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DUQUESNE LIGHT COMPANY
DOCKET NO. R-00974104

Direct Testimony
of
David D. Marshall

Contents:

Overview of Duquesne Customer Choice Plan

DIRECT TESTIMONY OF DAVID D. MARSHALL

I. QUALIFICATIONS

Q. What is your name and position with Duquesne Light Company ("Duquesne")?

A. My name is David D. Marshall and I am President and Chief Executive Officer of Duquesne.

Q. What are your current responsibilities?

A. As President and Chief Executive Officer, I am responsible for the overall management and direction of Duquesne.

Q. Please describe your educational and professional experience.

A. I received my undergraduate degree in mathematics and economics from Colby College in Waterville, Maine in 1975. In June 1980, I earned an M.B.A. degree from the Amos Tuck School of Business Administration in Hanover, New Hampshire.

From the time of my graduation from the Tuck School until February of 1985, I was employed by Central Vermont Public Service Corporation (CVPS), an electric utility located in Rutland, Vermont. I held a number of positions at CVPS, including Manager of Rates and Economic Research, Director of Economic Analysis and my last position as Assistant Vice President of Finance.

In February 1985 I joined Duquesne as General Manager, Planning, Budgeting and Rates. Subsequently, I held the positions of Vice President, Corporate Development (1987), Assistant to the President (1990), Executive Vice President

(1992), and President and Chief Operating Officer (1993). I was appointed to my current position as Chief Executive Officer in 1996.

Q. Have you ever testified before this Commission or any other regulatory commission?

A. Yes. As General Manager, Planning, Budgeting and Rates at Duquesne, I submitted extensive testimony in Duquesne's last general rate cases in 1986 and 1987. Most recently, as President, I gave testimony before this Commission in January of 1996 as part of its Investigation into Electric Power Competition and before the Senate of Pennsylvania in August of 1996 in the hearings that led to the enactment of House Bill No. 1509.

II. SUMMARY OF TESTIMONY

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide an overview of Duquesne's stand-alone restructuring plan ("Customer Choice Plan" or "Plan"). My testimony provides the summary of the Plan that is required by Appendix A to the Commission's February 13, 1997. I also discuss the additional benefits to customers that would result from Duquesne's proposed merger with the Allegheny Power System ("APS") and the joint restructuring plan associated with the merger. A joint restructuring plan by Duquesne and West Penn Power Company (the "Joint Plan") has been filed contemporaneously with this application in a separate docket.

Q. How is your testimony organized?

A. There are three main sections to my testimony. The first provides an overview of Duquesne's Customer Choice Plan. The second section provides a summary of the testimony of each witness appearing on behalf of Duquesne. The third section provides an overview of the additional benefits to Duquesne's customers that would result from the merger with APS.

Q. What relief does Duquesne seek in this proceeding?

A. Duquesne is requesting that the Commission approve its stand-alone restructuring plan without modification as an integrated, balanced program for the transition to competition that meets all the requirements of the restructuring legislation and is fair to both investors and consumers.

Q. You stated that Duquesne's Plan is a balanced program. Please summarize the benefits to customers.

A. The customer benefits of Duquesne's Customer Choice Plan include:

- access to alternative generation suppliers on fair and nondiscriminatory terms;
- a continued obligation to serve during the transition period;
- redesigned rates that encourage economically efficient consumption;
- accelerated amortization and depreciation of strandable assets without increasing rates above current levels;
- a new economic development rider applicable to commercial and industrial loads of 25 kW or greater;

- a total amortization and depreciation commitment of at least $1.7 billion over the transition period;
- a return on equity ("ROE") "spillover" provision to ensure that Duquesne does not earn in excess of a fair return during the transition period;
- a market-based process for setting competitive transition charges ("CTCs"); and
- customer-specific CTCs designed to prevent cost shifts between customers and customer classes.

The Customer Choice Plan builds on a history of innovation at Duquesne and contains a combination of innovative features that balance stakeholder interests. For example, the Plan uses a market-based valuation of generation to establish CTCs and to make a final determination of stranded costs. During each year of the transition period, Duquesne will conduct a competitive solicitation to sell a substantial block of generation, with the resulting market values used to determine the CTCs each year of the transition period. The CTCs paid by customers will therefore be known and measurable, as required by the restructuring legislation.

Duquesne also proposes a final valuation of the market value of Duquesne's generation assets in 2003 based on objective evidence of market value, not market price forecasts. This valuation will be provided by an unbiased arbitration panel. Duquesne will commit to be bound by the decision of the panel. There also is a mechanism by which this final valuation can be triggered before 2003 if market prices

rise to specified levels, or Duquesne completes its amortization commitment early, thereby ensuring that there will be no over-recovery of stranded costs.

The Customer Choice Plan also builds on the innovative approach to stranded cost mitigation that Duquesne first proposed in the Ft. Martin plan. Under that five-year plan, Duquesne used the proceeds from the sale of its interest in Ft. Martin to accelerate depreciation and amortization of strandable assets while maintaining rates at current levels. Section 2804(4)(v) of the restructuring legislation provides Duquesne the opportunity to build on this aggressive mitigation plan. In this case, Duquesne commits to a minimum of $1.7 billion in total amortization and depreciation of generation-related assets during the transition period while maintaining rates capped at current levels. Under Duquesne's proposal, shareholders will bear the risk that cost containment measures are not sufficient to generate the savings necessary to satisfy this commitment while maintaining earnings. If, to the contrary, revenues exceed expectations or additional cost savings are available, Duquesne has established an ROE "spillover" mechanism that will ensure that the related revenues are used to mitigate stranded costs, rather than to permit shareholders to earn higher than a fair return.

The Customer Choice Plan also uses innovation in the redesign of rates to encourage more efficient electricity consumption and to provide for additional stranded cost mitigation. Duquesne has been a leader in the past in encouraging economic development for certain classes of customers. Now, all customers will have the opportunity to benefit from a reduction in the cost of electricity for incremental

consumption. Equally important, Duquesne's innovative rate redesign proposal, which is described in detail by James A. Lahtinen (Statement No. 5), may increase the mitigation of stranded costs during the transition period by $15 million per year.

Q. Please summarize your conclusions with regard to Duquesne's proposal to merge with APS.

A. The Commission should go beyond approval of the Customer Choice Plan in this docket and approve the Merger Application and Joint Plan filed by Duquesne and APS. As explained in my direct testimony filed in that case:

- In addition to the customer benefits identified in Duquesne's stand-alone Customer Choice Plan, the merger will provide additional savings to Duquesne, on a nominal basis, of $365 million in generation-related costs, $173 million in distribution-related costs, and $9 million in transmission-related costs.
- Duquesne will flow through 100% of these cost reductions during the transition period to its ratepayers by (i) increasing the amortization of stranded costs by $160 million during the transition period, (ii) reducing distribution rates by $25 million in 2001, and (iii) freezing distribution rates at this reduced level until 2005.

III. OVERVIEW OF DUQUESNE'S CUSTOMER CHOICE PLAN

Q. Please explain how this part of your testimony is organized.

A. This part of the testimony is organized in four sections. The first discusses the implementation schedule for customer choice and the options customers will have. The second provides an overview of the unbundled rates filed by Duquesne. The third discusses the market-based valuation of stranded costs and the basis for Duquesne's request to recover stranded costs. The fourth discusses the effect of the restructuring legislation on utility planning and service obligations.

Implementation of Direct Access; Customer Options

Q. Please provide an overview of Duquesne's proposed schedule to implement customer choice.

A. Consistent with the restructuring legislation, Duquesne will phase-in customer choice over the 1999-2001 period, such that all retail customers will have the opportunity to choose their electric supplier by 2001. As explained in Mr. Frank Hoffmann's testimony (Statement No. 6), Duquesne has designed its phase-in plan for commercial and industrial customers to avoid, to the maximum practicable extent, creating competitive disadvantages for individual businesses or business segments.

Q. What options will direct access customers have?

A. Customers will have the option to purchase generation from alternate suppliers or continue taking all their requirements from Duquesne. If a customer chooses to remain with Duquesne, the customer will receive the same service at the same rates it does

today; however, pursuant to the unbundling requirements of the legislation, the customer will receive an unbundled bill. This unbundled bill will provide customers the information they need to determine whether they could realize savings by purchasing power on the open market.

Q. Will customers receiving direct access have the right to return to Duquesne at rates capped at current levels?

A. Yes. Consistent with the restructuring legislation, customers receiving direct access will have the option of returning to full requirements service from Duquesne at rates capped at current levels for the period specified in the restructuring legislation. To prevent the shifting of costs between customers and customer classes, a customer that returns to Duquesne will be required to remain with Duquesne for a twelve-month period. Otherwise, a customer could return to Duquesne in months when electricity prices are the highest, placing increased costs on Duquesne that limit its ability to mitigate stranded costs for the benefit of all customers. As explained by Mr. Lahtinen, Duquesne is willing, however, to consider other approaches to this issue.

Unbundling; Rate Caps; Rate Design

Q. Please summarize Duquesne's proposals regarding the rates to be charged customers beginning January 1, 1999.

A. The starting point for Duquesne's rate proposal is Section 2804(4)(v) of the restructuring legislation, which states:

> If an electric distribution utility rolls its energy cost rate into base rates at a combined level that does not exceed its combined

> level of such rates which have been approved by the commission as of the effective date of this chapter, the utility shall not be required to reduce its capped rates below the capped level upon the complaint of any party if the commission determines that any excess earnings achieved under the cap are being utilized to mitigate transition or stranded costs for the benefit of ratepayers or to offset other known and measurable cost increases that would be recoverable under traditional ratemaking but are not included within the capped rates.

Duquesne will comply with this provision by (i) rolling into current base rates an energy cost rate at the level approved by the Commission in the Ft. Martin rate plan, and (ii) committing to accelerate the amortization of stranded costs in an amount that, when added to test year revenue requirements, is equal to the revenues produced at current rate levels. As indicated, Duquesne's proposed amortization schedule of $1.7 billion is a minimum commitment. Duquesne's investors bear the risk that maintaining this commitment will depress earnings. Duquesne also will establish an ROE spillover to ensure that, if revenues exceed expected levels or costs are lower than expected, the resulting revenues are used to further mitigate stranded costs. These amortization and ROE spillover commitments are discussed in detail in the testimony of Donald J. Clayton (Statement No. 2).

Q. Is this approach to mitigation new for Duquesne?

A. No. In December 1995, Duquesne filed a rate plan associated with the sale of its interest in Ft. Martin Unit 1. This rate plan included a commitment to (i) freeze base rates for five years (1996 through 2000), (ii) record a one-time write down of $130 million in nuclear plant investment, and (iii) increase amortization of nuclear

investments in the amount of $25 million for 1996-98. Pursuant to discussions with the Office of Consumer Advocate ("OCA") and the Office of Small Business Advocate ("OSBA"), Duquesne agreed to additional protections, including a cap on the ECR of 14.7 mills/kWh and the amortization and write-off of certain rate synchronization costs for Beaver Valley 2 and Perry 1. The Commission approved the modified plan without change, holding:

> The proposal of Duquesne is a unique opportunity to restructure a portion of the assets and expenses. The combination of elements in the amended petition strikes a reasonable balance through rate stabilization, expense recognition and cost reduction. For these reasons, Duquesne's proposal is in the public interest.

Petition of Duquesne Light Company for Declaratory Order, Docket No. P-00951001 et al. (June 20, 1996). Duquesne's restructuring plan provides the same "reasonable balance" of rate stabilization and stranded cost mitigation that the Commission approved in the Ft. Martin proceeding.

Q. You previously referred to the revenue requirement filed by Duquesne in this case. Has Duquesne functionally allocated this revenue requirement to generation, transmission and distribution?

A. Yes. This functional allocation is set forth in the exhibits to the testimony of Morgan K. O'Brien (Statement No. 4). The functionalized costs are then used to develop unbundled transmission and distribution rates, which are presented in the testimony of Mr. Lahtinen.

Q. You mentioned earlier that Duquesne is proposing to redesign its rates. Please explain.

A. Duquesne is redesigning its rates in a manner that will allow customers to make more efficient consumption decisions, while also providing additional revenues that can be applied to mitigate stranded costs. The rate redesign consists of moving a significant portion of generation-related costs into a fixed customer charge, which results in a lower variable (per kWh) charge than exists today. For example, a typical residential customer today pays approximately 11.4 cents/kWh under current tariffs, which is a rate far in excess of the short-run marginal cost of supplying the customer's incremental demands during most hours of the year. The Customer Choice Plan redesigns rates to lower the variable charge and thereby provides customers more efficient price signals. As explained in Mr. Lahtinen's testimony, these more efficient rates are set at a level that maximizes stranded cost mitigation. The redesigned rates thus both contribute to stranded cost mitigation and provide customers more efficient price signals.

Stranded Cost Recovery

Q. Please explain Duquesne's proposal with respect to stranded cost recovery.

A. I will summarize two of the principal components of Duquesne's proposal. The first is Duquesne's proposal to satisfy the statutory requirements of Section 2804(4)(v). As indicated, this provision permits Duquesne to charge rates up to current levels provided that "any excess earnings achieved under the cap are being utilized to mitigate transition or stranded costs for the benefit of ratepayers." In applying this provision, the question becomes how long Duquesne is entitled to charge rates up to the price cap? To answer that question, Duquesne must calculate the net present value of its

stranded costs over the life of its generating assets. This calculation is provided by Mr. Clayton.

The second component is the calculation of CTCs during the transition period. The objective here is to set CTCs at a level that accurately reflects the market choices facing (i) the customer, as it considers purchasing power from a variety of suppliers, and (ii) Duquesne, as it sells power in the market to mitigate stranded costs. Duquesne will meet this objective by calculating customer-specific CTCs on the basis of actual market prices. By using a customer-specific CTC formula, Duquesne will ensure that no customer pays more, assuming the same usage level, than it would have paid under bundled rates. By using a competitive solicitation to set market prices, Duquesne will ensure that CTCs reflect only known and measurable stranded costs, thereby protecting both the customer and Duquesne.

Before discussing each component in more detail, I note that they involve different considerations. The first requires Duquesne (i) to calculate a stranded cost amortization schedule that, coupled with the ROE spillover, ensures that available earnings are used to mitigate stranded costs, and (ii) to project the market value of Duquesne's stranded costs over the life of its generating assets. The latter calculation is important in determining how long Duquesne should be entitled to charge rates up to the price cap. The second does not require either of these analyses. Rather, the second requires Duquesne (i) to design a customer-specific CTC that ensures each customer will pay no more, assuming a constant usage level, than it did under current rates, and

(ii) to calculate market prices for use in setting the customer-specific CTCs. The latter calculation involves short-term, rather than long-term, market prices. This is because customers have the option to return to service from Duquesne at current rates throughout the transition period. Duquesne therefore cannot sell its generation on a long-term basis to establish CTCs, with the assurance that returning customers will be charged the market rate prevailing at the time of their return.

Q. Please provide more detail on Duquesne's proposal to meet the requirements of Section 2804(4)(v).

A. To determine whether Duquesne can meet the requirements of Section 2804(4)(v) throughout the transition period, Duquesne must compare the book value of its generation at the end of the transition period with the market value of that generation at that time. Duquesne must first calculate the stranded cost amortization that is possible at current rate levels, which Mr. Clayton testifies is $1.7 billion over the transition period. Duquesne then must compare the book value of generation-related assets (net of amortization) at the end of 2005 to the expected market prices of generation at the end of 2005. Using a range of market prices projected by Michael M. Schnitzer (Statement No. 3), Mr. Clayton concludes that book values will continue to exceed market values at the end of 2005. Duquesne therefore is entitled under Section 2804(4)(v) to charge rates up to current levels throughout the transition period.

Q. You mentioned that Mr. Clayton performs his analysis using a range of market price projections supplied by Mr. Schnitzer. Are such projections sufficient to satisfy the requirement that stranded costs be "known and measurable"?

A. No. As Mr. Schnitzer explains, his analysis is based on the best available market price information, including the results of Duquesne's recent solicitation to sell firm power for the period 1998-2005 and conservative assumptions concerning the post-2005 market price of power. However, as Mr. Schnitzer acknowledges, there is simply too much uncertainty today with respect to long-term market prices for an analyst to "forecast" known and measurable stranded costs. The experience from other restructuring cases in Pennsylvania supports this conclusion. In those cases, the testimony filed by competing experts contains stranded cost estimates, based on long-term market price forecasts, that differ by several billion dollars. Clearly, the uncertainty inherent in such projections poses significant risks for both investors and consumers and cannot be consistent with the known and measurable standard.

Q. What is Duquesne's proposal?

A. Duquesne is proposing that a final determination of its stranded costs not be made to-day. Instead, Duquesne proposes to initiate a final valuation of stranded costs, computed over the life of Duquesne's generating assets, in 2003. The valuation will be provided by an unbiased three-member arbitration panel. Duquesne will select one member, a consumer representative (such as the OCA and/or Commission Staff) will select the second member and these two will select a third member. The panel will

establish a market value based on objective evidence, not market price "forecasts." The objective market evidence may include consummated market transactions in the relevant market, such as forward contracts, futures contracts and/or comparable generating unit asset sales. The panel also can rely on the results of a competitive solicitation by Duquesne to sell firm power for a term coincident with the average remaining life of its generating assets.

