seeks the lowest market value possible in order to insure the largest recoverable amount of stranded investment and to insure the greatest competitive position once the retail generation market begins to mature in the next century. PRA M.B. at 41-42.

The PRA urges rejection of Duquesne's proposals to delay a final valuation of stranded costs until a future date. Stranded costs must be set in this proceeding. A market valuation in a subsequent time period will have to rely upon forecasts of future market prices to establish whether stranded costs are fully recovered at that time; it will rely upon past market transactions as indicators of future market prices, a dubious proposition; and the rate cap/ obligation to serve argument is a red herring, since it simply means the CTC was established too high and Duquesne is overrecovering its stranded costs. PRA R.B. at 11.

Contrary to Duquesne's assertion, the PRA submits the Act does not elevate accuracy over any stranded cost formula. Duquesne is protected if market prices rise because that simply means it is overrecovering the CTC or its stranded costs. If market prices fall, Duquesne is still recovering its full CTC, it can purchase power supplies at the lower market cost and its recovery of stranded costs throughout the transition period lowers its net operating costs (particularly depreciation) thus enabling it to meet the lower market price. Duquesne

simply ignores the interdependence of the entire Act. The Legislature gave Duquesne the tools to meet competition by allowing it to receive its stranded costs. PRA R.B. at 11-12.

(viii) The Environmentalists Position

The Environmentalists note approximately 64% of Duquesne's total stranded cost claim is its calculation of $1.916 billion of stranded generating assets. They agree with Duquesne that it is not possible to determine and fix the level of stranded cost at this time. They admit not knowing what the true market price for power is today because no competitive market for power exists. They find any projection of a reasonable market price for electricity for 30 years into the future is just short of madness. Env. M.B. at 14-15.

The Environmentalists also note Duquesne proposes a methodology which makes an initial quantification of market price and stranded costs, and then revisits the issue in a second quantification expected to occur in 2002 or 2003. To the Environmentalists, this approach makes sense, but they have serious problems with several of the details. Id. at 15.

First, the Environmentalists express concern about Duquesne's methodology for determining the annual market price of electricity by auctioning off a small block of power and using the auction price as that year's market price. Since the annual power sale will be for only a portion of Duquesne's power, it is not clear how well the sale price will reflect the overall market price. Id.

Also, because the power sale will take place in the context of a mixed competitive/regulated market, the Environmentalists find it is unlikely the price will accurately reflect a true market price. As long as buyers and sellers in the marketplace are receiving

stranded cost recovery in a regulated setting, it is likely the market price will be artificially low. If utilities are not allowed recovery of stranded cost, then the price which develops in the competitive marketplace will be a true market price, but the act of setting a stranded cost level determines the market price. In the presence of stranded cost recovery, a true market price is unlikely to develop. Id.

The Environmentalists second objection is that the second-phase valuation, scheduled to occur in 2002 or 2003, is not described well in Duquesne's filing and there is little assurance that absent a total divestiture, one will be any more able to determine the true market value then than today. If Duquesne's shopping credit is accepted, the Environmentalists doubt that much of a competitive market will develop until the CTC ends, when one will face as much uncertainty in 2002 as now. The proposal to sell a small slice of generation to set the market value of all of Duquesne's generating plant is not the correct approach. Id. at 15-16.

(ix) MAPSA's Position

MAPSA notes Duquesne's argument that 66 Pa. C.S. §2804(4)(v) suggests a Legislative preference for accelerating stranded cost amortization. MAPSA disagrees with Duquesne's suggestion that lengthening the CTC recovery period is not allowed by the Competition Act, if that is what Duquesne intends to imply. Rather, the Competition Act expressly allows for the extension of the CTC recovery period if it is necessary to promote competition. MAPSA R.B. at 7-8; 66 Pa. C.S. §2808(b).

(b) Market Price Projections

(i) Forecasting Methodology

(1) Duquesne's Proposal

Duquesne notes the market price projections discussed below need only be addressed if the Commission determines a one-time forecast of stranded costs must be made today.[66] Three witnesses submit market price forecasts: Mr. Schnitzer (Duquesne), Mr. Smith (OCA) and Mr. Falkenberg (DII). The key methodological difference between the Duquesne and OCA/DII forecasts is that Mr. Schnitzer bases his forecasts, wherever possible, on market transactions. Specifically, for the years 1997-2005, Mr. Schnitzer uses the results of Duquesne's eight-year RFP. Duquesne Exh. MMS-4; Duquesne St. 3 at 32-39; Duquesne St. 2-R at 12.[67] Duquesne submits this is the only market evidence of power prices during that period.[68] For the years beyond 2005, no comparable market evidence was available and, therefore, Mr. Schnitzer based his forecast (for those years) on the cost of new capacity; the cost of new capacity serves as a "cap" on market prices, although prices may well be below the cap. Duquesne St. 3 at 25-37.[69] In estimating the cost of new construction (a combined cycle unit), he provides a range

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[66] Duquesne also notes the exception is that if the Commission adopts the final valuation proposal, the Commission also should find that the market price forecasts of OCA (or Duquesne) are reasonable for the more narrow purpose of setting the date for the final valuation. Duquesne M.B. at 28, fn. 16.

[67] That auction produced 11 bids for 1300 MW of firm power to be sold by Duquesne for an eight-year period. Duquesne M.B. at 29, fn. 17; Duquesne St. 7 at 9.

[68] Duquesne claims the evidence is consistent with historic market price data for power sales in its area. Compare, Duquesne St. 7 at 9 with Id. at 3-6 and Duquesne St. 5 at 74-76. Duquesne M.B. at 29, fn. 18.

[69] Duquesne submits the cost of new capacity provides a "ceiling" (or cap) on the prices (continued...)

("low" and "high") of prices and, again, relied on actual market data as much as possible. Id. at 26-27 (using market data for gas and gas transportation costs). Duquesne M.B. at 29-30.

The Company urges the Commission to find Mr. Schnitzer's forecasts are inherently superior to the OCA/DII methods, given that he uses market evidence wherever possible.[70] Duquesne finds, even despite the methodological differences, the results of Mr. Schnitzer's low price forecast and Mr. Smith's forecast are nearly identical. Duquesne M.B. at 30; Duquesne St. 3-R at 24.

(2) The OTS's Position

The OTS agrees with the Company's assessment that market price forecasts are inherently inferior to use of actual market prices for determining market value. However, if a one-time administrative determination of stranded costs is required as of January 1, 1999, then market price projections must be used to determine market value to be netted against net book value for determining stranded generation plant costs. The OTS accepts the Company's market price forecasting methodology, but recommends use of the delayed entry portfolio of market prices. OTS M.B. at 27.

(...continued)
existing producers can charge "because if market prices were to exceed the ceiling it would be economic for new entrants to contest the market at those prices." Duquesne M.B. at 29, fn. 19; Duquesne St. 3 at 25.

[70] As indicated by Mr. Marshall, Duquesne is not recommending the use of estimates of market prices, including Duquesne's own estimate, for purposes of making a one-time determination of stranded costs. Duquesne M.B. at 30, fn. 20; N.T. 75-79.

(3) The OCA's Position

(A) Duquesne's Approach

The OTS notes the Company develops projected market values based on an analysis of market prices prepared by Michael M. Schnitzer, a consultant with the NorthBridge Group in Waltham, Massachusetts. For this purpose, Mr. Schnitzer develops "a range of ceiling market prices . . . based on the cost of new entry beyond 2005." Duquesne St. 3 at 25. In other words, rather than estimating market prices in 2006 and beyond per se, Mr. Schnitzer estimates the cost of entering the market by new construction in 2006 and this cost represents the "ceiling" on the market price. Id. Mr. Schnitzer opines this approach is "conservative" and will tend to overstate market prices (and thus understate stranded costs) "because if market prices were to exceed the ceiling it would be economic for new entrants to contest the market at those prices." OCA M.B. at 30; Duquesne St. 3 at 25-26.

In performing his analysis, Mr. Schnitzer assumes "the technology of choice for new entrants in 2006 will be a gas-fired combined cycle unit" and develops a range of prices reflecting alternate assumptions concerning capital cost, heat rate and the capital structure and payback requirements of the project. Id. at 26. The details of these alternate assumptions are set forth in Exhibit MMS-2. In order to determine market prices for new gas-fired combined cycle entrants, Mr. Schnitzer also estimates gas prices delivered into ECAR. OCA M.B. at 30-31; Duquesne St. 3 at 26-27.

Using this approach, Mr. Schnitzer estimates market prices in 2006 ranging from $34/mwh to $44/mwh in 2006 dollars, and escalates these prices with an annual estimate of general inflation of 2.5%. Id. at 27. Further, these prices were presented as "a real levelized

price" reflecting an 84% capacity factor, which reflects the average capacity factor of Duquesne's generation portfolio. Id. Mr. Schnitzer states, in his view, prices are likely to be lower than this range due to improvements in technology, customer demand response, i.e., customer willingness to interrupt, less costly supply options than included in his projections, and excess entry into the competitive market. Id. at 30-31. Additionally, Mr. Schnitzer points to Duquesne's RFP to support his view that the Company's low market prices are more realistic. OCA M.B. at 31; Duquesne St. 3 at 32-37.

In his rebuttal testimony, Company witness Clayton calculates stranded costs as of December 31, 1998 in Exhibit DJC-20 based on Mr. Schnitzer's low market scenario since the Company believes it is this scenario that is "most likely to occur." Duquesne St. 2R at 12. This analysis produces stranded costs of $1.916 billion, as shown on Duquesne Exhibits DJC-10 and DJC-20. OCA M.B. at 31.