Interested parties, including Duquesne, will have the opportunity to provide market price data to the panel and the panel's findings will be submitted to the Commission. Duquesne will commit to be bound by the panel's findings, subject only to one condition: if the Commission rejects the panel's findings and substitutes a market valuation that is adverse to Duquesne, the Commission will allow Duquesne to recalculate stranded costs by divesting some or all of its generating units, or spinning off its generating assets to a separate subsidiary and conducting an initial public offering for a portion of the stock of the new company.

Q: Assuming the panel's findings are accepted by the Commission, how will the findings affect stranded cost recovery?

A: If the panel's valuation demonstrates, contrary to expectations, that Duquesne will fully recover its stranded costs within the transition period, Duquesne will reduce the transition period accordingly. If, however, this valuation confirms that Duquesne cannot fully recover its stranded costs during the transition, the valuation will provide

the basis for any further relief that Duquesne is entitled to seek under the restructuring legislation.

Q. Is it possible that market prices will rise sufficiently prior to 2003 that this final market valuation will reveal that Duquesne has over-recovered its stranded costs?

A. It is theoretically possible, but highly unlikely given the low market prices revealed in Duquesne's recent solicitation. However, to ensure that there is no such over-recovery, Duquesne commits to accelerate the final valuation to 2001 or 2002 if market prices rise to the levels specified in Mr. Clayton's testimony.

Q. You have discussed in some detail the market valuation process to determine whether Duquesne's proposed amortization schedule will reduce book values to market levels at the end of the transition period. Is there anything further you wish to mention regarding Duquesne's amortization proposal?

A. Yes. Duquesne's amortization proposal provides customer benefits that go beyond the protections contained in Section 2808(f) of the legislation. Duquesne is proposing a minimum committed amortization schedule of $1.7 billion. This means that Duquesne's shareholders will bear the risk that this amortization is achieved at the cost of reduced earnings. For example, under Duquesne's proposal, if sales are above forecast levels, the associated revenues will be used for additional stranded cost mitigation; however, if sales are below forecast levels, Duquesne will not reduce its amortization of stranded costs below the minimum $1.7 billion commitment. Duquesne is proposing the same treatment for cost fluctuations. If the cost of service is below expected

levels, the resulting savings will be used for further mitigation; but if costs exceed expected levels, amortization will not be reduced below the minimum commitment.

Q. Please turn now to the second issue -- setting CTCs during the transition period.

A. Duquesne will calculate CTCs using a market-based determination of the value of Duquesne's generation. Each year during the transition period, Duquesne will conduct a public solicitation, or "request for proposals" ("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 baseline consumption and information on class load shapes. The purpose of the customer-specific CTC methodology is to ensure that customers that are more expensive to serve (i.e., those taking a greater proportion of their requirements during peak hours) receive a higher credit and those that are less expensive to serve receive a lower credit. This is consistent with Section 2808(a) of the restructuring legislation, which states that CTCs should be set "in a manner that does not shift interclass or intraclass costs."

Q. Why is Duquesne using an RFP to set CTCs?

A. The RFP will provide reliable and objective evidence of the market prices prevailing in Duquesne's area. The RFP will protect both consumers and investors because it ensures, as the restructuring legislation requires, that CTCs are set to recover only known and measurable stranded costs.

Q. You have stated several times that Duquesne will use a market-based valuation of stranded costs, rather than a market price "forecast." Are other utilities using long-term market price forecasts to calculate stranded costs?

A. Yes, but as explained in the testimony of Mr. Schnitzer, market price forecasts have routinely proven inaccurate. This Commission's experience with "avoided cost" forecasts under PURPA should alone be sufficient to dissuade it from reliance on long-term forecasts. A market-based approach, by contrast, will protect both consumers and investors from the inaccuracy of forecasts. In Duquesne's opinion, a market-based approach is the best -- and perhaps only -- way to meet the requirement in the restructuring legislation that stranded costs be "known and measurable."

Q. You have discussed the role of market prices in computing stranded costs. Does the restructuring legislation also require that CTCs include the effects of cost of service mitigation?

A. Yes. Section 2808(c)(4) provides that the Commission may take into account past mitigation efforts and that utilities have a duty to pursue cost mitigation throughout the transition period. As explained in the testimony of Mr. Clayton, Duquesne is presenting a fully mitigated cost of service. This means that the revenue requirements on which Duquesne is proposing to set rates not only include the benefits of aggressive mitigation in the past, but also project a future cost of service that includes aggressive stranded cost mitigation, particularly the amortization of existing generating assets.

Q. Please describe Duquesne's past mitigation efforts.

A. I will provide only a summary of these efforts, given that Mr. Clayton provides a detailed recital of them. In the 1980s Duquesne faced the challenges of the shrinking steel industry in western Pennsylvania. By the end of the 1970s, the steel industry was predicting rapid expansion of its Pennsylvania production in the next decade. Not only did this growth not materialize, but by 1982 Duquesne had lost 50% of its existing industrial load and 30% of its total load.

The company took immediate steps in to deal with this loss of 700 MW of load. In 1980, the Erie nuclear units 1 and 2 and Davis Besse nuclear units 2 and 3 were canceled. The Phillips and Brunot Island units were later placed in cold reserve and removed from rate base. In addition, Perry 2 was declared de facto abandoned in Duquesne's 1986 rate case filing. Consequently, by the time of Duquesne's 1986 and 1987 base rate cases, Duquesne had mitigated the worst consequences of the steel decline. However, the Company was still faced with the cost and rate consequences associated with the capacity additions of Beaver Valley 2 and Perry 1. In the 1987 rate case, Duquesne therefore made a commitment to: stabilize rates and reduce costs; pursue marketing and economic development; reshape the company and reduce excess capacity; improve its financial condition; assist low income customers; and pursue shareholder initiatives to create value. Since that time, Duquesne has taken aggressive steps to meet the commitments it made. The specific mitigation measures undertaken by Duquesne in this period are detailed in Mr. Clayton's testimony.

Q. What were the tangible results of Duquesne's mitigation efforts?

A. Faced with an enormous challenge from the collapse of the steel industry load, Duquesne's innovative response has resulted in $340 million in stranded cost mitigation and $700 million in avoided rate increases to date. The continuing effects of this mitigation, calculated through 2005, total $1 billion in stranded cost mitigation and $700 million in avoided rate increases. Thus, the stranded cost problem facing Duquesne today is significantly smaller than it would have been had Duquesne not undertaken these mitigation measures.

Q. Has the Commission recognized these mitigation efforts?

A. Yes. In Duquesne's 1986 general rate case, the Commission recognized what it described as Duquesne's "self-imposed austerity" measures. Duquesne Light Company, Docket Nos. R-860378 et al. (Mar. 10, 1987). More recently, in the proceeding on the Ft. Martin sale, Commissioner Crutchfield observed that the sale was a "smart business decision made by Duquesne in response to the competitive pressures occurring the in the electric industry." Statement of Lisa Crutchfield, Docket No. P-00951001 (May 23, 1996). As indicated previously, the Commission found that the mitigation proposal contained in the Ft. Martin plan struck a "reasonable balance."

Q. You also stated that Duquesne's revenue requirements for the transition period include the benefits of aggressive mitigation in the future. Please explain.

A. This mitigation plan is described in more detail in the testimony of Duquesne's other witnesses, but I will summarize some of the key elements here:

- a minimum of $1.7 billion in total amortization and depreciation of regulatory assets and stranded generation costs during the transition period, with additional amortization and depreciation possible through the ROE spillover mechanism;
- additional revenues through the redesign of rates to encourage additional consumption at more efficient levels, which may yield approximately $15 million per year in additional stranded cost mitigation;
- reductions in operation and maintenance expenses and capital expenditures below historic levels at both fossil and nuclear plants, totalling more than $25 million per year;
- the continuing benefit of past mitigation, including the financial mitigation discussed by Mr. Clayton (nearly $700 million during the transition period); and
- approximately $550 million in additional mitigation due to the cost savings associated with the proposed merger with APS.

All the foregoing mitigation will be passed on to Duquesne's ratepayers through the Customer Choice Plan or, as to the last point, the Joint Plan.

Q. You have discussed Duquesne's methodology for calculating CTCs and its mitigation plan, but you have not discussed the appropriate standard for stranded cost recovery. Please turn to that subject.

A. The Commission should apply the following standard: rates should be set at a level that gives Duquesne a fair opportunity to recover a return on and of all prudent investments that may become stranded in the transition to competition.

Q. Does this standard guarantee Duquesne recovery of all its stranded costs?

A. No. Duquesne could fail to fully recover its stranded costs for several reasons. Full recovery would be impaired if Duquesne was unable to keep operation and maintenance costs below the levels approved by the Commission in setting rates. Full recovery also would be impaired if sales to retail customers were lower than the level assumed by the Commission in setting rates. Finally, Duquesne is entitled to rates designed to recover only prudently incurred costs.

Q. Does Duquesne's Customer Choice Plan fairly balance investor and consumer interests?

A. Yes. The Customer Choice Plan balances investor and consumer interests. The following are examples of the benefits and protections for consumers:

- access to alternative generation suppliers on fair and nondiscriminatory terms;
- a continued obligation to serve at current rate levels, which provides customers the benefits of a competitive market and the protections of the traditional regulatory compact;
- unbundled and redesigned rates that reduce rates for incremental consumption an average of 25% and contribute to stranded cost mitigation; and

- a new economic development rider that will reduce rates an average of 20-25% for a typical commercial or industrial customer over a five-year period;
- rate levels that include a guaranteed level of stranded cost amortization and an ROE spillover that ensures that investors do not earn more than a fair return;
- a CTC based on "known and measurable" market values set by an RFP and a final market valuation in 2003 by an unbiased arbitration panel.

Investors also will be treated fairly under the Customer Choice Plan. The Plan is designed to provide investors with a fair opportunity, consistent with the customer protections above, to earn a fair return on and recovery of Duquesne's prudent investments.

Q. Some have argued that investors have no reasonable expectation of earning a fair return on investments that cannot be recovered in a deregulated market. Please comment.

A. I do not agree. Duquesne's investments were made under a regulatory system that provided investors a reasonable expectation that they would earn a fair return on and recovery of prudent investments by the utility.

Q. Please explain your point.

A. The regulatory system to which I refer, sometimes called the "regulatory contract," is typified by the utility's obligation to serve the demands of all customers within its franchised territory. To meet this obligation, Duquesne forecast the expected demands of its customers over a planning horizon of 20 years and planned to have in place the generation needed reliably to serve these demands. Each of Duquesne's investment

decisions in generation was based on this obligation to serve and each investment decision over the last twenty years was scrutinized by the Commission. With minor exceptions, all the associated costs were found to have been prudently incurred.

The fact that the remaining book value of these investments may not be recoverable in a deregulated market does not mean that recovery of these investments in a CTC is not appropriate. The *quid pro quo* for Duquesne accepting the foregoing obligation to serve was the grant of an exclusive franchise to serve these customers. Duquesne therefore could reasonably expect that the loads forecasted for its customers would be served by Duquesne, not by other utilities in the region, and thus that Duquesne could reasonably recover its investment in rates over the life of those investments. While there was some risk of self-generation in recent years, there was no obligation to deliver energy produced by others over Duquesne's transmission and distribution wires, as there is under the restructuring legislation. Moreover, any revenue impacts associated with the loss of load were, consistent with traditional regulation, spread across all customer classes, not borne by shareholders. In short, prior to the change in policy reflected in the legislation, Duquesne's rates were sufficient to permit it to earn a fair return on and of its investments; it is the change in regulatory policy that creates the potential of stranded costs at issue in this case.

Q. Some have argued that, since the government does not insulate other industrial companies from changes in economic conditions or government policies, utilities should receive no such protections. Please comment.

A. There is a material difference between a regulated electric utility and other industrial companies. Take, for example, a large supplier of aircraft. A supplier of aircraft builds fleets of planes and invests large amounts of capital in doing so. The supplier is subject to intense competition from other aircraft manufacturers and is aware that the airlines will have the option of purchasing their aircraft from a number of suppliers. To compete as a manufacturer, the supplier has the choice of investing capital to build aircraft on the assumption that the airlines will purchase their requirements from that supplier (and not others), or of executing contracts under which the airlines make certain quantity and price commitments in return for the supplier making the required investments. In addition, the supplier has the choice not to construct additional aircraft or to limit its production -- for example, because of the unwillingness of airlines to make the necessary contractual commitments.

This is in contrast to the contractual opportunities and investment decisions faced by electric utilities. Consider the example of Duquesne when it began its nuclear construction program to meet the expected growth in demand from the steel sector. Duquesne had the legal obligation to plan for and serve that demand growth. Duquesne did not have the option to decline to make the required investments unless the steel companies signed long-term contracts to pay for such investments. Rather, Duquesne was required to make prudent investment decisions to serve all its load based on the information available at that time, with the expectation that the Commission would permit Duquesne to roll such investments into the rates of customers. Now that

this regulatory system has been modified it would be unfair to permit customers to avoid responsibility for such investments and to shift such responsibility to Duquesne's investors.

To do so would result in an arbitrary and one-sided switch in policies. Traditional regulation does not allow a utility to earn more than a fair return during "good times," such as when growth in customer demand exceeds expectations, the cost of service is lower than expected, or investments have a positive market-to-book value. The sale of Ft. Martin is a good example. Duquesne sold its interest in Ft. Martin for $130 million (pre-tax) in excess of the remaining book value of the plant. Duquesne was not, however, permitted to return this value to shareholders through excess earnings. Rather, Duquesne returned this value to ratepayers through the accelerated amortization of assets. Another example was Duquesne's proposed sale of 500 MW of firm power to General Public Utilities in 1990 through reactivation of the Phillips and Brunot Island plants. The Commission determined that the net revenues from the proposed sale, estimated at over $300 million, would be fully credited to ratepayers. This was the case even though Duquesne's investors had been incurring the "caretaker" costs of maintaining those units in a condition that would permit their reactivation. While the sale ultimately fell through due to a lack of regulatory approval in New Jersey, the point is that the Commission determined that ratepayers, not investors, should benefit from market values in excess of the book value on which Duquesne is permitted to earn a fair return.

I comment on the Ft. Martin and proposed GPU sales not to criticize the Commission orders issued in those cases. Rather, those orders were entirely consistent with the regulatory contract. I discuss the orders simply as a point of comparison to the arguments of some that the Commission should now, when book values exceed market values, change policy and require Duquesne's investors to absorb the difference. Clearly, this would an arbitrary and unfair switch in policy and would produce a result for which shareholders have not been compensated. I fully expect and trust that the Commission will not be influenced by such arguments and will set rates that provide Duquesne a fair opportunity to fully recover a return on and of all prudent investments.

The Restructured Business

Q. Please summarize the nature of the changes in the organization and operation of Duquesne Light as the result of the Customer Choice Plan.

A. I will discuss two aspects of this topic. The first is the change in the nature of Duquesne's generation planning function and its obligation to serve customers within its service territory. The second is the functional unbundling of Duquesne's business into those units that will continue to provide services that are regulated on a cost of service basis and those that are not regulated.

Q. Please turn to Duquesne's generation planning function and the nature of the obligation to serve during and after the transition to competition.

A. As I discussed earlier in my testimony, electric utilities have operated under a regulatory system that required them to plan to serve all customers within their territory

on a reliable basis. The amount of generation constructed to meet these demands was a function of the expected peak customer demand plus a "reserve margin." This reserve margin allowed the utility to continue serving load reliably during periods when demand exceeded forecasts or when a portion of the utility's generation was unavailable due to forced or planned outages. The reserve margin was calculated using a "loss of load probability" model that generally used as its solution a one-day-in-ten-years standard of interruption.

This planning process will change in a number of important respects, two of which I will mention here. First, following the transition to competition, utilities in Pennsylvania will no longer be obligated to serve all the energy requirements of the customers in their service territory. Utilities such as Duquesne thus will no longer be obligated as a matter of law to have available sufficient generation to serve these customers. Rather, the regulatory-based obligation to serve will be replaced by contractual obligations between customers and generation suppliers.

The second major change will be in the nature of "reliable" service. Today, reliable service means service without interruption -- regardless of the cost to supply customers in a given hour. In the future, as utilities install real-time meters and as hourly spot energy prices become public, customers and suppliers will have the information necessary to determine whether it is economic to increase or decrease consumption at peak periods when the marginal cost of service is very high. Conversely, customers and suppliers will have similar price signals available in off-

peak periods when the cost of service is very low. Using this information, I expect many customers will choose to be interrupted or to reduce their consumption in peak hours instead of paying the high cost of energy in those hours.