(B) The OCA's Approach

In contrast to Duquesne witness Schnitzer's analysis of the cost of entry as the upper bound of a range of market value, OCA witness Douglas C. Smith presents a dispatch simulation model of the APS/DQL system as a single market area using the ENPRO dispatch simulation model to estimate market revenues in each hour. OCA St. 2 at 5. ENPRO is a detailed, chronologic model used by utilities and others for a range of operational and planning analysis, and is well suited for the purpose of estimating market prices based on the dispatch of marginal units for a large electric system. Id. In PECO Energy, Slip Op. at 89, the

Commission specifically approved the ENPRO model as quite suitable to the task of estimating generating market revenues. OCA M.B. at 31-32.

The OCA explains ENPRO incorporates a number of key inputs into the model itself, while other inputs were determined by Mr. Smith. In particular, ENPRO represents unplanned (or "forced") outages of generating capacity randomly on a daily basis, and planned outages are scheduled to the extent possible during off-peak periods. OCA St. 2 at 5. Imports are represented explicitly as available sources to be dispatched when economic. OCA M.B. at 32. OCA St. 2 at 5.

Mr. Smith represents the energy market in terms of bids for delivered energy from each generating unit, with each bidder assumed to bid a price sufficient to recover its average variable cost based on the unit's historical as-operated heat rate. Id. Like Mr. Schnitzer, Mr. Smith also assumes that, over time, market prices must be sufficient to support the cost of new market entrants. Id. For this purpose, he assumes newly constructed Combustion Turbine ("CT") units will be used for peaking duty and Combined Cycle ("CC") units will be used for baseload/intermediate duty. Id. Mr. Smith assumes all-in capital costs of $560/kW in 1997 dollars for the CC option and $296/kW in 1997 dollars for the CT option, based on a review of industry data and estimates provided by other Pennsylvania utilities. Id. at 9. These estimates are derived on Mr. Smith's Exhibits DCS-2A (CC) and DCS-2B (CT). Id. Mr. Smith views these as conservatively low estimates of the costs associated with new entrants for a number of reasons, including: (i) his expectation of greater interest costs during construction; (ii) increases in CC/CT equipment costs from current market conditions, which represent historical lows for such costs; (iii) higher land costs as compared to the generic land

prices used by Mr. Smith; (iv) higher project development costs ("soft costs"); (v) higher plant costs associated with selection of other than "plain vanilla" plant equipment and services, reflecting choices of units with more efficient steam cycles, reliability features such as a bypass stack or multiple shaft design, more extensive site work and buildings and large inventories of spares; (vi) higher costs associated with selective catalytic reduction equipment; and (vii) the inclusion of general plant (not included in his estimate), which will presumably be incurred by generating companies in the ECAR market. OCA M.B. at 32; OCA St. 2 at 9-10.

The costs of new entrants were factored into Mr. Smith's dispatch model through the use of an annual fixed charge, or carrying charge rate, which reflects the capital-related costs of the unit as a percent of the project's initial cost. Id. For this purpose, he utilizes a 12.75% carrying charge rate. OCA M.B. at 33; OCA St. at 10-11.

Mr. Smith's analysis assumes all generators selling into the spot market at any given time will receive the same price for their output and price will reflect the highest bid accepted by the system operator, and bidders will bid hourly output based only on its variable cost. Id. at 11. Thus, generating units with high variable costs that run infrequently will receive little or no contribution toward their fixed costs in most hours. Id. However, such units will need to recover such costs and Mr. Smith indicates the market will provide mechanisms to enable the recovery of such costs. Id. at 11-12. He identifies four ways in which the market will compensate for these costs: (i) bids above variable costs; (ii) interruptible demand payments; (iii) bilateral transactions; and (iv) ancillary service revenues. OCA M.B. at 33; OCA St. 2 at 12-13.

Mr. Smith expects a combination of these mechanisms will yield market prices sufficient to support the level of system reliability that customers desire, or that is established through minimum capacity requirements. Id. at 13. Thus, Mr. Smith explains, "generation market prices will most likely exceed the variable cost of the highest-cost generating unit(s) in the market during some fraction of the year," resulting in what he terms "reliability-related" revenues. Id. Mr. Smith assumes in his analysis that, in the long run, such revenues are capped at the estimated cost of peaking capacity, i.e. "the real-levelized cost of a newly constructed combustion turbine." Id. He further assumes these revenues will be concentrated in "only the highest-demand hours, so that all generating units will receive the same reliability-related revenues on a per-kW basis" and sufficient generating capacity will be constructed to maintain an 8% reserve margin of installed capacity above the annual peak demand. OCA M.B. at 33; OCA St. 2 at 13.

Mr. Smith explains actual market prices can turn out to be higher because upward pressure may be exerted on prices in the Northeast and Mid-Atlantic due to an earlier need for capacity in the PJM market and retirements and unavailability in the NEPOOL market area. Id. at 14. Upward pressure resulting from the retirement of units for economic reasons may also drive prices higher than assumed by Mr. Smith, who did not test the economic viability of ECAR generating units; he conservatively assumes existing units will continue to operate. OCA M.B. at 33-34.

Therefore, the OCA argues, in comparison to Duquesne witness Schnitzer's analysis, OCA witness Smith's forecasting methodology provides a more robust analysis of the

interactions between supply and demand in the marketplace than that presented by Duquesne in this proceeding. Id.

The OCA notes the Company's only criticism of Mr. Smith appears in a footnote, where it criticizes his assumption of an 8% reserve factor as a market rule which does not exist and which produces a significant increase in price in 2003. Duquesne M.B. at 31, fn. 22. The OCA explains the 8% reserve factor assumption reflects Mr. Smith's judgment that customers will seek a level of system reliability comparable to historical minimum targets and is extremely reasonable given the current high levels of reserves in ECAR. OCA R.B. at 9.

While the Company provides few comments about OCA's market price projections, the OCA further notes the Company suggests its own witness' market price projections are superior because they rely on the best market evidence available, estimated prices for new market entrants in 2006. Duquesne M.B. at 30. OCA strongly disagrees with this assertion. Effectively, Duquesne witness Schnitzer's analysis relies on only two data points: (i) the current price of gas-fired combined cycle plants, escalated to 2006; and (ii) natural gas price forecasts. OCA M.B. at 30-31. In contrast, Mr. Smith's ENPRO analysis incorporates not only market data regarding the cost of new entrants (both coal and gas-fired) using the same sources as Mr. Schnitzer and fuel forecast data, but utilizes a range of other data regarding the operation of the marketplace that will clearly impact on supply and demand and drive market prices. OCA M.B. at 31-38. The OCA submits the Commission is familiar with Mr. Smith's modeling efforts and has found his analysis to be objective, adopting his market value estimate in PECO Order, Slip Op. at 88. The OCA recommends its utilization for purposes of determining stranded costs in this proceeding. OCA M.B. at 9-10.

(4) The City's Position

The City finds universal agreement that a regulatory approach that involves forecasting market prices over a long period of time is inaccurate and unreliable and the best approach is to use actual market information - actual sales of generating assets. Duquesne expresses a strong view that predictions of future market prices are unreliable. Indeed, Mr. Schnitzer testified that ". . . a market-based determination of stranded costs is inherently superior to an administrative determination." Duquesne witness Marshall concedes as much in his surrebuttal when he proposes a 2003 divestiture. Yet, Duquesne continues to rely on its admittedly flawed methodology, which can cost Duquesne ratepayers many millions of dollars. City M.B. at 8-9.

By adopting an administrative approach and projecting long-term electricity market prices, the City argues Duquesne ignores the best evidence of value available: actual market value of generating assets, including Duquesne's sale of its interest in Fort Martin Unit 1 to APS' unregulated subsidiary for what amounted to $130 million in excess of the plant's book value. This proves Duquesne's claim intentionally is inflated to provide it the highest recovery and greatest insulation from competition. APS, Duquesne's proposed parent, presumably used a forecast of prices and determination of value of the Fort Martin facility that justified paying $130 million over book value. Yet, Duquesne actually estimates it will have to pay someone to own its plants. This blatant inconsistency and Mr. Schnitzer's rebuttal testimony dismissing the Fort Martin sale as irrelevant speaks volumes regarding Duquesne's true motivation in using an administrative, rather than a market, approach. The City finds Duquesne's approach is neither plausible, reasonable nor credible. City M.B. at 9.

(5) DII's Position

DII's market price projection uses a model referred as "the KPC Model." DII argues the KPC Model is appropriate because it is designed to predict prices in a competitive bid-based market, such as the market that Duquesne's generation assets will face during the transition period and beyond. The KPC Model contains two types of market price simulations: a probabilistic simulation and a "Monte Carlo" pumped storage simulation. DII St. 2 at 35-39. The KPC Model has been used in numerous regulatory proceedings throughout the country and has been successfully benchmarked against the utility company models in those proceedings. DII St. 2 at 37-38; DII Exh. RJF-2. The KPC Model is clearly suitable and appropriate to perform the market price analysis in this proceeding. DII M.B. at 35.

Duquesne does not criticize the KPC Model; rather, Duquesne professes a general aversion to all modeling. Duquesne St. 3 at 7-16; Duquesne St. 9R at 3-4. Although DII agrees with the Company that some uncertainty is inherent in forecasting market prices, that uncertainty is not sufficient to mandate rejection of the DII market price forecast in this proceeding. DII St. 1 at 26; DII St. 2 at 13. Many aspects of this proceeding rely on projections of costs or expenses. For example, Duquesne's nuclear decommissioning stranded cost claim relies on a projection of decommissioning expenses 30 years into the future. All market participants rely on projections that may not come to fruition. DII St. 1 at 26-28. The balancing of interests necessary under the Act mandates that the Commission rely on the most reasonable projections to establish Duquesne's stranded cost entitlement. 66 Pa. C.S. §2802(8). DII respectfully submits its market price analysis is the most reasonable projection and should be accepted by the Commission. DII M.B. at 35-36.