Q. Do you expect these changes to occur immediately?

A. No. The restructuring legislation continues to impose on Duquesne an obligation to serve throughout the transition period. Duquesne will choose the most economic means of meeting this obligation, such as making short-term capacity purchases in the wholesale market. The testimony of Mark Karl (Statement No. 9) discusses this continuing obligation to serve in more detail.

Q. You have stated that the obligation to serve will be replaced by competition among a variety of suppliers. Do you expect that the introduction of competition to supply retail customers will benefit those customers by reducing rate levels?

A. Introducing retail competition will benefit customers by securing for them the efficiencies of a competitive generation sector. This does not necessarily mean, however, that rates will be lower immediately. In the long-run, I am confident that competition will produce lower rates than will continued reliance on comprehensive regulation of the generation sector. However, the Commission should bear in mind that this does not necessarily mean that rates will be "lower" than they are today at all times in the future; rather, the point is that they will be lower than they otherwise would have been under traditional regulation. Competition encourages the efficient utilization of societal resources; it does not guarantee "low" rates or any rate in

particular. Rather, the benefits to consumers will consist of more efficient risk bearing by suppliers; increased operational efficiencies of power producers; a greater range of customer choices, products and services; improvements in technological innovation; and better use and expansion of the transmission system.

Q. Please turn to the functional unbundling of regulated and unregulated services and business units.

A. Duquesne began the unbundling of services and business units in mid-1996 with the implementation of FERC Order Nos. 888 and 889. In these orders, the FERC required that the wholesale merchant function be separated from the transmission function to ensure that the utility's power sales would not receive preferential access to transmission system information.

Q. What is Duquesne's position on independent system operators ("ISOs")?

A. Duquesne has been a long-standing advocate of ISOs. In 1996, I testified before this Commission that a regional ISO that administers an efficient location-based transmission pricing regime was the best way to achieve transmission comparability and efficiency. Duquesne has taken the same position in all its pleadings and testimony filed with the FERC.

Q. Has Duquesne been involved in the efforts to form an ISO in its region?

A. Yes. Duquesne has been active in the PJM restructuring proceeding. In fact, Duquesne's Section 211 request submitted to PJM in 1994 included many of the

principles adopted by PJM in its ISO proposal, including a single-system transmission rate and comparability for all transmission users.

Q. Commissioner Hanger has expressed concern that non-PJM utilities in Pennsylvania have not yet joined an ISO. How can Duquesne effect reform in this area?

A. Duquesne is a small utility that simply does not have sufficient influence to lead a reform effort in this area. That is one of the advantages of the proposed merger with APS. The merged company will be well situated to be a leader with respect to the trend toward greater separation of the generation and transmission functions. My testimony in the merger proceeding addresses the joint proposals of Duquesne and APS in this area.

Q. Do additional functional separation and unbundling issues arise as the result of the transition to retail competition?

A. As explained in Mr. Hoffman's testimony, the transition to competition at the retail level will require that Duquesne functionally separate regulated retail functions from those that will not be regulated. Duquesne is taking the first step in this area by proposing a code of conduct that will govern the interaction of the regulated and unregulated units of Duquesne.

IV. INTRODUCTION OF COMPANY WITNESSES

Q. Please identify the other witnesses providing direct testimony on behalf of Duquesne in this proceeding.

A. In addition to myself, the following witnesses will be responsible for presenting the Company's case-in-chief:

Donald J. Clayton is Treasurer of Duquesne. Mr. Clayton describes how Duquesne has aggressively mitigated stranded costs and moderated rates in the past. He also describes how these efforts will continue throughout the transition period, resulting in total mitigation of $1.0 billion. Mr. Clayton also describes how Duquesne proposes to recover its stranded costs under a rate cap through 2005 and demonstrates why the Company meets the requirements of Section 2804(4)(v). To make this showing, Mr. Clayton calculates a range of stranded costs that are likely to remain in 2006, despite a minimum commitment of $1.7 billion of depreciation and amortization during the transition period. He also describes the equity return spillover mechanism that ensures the committed level of amortization is a floor, and that prospective earnings in excess of the allowed return would be applied to increase this amortization level. Mr. Clayton also describes the events that might trigger an early termination of the transition period.

Michael M. Schnitzer is President and a Director of The Northbridge Group, an economic and management consulting firm based in Waltham, Massachusetts. Mr. Schnitzer provides independent support for Duquesne's compliance with the known and measurable standard under the Act. He supports use of a market-based approach rather than an administrative determination of stranded costs. Mr. Schnitzer supports Duquesne's proposal to meet the requirements of Section 2804(4)(v) of the

restructuring legislation to establish a price cap through 2005. Mr. Schnitzer also supports Mr. Clayton's market valuation as of 2005 with a market price ceiling estimate based on a gas-fired combined cycle unit. In addition, Mr. Schnitzer supports Mr. Lahtinen's use of a market-based approach to CTC calculation. Mr. Schnitzer also provides independent support for the final market valuation mechanism in 2003 used to calculate a residual value for Duquesne's generation assets at the end of the transition period. Finally, Mr. Schnitzer supports the customer safeguards built into the Customer Choice Plan.

Morgan O'Brien is Controller of Duquesne. Mr. O'Brien supports the Company's claim for recovery of regulatory assets, unfunded nuclear decommissioning expenses and fossil decommissioning expenses under the Act. Mr. O'Brien also presents the 1996 cost of service and the pro forma financial data and the Company's responses to the Commission's restructuring plan filing requirements in Appendix A of the Restructuring Order. The results of Mr. O'Brien's study are used by Mr. Lahtinen to unbundle Duquesne's rates.

James A. Lahtinen is General Manager, Regulatory and Economic Analysis Unit of Duquesne. Mr. Lahtinen sponsors Duquesne's unbundled allocated cost of service study and unbundled tariffs designed to recover such costs. He supports the approach the Company has taken in unbundling transmission, distribution, ancillary service and generation costs by customer class. Mr. Lahtinen explains Duquesne's approach to calculating Customer Generation Credits and CTCs based on actual market

price data. He also describes the rationale underlying Duquesne's proposed rate redesign and how these rates were calculated to comply with the restructuring legislation and to mitigate stranded costs. Finally, he provides public data on market prices that corroborate the prices received by Duquesne in its recent request for proposals.

Frank A. Hoffmann is General Manager, Marketing and Sales Unit of Duquesne. Mr. Hoffmann outlines Duquesne's method for phasing-in customers for direct access during the three-year phase-in period. Mr. Hoffmann also summarizes Duquesne's proposals on universal service and energy conservation. Duquesne will maintain all existing programs for assisting low income customers. He also describes the Company's proposed consumer education program. This program is multi-faceted and is designed to reach all segments of our diverse customer base. Mr. Hoffmann also presents the proposed Code of Conduct for ensuring that all alternative suppliers are treated fairly and that confidential information is not released without authorization. Finally, Mr. Hoffmann describes the Company's economic development rates and how those rates will change or continue in the future.

Robert Irvin is General Manager, System Operations Unit of Duquesne. Mr. Irvin describes the current market prices for power delivered in Duquesne's service territory. Mr. Irvin also describes Duquesne's recent RFP. He also discusses the procedures and systems that Duquesne will implement to promote competition and

provide unbundled access to electric generation during the transition period. Finally, he describes how Duquesne differentiated between distribution and transmission assets.

Fred Allison is Assistant Controller of Duquesne. Mr. Allison addresses the implementation of metering, meter reading, billing, payment processing, collections and supplier settlement for purposes of direct access. Mr. Allison describes a new metering technology that Duquesne has begun installing. This new technology will enhance service reliability, allow greater flexibility in meter reading and billing and allow the Company to receive real-time information on customer usage. Mr. Allison also addresses the arguments of some stakeholders that, in addition to unbundling generation, transmission and distribution, all "revenue cycle services" should be unbundled. Finally, Mr. Allison describes the Company's proposed procedures for addressing supplier settlements.

Mark Karl is a Senior Consultant, responsible for Duquesne's Integrated Resource Planning Department. Mr. Karl supports the forecast of generation output for Duquesne's units used in Mr. Clayton's analysis. Mr. Karl also supports the price duration curve analysis that is used to derive hourly market prices from the annual market data obtained from the Duquesne RFP.

Ralph L. Nelson is Manager of Operations Services in Duquesne's Fossil Generation Unit. Mr. Nelson provides the calculation of Duquesne's operation and maintenance expense and capital expenditures during the transition period for

Duquesne's fossil generation. Mr. Nelson also describes the cost mitigation that has allowed Duquesne to reduce the cost of operating its fossil units.

Ralph E. Duckworth is Controller of Duquesne's Nuclear Unit. Mr. Duckworth provides the calculation of Duquesne's operation and maintenance expense and capital expenditures during the transition period for Duquesne's nuclear generation. Mr. Duckworth also describes Duquesne's mitigation of nuclear O&M costs.

Jeffrey D. Makholm is a Senior Vice President of National Economic Research Associates, Inc., an economic consulting firm based in Cambridge, Massachusetts. Dr. Makholm supports the equity cost of capital used by Duquesne to calculate its revenue requirements and by Mr. Clayton to derive present value calculations. Mr. Makholm also explains why utilities should be permitted to recover stranded costs and shareholders have not already been compensated for the risk of stranded costs.

Thomas P. LaGuardia is President of TLG Services, Inc. Mr. LaGuardia presents the results of his analysis of the nuclear decommissioning costs for Beaver Valley Units 1 & 2 and Perry Unit 1. He also presents fossil decommissioning studies for the Company's fossil-fired generating stations.

V. THE MERGER WITH APS

Q. Please discuss why the Commission should go further and approve the Merger Application and the Joint Plan.

A. The rationale for Commission approval of the Merger Application and the Joint Plan is fully set out in the Company's joint application with West Penn. As documented therein, additional synergy benefits will be created by the merger and shared by the customers of Duquesne, West Penn and the other non-jurisdictional subsidiaries of Allegheny Power. In summary, the evidence shows that:

- In addition to the customer benefits identified in Duquesne's stand-alone Customer Choice Plan, the merger will provide additional savings to Duquesne, on a nominal basis, of $365 million in generation-related costs, $173 million in distribution-related costs and $9 million in transmission-related costs.
- *Duquesne will flow through 100% of these cost reductions during the transition* period to its ratepayers by (i) increasing the amortization of stranded costs by $160 million during the transition period, (ii) reducing distribution rates by $25 million in 2001, and (iii) freezing distribution rates at this reduced level until 2005.

Q. Does that conclude your testimony?

A. Yes it does.

R-00974104

DUQUESNE STATEMENT NO. 1-REJOINDER

Pittsburgh 12-15-97 NEW

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

0233319

DUQUESNE LIGHT COMPANY

DOCKET NO. R-00974104

Rejoinder Testimony

of

David D. Marshall

Contents:

Q. Please state your name.

A. My name is David D. Marshall

Q. Are you the same David D. Marshall who filed direct testimony in this docket on August 1, 1997 and rebuttal testimony on December 2, 1997?

A. Yes, I am.

Q. What is the purpose of your rejoinder testimony?

A. To respond to criticisms of Duquesne's auction proposal, as described in my rebuttal testimony. My rebuttal testimony proposed that Duquesne would offer the Commission the option of ordering Duquesne to auction generation assets in 2003 to determine the market value of generation. The surrebuttal testimonies of Mr. Kahal (Office of Consumer Advocate) and Mr. Baron (Duquesne Industrial Intervenors) agree with such an auction in principle, but object to the timing of the auction. Specifically, they argue that an auction of generation should not be delayed to 2003, but must occur now to value the generation assets as of January 1, 1999.

Q. What is your response?

A. The Company does not agree that an immediate auction of generation is desirable or necessary for the reasons set out in my rebuttal testimony. However, if the Commission determines that it cannot accept Duquesne's auction offer because of its timing, Duquesne will agree that the Commission may order an immediate auction of the Company's generation in order to determine its market value and Duquesne's owned-generation stranded costs as of January 1, 1999.

Q. Does this offer apply to all Duquesne's generation assets?

A. Yes. The Commission may order Duquesne to auction up to 100% of its generation assets.

Q. In your rebuttal testimony, you argued that an immediate auction should not be ordered because of the continuing obligation to serve under the rate cap. Has your opinion changed?

A. No.

Q. Does any intervenor witness agree that this is an issue that must be addressed?

A. Yes. The surrebuttal testimony of OCA witness Kahal recognizes this as an issue, but seems to suggest that it could be addressed through negotiation. While I appreciate his optimism, the fact remains that this issue must be fairly addressed before an auction of assets can be completed. If the Commission orders an immediate auction, Duquesne will respond with a proposal to address the generation rate cap issue at that time.

Q. What if the Commission ordered an auction of 100% of Duquesne's generation, but no bids were received for certain assets (e.g., nuclear plants)?

A. As described in my rebuttal testimony, the receipt of no bids for a particular asset would constitute a cap on market value for that asset equal to zero. In addition, in such an event, there may also be unavoidable costs independent of operation that could result in additional stranded costs. This issue is described in detail by Mr. Schnitzer and Mr. Clayton in their rebuttal testimonies. As indicated therein, the level of such costs would be referred to the arbitration panel for determination.

Q. Does this conclude your rejoinder testimony?

A. Yes it does.

R-00974104
Pittsburgh 12-15-97
GSL

VOLUME I

Duquesne Statement No. 2

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

DUQUESNE LIGHT COMPANY
DOCKET NO. R-00974104

Direct Testimony
of
Donald J. Clayton

Contents:

Regarding Cost Mitigation Efforts, Stranded Cost Calculations and Recovery, Cost of Capital and Capital Structure.

DIRECT TESTIMONY OF D. J. CLAYTON

I. QUALIFICATIONS

Q. Please state your name and business address for the record.

A. My name is Donald J. Clayton. My business address is 411 Seventh Avenue, Pittsburgh, Pennsylvania 15230-1930.

Q. By whom are you employed?

A. I am employed by Duquesne Light Company ("Duquesne," "Duquesne Light" or "the Company").

Q. What is your position with Duquesne?

A. I am the Treasurer.

Q. How long have you been employed by the Company?

A. I have been employed by Duquesne since August of 1985.

Q Please describe your responsibilities as Treasurer of the Company.

A. My areas of responsibility include corporate finance, cash management, financial planning, corporate budgeting, electronic commerce and shareholder relations.

Q. Please describe your professional and educational background?

A. A copy of my curriculum vitae which describes my professional and educational background is provided as Exhibit DJC-1.

Q. Have you previously testified before this Commission?

A. Yes. I have testified before the Commission in the Company's last two base rate proceedings at Docket Nos. R-860378 and R-870651. I have also supported the

Company's filings at P-00951001, related to the sale of the Ft. Martin Plant; P-900485, related to the proposed power sale to GPU and affiliated interest filings at G-00940376 (Woods Run) and G-00940392 (Headquarters' Building).

II. PURPOSE AND CONCLUSIONS

Q. What is the purpose of your testimony in this proceeding?

A. The purpose of my testimony is to explain the efforts that the Company has undertaken to mitigate its stranded costs and to minimize its costs generally, to describe and provide support for the Company's stranded cost calculations and stranded cost recovery plan, and to support the Company's overall cost of capital (excluding return on equity) and capital structure. I am also sponsoring several of the required data items identified in Appendix A to the Commission's Order dated February 13, 1997 at Docket No. M-00960890.

Q. Please summarize your conclusions.

A. My conclusions correspond to the purposes of my testimony. First, Duquesne has already implemented the most aggressive mitigation strategy of any utility in Pennsylvania. These past efforts have resulted in over $1 billion of mitigation which has enabled the Company to avoid $700 million in rate increases and to reduce its potentially stranded costs as of January 1, 1999 by $340 million. The results of this past mitigation will continue after January 1, 1999 through December 31, 2005 (the "Transition Period") and over this period will result in further reductions in potentially stranded costs of $690 million. Witnesses Marshall, Lahtinen and Karl describe the Company's ongoing mitigation efforts.

Second, Duquesne has proposed a restructuring plan that relies on a true market-based determination of stranded costs as of the end of the Transition Period. The plan provides

for a generation price cap and a minimum commitment of $1.7 billion of depreciation and amortization of generation and regulatory assets by December 31, 2005. All of the generating plant and regulatory assets that will be recovered under the accelerated depreciation and amortization for which the Company is now seeking approval were either approved in prior rate and regulatory proceedings or recognized for recovery in future proceedings. Hence, the prudence of these investments has already been determined by the Commission.

Third, the appropriate overall cost of capital for the Company is 9.61% and the appropriate after-tax discount rate for use in the present value calculations is 7.83%. This cost of capital is based on a cost of common equity of 11.50% and a year end 1996 capital structure of 40.08% common equity, 9.69% preferred equity and 50.23% long-term debt. The cost of common equity is independently supported by the testimony of Dr. Jeffrey D. Makholm.

III. DUQUESNE HAS AGGRESSIVELY MITIGATED STRANDED COSTS AND MODERATED RATES

Q. Why are Duquesne's historic and planned mitigation efforts important to the Company's claim for stranded cost recovery?