DII notes Duquesne's statement that examination of market price projections is necessary only if the Commission determines a definitive stranded cost total in this proceeding. Duquesne M.B. at 16. DII explains such definitive determination must be made under the Act. DII M.B. at 30-35. Consequently, if an immediate, total and unconditional auction of Duquesne's assets does not occur, the Commission must address and adopt the DII or OCA stranded generation cost calculation based on a market price forecast. The arguments raised by other parties do not undercut the validity of that analysis. DII R.B. at 19.

The OCA asserts Mr. Smith's market price forecast should be used because it was used by the Commission in the PECO proceeding. OCA M.B. at 2 & 28-29. Although DII believes many issues must be addressed consistently on a statewide basis, the use of one forecaster's market price analysis of two different markets is not one of those issues. Many of the inputs to the forecast logically should be consistent (such as the cost of new capacity). However, ECAR and PJM are different regional energy markets. In addition, the Commission specifically stated in the PECO decision that by adopting Mr. Smith's analysis, the Commission was not adopting "each and every input and assumption." PECO Energy, Slip Op. at 90. The Commission focused on the overall balance in Mr. Smith's market price projection for PJM. Id. Furthermore, the Commission found "substantial merit" in several of Mr. Falkenberg's recommendations. Consequently, DII asserts the OCA places too much emphasis on the PECO precedent. DII contends Mr. Falkenberg presents a reasonable and reliable projection of market prices for the ECAR region that should be accepted by the Commission.[71] DII R.B. at 19-20.

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[71] For these reasons, DII agrees that the same market price forecast should be used for both the Duquesne and the West Penn Power (Allegheny Power System) proceedings. DII R.B. (continued...)

Although the Company offers conclusory statements regarding the reputed superiority of its forecasts, DII notes it does not criticize the KPC Model in this proceeding. Moreover, the Company's general aversion to all computer models is both baseless and unrealistic. DII claims the DII model and recommendation are the best evidence of asset market value submitted in this proceeding (absent immediate, full and unconditional auction of Duquesne's assets). DII M.B. at 30-39; DII R.B. at 20.

(6) HSS/ARI's Position

HSS/ARI note Duquesne relies upon the testimony of Mr. Schnitzer to determine market prices for purposes of its stranded cost calculations (both as of January 1, 1999 and as of December 31, 2005). In determining his market price projections, Schnitzer uses a two-step process. First, he estimates future market prices for the period 1998 through 2005 using as a starting point for his analysis the results of Duquesne's summer 1997 Request for Proposals ("RFP"). Second, he inputs into a computer a handful of assumptions to derive price projections for the period 2006 until the book retirement date of each of Duquesne's generation facilities. HSS/ARI M.B. at 28.

HSS/ARI argue the adjustments Schnitzer makes to Duquesne's RFP results are inadequate to transform the result of Duquesne's wholesale auction of an incremental quantity of power into a price that reasonably is reflective of future retail market prices. Thus, Schnitzer's 1998-2005 price projections unreasonably understate likely prices at the retail level.

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[71](...continued)
at 20, fn. 7.

HSS/ARI also assert the assumptions that Schnitzer relies upon for his computer-generated post-2005 price projections also are designed to understate unreasonably future market prices. However, there is a preliminary matter that should be discussed that demonstrates why Schnitzer's price forecasts so grossly understate likely future market prices. Id. at 28.

HSS/ARI emphasize one must understand the starting points Schnitzer uses in his two sets of calculations are unreasonably low, thus, ensuring an understatement of future market prices. With respect to Schnitzer's 1998-2005 price projections, it is critical to understand why the prices paid in Duquesne's RFP were so low and, thus, wholly inadequate for purposes of estimating future market prices. With respect to Schnitzer's post-2005 price projections, it is critical to understand that his starting point, his estimates of the capital costs of combined cycle units, are so low that they are at odds not only with reality, but even with the specific source that Schnitzer touts as support for his estimates. Focusing on those two points in the following discussion demonstrates why even Duquesne and Mr. Marshall cannot support Schnitzer's price projections. Id.

(7) The PRA's Position

The PRA agrees with the analysis of the OCA on this issue. PRA M.B. at 42-47; PRA R.B. at 12.

(ii) Input Assumptions

(1) Duquesne's Proposal

The Company finds three disputed "input assumptions" merit discussion here. The first is Mr. Falkenberg's (DII) assumption that ECAR utilities will begin constructing new generating capacity immediately to meet an assumed 15% reserve margin requirement. DII St. 2 at 21; Duquesne St. 3R at 27.[72] Duquesne opines no evidence exists in the record to support Mr. Falkenberg's assumption. Rather, he simply asserts, without explanation, that "I add capacity to meet a 15% reserve margin requirement for ECAR." DII St. 2 at 21. Duquesne posits it is undisputed that no such reserve margin requirement exists in ECAR. Duquesne St. 9R at 2. Moreover, even apart from whether there is any such "requirement," ECAR predicts it has ample capacity through at least the year 2005. Duquesne St. 9 at 9. This is borne out by the results of Duquesne's recent power sale auction, Duquesne St. 3R at 27, and by recent capacity purchases by Duquesne that reflect the current excess capacity situation in ECAR. Duquesne St. 7 at 5-6. In sum, Duquesne finds no support for Mr. Falkenberg's assumption regarding capacity additions.[73] Duquesne M.B. at 30-31.

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[72] Duquesne claims this assumption causes his market price to escalate sharply in the early years of the transition period (when the net present value of such an adjustment is the greatest). Duquesne M.B. at 30, fn. 21; DII Exh. RJF-5b; Duquesne St. 3R at 26-27.

[73] Duquesne notes the OCA's Mr. Smith also makes an assumption that ECAR will add capacity pursuant to a set reserve margin, although his assumption (8%) is far less aggressive. OCA St. 2. His assumption produces an arbitrary "spike" in prices in the year 2003. OCA Exh. DCS-4. For the same reasons as discussed above, Duquesne argues such an "assumption" regarding capacity rules that do not today exist cannot possibly meet the known and measurable standard. Duquesne M.B. at 31, fn.22.

The second disputed assumption relates to Mr. Schnitzer's use of market prices from Duquesne's eight-year power sale auction. While Mr. Smith does not criticize this assumption[74] and Mr. Falkenberg devotes only a single sentence to it,[75] HSS and MAPSA attempt to criticize every aspect of the RFP. MAPSA St. 1 at 25-29; HSS St. 1 at 24-39. None of these criticisms is valid, as explained in detail by Mr. Lahtinen. Duquesne St. 5R at 5-20; Duquesne Exh. JAL-14; Duquesne St. 5R. Moreover, the arguments fail for a very simple reason: the prices produced by the RFP are consistent with all the other actual market data (not forecasts) in this case, none of which have the supposed "design defects" of the RFP. Duquesne St. 7 at 3-6; Duquesne St. 5 at 74-76. What MAPSA and HSS really dislike is the fact that prices are low in ECAR because the region has excess capacity. Duquesne M.B. at 31-32; Duquesne St. 9 at 9.

The third disputed assumption is Mr. Schnitzer's forecast of the cost of a new combined cycle unit. DII witness Mr. Falkenberg devotes considerable effort to attacking this forecast, yet his criticism is academic given that his own market price forecast for the same period (post 2005) is below Mr. Schnitzer's forecast. Duquesne St. 3R at 20: HSS/ARI witness Dr. Weisenmiller also criticizes Mr. Schnitzer's forecast, but neglects to criticize either (I) the OCA forecast, which is consistent with Mr. Schnitzer's forecast for the entire period; or (ii) the

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[74] Duquesne notes, with one exception, his own forecast closely tracks the RFP results. Duquesne St. 3R at 24. The one exception, as indicated in the previous footnote, is his assumption regarding the addition of new capacity in 2003. Duquesne M.B. at 31, fn.23.

[75] Mr. Falkenberg refers to the RFP results as reflecting "lower market prices" that do not "provide a realistic assessment of market prices." DII St. 2 at 14. Duquesne finds this comment is circular, just like his assumption of higher prices in the early transition years based on his assumption regarding the addition of new capacity immediately. Duquesne M.B. at 31-32, fn. 24.

DII forecast, which is consistent with Mr. Schnitzer's forecast post-2005. Thus, Mr. Schnitzer's forecast hardly stands alone, as Dr. Weisenmiller wrongly suggests. Duquesne M.B. at 32; HSS/ARI St. 1 at 152.

(2) The OTS' Position

The OTS notes the delayed entry portfolio assumes new combined cycle capacity will not become economic until after the year 2006. Duquesne St. 3 at 35. The OTS agrees this is a reasonable assumption since it is unlikely new combined cycle capacity will be economic to build in 2006 based on the 1997 RFP results, particularly if the required new entry prices are at the high end of the range, as Duquesne projects. OTS M.B. at 27-28; OTS St. 4SR at 6.

(3) The OCA's Position

(A) Introduction

In PECO Energy, Slip Op. at 88, the OCA notes the Commission specifically concluded that Mr. Smith's objectivity was evidenced by his not adjusting "PECO's treatment of nuclear capacity factors and reserve requirements in a way that increases stranded cost recovery . . . even though adjustments would have reduced PECO's stranded cost recovery significantly and would have been consistent with his credible testimony in the May 22, 1997 QRO proceeding." OCA M.B. at 34.

A number of the input assumptions utilized by Company witness Schnitzer and OCA witness Smith in the present case have been discussed above in connection with their forecasting methodologies. Because Mr. Schnitzer does not use a dispatch simulation model,

his input assumptions – primarily his estimated cost of new capacity – are very limited and in large part have been discussed above. The OCA summarizes Mr. Smith's other input assumptions and rebuts the Company's criticisms of them. Id. at 34-35.

In PECO Energy, Slip Op. at 89-90, the OCA notes the Commission indicated its agreement with Mr. Smith's assumptions regarding fuel price and the cost of new generation capacity. The Commission also agreed with Mr. Smith's assumptions regarding unit commitment, NUG operations, fuel prices, imports and exports, fuel use by dual fuel units, and the use of average heat rates. Id. Mr. Smith's primary input assumptions are, for all practical purposes, the same as he used in PECO Energy. OCA M.B. at 35-36.