A. In Section 2808(C)(4) of the Customer Choice Act it states that:

> "the Commission shall consider the extent to which the electric utility has undertaken efforts to mitigate generation-related transition or stranded costs by appropriate means in a manner that is reasonable under all of the circumstances, including consideration of whether mitigation has been commensurate with the magnitude of the electric utility's generation-related transition or stranded costs."

Therefore, Duquesne's aggressive historic mitigation efforts should be recognized by the Commission as a proactive solution which reduces the Company's stranded cost to the absolute minimum level possible before the phase in to competition begins in 1999.

Q. In your summary of the Company's position with respect to stranded cost recovery you state that Duquesne has implemented the most aggressive mitigation strategy of any company in Pennsylvania. Will you identify the components of this strategy?

A. Yes. Duquesne's historic mitigation efforts fall into six major areas, as follows: (1) cost containment; (2) financial restructuring; (3) maximization of market revenues; (4) acceleration of depreciation and amortization; (5) asset sales; and (6) tax planning.

Q. Are Duquesne's historic mitigation strategies consistent with the mitigation strategies described in the Customer Choice Act?

A. Yes. In Section 2808(c)(4) the act states that:

> "during the transition period, electric utilities shall have the duty to mitigate generation-related transition or stranded costs to the extent practicable. Efforts may include the following:
>
> (I) Acceleration of depreciation and amortization of existing rate base generation assets.
>
> (II) Minimization of new capital spending for existing rate base generation assets.
>
> (III) Reallocation of depreciation reserves to existing rate base generation assets.
>
> (IV) Reduction of book assets by application of new proceeds of any sale of idle or under-utilized existing rate base generation assets.
>
> (V) Maximization of market revenues from existing rate base generation assets.
>
> (VI) Issuance of securitized debt pursuant to the provisions of Section 2812 (relating to approval of transition bonds)."

Duquesne's depreciation, cost containment, asset sales and maximization of market revenue strategies are specifically identified in the Act. Duquesne's historic mitigation

efforts have, however, gone well beyond the strategies specifically identified in the act. With respect to cost containment Duquesne has not only reduced generation related capital spending but has reduced operating and maintenance expenses throughout the Company as well as capital spending related to transmission and distribution. Duquesne's financial restructuring efforts have significantly reduced its overall cost of capital and these efforts are consistent with the benefits other companies may be able to derive from asset securitization. Duquesne's tax planning strategies are unique and have significantly contributed to the Company's mitigation efforts.

Loss of Steel Load Placed Duquesne in Financial Distress

Q. Please describe the historical context for Duquesne's past mitigation efforts.

A. Throughout the 1970s, various steel companies had informed Duquesne that they intended to add significant high load factor load over the next several years. With these and other additions, it was expected that the Company's total load would approach 3300 MW. All indications were that the Company was deficient in base load capacity and would have to make significant capacity additions in order to fulfill its public service obligation to meet this demand. Consequently, Duquesne had approximately 3,600 MW of capacity in service or under construction and another 400 MW on the drawing board. (Perry Units No. 1 and No. 2 and Beaver Valley Unit No. 2 were under construction and Erie Nuclear Units No. 1 and No. 2 and Davis Besse Units No. 2 and No. 3 were in the planning and design stages).

Q. Did this load growth actually occur?

A. No. Quite the contrary. The steel making industry in Pittsburgh virtually collapsed. This factor, and its consequent ripple effect through the Pittsburgh economy, was devastating.

In fact, by 1982, the Company had lost 50% of its then existing industrial load (700 MW) and 30% of its total load. At the same time, Duquesne was left with expensive new nuclear generating units to serve the base load that had just evaporated. The resulting upward pressure on rates began to manifest itself immediately, with revenue declining and rate base expanding.

Q. What steps did the Company take to address this situation?

A. Duquesne acted to reduce its planned and existing capacity. In 1980, the Company canceled the four nuclear plants, Erie Unit Nos. 1 and 2, and Davis Besse Units No. 2 and No. 3 which were in the design phase. In 1986, the Company declared a de facto abandonment of Unit No. 2 at the Perry Nuclear Plant. At about the same time, the Company placed its Phillips Generating Station (an older coal-fired unit) and a portion of its Brunot Island Units in "cold reserve" and removed them from its rate base. These actions had the effect of reducing the Company's capacity to approximately 2,800 MW. At the same time, the Company attempted to address its revenue losses by aggressively selling power at wholesale.

Q. Was there a point at which this situation became critical for the Company?

A. Yes, the lowest point was reached in 1986. In that year both Beaver Valley Unit No. 2 and Perry Unit No. 1 were nearing completion but not producing any revenue. As one can imagine, the associated drain on the Company's financial resources was devastating. Duquesne's bond rating was reduced to "BBB-", the last notch above a junk bond. In order to begin to restore the Company's financial health, the Company reduced its dividend by 41%. (The Company's dividend level has not yet reached the pre-1986 level). The drain on our human resources was also severe. We were forced to lay off 100

employees and implement salary reductions and freezes. Throughout these trying times, the Company managed to maintain its standards of customer service and environmental protection. Nevertheless, 1986 was truly a watershed year despite the hardships endured by the Company and its customers. In 1986 the Company formulated and adopted the "Duquesne Plan," which ultimately restored the Company to financial health and led to its ability to contain costs and obviate the need for rate relief. I will discuss the Duquesne Plan in detail after I discuss the Company's 1987 rate case, which was decided in March 1988 in Docket R-870651.

Q. What were some of the significant results of the rate case that was decided in 1988?

A. In that case, the Commission found that the Company required a revenue increase of approximately $232 million, to be phased-in over a three year period. The phase-in was to be followed by a three-year rate freeze and then a rate decrease of approximately 8% in 1994. Although the Commission deemed that 95% of the costs associated with Beaver Valley Unit No. 2 were prudent, the Company was denied any equity return of the investment associated with that plant through December 31, 1991. The Commission also required as a *quid pro quo* for the inclusion in rate base of the investment in Perry Unit No. 1, that an equivalent amount of capacity of the Company's Elrama units be denied an equity return on rate base. Duquesne was also prohibited from continuing to amortize the costs associated with the canceled nuclear units, (Erie Units No. 1 and No. 2 and Davis Besse Units No. 2 and No. 3) which had been authorized in earlier orders. Duquesne was also required to maintain its equity ratio at a level of 40% to 42%.

Q. You stated that you wanted to expand upon your description of the Duquesne Plan. What were the central elements of the Duquesne Plan?

A. The Duquesne Plan is, perhaps, best expressed in the following quote from the Company's 1986 Annual Report:

> "To become more efficient, more competitive, more market-driven, more customer-oriented and more profitable, we are determined to evolve and change."

Clearly, long before electric competition became the law in this State, Duquesne recognized that it needed to become a nimble, active competitor if it was to survive and prosper.

Duquesne Aggressively Pursued Cost Containment

Q. What cost containment measures did you undertake?

A. The Company began an aggressive fuel cost reduction effort. For example, in 1988 our average fuel component in base rates was 16.45 mills per kwh. Today our fuel cost is capped at 14.70 mills per kwh[1]. We established cost containment and reduction programs for both capital expenditures and O&M. Since 1988, the Company's capital expenditures have averaged just $101 million annually or approximately two thirds of the Company's normal depreciation level. The Company's O&M costs have been reduced in nominal terms from $342 million in 1988 to $331 million in 1996. Also, since the implementation of the Duquesne Plan, the Company's workforce has been reduced from 4,500 to today's level of 3,500 with most of this reduction being accomplished through attrition and hiring freezes.

Duquesne Completed an Aggressive Financial Restructuring

Q. What other efforts were undertaken?

[1] Under the Fort Martin Agreement, the fuel component is permitted to be no higher than 14.7 mills per kWh and is currently being charged at a much lower rate (12.8 mills per kWh).

A. Duquesne embarked upon an aggressive financial restructuring program to reduce our capital costs through the sale and leaseback of Beaver Valley No. 2, debt refinancing and a buy-back of equity. Since 1988, the Company has reduced its outstanding debt by $216 million, reduced its outstanding preferred and preference stock by $25 million and has repurchased $270 million of its common stock. Also, in 1996, the Company declared a one time dividend of $150 million to DQE which further reduced the Company's equity capitalization. As a result of these programs, the Company's interest cost has been reduced by approximately $60 million and the Company's overall cost of capital has dropped from 10.94% in 1988 to just 9.61% which compares favorably with the other electric utilities in Pennsylvania. At the same time as we were reducing the cost of capital through financial restructuring, we were adding flexibility to our financing ability by replacing our 1947 mortgage indenture. The Company's new mortgage indenture will make it much easier for the Company to truly "unbundle" its assets and to continue to downsize its capital structure.

Duquesne Aggressively Pursued New Sources of Market Revenues

Q. What has Duquesne done to maximize market revenues?

A. Earlier, I mentioned the Company's off system sales. We aggressively pursued this source of revenue and flowed through the benefits to our customers. Off-system sales prior to the sale of Ft. Martin have averaged 3,000 gwh per year making the Company a major seller of power in the wholesale market. This has produced significant gross margins ($10 to $12 million per year) that lessened the rate burden on our customers through a credit to the Company's fuel clause. We also vigorously pursued economic

development activities in our service territory in an effort to increase revenues in a manner that would reduce the need for rate increases for all customers. Duquesne pursued numerous economic development activities, such as: the adoption of economic development riders to our tariff (which offer reduced rates to new customers for up to five years); the adoption of "Rule 4" (which allows the company to negotiate confidential rates with large customers); a loan program for developers who agree to use electric equipment; maintenance of a database of potential development sites; and active participation in the business community. As a result of these programs and others, Duquesne's industrial and commercial sales growth in recent years has been strong and recently our peak load has once again reached its 1981 level.

Accelerated Depreciation and Asset Sales Have Mitigated Stranded Costs

Q. When did the Company first accelerate depreciation related to its nuclear facilities?

A. The Company increased the depreciation expense related to Perry by $25 million in 1995. Duquesne was the first company in Pennsylvania to request such an increase in depreciation without a corresponding request for a rate increase. This was made possible because of the previously discussed mitigation strategies.

Q. Please describe the Ft. Martin sale and rate agreement.

A. In continued pursuit of its mitigation strategies, the Company negotiated the sale to AYP Capital, Inc. (an unregulated subsidiary of Allegheny Power Systems, Inc. ("APS") of its 50% interest (267 MW) in Unit 1 of the Ft. Martin Power Station, which is located on the Monongahela River between Morgantown, West Virginia and Point Marion, Pennsylvania. The sale of the Company's interest in this plant enabled it to sell, at a price of $169 million, an asset that because of the West Virginia Export Tax, was

relatively expensive for the Company to operate. Moreover, the Company's sale of this asset enabled it to propose to the Commission the Ft. Martin Agreement which produced very substantial benefits for customers.

Q. Please discuss the Ft. Martin Agreement and its attendant benefits.

A. The principal elements of the Ft. Martin Agreement, contained in the Company's amended petition to the Commission for its approval of the sale of the Ft. Martin plan to AYP Capital, Inc. are, as follows:

1. Duquesne shall cap its rates through December 31, 2000.

2. Duquesne will use its net proceeds from the sale to record a one time reduction of $130 million (pre-tax) in the value of its nuclear plant investment;

3. The Company will restore to service its generating units located at its Brunot Island Power Station;

4. Duquesne will increase its annual depreciation and amortization by $25 million for the years 1996, 1997 and 1998 for its nuclear units;

5. The Company will increase its annual contribution to its nuclear decommissioning trust fund by $5 million;

6. Duquesne will cap its energy costs in its Energy Cost Rate at 14.7 mills per kwh, including a $5 million credit to offset the loss of potential off-system sales from the Ft. Martin Plant;

7. Duquesne will begin to amortize its $51.1 million in rate synchronization costs for Beaver Valley Unit No. 2 and Perry Unit No. 1 with an initial $9 million charge off followed by a ten year amortization of the remaining balance of $42 million; and

8. The Company will contribute $500,000 annually to assist low income customers.

The Office of Consumer Advocate ("OCA") concurred in the Company's proposal, and the Commission, by order entered June 20, 1996, approved it as being in the public interest.

Duquesne Has Used Innovative Tax Planning Strategies to Mitigate Stranded Costs

Q. Please explain how Duquesne has and will continue to mitigate its stranded costs through innovative tax planning.

A. The Company is providing in its cost of service a tax allocation factor which lowers its effective tax rate from 41% to 24%. This lower tax rate reflects the tax benefits of certain investments made at subsidiaries of Duquesne. Previously flowed through tax benefits have now reversed and are causing taxable income for both federal and state income tax purposes to be higher than regulatory book net income. The tax benefits mitigate the taxes that would otherwise be payable by customers in rates. Going forward, the Company is reflecting the future tax benefits of certain investments made at Duquesne and its subsidiaries to mitigate nearly $300 million of the Company's potential stranded costs.

The Internal Revenue Code was amended in 1982 to encourage companies to invest capital in fixed assets within the U.S. and allowed for accelerated depreciation of those investments under a system known as the ACRS depreciation system. Under the ACRS system nuclear power plants were depreciated over a ten year period using a 150% declining balance methodology. Thus, Duquesne's investment in Perry Unit No. 1 and

Beaver Valley Unit No. 2 were depreciated for tax purposes over 10 years. For ratemaking purposes these investments would be depreciated over their expected operating period of 40 years. In both of its most recent base rate cases, R-860378 and R-870651, Duquesne was required to flow through to customers the state income tax benefit of the ACRS tax depreciation exceeding the ratemaking depreciation, as well as certain federal income tax benefits for deducting certain costs currently for income tax purposes (as opposed to capitalizing for regulatory accounting purposes). This regulatory treatment causes significant income tax liability to be recognized commencing with the year the regulatory depreciation exceeds the income tax depreciation and continuing through the regulatory accounting life of the plant. Duquesne recognized early on that, absent any mitigation, these future tax burdens caused by the reversal of the accelerated depreciation would have to be borne by its customers through higher rates.

Beginning in 1995, Duquesne and its subsidiaries invested in a series of investments whose returns were centered around the income tax benefits which the Company could use to mitigate its growing tax burden. These investments included investments in affordable housing projects, investments in Internal Revenue Code ("IRC") Section 29 alternative fuels projects, as well as, leasehold interest investments. The affordable housing projects are all located within the state of Pennsylvania and the majority of the investments are actually located within the service territory of the Company. These projects provide affordable housing to low-income families and supplement the investors' return with income tax credits. The Section 29 alternative fuels projects are

investments in gas projects which economically would not warrant development but for the income tax credits which the U.S. Congress created to enhance energy exploration and development by investors. These projects are also all within the state of Pennsylvania. Finally, Duquesne invested through a subsidiary in a series of leasehold interests which were structured to pass on the tax benefits of lease arrangements from lessees who would not otherwise have been able to realize these tax benefits for a variety of circumstances. In total, through these tax advantaged vehicles, Duquesne is providing a reduction in its effective tax rate from 41% (a rate which reflects the reversal of the previously flowed through benefits) to only 24%.

DQE Passed On Tax Planning Expertise to Benefit Customers

Q. How did Duquesne acquire the expertise to enter into tax advantaged investments?

A. In 1989, DQE was formed as a holding company, both to help meet competition and to strengthen the Company's financial position. Due to the initial inherent riskiness, an unregulated subsidiary of DQE was used as the vehicle for DQE's first tax advantaged transactions involving leveraged leases. In 1993, DQE entered the field of affordable housing through an unregulated subsidiary. Essentially, the federal government subsidizes affordable housing transactions by providing tax benefits. Prior to DQE's involvement, most of the affordable housing credits in Pennsylvania went to Philadelphia, almost none went to Pittsburgh. Having developed the expertise in this area (and, more importantly, having absorbed the initial risk) DQE then shared that expertise with Duquesne, which allowed the Company to develop its own affordable housing projects in Pittsburgh. These projects provide multiple benefits. They not only help the local economy (by injecting capital) and low income residents (who are given

access to good quality, affordable housing), but they also reduce Duquesne's federal income tax rate and, hence, its overall cost of service. These projects also demonstrate the feasibility of "all electric" energy for such developments.

Q. Was the expertise in Section 29 transactions and tax advantaged lease transactions similarly transferred from DQE to Duquesne?

A. Yes. For the transactions known as alternative fuels transactions which qualify for tax credits under IRC Section 29, as with the affordable housing projects, the expertise was developed by DQE's unregulated subsidiary which took the initial risks associated with the transaction. When it became clear that the risks were manageable, the expertise was then shared with Duquesne so that it could benefit from this tax planning strategy. These transactions were especially valuable because they permitted Duquesne to obtain an entry into the natural gas business and to take advantage of the convergence in the energy market. The expertise for the other type of transactions known as Leasehold Interest transactions were similarly transferred. Again, DQE first entered into these transactions in 1994. When it became clear that they were viable and the risk was manageable, the expertise was shared with Duquesne. In 1995, the Diemen-Flevo transaction became available in the Netherlands and Duquesne was able to take advantage of it due to the expertise developed by DQE, thereby reducing the Company's Federal Income tax rate and, hence, its cost of service.