(B) Capacity Reserve Margins

In his rebuttal testimony, Company witness Karl criticizes a number of the assumptions OCA witness Smith uses in his analysis. First, Mr. Karl criticizes Mr. Smith's use of an 8% capacity reserve margin, implying that Mr. Smith inappropriately uses this value as an administratively determined capacity requirement for ECAR. Duquesne St. 9R at 2. However, the OCA explains Mr. Smith's analysis is not based on the assumption of an administratively determined capacity payment; rather Mr. Smith assumes customers will seek a level of system reliability comparable to historical minimum targets, which have been estimated to require approximately an 8% regional installed capacity reserve margin. OCA St. 2S at 2-3. The OCA submits it is reasonable to use this approach in the context of forecasting generation market prices. Indeed, the Commission specifically endorsed Mr. Smith's capacity assumptions in PECO Energy. OCA M.B. at 36.

(C) Generating Unit Availability

The OCA notes Company witness Karl also questions the generating unit availability assumptions Mr. Smith uses, which is based on historical availability records for major classes of generating units as assembled by the North American Electric Reliability Council ("NERC"). Mr. Karl claims this data is problematic because it does not represent unique units/plants. However, Mr. Smith explains the future availability of generating units is uncertain and even unit-specific availability records provide no guarantee of future performance. OCA St. 2-S at 3. Furthermore, small variations in availability for particular generating units will have only a limited effect on market prices in a system such as the APS/DQL system modeled in Mr. Smith's analysis. Id. Thus, Mr. Smith concludes it is not an important limitation of the analysis. OCA M.B. at 36-37.

(D) System Load Shapes

In his analysis, OCA witness Smith assumes annual peak demands and energy requirements in the APS/DQL area will increase as projected for ECAR in the 1996 NERC Electricity Supply and Demand Database; he develops an hourly load shape based on an average of the 1995 and 1996 actual hourly shapes. Id. at 37; OCA St. 2S at 4.

The OCA notes Company witness Mr. Karl criticizes this input, contending that development of a combined load shape requires an assessment of the individual customer classes for APS and DQL. Duquesne St. 9R at 7. Mr. Smith explains this is not the case for the base year, which simply represent the sum of the hourly loads of the two systems. OCA St. 2S at 4. While the hourly load shape in future years is uncertain, the relatively stable nature of installed

loads and usage patterns make the historical curve the best basis from which to forecast. Id. Mr. Smith explains further that short term trends in load shape will likely have only a secondary effect on market prices and other factors, such as, the overall magnitude of demand growth, fossil fuel prices and the cost of new market entrants will likely be more important. Id. In the long term, it is reasonable to expect that changes in the system load shape will be partially or entirely offset by changes in the generation mix, with the amounts and type of new market entrants developed to "fit" the actual load shape and market price signals. OCA M.B. at 37.

(E) Generating Unit Heat Rates

While Mr. Karl does not disagree with Mr. Smith's use of as-operated heat rates, he points out that changes in a generating unit's operating role over time can alter the unit's as-operated efficiency and heat rate. Duquesne St. 9R at 9-10. Mr. Smith explains units that are called upon to operate in the same manner as they were in the past, but are simply called upon to do so more often, are unlikely to experience material changes in their as-operated heat rates. OCA M.B. at 37.

(F) Fuel Price Assumptions

With respect to fuel price assumptions, Company witness Karl raises a general concern with respect to natural gas price forecasts, based on Duquesne's experience that such forecasts have overstated actual market prices in the past. Duquesne St. 9R at 11. While future fossil fuel prices are plainly uncertain, the OCA suggests this fact does not mean fuel price forecasts are not appropriate for estimating future prices. OCA St. 2S at 5-6. The DRI

forecast, which Mr. Smith uses, is widely accepted and was effectively adopted by the Commission in PECO Energy. The Commission should use a consistent forecast in this case. OCA M.B. at 37-38.

(4) The City's Position

The City argues Duquesne's assumptions are either too conservative or are erroneous. They uniformly result in an understatement of value, and it is clear Duquesne's low case of value is particularly exaggerated. The City points out Duquesne's treatment of its Cheswick plant demonstrates a good example of the problems with Duquesne's assumptions. In its low market scenario, Duquesne will have to pay someone to take this plant. Yet, Duquesne has made the following faulty assumptions that undervalue the Cheswick plant:

- Duquesne uses an average availability factor that conflicts with its own witness' testimony that is higher. Using the higher factor results in a $14 million increase to the value of the plant in the low price scenario and $28 million in the high price scenario.

- Rather than assuming that 6% of the Cheswick plant's output is unavailable to sell into the market, Duquesne should have calculated its plants' projected revenue consistent with Schnitzer's methodology whereby Schnitzer does not adjust his calculations for any losses in the transmission or distribution systems. If Duquesne did so, the value of the plant in the low price scenario would increase by $10 million and by $20 million in the high price scenario.