As a direct consequence of all of these tax planning strategies, Duquesne has been able to lower its effective Federal Income Tax rate to just 24%. In most cases, utilities are seeking to transfer expertise developed at the regulated level to unregulated affiliates or

subsidiaries and keep all of the benefits for the shareholders. Here, in stark contrast, DQE developed tax mitigation expertise at the unregulated level and, rather than keeping all of the benefits for shareholders, allowed the regulated subsidiary, Duquesne, to participate in the tax planning strategies. This participation has produced direct benefits to the form of lower costs that have enabled the Company to forego rate increases until 2001 and aggressively mitigate its stranded costs.

Duquesne Has Pursued Other Sources of Mitigation

Q. Are there other major areas where the Company has successful mitigated its stranded costs?

A. Yes. We have successfully mitigated our stranded costs by reducing the unfunded portion of nuclear decommissioning costs and by writing off part of our "early window" costs.

Q. Explain how the Company reduced the unfunded portion of Nuclear Decommissioning.

A. Without additional rate relief from the Commission, Duquesne has increased its annual funding of nuclear decommissioning expense from $1,345,467 to $8,762,097. This amount is more than six times higher than the amount authorized by the Commission and included in the Company's rates. In Duquesne's most recent base rate case (R-870651), the Commission allowed annual recovery through then current rates of $1,345,467. The Company was limited to funding that amount of its estimated decommissioning liability in a "qualified trust" by Internal Revenue Code § 468A. In 1994, the Company sought and obtained a landmark ruling from the National office of the IRS, which for the first time allowed funding for nuclear decommissioning to be placed into a "qualified trust" based on an accounting order of the Commission, rather than a base rate increase, as had been previously required. At the same time, the Company received an order, in Docket P-

00940843, which recognized an increase in annual funding of nuclear decommissioning expense to $3,624,486 without a concomitant base rate increase. In a public meeting held October 17, 1996, the Commission issued an order in Docket P-0091110, which further increased the Company's funding of decommissioning (consistent with the Ft. Martin rate agreement) of the BV Unit Nos. 1 and 2 and Perry Unit 1 to $8,762,097, again without increasing base rates to customers.

Q. Explain how the Company has mitigated its regulatory assets through its treatment of Deferred Rate Synchronization or "Early Window" Costs.

A. In Duquesne's petition in Docket P-870222, the PUC granted the Company's request for "early window" rate treatment for Beaver Valley Unit No. 2 and Perry Unit No. 1. As part of the settlement agreement related to the sale of the Ft. Martin plant, Duquesne agreed to write-off $9.0 million of these deferred, early window costs. Moreover, the company agreed to amortize the remaining $42 million of these early window costs over a ten year period without any increase in rates to customers.

Duquesne Has Moderated Rates

A. Section 2808(c)(5) of the Customer Choice Act states:

> "of equal importance to the mitigation efforts under paragraph (4)(I) through (VI), the Commission shall consider efforts undertaken over time, prior to the enactment of this chapter to reduce or moderate customer rate levels while maintaining safe and efficient operations."

Q. How has Duquesne complied with the Act to moderate rate levels?

A. Duquesne has not requested a base rate increase since 1988. Since 1992 (the last year of the Company's rate phase-in from the 1988 rate order) both the nominal and real cost of electricity in Duquesne's service territory has fallen and the decline in real terms is

expected to continue throughout the transition. This could not have been accomplished without extraordinary even heroic efforts by Duquesne's employees and the sacrifices made by both employees and the Company's shareholders. Indeed, when one considers the situation with which the Company was faced in 1982, it is nothing short of a miracle that Duquesne has managed to contain its costs and reduce its rates.

Q. How do Duquesne's rates compare to other utilities?

A. Duquesne's charges to its residential customers are often mischaracterized as being high because they are expressed in terms of cents per kilowatt hour. This ignores the fact that Duquesne has one of the lowest average usage levels (i.e., 500 kwh/month) for residential customers of any Company in the country. When Duquesne's charges to customers are expressed as an average monthly bill the Company finds itself in the middle of the pack when compared to other U.S. utilities and actually lower than the Pennsylvania average. Duquesne's commercial rates compare favorably to the ECAR and MAAC averages and its industrial rates are below average in the ECAR and MAAC regions.

Q. Has Duquesne maintained safe and efficient operations?

A. Yes. The Company has maintained its commitment to safe and efficient service. Perhaps this is best evidenced by the fact that we are the only electric company in the state to guarantee service by offering a $25 bill credit if we are not on time for appointments, do not connect a new customer within 24 hours, do not provide an accurate bill or do not act professionally and courteously in our dealings with our customers. While the Company has reduced overall capital spending it has made significant investments in the customer service area. In 1992 the Company completed a new $24 million customer information system (DISCUS). Our field representatives use laptop computers to enhance their service

capabilities and were singled out by Lotus for the development of this unique application of their Notes™ software. Currently the Company is working with ITRON to install the Customer Advanced Reliability System (CARS) which will enable two-way wireless communication between the Company and a customer's meter. Historically Duquesne's reliability and safety records have been above average, and the Company is committed to maintaining its high standards.

Q. You spoke earlier about the Ft. Martin Agreement having imposed a rate cap. For how long have Duquesne's rates remained essentially frozen?

A. The Company has not sought a base rate increase since 1987. That case produced a rate increase in March 1988. The Ft. Martin Agreement caps the Company's base rates and fuel clause until October of 2001. Therefore, prior to the passage of the Act, Duquesne had already taken actions that resulted in a rate cap through 2001. In effect, the Company was operating under a self-imposed regime of price cap regulation significantly before the Legislature even took action to restructure Pennsylvania's electric industry. While the Act specifically permits the Commission to prospectively employ performance based rates and alternative regulation in Section 2806(I), in fact Duquesne has been operating under the discipline of incentive regulation since 1988.

Duquesne Has Achieved Efficiencies Through Price Cap Regulation

Q. Are you equating price cap regulation with performance based regulation?

A. Yes, absolutely. In the "old world" of cost plus regulation, cost increases were passed on to customers in the form of higher rates. With our last rate increase in 1988, we concluded that our rates had reached levels that could impede our ability to compete. We therefore

determined to completely change our corporate philosophy to stress competition and cost reduction. We were determined to "live within our means," directing all of our efforts to reducing our costs and operating more efficiently, rather than to rate cases and increased prices, to earn appropriate returns for our shareholders.

Q. *Have these efforts been successful?*

A. Our record of being able to avoid base rate increases for almost 14 years (March of 1988 to October of 2001) speaks for itself. Moreover, we have reduced our rates in nominal terms and the effect of inflation over that period has made our product increasingly less expensive in real terms than it was in 1988.

Q. What was the average base rate allowed in the last rate case in 1988?

A. In 1988 the average rate level allowed was 9.9 cents/kwh.

Q. *How does that compare to the average base rate level today?*

A. Today's average rate level is 8.8 cents/kwh.

Q. What percentage decrease does this represent?

A. In nominal terms, this is a 12.5% decrease in rates.

Q. Is this a representative figure?

A. Not particularly, because during the period from 1988 to today, inflation has continued. Therefore, in real terms rates had actually decreased 24% by 1996; and are expected to *decrease a total of 40% by 2000.*

Q. Earlier in your testimony you alluded to the fact that Duquesne's unit cost rates were higher than the average electricity rates in Pennsylvania. Is that a particularly relevant statistic?

A. I do not believe it to be. As I have previously pointed out, usage is an important factor. As well, because Duquesne operates primarily in a major urban area with the high cost of an underground system in the downtown area, it is more relevant to compare our rates to those charged by utilities serving other large metropolitan areas. Viewed in that perspective, Duquesne's rates are certainly in line with other companies. Duquesne's average residential rate was approximately 11.7 cents per kwh in 1995. In contrast, PECO's average residential rate was nearly 13 cents in 1995, Boston Edison's rate was 12.5 cents and Consolidated Edison's rate was over 16 cents. Additionally, Southern California Edison's and PG&E's residential rate were both over 12 cents. It should be noted, however, that none of those companies suffered load losses comparable to the devastating load losses suffered by Duquesne in the early 1980's and all of these companies have significantly higher average residential usage levels than Duquesne.

Company Shareholders Have Borne Costs of Mitigation

Q. How have the Company's shareholders been affected by the Company's mitigation strategies.

A. The Company's shareholders have borne a significant portion of the burden of Duquesne's mitigation strategies. Since the Company's last base rate case the Company's shareholders have never achieved the 12.87% return on equity authorized by the Commission and, to date, the DQE dividend level has not returned to the level set for Duquesne at the end of 1985.

Duquesne Has Balanced Other Stakeholder Interests While Mitigating Stranded Costs

Q. How have the interests of the Company's other stakeholders been balanced?

A. I have previously discussed some of the effects of the Company's mitigation strategies on employees and the burdens employees have borne as a result. On the positive side, however, the Company received the EEI Diversity Award in 1994 and 1995 and the EEI Minority Business Development Award in 1996. The Company has extended the current contract with its bargaining unit employees to 2001. Throughout this period the Company has instituted several innovative programs including pay for knowledge at power stations, a performance based 401K matching program, cafeteria style benefit plans, part-time work in certain areas, cost effective health care plans, and other pro-employee benefits. The Company has created a motivated workforce that is expected to perform at high standards and has done this while reducing the size of the total workforce and its costs.

At the same time, the Company has consistently been an environmental leader. This is most recently evidenced by receipt of the 1996 Governor's Award for Environmental Excellence which recognized the Company's efforts in the air pollution area. The Company has a long record of environmental achievement ranging from being the first company in the country to install a full plant scrubber system, to the creation of the natural habitat on Brunot Island. The Company's generation system met all of the requirements of Phase I of the Clean Air Act long before the deadline for compliance.

In addition to its environmental leadership, the Company has been an outstanding corporate citizen. Duquesne Light contributes approximately $2,000,000 (grants and in-kind donations) to educational, health, civic and human service organizations annually. The Company and its customers contribute over $800,000 to the Dollar Energy Fund

annually. This is a matching program in which customer contributions are matched dollar for dollar by Duquesne Light. Duquesne and its employees contribute approximately $1,000,000 annually to the United Way of Southwestern Pennsylvania, making it the area's 6th largest corporate contributor. Each year, Duquesne Light loans seven employees to the United Way Loaned Representative program, making it the most generous corporate supporter of this program in our region.

In the area of education, our 12-year-old Partners In Education program operates under the philosophy that, by enhancing the physical and human resources in area schools, we can help students increase their level of achievement. Under this special relationship with five area school districts in Allegheny and Beaver counties, Duquesne Light provides grants, job-shadowing experiences with company employees, field trips to company facilities, supplies and equipment, cultural experiences, and teacher development.

Employee volunteerism is an equal partner with corporate giving in the company's total community outreach program. An internal organization called the Employee Community Advisory Committee (ECAC) coordinates volunteer activities, offering employees a variety of ways to contribute their time and talents. Among the annual projects ECAC sponsors are: Scouting for Food, Juvenile Diabetes Race for the Cure, and United Way Day of Caring. Some 40 employees also volunteer their time, expertise and enthusiasm as members of the Duquesne Light Speakers Team. Each year, they make nearly 200 presentations to schools, community, senior citizen, and professional groups on topics related to electric safety, usage, efficiency, and reliability; and the environment.

The Company has also provided a significant amount of assistance to its low income customers. The Company contributes $500,000 annually to its Pilot Customer Assistance program which gives low income customers a chance to zero-out arrearages in their electric bills and reduce consumption to affordable levels. $700,000 is contributed to "Smart Comfort" a program for low income customers to make more efficient use of electricity. The "Smart Comfort" program received the Governor's Energy Award in both 1992 and 1993. The "Smart Comfort" program received the Governor's Energy Award in both 1992 and 1993. Our "CARES" program helps payment troubled customers with special needs to obtain the necessary social support and assistance. The Company's hardship fund is a partnership with the Dollar Energy Fund in which the Company's stockholders match contributions up to $325,000 annually while the Company provides administrative support. The Company also has a "Gatekeeper" program to identify situations where social support is needed and offers consumer credit counciling services.

Overall the Company has done an admirable job of balancing the diverse interests of all of its stakeholders.

Duquesne Will Mitigate $1.0 Billion of Potentially Stranded Costs And Has Avoided $700 Million of Rate Increases

Q. Could you summarize Duquesne's mitigation efforts?

A. Yes. A quantification of the various mitigation strategies previously discussed is presented in Exhibit DJC-2. The exhibit shows that by December 31, 1998 Duquesne will have mitigated $340 million of potentially stranded costs and that by December 31, 2005

the Company will have reduced its potentially stranded costs by approximately $1,030 million. The exhibit also shows that the Company has avoided some $700 million of rate increases which would have been required had the Company not pursued its aggressive mitigation strategies. Duquesne has actively engaged in mitigation efforts for more than ten years. Even though the Company was dealt crushing blow by the loss of steel load in the early 1980s it has rebounded while balancing the interests of it customers, shareholders, employees and other stakeholders. Duquesne pursued aggressive cost containment for fuel, O&M and capital additions. Duquesne was the only company in Pennsylvania to use the proceeds of a sale and leaseback transaction to financially restructure itself and significantly reduce its cost of capital. Duquesne has been a significant seller of power in the wholesale market and has passed all of the benefits of these sales to ratepayers through its fuel clause. The Company was the first Company in the state to voluntarily accelerate depreciation related to nuclear plants and has increased its depreciation and amortization rate by more than any other utility in the state. Duquesne is the only Company who has voluntarily increased its nuclear decommissioning funding level to over six times the amount originally included in rates. Duquesne is the only company in the state to sell a power plant and use the gain to offset a portion of its stranded cost. Duquesne is the only Company to use innovative tax planning strategies to mitigate stranded costs. Duquesne has reduced its base rates since 1992 while other companies in Pennsylvania have received rate increases. Duquesne's mitigation plan has complied with both the letter and intent of the Act and should be recognized by the Commission in determining that Duquesne is indeed entitled to an opportunity to fully recover its stranded costs. In addition to our stand alone proposals, a critical mitigation

strategy to be employed by the Company is the proposed merger with Allegheny Power Systems[2] Approval of the merger will permit the Company to commit to an additional $160 million of depreciation and amortization, a $25 million reduction in our distribution rates beginning July 1, 2001, and a rate freeze for distribution through 2005. In addition, it is likely that our stranded costs as of December 31, 2005 will be $200 million less than they would be without the merger and that the merger synergies will enable the Company to shorten its stranded cost recovery period.

IV. DUQUESNE PROPOSES A MARKET-BASED RESTRUCTURING PLAN FOR CALCULATION AND RECOVERY OF STRANDED COSTS

Q. You have described the mitigation efforts of the Company in the first part of your testimony. How does the Company propose to recover its "Transition or Stranded Costs" during the Transition Period?

A. Section 2803 of the Customer Choice 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 Commission determines will remain following mitigation by the electric utility."

In my testimony, I have used the term "stranded costs" to refer broadly to these costs. Most of the Company's stranded costs fall into two categories; generation related stranded costs (including future decommissioning expense) and regulatory assets. A third category, transition costs, are smaller in magnitude and include such items as the cost of our restructuring filing, the cost of customer choice education programs, and the cost of

[2] The details of the Company's merger application and combined restructuring proposals are set forth in the joint restructuring plan filing.

implementing the pilot program. Generation related stranded costs arise because it is expected that the market price of power will not support both a return on and return of the historic investments made by companies in generating assets when all future cash flows, including fuel cost, operating and maintenance expenses, future capital expenditures, and taxes are considered. Regulatory assets are assets which have been created because there has been either an explicit or implicit regulatory promise that such amounts will be recoverable and provided for in future revenues. In other words, regulatory assets are created (or impaired) by the actions of regulators. Mr. O'Brien in his testimony (Duquesne Statement No. 4) further explains how investors have relied upon these regulatory promises.

Duquesne Proposes to Recover its Stranded Costs Under a Rate Cap

Q. Please describe Duquesne's approach to stranded cost recovery.

A. The starting point for Duquesne's approach is section 2804 (4)(v) of the Customer Choice Act, which states:

> "If an electric distribution utility rolls its energy cost rate into base rates at a combined level that does not exceed its combined level of such rates which have been approved by the Commission as of the Effective Date of this chapter, the utility shall not be required to reduce its capped rates below the capped level upon the compliant of any party if the Commission determines that any excess earnings achieved under the cap are being utilized to mitigate transition or stranded costs for the benefit of ratepayers or to offset other known and measurable cost increases that would be recoverable under traditional ratemaking but are not included within the capped rates."

Pursuant to this provision, Duquesne is rolling into current base rates an energy cost rate that is cost-justified and equal to the ECR cap approved by the Commission as part of the Ft. Martin Agreement. In addition, Duquesne is committing to accelerate the depreciation and amortization of stranded costs in an amount that (when added to test

year revenue requirements) will result in a total revenue requirement equal to the revenues produced by current rate levels. As I will discuss below, this depreciation and amortization level is a minimum commitment and Duquesne's investors bear the risk that maintaining this commitment will depress earnings. In the event, however, that revenues exceed expected levels, or the cost of service is lower than expected, Duquesne is proposing an ROE spillover mechanism that will, as contemplated by the statute, ensure that the associated revenues are used to further mitigate stranded costs.

Q. Section 2804 (4)(v) refers to the mitigation of stranded costs, but does not refer to a specific stranded cost calculation. Why is this?

A. Section 2804 (4)(v) contemplates an approach under which a utility can continue to charge rates at current levels if it can support such rate levels with its test year revenue requirement calculation plus an annual depreciation and amortization of stranded costs. Thus, whatever "total" stranded costs may be, the utility can continue to charge rates each year at current levels so long as it uses any potentially excess revenues to accelerate the depreciation and amortization of stranded costs.

Q. Will Duquesne do a specific calculation of stranded costs at some time in the future?

A. Yes. As discussed in the testimony of Mr. Schnitzer (Duquesne Statement No. 3), Duquesne is proposing a final market-based valuation in mid-2003. This will determine stranded costs after netting out the accelerated depreciation and amortization under the rate cap.

Duquesne is Entitled to a Rate Cap Under Section 2804(4)(V)

Q. To show you are entitled to a rate cap, doesn't Duquesne need to calculate the stranded costs that would be amortized?

A. Yes, but in a narrow respect. As detailed in Mr. Schnitzer's testimony, Duquesne must make a *prima facie* showing that:

- Excess earnings achieved under the cap will be utilized to mitigate transition or stranded costs for the benefit of ratepayers under the proposed minimum amortization commitments and ROE spillover mechanism
- The market value of generation beginning in 2006 is below the book value of generation and generation-related regulatory assets net of the committed minimum level of depreciation and amortization.

Q. How will you make the first showing?

A. My analysis quantifies the level of generation related depreciation and amortization that can be achieved between 1999 and 2005 under a generation price freeze, while still providing the Company with an opportunity to earn a fair return on invested capital. As shown in Exhibit DJC-3, this analysis indicates that the net book value of the Company's generation related assets can be reduced by approximately $1.7 billion under the price cap leaving a net book value of approximately $535 million.

Q. How will you make the second showing?

A. My analysis compared the estimated range of market value of the Company's generatory stations as of December 31, 2005, with the projected net book value of its generating assets and regulatory assets with depreciation and amortization of no less than $1.7 billion. This analysis demonstrates that the Company will likely have remaining stranded costs of $8 to $582 million at the end of 2005, depending on the level of market prices in 2006 and beyond.

Q. Please describe the results for each station as shown on Exhibit DJC-3.

A. Exhibit DJC-3 shows the gross plant value, accumulated depreciation, accumulated deferred income tax and accumulated investment tax credit balances for each station as of December 31, 1996 and the bring down of these balances to December 31, 2005. These net plant balances are then used as the basis for determining the Company's range of stranded generation cost remaining as of December 31, 2005.

Q. How did you estimate the market value of the Company's generating assets as of year end 2005 for purposes of showing that Duquesne will still have stranded costs?

A. The market value of the Company's generating assets as of year end 2005 was estimated using a margin analysis approach. The future cash flows or "to go" costs were assembled for each of the Company's generating stations through the end of its book life. These amounts were then deducted from a forecast of market revenues for each of the Company's generating stations using a range of market prices as forecasted by Mr. Schnitzer (Duquesne Statement No. 3). As described in Mr. Schnitzer's testimony, the range of prices is a market price ceiling based on the cost of entry of new gas-fired combined cycle capacity. The margin contribution of generation was tax affected and then discounted at the Company's after-tax cost of capital to arrive at the market value of the generating portfolio as of December 31, 2005. These results are summarized in Exhibit DJC-3.

Q. I notice that other Duquesne witnesses have criticized the use of market price "forecasts." Why are you using one to estimate stranded costs?

A. I am doing so for the narrow purpose of making the *prima facie* showing that Duquesne is entitled to continue its rate cap through 2005. The process of setting a "known and measurable" CTC for individual customers, and of making a final determination of any

generation values beyond 2005, is a distinct undertaking and one that uses the market-based valuations described in the testimony of Mr. Schnitzer.

Q. What do you conclude based on your comparison of estimated book and market values in 2005?

A. Given a range of $(47) million to $527 million of market value based on Mr. Schnitzer's estimate of the market price ceiling, the results of this analysis show that as of December 31, 2005 the Company will likely have from $582 million of stranded costs under the low market value to $8 million of stranded costs under the high market value. Thus, it is likely that Duquesne will have stranded costs remaining in 2006 over a wide range of potential market prices.

Q. What do you conclude about Duquesne's showing for purposes of Section 2804(4)(v)?

A. Duquesne has made a *prima facie* showing of both of the propositions required under Section 2804(4)(v) and is therefore entitled to a price cap during the Transition Period.

Stranded Costs Are Likely to Remain in 2005

Q. Please elaborate on the estimate of stranded costs you made as of 2005. What do the unit by unit margin calculations show?

A. Pages 44 to 67 of Exhibit DJC-3 shows the margin calculation for each of the Company's stations. The schedule shows the market revenues to be derived from each station. The market revenue for each station was determined based on Mr. Schnitzer's range of market prices. For purposes of the analysis Duquesne's equivalent availability factor were assumed to be maintained at historic levels. Once the market revenues by plant were

determined the "to go" costs were deducted to arrive at the contribution margin from each plant.

In addition to direct cost at each station an allocation of administrative and general expenses was made based on the overhead allocation methodology described in detail in Mr. O'Brien's testimony (Duquesne Statement No. 4). Once the margin calculations were complete the margin contributions were tax affected and then discounted at the Company's after-tax cost of capital. The sums of these amounts by plant were then compared to the Company's net book value amounts by plant at December 31, 2005. Duquesne's range of generation related stranded costs of $8 to $582 million was then computed by deducting the estimated market values from the Company's net book values. The results show that Duquesne's generating plants will have unamortized stranded costs, as follows: Beaver Valley 1 - $36 to ($92) million (benefit), Beaver Valley 2 - $28 to ($34) million (benefit), Perry - $34 million, Cheswick - $20 to $179 million, Elrama - $35 million, Mansfield - $129 to ($11) million (benefit), Sammis - $11 million to $46 million, Eastlake - $27 to $53 million, Brunot Island - $8 to $32 million and Phillips - $10 million.

Supporting Data Confirms Stranded Cost Analysis

Q. What other supporting data are provided for the "to go" costs and market based revenue forecasts?

A. The fixed and variable production costs, load forecasts and plant availability data are consistent with the revised Integrated Resource Plan which has been provided in response to Appendix A, Item G-7 and is being supported by Mr. Mark Karl (Duquesne Statement No.

9). The capital expenditure forecast by generating station is being supported by Messrs. Nelson and Duckworth (Duquesne Statement Nos. 10 and 11). As previously stated, the range of market price ceilings forecast beyond 2005 is supported by the testimony of Mr. Michael Schnitzer (Duquesne Statement No. 3).

Q. How were the Beaver Valley Unit No. 2 lease payments included in your analysis of generation related stranded costs?

A. The Beaver Valley Unit No. 2 lease payments beyond 2005 were discounted at the after tax cost of capital and the accelerated amortization applied to the lease (including earnings) through 2005 were netted. This amount was then added to the Company's net book values at December 31, 2005 before the comparisons to market values were made.

Q. Has the Company included "cold reserved" units in its stranded cost determination?

A. Yes. The company has included the Phillips Power Station and the cold reserved portion of the Brunot Island Power station in its determination of stranded costs.

Q. Given stranded cost recovery for your cold reserved units, how would the Company treat any proceeds from sales of these assets?

A. There is no market for the Company's cold reserved units at this time. However, should these assets prove to be valuable, the proceeds of any sale of these assets would be used to directly reduce the Company's stranded costs. The procedure for crediting the proceeds of any future sales are described in Mr. Schnitzer's testimony.

Q. How were possible life extensions of generating plants treated in your analysis of stranded costs?

A. No life extensions beyond the currently estimated book lives were assumed in the stranded cost analysis. The purpose for which stranded costs are being calculated as of December

31, 2005 is to demonstrate that Duquesne is entitled to continuation of a rate cap throughout the Transition Period under Section 2804(4)(v) of the Customer Choice Act. A final market-based valuation of the plants as of December 31, 2005 will take place in mid-2003 under Duquesne's proposal. As part of the final valuation, life extension analyses for Duquesne's fossil generating stations would be completed to assess whether such extensions were economic based on the market price data available in 2003. The analysis would consider the cost of life extension based on more certain information about environmental compliance costs. Any incremental market value from such life extensions would be reflected in the final market valuation.

Q. Why were decommissioning costs excluded from the margin analysis?

A. Decommissioning costs are truly "sunk costs." That is, the obligation to decommission power plants has already been assumed by the Company. The present value of Duquesne's unfunded decommissioning liability was deducted directly from the Company's market value estimates rather than including the periodic funding as a "to go" cost in the margin analysis. Mathematically the Company's stranded cost claim would be unchanged given this alternative treatment. It should be noted that with the nuclear decommissioning funding proposed, it is estimated that there will be only a small unfunded nuclear liability in 2005 (i.e. $2 million). However, the actual level of required funding would be determined as part of the final market-based valuation in mid-2003.

Q. How were the decommissioning costs for fossil and nuclear generation stations determined?

A. The estimated decommissioning costs for each of the Company's generation stations were prepared by Mr. Thomas LaGuardia and are supported in his direct testimony (Duquesne Statement No. 13). The decommissioning cost estimates prepared by Mr. LaGuardia were

made in current dollars. These estimates were escalated to the end of each of the generating stations' useful lives. A 2.5% escalation rate was used for fossil stations and a 4.0% escalation rate was used for nuclear stations. The inflated amounts were then discounted at the Company's after-tax cost of capital for fossil stations and at 7.5% for nuclear stations (i.e. the expected after-tax earnings rate on the Company's external funds for nuclear decommissioning) to December 31, 2005. The unfunded portion was then deducted from the present value of the margin analysis for each station before the comparison to the Company's net book value at December 31, 2005 was made. A summary of the decommissioning cost estimates and the related calculations are shown in Exhibit DJC-7.

Q. You stated previously that Duquesne is proposing to roll into base rates an ECR of $14.7 mills/kWh. Is this the same rate level as the currently effective ECR?

A. No.

Q. Please explain the basis for this adjustment?

A. Section 2804(4) (v) permits Duquesne to roll the ECR into base rates at a combined level that does not exceed that previously approved by the Commission. Duquesne's proposal is consistent with this requirement because the Commission has previously approved, as part of the Ft. Martin rate plan, an ECR of up to 14.7 mills/kWh. As indicated in the fuel cost projections contained in Exhibit DJC-3, Duquesne's fuel costs throughout the transition period will exceed 14.7 mills/kWh.

Q. Does the increase in the ECR mean that customers will pay higher rates that they would have in the absence of restructuring?

A. No. Even in the absence of the restructuring legislation, Duquesne had the right to propose a cost-justified ECR of 14.7 mills/kWh and indeed Duquesne did so earlier this year. The Commission did not approve the proposed increase, however, stating that the matter should be considered in the restructuring case. I also would note that, if, contrary to the projections in Exhibit DJC-3, Duquesne's energy costs fall below 14.7 mills/kWh in the future, the associated excess earnings will be used for further stranded cost mitigation under the ROE spillover. Finally, it is important to remember that, as Mr. Lahtinen testifies, Duquesne's customers will receive a significant rate reduction -- 50% for residential customers -- for incremental usage under Duquesne's proposed rate redesign.

Regulatory Assets are Fully Amortized By the End of 2005

Q. How was the $758 million of generation related regulatory assets as of December 31, 1998 shown in Exhibit DJC-4 determined and amortized?

A. The $758 million of generation related regulatory assets as of January 1, 1998 shown in Exhibit DJC-4 was developed from the Company's balance sheet as of December 31, 1996 and a bring down of each of the regulatory asset balances using known and estimated amortization amounts for 1997 and 1998. The December 31, 1998 balance was then amortized on a straight line basis through 2005. Mr. O'Brien in his direct testimony (Duquesne Statement No. 4) details each of the Company's regulatory assets and describes the basis for recovery of each regulatory asset class.

Q. Is the Company claiming a return on all of its regulatory assets?

A. No. For certain regulatory assets only the present value of amortization (or recovery) is claimed. These assets include deferred rate synchronization or "early window" costs,

deferred Employee Costs, DOE Decontamination and decommissioning costs, pre-accrual of nuclear outage costs, deferred pilot program costs. A return as well as recovery is claimed for all of the Company's other regulatory assets.

Q. Is it appropriate for the Company to earn a return on the regulatory asset related to FAS 109?

A. Yes. For purposes of estimating stranded costs as of 2005, the Company has reduced the book value of its generation assets by the full amount of its accumulated deferred tax and accumulated ITC balances. The Company proposes that the final market-based valuation should similarly account for deferred taxes and ITCs. Thus, customers will be credited with the full value of these balances against the book value of generation. Accordingly, it is appropriate for the Company to claim a return on the tax related asset. Since the Company is amortizing its tax related regulatory asset more rapidly than it is reversing its deferred tax balance (i.e., the regulatory asset is being amortized over the Transition Period while the deferred tax balance is being reversed over the remaining life of the Company's plants), Duquesne's customers will actually incur a lower total revenue requirement than they would under traditional ratemaking. Of course, both methods produce the same present value of revenue requirements. If a return were to be denied on the tax related assets, then an offsetting adjustment should be made to the generation related deferred tax balance.

Q. How were debt discounts and premiums included in your stranded cost claim?

A. Duquesne's cost of capital assumes that debt discounts and premiums will be amortized (and earn a return equal to the Company's cost of capital) over the average remaining life of its outstanding debt and preferred securities. Since the Transition Period is shorter than the remaining average life of the Company's securities, a shortfall would be experienced. As

such, the Company has included an amount equal to the amount of debt discounts and premiums above what would normally be amortized through the cost of capital and amortized this amount between 1999 and 2005.

Q. How was the Beaver Valley Unit No. 2 sale/leaseback premium handled?

A. The sale leaseback premium was handled similarly to the debt premiums and discounts. The portion of the debt premium which would normally be amortized prior to 2006 through the lease payment expense was so amortized. The amount which would have been amortized between 2006 and 2016 (i.e., the end of the lease period) was included in regulatory assets and amortized between 1999 and 2005.

Q. Are there any other items which are unusual in Duquesne's stranded cost claim?

A. Most of Duquesne's other regulatory assets are normal course of business items. However, the deferred fuel amount has been adjusted to reflect the deferral required as a result of our most recent ECR filing and a new item has been added related to our pilot program participation incentive. Neither of these items was on our 1996 balance sheet but have subsequently been created by the Commission's Orders at (M-00970917) and (P-00971175).

Q. How were the $18.2 million of transition costs determined?

A. The transition cost estimates shown in Exhibit DJC-5 are based on the best available information to date. The pilot program implementation expense and restructuring implementation expense were prepared by Mr. Allison. The customer education expenses were estimated by Mr. Hoffmann. The deferred pilot program costs are based on the Company's settlement proposal at Docket No. P-00971175. Restructuring filing expense has been estimated by the Company's legal department.

Q. Does the Company have any significant stranded costs related to Non-Utility Generator (NUG) contracts?

A. No. The Company has no significant stranded costs related to NUG contracts. The small contracts (56 MW) to which the Company is committed are however included in the Company's generating cost forecasts.

Q. Have all of the Company's stranded cost claims been made on a net present value basis and netted against any benefits which would be normally recognized under current Pennsylvania regulatory practice?

A. Yes. All of the Company's stranded cost claims are made on a net present value basis and have been reduced by any potential benefits which could have been expected to accrue to the Company under current Pennsylvania regulatory practice.

Q. Are all of the Company's claimed stranded costs currently recoverable under current regulatory practice?

A. Yes. As further described by Mr. O'Brien, all of the Company's claimed stranded costs have been either specifically approved for recovery by the Commission or have been typically recoverable under current Pennsylvania regulatory practice.

Duquesne Commits to Generation Related Depreciation and Amortization of $1.7 Billion

Q. You have previously indicated that there will be unamortized stranded costs of between $8 million and $582 million at the end of 2005. Is the Company committing to a certain level of generation related depreciation and amortization by year end 2005?

A. Yes. The Company proposes to use the generation related depreciation and amortization schedule shown in Exhibit DJC-6. This schedule is the minimum level of amortization to

which the Company is committed. As explained below, the Company will further accelerate depreciation and amortization if it is able to do so while maintaining an 11.5% ROE.

Q. How are customers protected by the guarantee of a minimum level of depreciation and amortization?

A. Duquesne's minimum depreciation and amortization commitment ensures that the net book value of generation to be used for purposes of finally determining stranded costs will be at the level shown in Exhibit DJC-3 (except for possible deviations in future capital spending or changes in the tax law). Of course, future capital expenditures would have to be cost justified and prudent or the Company would not be able to recover these amounts in any case. Tax law changes are outside of the Company's control and would be addressed as such changes (if any) occur.