The City contends Duquesne makes other erroneous assumptions calculated to reduce value:

- Duquesne retires its units at the end of book life.

- Duquesne fails to consider technology and productivity improvements and other efficiencies that it admits are associated with deregulation and should be considered.

- Duquesne fails to consider the impact of future gas prices on market prices. There is likely to be upward price pressure on gas markets, which will impact and increase long-term electricity prices.

- Duquesne's inflation data results in an understatement of market prices.

- Duquesne's market price projections are unreasonably low compared to other recent estimates.

- The projections Duquesne uses resulting from its recent solicitation, or RFP, are not credible as to what electricity market prices will be, and suggests instead that prices in a deregulated market will be higher. If Duquesne believed its own solicitation analysis, it would be best for Duquesne to shutdown all of its coal fired plants and two of its nuclear plants and thereby save $1.158 billion between now and 2005.

The terms of Duquesne's proposed RFP or annual solicitation to set the stranded cost charge or CTC are designed to depress bid prices and understate market prices. For instance, bidders are not provided assured transmission rights on Duquesne's system. Additionally, the solicitation is for energy only and does not reflect the cost of other services. The bottom line is that the solicitation will not reflect market prices. The City claims Duquesne as much admitted this. City M.B. at 9-11.

(5) DII's Position

The DII market price forecast relies on independent publicly available data sources such as information supplied to the Federal Energy Regulatory Commission ("FERC"), the North American Electric Reliability Council ("NERC") and the East Central Area Reliability Coordination Agreement ("ECAR"). DII St. 2 at 41. The data is changed only where the original source is clearly wrong or inappropriate for the model. Id. at 34, 42. DII discusses the major inputs to that forecast below, i.e., relevant market, fuel price projection, reserve

margin, and cost and efficiency of new generators. DII claims its inputs are reasonable and the resulting market price forecast should be accepted by the Commission. DII M.B. at 36.

The first input to be considered in performing a market price projection is the relevant market that the projection will model. DII models the ECAR market with consideration of imports and exports to that market. DII St. 2 at 15. ECAR is used because Duquesne currently participates in pool-wide relationships for reliability with the other ECAR members. OCA also models the ECAR market. OCA St. 3 at 3-4. No substantial dispute exists in this proceeding as to whether ECAR is the correct market for modeling purposes. DII M.B. at 36.

The second major input to the market price forecast is fuel price projections. DII relies on the Energy Information Association ("EIA") fuel price forecast, which periodically releases projections for the escalation of coal, oil and natural gas prices. DII St. 2 at 20. These projections are needed to determine the expense that a generating unit will face for the fuel necessary to operate the unit. Duquesne agrees that DII's use of the EIA forecast is "reasonable." DII M.B. at 36-37; Duquesne St. 9R at 11.

Another critical input in a market price forecast is the assumption of any type of reserve margin on a market-wide basis. The reserve margin incorporated in the analysis triggers the addition of new generating capacity where demand for electricity begins approaching the maximum output of the units modeled. DII St. 2 at 21. DII uses a 15% reserve margin adder to market prices to account for new capacity. Duquesne objects to this input stating: "It is inappropriate to force all suppliers to meet a 'one size fits all' reserve level, and it is incorrect to assume a planning reserve level in the development of market prices where no such reserve level is required by the region." Duquesne St. 9R at 3. Duquesne believes the market will

determine the appropriate reserve level in the future. N.T. 914. Duquesne currently uses a 12% reserve in its integrated reserve planning and plans to maintain that level so customers will "enjoy traditionally high levels of service reliability." Duquesne St. 9 at 9. It is reasonable to expect that customers in the deregulated environment will desire the same level of reliability they now obtain from Duquesne as a regulated entity. N.T. 919. Consequently, it is reasonable to assume the market itself, as dictated by customers' desire for a continued higher level of reliability of electricity supply, will fall at an equilibrium based on a 15% reserve requirement. DII's use of a 15% reserve margin is clearly appropriate and should be endorsed by the Commission. DII M.B. at 37.

The final major input to the market price projection is the cost and efficiency of new generating capacity. As the demand for electricity approaches the maximum amount of electricity that current generators can supply, DII suggests new units will be constructed. Consideration of anticipated capacity additions is necessary because the cost and efficiency of those new units will affect future market prices. New units must sell electricity at prices sufficient to recover their average variable cost, which includes a contribution to the fixed cost associated with operating the unit. DII St. 2 at 16. DII uses the following costs of new capacity: $595/kW CC; and, $300/kW oil-fired CT. Id. at 25. These figures are consistent with assumptions used by other utilities in restructuring proceedings. The efficiency of new units is indicated by the anticipated heat rate. DII uses a heat rate of 7,000 btu/kWh. Id. at 17. This is a reasonable assumption based on the most recently built generating units and the possibility of new environmental regulations, plant aging or effects of cycling that may degrade

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