Q. Please explain the Company's proposed "final market-based valuation"?

A. The Company has proposed a final market-based valuation to ensure that residual credit is given to its customers that properly reflects the market value of the Company's generating stations beyond 2005. The Company believes that the range of preliminary estimates of the market value of its generating plant as of December 31, 2005 spans the most likely range of values. However, the actual market value could be higher than the high end of the range or lower than the low end of the range. It is generally accepted that the markets for electricity will be more fully developed in the future than they are today. Given a more fully developed market for electricity in the future, the residual value of the Company's generating plants will then be able to be determined based on market evidence. Mr.

Schnitzer's testimony (Duquesne Statement No. 3) provides additional detail on the Company's proposed final market-based valuation.

Q. How does the Company propose to recover stranded costs which remain at the end of 2005?

A. The Company proposes to extend the rate cap beyond 2005 to recover any stranded cost which will remain after 2005 based on the final market-based determination of stranded costs in mid-2003.

Triggers Protect Ratepayers from Excess Amortization

Q. Are there any conditions which would trigger an early determination of the final market-based value of the Company's plants.

A. Yes, there are two triggers. First if the long term market price of power rises significantly prior to 2003, then it is possible that the residual market value at the end of 2005 will exceed the unamortized book value of generation. The proposed solution is to trigger an early final market valuation based on established price triggers for the years 2001 and 2002. I have calculated the market prices for generation for each of these years based on an adjusted percentage of the high market price ceiling as forecasted by Mr. Schnitzer. I deflated Mr. Schnitzer's 2006 price to 2001 and 2002 using a 2.5% discount rate. I then applied a 75% discount factor to this price to calculate the trigger prices of $28.5/mwh for 2001 and $29.2/mwh for 2002. The early trigger price is that market price which would be likely to establish a high enough residual value to allow an early end to the rate cap and further collection of CTC. Duquesne will commit to accelerate the final market valuation to 2001 or 2002 if the trigger is exceeded. The market evidence to be used for the trigger mechanism is the annual solicitation for sale of firm power held in 2000 and 2001 to establish the customer specific CTCs for 2001 and 2002. If the market price determined in

those solicitations exceeds the values set forth above, the final market-based valuation will be accelerated.

Q. What is the second trigger?

A. Under the ROE spillover proposal described below if the accumulated revenue credit when netted with the net book value of the Company's generating and regulatory assets was equal to (or less than) the Company's net book value estimated in 2005 as shown in Exhibit DJC-3 at any time before mid 2003 an early valuation would be triggered. That is, if the Company were able to complete its minimum committed schedule of amortization and depreciation ahead of schedule then it would be appropriate to trigger an early valuation.

Q. How does this second trigger relate to the Company's ROE spillover proposal?

A. The Company's proposed "ROE spill over" adjustment will ensure that the Company does not have excessive earnings during the Transition Period and that customers are given the proper credit through a shortening of the rate cap period if the Company's actual results are better than expected. The Company proposes to establish a collar on its earnings of + or - ½% around its claimed ROE of 11.5%. If the Company's earnings exceed 12%, it would establish a deferred revenue credit account which would ultimately be used to fund accelerated depreciation and amortization. If earnings fall below 11% an adjustment to the deferred revenue account will be made to increase the Company's earning to the 11% ROE level or to eliminate the credit and balance in the account, which ever is smaller. If at any time during the transition period, the balance in the deferred revenue credit account (including income tax provisions) when netted against the Company's net book value of generating and regulatory assets was equal to the estimated net book value as of December 31, 2005 as shown in Exhibit DJC-3, the final market-based valuation would be triggered.

Q. What circumstances would cause the ROE spillover to be used?

A. Probably the most important positive factor would be the effect of increased "tail block" sales on the Company's revenue forecast. Under the Company's proposed rate design it is likely that sales levels will increase as marginal consumption increases due to lower rates for consumption above historic levels. Since the magnitude of these sales is unknown they have not been included in the Company's base forecast. These sales could be significant and would be credited through the ROE spillover proposal to reduce the Company's book value below committed levels. Of course, any decreases in the Company's costs could also trigger the ROE spillover mechanism.

Q. How would the Company's final market-based valuation and ROE spillover proposal change if the Commission makes different determinations with respect to stranded cost, and CTCs for the Company?

A. The Company's final market-based valuation and ROE spillover proposals are part of a comprehensive restructuring plan. The Company believes that it is important to let the market determine the market price of power and that a reasonable opportunity to fully recover its stranded costs must be afforded to the Company. If unfavorable determinations are made then the Company would have to re-evaluate its final market-based valuation and ROE spillover proposals. We believe that our proposals ensure that the Company's customers will never pay more than the minimum amount required to write the company's generation assets down to market value and that the burdens of stranded cost recovery have and will continue to be borne by all of the Company's stakeholders in a balanced manner. If, however, the Commission made a significant disallowance of our stranded cost recovery or if there was no opportunity to let the market make the final determination of stranded

costs for the Company, the Company would not be able to implement its restructuring plan. Under these conditions the ROE spillover would be moot because the Company would have little hope of earning a fair return. Similarly, if an artificially determined high market price is used to deny recovery under the rate cap, the Company will have little hope of earning a fair return on its assets.

Q. Is the Company proposing to unconditionally cap its rates during the transition period?

A. No. Although the Company believes that it will be able to operate under the rate cap, the Company is reserving the right to raise rates as permitted under Section 2804(4) of the Act.

V. COST OF CAPITAL

Q. In preparing your overall rate of return recommendations, what underlying principle has served as your guide in establishing the evidence you will present?

A. The criterion for establishing a fair rate of return for a public utility has been long established and was a result of landmark decisions of the United States Supreme Court. In 1923, in the Bluefield Water Works and Improvement Co. vs. Public Services Commission (262 U.S. 679, 1923) case, the Court said:

> "A public utility is entitled to such rates as will permit it to earn a return on the value of the property which it employs for the convenience of the public equal to that generally being made at the same time and in the same part of the country on investments in other business undertakings which are attended by corresponding risks and uncertainties; but has no constitutional rights to profits such as are realized or anticipated in highly profitable enterprises or speculative ventures."

And, in 1944, in the Federal Power Commission vs. Hope Natural Gas Company (320 U.S. 591, 1944) case, the Court said:

> "From the investor or company point of view, it is important that there be enough revenue not only for operating expenses, but also for the capital costs of the business. These include service on the debt and dividends on the stock. By that standard the return to the equity owner should be commensurate with returns on investment in other enterprises having corresponding risks. That return, moreover,

should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

Thus, the Supreme Court has made it clear that a fair rate of return should result in an overall rate of return sufficient to insure investor confidence in the financial soundness of the utility.

Q. Please explain briefly how you have determined the fair rate of return.

A. I have followed what is commonly known as the "cost of capital" method. This approach first identifies the various components of the capital structure and their corresponding percentages of the capitalization total. Next, the cost of each type of capital item is determined, and with these two sets of data in hand, the weighted cost of capital is calculated. Thus, the overall cost of capital equals the sum of the weighted costs.

Q. What is the overall rate of cost of capital you are recommending?

A. Appendix A, Item H-1 shows the development of the Company's overall cost of capital of 9.61%. Appendix A, Item L-8 shows the after-tax discount rate of 7.83% used in the present value calculations which is also based on the Company's overall cost of capital. The data shows the consolidated capitalization at the end of the test period and it shows the annual cost of each of the capitalization components at that time.

Q. How did you develop the capital structure used to generate the overall rate of return recommendations?

A. The capital structure used to determine the overall rate of return and after-tax discount rate was the capital structure at year end 1996. As part of the company's mitigation plan, approved in conjunction with the sale of the Ft. Martin Power Station, the company agreed to target the components of its capital structure to be similar to the levels approved in its last

base rate case or 40.2% common equity, 9.96% preferred and preference equity and 49.84% long-term debt. As of year end 1996, the company's capital structure had the following percentages; 40.08% equity, 9.69% preferred equity and 50.23% long-term debt. Since the year end 1996 capital structure is very close to the company's target capital structure I have used the year 1996 capital structure throughout the filing. As previously noted, the detailed capital structure is set forth in Appendix A, Item H-1.

Q. Please describe the capital costs you applied to your recommended capital structure.

A. The annual cost applied to the consolidated capitalization components is shown under the columns entitled "average rate" on Appendix A, Item H-1. The long-term debt component is shown with a cost of 8.51 percent and is developed in detail in Appendix A, Item H-2. The preferred and preference stock component is shown with a cost rate of 7.45 percent and is developed in detail in Appendix A, Item H-7.

Q. Please describe how you developed the cost of long-term debt and preferred and preference stock.

A. I developed the Company's long-term debt cost and the cost of preferred and preference stock at the end of the test year using all known interest and dividend rates and applicable terms on the Company's outstanding long-term debt and preferred and preference stock issues. I did not assume that any additional long-term debt or preferred or preference stock would be issued. The Company's claimed costs of both long-term debt and preferred and preference stock are based solely on the Company's embedded cost rates.

Q. How did you determine the 11.5% cost of common equity claimed in this proceeding?

A. An 11.65% cost of common equity for Duquesne has been identified by Dr. Jeffrey D. Makholm in his direct testimony. To be conservative, I have reduced this amount to 11.5% as the Company's claimed cost of common equity.

Q. How does the Company plan to keep its capital structure in line with the test year capital structure throughout the transition period?

A. The Company's scheduled debt maturities and the call provisions of its long-term debt will allow it to continue to reduce its outstanding debt throughout the transition period. Common equity can be maintained at the 40% level by paying dividends to DQE (the Company's sole shareholder) which is equivalent to repurchases of common stock for publicly traded companies. The Company can repurchase preferred through open market purchases or tender offers. A sample financing plan which demonstrates the feasibility of maintaining the Company's capital structure is shown on Exhibit DJC-8. Of course the actual financing plan may differ from the sample plan but the sample plan produces a reasonable result given the Company's current forecast and proposed restructuring plan.

Q. You have stated elsewhere in your testimony that Duquesne's overall cost of capital compares favorably to the other utilities in the state. Is that correct?

A. Yes. Exhibit DJC-9 shows a comparison of Duquesne's claimed cost of capital with the claimed cost of capital for the other Pennsylvania electric utilities as claimed in their respective restructuring filings.

Q. Will the company securitize its stranded costs?

A. At this time, the Company is not requesting to securitize any of its stranded cost. However, the Company reserves the right to request securitization in a future proceeding.

Q. Is securitization beneficial to the Company at this time?

A. No. At this time there are no economic benefits to be derived from asset securitization for Duquesne. There is no economic basis to securitize because the Company has already restructured its finances to the point where its current debt costs are lower than the cost of issuing securitized debt, and the Company is already employing a high degree of debt leverage in its capital structure. In fact, Duquesne's debt leverage is higher than any other Pennsylvania electric company as shown in Exhibit DJC-9. Since 1986 the Company has repurchased 30% of its common stock, has refinanced all of its debt and has refinanced several of its preferred and preference issues. At this point securitization could place Duquesne's current investors at greater risk because the cash flow related to securitized debt would have a higher priority of payment than the payment to Duquesne's other security holders. Since the Company's total revenues will be unchanged, the cash flows to current investors will be more uncertain than they are today and hence more risky than they are without securitization. Since there are no economic benefits to help offset this increased risk, securitization is not appropriate at this time for Duquesne.

Q. When would securitization be appropriate?

A. Securitization would be appropriate if there were a true economic benefit to be derived from issuing such securities.

V. APPENDIX A ITEMS

Q. Will you please identify the Appendix A items you are sponsoring?

A. I am sponsoring the following Appendix A items:

G-1	Corporate History
G-2	System Map
G-3	Base Budget
G-4	O&M/capital Budget Projection
G-5	Financial Schedules
G-6	Property Description
H-1	Claimed Capitalization
H-2	Embedded Cost of Long Term Debt
H-3	Economic Cost of Debt
H-4	Short Term Debt - Lines of Credit
H-5	Other Short Term Debt
H-6	Long Term Debt Reacquisitions
H-7	Embedded Cost of Preferred Stock
H-8	Common Stock Issuances
H-9	Common Stock Offering Information
H-10	Parent Company Capitalization
H-11	Parent Company Financial Statements
H-12	Corporate Organizational Structure
H-13	Quarterly and Annual Financial Reports for Company and Parent
H-14	Projected Capital Requirements

H-15 Restrictive Financial Covenants

H-16 Comparative Financial Data

L-1 Competitive Transition Charge

L-2 Stranded Cost Summary

L-3 Stranded Cost Methodology

L-4 Securitization Amounts

L-5 Generating Station Data

L-6 Return to Revenue Factor

L-7 Generation Station Costs per Kilowatt Hour

L-8 Discount Rate

L-9 Market Price Forecast and Generation Station Information

L-10 Operating and Maintenance Expense Efficiency Factor

L-11 Inflation Rate Assumptions

L-17 Stranded Cost Graph

O-1 Securitization Filing

O-2 Description of Merger Consolidation, Acquisition or Disclosures

O-3 New Business Entities

Q. Does this conclude your testimony?

A. Yes. It does.

R-00974104

Duquesne Statement No. 2-R

Pittsburgh 12-15-97

GST

BEFORE THE

PENNSYLVANIA PUBLIC UTILITY COMMISSION

DUQUESNE LIGHT COMPANY
DOCKET NO. R-00974104

Rebuttal Testimony
of
Donald J. Clayton

Contents:

Response to Intervenor Testimony Regarding Cost Mitigation Efforts, Stranded Cost Calculations and Recovery, Regulatory Assets, and Other Financial Matters

I. INTRODUCTION

Q. Please state your name and business address for the record.

A. My name is Donald J. Clayton. My business address is 411 Seventh Avenue, Pittsburgh, Pennsylvania 15230-1930.

Q: Have you previously testified in this proceeding.?

A. Yes. I submitted direct testimony (Duquesne Statement No. 2) and various supporting exhibits (DJC-1 through DJC-9) with Duquesne Light Company's August 1, 1997 restructuring filing.

Q: What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to discuss the Company's proposed modifications to its original proposals with respect to stranded cost. I will then discuss the Company's position with respect to the proposals of the various intervenors on stranded cost and stranded cost recovery, adjustments to regulatory assets, adjustments to nuclear and fossil decommissioning, life extension of certain generating plants, shut down of certain generating plants , ECR roll in, ROE spillover, and asset securitization. I will also update the Company's range of stranded costs as of December 31, 2005 and discuss the negative impact on Duquesne's financial viability under the "sharing proposals" which have been advanced by various parties.

Q: Will you summarize the positions of the various parties relative to stranded cost and stranded cost recovery?

A. Yes, four parties, the OCA, OTS, DII and HSS/ARI, have made more or less

comprehensive assessments of the Company's stranded cost and stranded cost recovery. These parties have commented on virtually every aspect of the Company's stranded cost and stranded cost recovery proposals. (However, OTS and HSS/ARI have not proposed an independent valuation of the Company's owned-generation stranded costs as of December 31, 1998.) Other parties have made proposals which would impact the Company's claims but have not made comprehensive proposals of their own. In general, there was fair agreement among the parties on the amount of the Company's generation plant assets and there was a large degree of overlap on regulatory assets. In contrast, there was a fairly wide range of opinion on the market value of Duquesne's generating plants and there was a significant difference of opinion among the parties on the amount of stranded cost recovery which should be allowed. Exhibit DJC-10 shows the relative positions of OCA, OTS, DII and HSS/ARI with respect to the Company's level of stranded cost as stated on a consistent basis with the Company's positions as of December 31, 1998. Exhibit DJC-11 shows the total impact on revenues of the various proposals and Exhibit 12 shows the sharing proposals of the OCA and DII. In the sections that follow, I will detail the Company's position with respect to each of the major adjustments proposed by the various parties and show why each of the proposed adjustments should be rejected by the Commission.

II. MODIFICATIONS TO THE COMPANY'S PROPOSALS ON STRANDED COST

Duquesne's proposed modifications address many of the concerns raised

Q. Given the testimony of the other parties to this proceeding, has the Company changed any of its original proposals with respect to the determination of or recovery of stranded costs?

A. Yes. The Company has modified its proposal in three ways that I will discuss. First, the Company has agreed to divestiture, at the Commission's option, in 2003 as the method to determine market value. Second, the Company will revise the market price trigger to reflect the OCA market price line. Third, the Company has eliminated the deadband around the proposed ROE for purposes of the ROE spillover mechanism.

Q. Please elaborate on the Company's first proposed modification.

A. Duquesne will commit to allow the Commission to order Duquesne to auction its generation in 2003. Several parties have suggested that divestiture of the company's generating plants is the only way to arrive at a definitive market value for the Company's generating plants. While the Company does not agree that this is the only way, the Company does recognize that asset divestiture is a proper way to establish market value. As such, as part of its stand alone restructuring proposal the Company will modify its final valuation proposal to include an option whereby the Commission could order the Company to divest its generating assets in 2003 (or sooner if there is an early trigger of the final valuation). Under this modified proposal, the Commission could order the Company to offer for sale its entire generating portfolio including both its fossil

and nuclear units. The divestiture would be conducted so as to maximize the value of the generation portfolio and the Commission would approve the procedures to be used to complete the divestiture.

Q. Is the Company still proposing an arbitration panel of experts for the final market valuation?

A. Yes. If the Commission does not elect to order Duquesne to determine market value by conducting an auction of its generation assets, then a market-based valuation without a divestiture would take place. This valuation procedure would rely on all the market evidence described in Duquesne's direct case for the arbitration panel. However, because the Commission is given the initial option to order divestiture, if it did not exercise that option and Duquesne objected to the market valuation determined by the panel, then Duquesne would have the further option to undertake divestiture to determine generation plant value as set out in Duquesne's direct case.

Q. Would divestiture settle all issues regarding market value?

A. Most, but not necessarily all. If no bids were received for a generation unit, then that would establish the market value ceiling for the unit of zero. The arbitration panel would then have to determine if there were unavoidable costs of shutting down the unit and, hence, whether the value of the unit was negative and in what amount. This circumstance could, for example, arise with respect to the sale of the nuclear units, given that, at present, there appears to be minimal demand for the purchase of nuclear assets.

Q. Why is the Company proposing to wait until 2003 to trigger the divestiture option?

A. The Company is proposing to wait until 2003 for a number of reasons. The most important reason for waiting is that under the restructuring legislation the Company will retain the obligation to serve customers at the generation price cap and will serve as the supplier of last resort. Second, as discussed in the direct case, the Company believes that by 2003 the electricity markets will be more fully developed than they are today. As such, a reasonable final market valuation may be able to be easily determined based on methods other than an ordered divestiture.

Q. Would the trigger mechanisms discussed in your direct testimony still apply to accelerate the final valuation, including the Commission option to order divestiture?

A. Yes. If the early valuation is triggered, the Company would be willing to divest at that time under the Commission ordered divestiture option discussed above. Mr. Schnitzer discusses the use of the OCA market price line as a benchmark for assessing whether Duquesne will have sufficiently amortized and depreciated its stranded cost. I propose below a trigger based on the OCA price line. Other than the change to the market price trigger discussed by Mr. Schnitzer, the two triggers would operate as proposed in Duquesne's direct case.

Q. What is the Company's second modification?

A. The second modification is to adopt the price line of the OCA for the purposes of determining the early trigger points for the final valuation. Under the Company's original proposal, Duquesne would have triggered an early valuation in either 2001 or 2002 if the market price from its annual solicitation was greater than $28.5/MWh in 2001 or $29.2 in 2002.

As Mr. Schnitzer demonstrates in his testimony, under the OCA's assumptions (except for sharing/disallowance) the Company's market and book values for generation assets would be approximately equal at year end 2003. The OCA market values beyond 2003 are predicated on the jump in prices forecast by OCA witness Doug Smith in Exhibit DCS-5 in the year 2003. The Duquesne weighted generation market price line of the OCA for 2003 shown in Exhibit DCS-5 is $29.28/MWh based on an average capacity factor of approximately 75% for all Duquesne's units. The Company proposes to reset the triggers at 90% of that 2003 price deflated to 2001 and 2002 at the OCA's inflation rates. This would result in a lowering of the trigger price in 2001 from $28.5 to $24.9 and in 2002 from $29.2 to $25.6. These lower price triggers add conservatism to the Company's case, given that they make it more likely that an early valuation will occur. The price used to determine if the trigger price was exceeded would be the 75% capacity factor price from the 1 year solicitation used to establish the CTC for 2001 and 2002 respectively. If an alternative means were used to establish the market price (and the CGC/CTC) as discussed in Mr. Marshall's testimony, then that standard (adjusted to a 75% capacity factor) would be used to determine if an early final valuation would be triggered.

Q. What is the third proposed modification?

A. The Company will eliminate the bandwidth around the proposed ROE of 11.5%. Duquesne has been criticized for its ROE spillover proposal which includes an 11.5% ROE with a ½% collar for the determination of the entries to the proposed deferred revenue account. The Company proposed the collar to avoid making

insignificant accounting entries and not to try to gain approval for a 12% ROE as some have suggested. In fact, the Company believes that it will be difficult enough to reach the 11% floor given its proposed minimum amortization commitment of $1.7 billion between 1999 and 2005. However to avoid controversy over this item, the Company would remove the collar from its proposal and record all entries to the deferred revenue account based on an 11.5% ROE.

Q. How do these proposed modifications to the Company's original filing improve the Company's plan?

A. These changes are intended to answer criticisms raised by intervenors and demonstrate Duquesne's continuing commitment to a fair market-based determination of stranded costs. The option for the Commission to order divestiture in 2003, the revised early valuation trigger and the removal of the ROE collar will address a number of concerns raised by various parties, including life extension, fossil and nuclear decommissioning, plant shut down, future market price of power, and possible efficiency gains. Several parties believe that an asset divestiture is the only true way to establish the value of the Company's generating units. The Company believes that a fair, timely and independent valuation is important to the determination of stranded costs and recognizes divestiture and the early trigger modification as means to these ends. The Company's position is and always has been that it should recover no more (and no less) than its fully mitigated stranded costs and that on a present value basis it should only receive what it could have expected to receive under traditional

ratemaking. The ROE spillover without a collar and the other proposed modifications should further ensure this result.

Q. Specifically how does the early trigger modification respond to concerns raised by others?

A. By modifying the early trigger, the Company can assure the OCA and others that it will not over recover its stranded cost prior to the final valuation in 2003 if market prices rise above the levels anticipated by the OCA.

Q. How does the removal of the ROE collar address concerns raised by other parties?

A. By eliminating the collar there is assurance that the Company will only be able to earn up to, and in no circumstances, over its exact authorized ROE level.

III. STRANDED COST AND STRANDED COST RECOVERY

Duquesne's Rate Cap Proposal is Justified

Q. Several parties (e.g., OCA, HSS/ARI, and City of Pittsburgh) have argued that the Company has failed its own test to justify continuation of a rate cap because the Company may fully recover its stranded costs before 2006. Is the Company's current position inconsistent with the Company's position in its original filing given the corrections which were made to your testimony subsequent to the date of the original filing?

A. No, quite the contrary. In its original filing the Company discussed the difficulties with determining stranded costs as of December 31, 1998 and developed a second stage valuation proposal with early triggers and an ROE

spillover to ensure that there would be no over recovery of stranded cost. The early triggers and the ROE spillover were specifically designed to make certain that stranded costs would be recovered as quickly as possible and were incorporated as part of the Company's proposals in contemplation of a situation in which stranded costs could be fully collected before 2006. As part of the discovery process the Company updated and corrected its exhibits (DJC-3,DJC-4 and DJC-7) supporting its likely range of stranded costs remaining at the end of 2005. This correction has been reproduced and included as Exhibit DJC-21. The Company's updated exhibits show that under a high market price scenario that there would be a $233 million benefit in 2005. This does not mean that the Company doesn't have any stranded costs; it simply means that the Company would be able to recover its stranded costs before 2006. Under that scenario, the Company would fully recover its stranded costs sometime in 2004 assuming that rates were charged at current levels. This point is more fully developed in Mr. Schnitzer's testimony.

Q. Does Duquesne's proposal mean that it will in all circumstances charge rates up to its rate cap through the end of 2005?

A. No. The company has proposed to charge rates up to its allowed rate cap only until its stranded costs are recovered.

Q. Before the Company updated and corrected its Exhibits, was there a scenario that would have shown the Company could collect its stranded costs before 2006?

A. Yes. In the Company's original filing, merger synergies of $200 million were identified which indicated that full recovery of stranded costs would likely occur before 2006 under the company's high market price scenario. Under this

scenario the company showed a net of $8 million of stranded cost less $200 million for merger synergies or a $192 million net benefit as of December 31, 2005.

Q. Does the Pennsylvania restructuring legislation permit the Company to continue to charge rates at existing levels so long as it is mitigating stranded costs?

A. Yes. Section 2804(4)(v) of the Act states that a Company "shall not be required to reduced rates below the capped level" if it is continuing to mitigate stranded costs. So long as a utility is mitigating (reducing) its stranded costs, capped rates can be charged and need not be reduced until the Company no longer has stranded costs. If a utility has any level of stranded costs, then capped rates can continue to be charged until these stranded costs are fully mitigated through accelerated amortization. This sub-section does not link use of the rate cap to any specific time period for the recovery of stranded costs.

Q. Under the forecasts of OCA or DII, would Duquesne recover its stranded costs prior to the time the Company proposes that the market determination of its stranded costs be made?

A. No. Even under the OCA and DII views of the world, there is simply not enough room under the rate cap to reduce the book value of Duquesne's generation assets to market levels before the end of 2003. Mr. Schnitzer has prepared sensitivity studies which show the points at which stranded costs would be recovered (i.e., that book and market values would be equal) under the OCA and DII proposals, adopting -- for purposes of argument -- their views on market prices, operating costs, plant shutdowns and life extensions, and discount rates. Even when all of

the adjustments (other than the confiscatory sharing proposals are considered), the Company's rate cap would extend to the end of 2003.

Duquesne has a Significant Level of Stranded Cost

Q. Several parties have criticized Duquesne for failing to make a definitive projection of its stranded costs. How do you respond?

A. It seems to me that these parties are missing the point. Duquesne's Customer Choice Plan seeks to avoid a contest of numerical calculations, focusing instead on choosing the best methodology for valuing Duquesne's generating assets and, hence, for calculating known and measurable stranded costs. Through use of such a market-based methodology, Duquesne will recover no more than its known and measurable stranded costs.

Q. Does this mean that Duquesne's direct case failed to quantify stranded costs?

A. No. Duquesne calculated a range of stranded costs, recognizing that stranded costs vary with the level of market prices that are assumed. These calculations were updated on October 16, 1997, showing the likely range as of December 31, 2005 to be a $233 million benefit to a $423 million stranded cost.

Q. Most other parties projected stranded costs as of December 31, 1998. Why did Duquesne calculate stranded costs as of 2005?

A. Duquesne did so to project the date on which the Company could cease collecting a CTC, assuming it could charge rates up to currently approved levels during the transition period, per Section 2804(4)(v), with any excess earnings being used to accelerate the amortization of stranded costs.

Q. Is it possible to translate your earlier calculations into projected stranded costs

as of December 31, 1998, such that Duquesne's projections can be compared to those of the intervenors?

A. Yes. Duquesne has calculated pro-forma stranded costs as of December 31, 1998 in Exhibit DJC-20. These calculations were made based on the all hours spot prices from Company Exhibit MMS-4 for the years 1999 to 2005 (adjusted for each unit based on the Promod output) and the three post-2005 market price scenarios identified in Mr. Schnitzer's direct testimony identified as Low, Delayed Entry, and High. The stranded costs resulting from these calculations are, as follows:

	Without Merger(1) ($000)	With Merger ($000)
Low	$1,916	$1,716
Delayed Entry	$1,695	$1,495
High	$1,537	$1,337

Q. Which of the above stranded cost scenarios does the Company believe is most likely to occur?

A. Based on the market price evidence from its recent RFP and the testimony of Mr. Schnitzer, it is likely that actual market prices will be closest to the Company's low market price scenario, which is $1,916 billion in stranded costs as of December 13, 1998.

Q. Have other parties to Duquesne's restructuring proceeding identified significant stranded costs for Duquesne?

A. Yes. Several parties have identified significant levels of stranded cost for Duquesne. I have summarized the positions of the various parties and have

quantified stranded costs as of December 31, 1998 in Exhibit DJC-10 after making adjustments to present the data in a consistent format, as follows:

	Without Merger	With Merger
Office of the Consumer Advocate	$1,258	$1,058
Office of Trial Staff[1]	$ 658	-
Duquesne Industrial Intervenors	$1,455	-
HSS/ARI	$ 84	-

Q: Why has Duquesne included a line item for PV of Costs Independent of Operation in its estimate of stranded costs set out on Exhibit DJC-10?

A. These costs represent sunk costs that will be incurred regardless of whether Duquesne operates the units. Exhibit DJC-13 presents an avoidable cost analysis of Duquesne units that would otherwise show a negative present value ("PV") of operating margin as of December 31, 1998. In calculating the market value of these units, Duquesne has adopted the convention of setting the PV of the margin to zero when the result is negative. For example, under the Low market price line, the market value of the Duquesne generation is only $27 million on a PV basis as of December 31, 1998. This cumulative value reflects significant negative margins for Cheswick, Perry, Beaver Valley II and Elrama that have been set to zero[2]. Another output of the avoidable cost analysis is to show which costs cannot be avoided by shutting down a

[1]The OTS has not made an estimate of owned-generation stranded cost see testimony of OTS Witness Metro at pp. 19 and 20.

[2]The consequence of calculating a negative margin is not of necessity that the unit must be shut down.

generation plant. The breakdown of plant costs into avoidable and unavoidable costs is sponsored in the rebuttal testimony of Messrs. O'Brien, Duckworth and Nelson. The present value of the unavoidable costs of the plant independent of operation is shown in Exhibit DJC-10.

Q. Why were these costs not identified in the earlier margin analysis as of December 31, 2005?

A. The 2005 margin analysis reflected the present value of operating margins in 2006 and beyond. The one-time analysis as of 1998 reflects the low market prices in the years 1999-2005. Under Duquesne's original two-stage proposal, the final valuation of generation would not take place until 2003. Mr. Schnitzer's direct testimony establishes that Duquesne would have the proper incentives to shut down uneconomic generating units during the transition period. However, if Duquesne were asked to present a one-time analysis of stranded costs, the actual economics facing the Company must be reflected in the stranded cost estimate. Duquesne cannot shut these units down without facing certain unavoidable costs independent of operation. Duquesne also has sunk costs that will not be recovered if the plants are shut down.

Q. What conclusions do you draw from the range of stranded costs identified by the other parties to Duquesne's restructuring proceeding?

A. First, it is likely that the Company has a significant level of stranded cost. Second, stranded costs span a wide range of possible values giving further credence to the Company's position that it would be more desirable to determine stranded costs in the future once the markets for electricity in a competitive environment are more fully developed.

Q. Will you comment on the HSS/ARI stranded cost estimate.?

A. Yes. It appears that HSS/ARI is an outlier in this process. In his deposition HSS/ARI witness Weisenmiller admitted that although he concluded the Company had no owned-generation stranded costs as of the end of 2005 (using assumptions no other party makes), he had done no analysis to support this conclusion as of the end of 1998. Weisenmiller deposition at 136. In short, Mr. Weisenmiller has made no analysis of stranded costs. Although the Company is tempted to simply dismiss HSS/ARI's testimony as unsupportable and sophomoric, I will address the specifics of the most egregious positions taken by HSS/ARI elsewhere in my testimony. In general the HSS/ARI estimate of $84 million of regulatory asset stranded cost for Duquesne relies on adjustments which include one sided accounting entries, questionable allocation methods, a biased estimates of plant values, and proposals which are contrary to past Commission practice in Pennsylvania and contrary to the provisions of the Act.

Duquesne's Regulatory Asset Claims are Appropriate

Q. Please summarize this portion of your testimony.

A. The witnesses have accepted a large portion of the total dollar value of the regulatory assets claimed by the Company. The only exception is the witness for HSS/ARI, Dr. Weisenmiller. Dr. Weisenmiller basically denies recovery of substantially all of the Company's claim.

Q. Are there any disputes regarding the appropriate standard for determining whether an asset qualifies as a regulatory asset?

A. Yes. Several witnesses contend (or their analysis implies) that the appropriate standard is whether each asset has previously been determined by the Commission, in a specific rate order, to be recovered from ratepayers in some future period. That, however, is not the standard adopted in the Customer Choice Act, nor is it the standard under generally accepted accounting principles. The Customer Choice Act defines a regulatory asset as "assets or other deferred charges typically recoverable under current regulatory practice." Thus, the standard is whether an asset is "typically recoverable" under current "regulatory practice," not, as some intervenors suggest, whether an asset is "specifically recoverable" under a "specific rate order."

Q. Has there been any prior review by the Commission or third parties into whether the Company has properly classified and recorded its regulatory assets?

A. Yes. There have been numerous audits of the Company's financial statements. These audits include audits performed by regulatory bodies such as the Chief Accountant's office of the Federal Energy Regulatory Commission (FERC), and Bureau of Audits for the Pennsylvania PUC. These audits also include audits by the Company's independent auditors, Deloitte & Touche, LLP, as well as acceptance of the audited financials by the Securities and Exchange Commission (SEC). A listing of these audits and orders were provided in response to interrogatories HSS-1-043, HSS-1-092 and HSS-2-023, attached hereto (without attachments due to their bulk) as Exhibit DJC-22.

Q. You previously referred to generally accepted accounting principles. Please describe what are the criteria, from an accounting standards perspective, when

a company can record a regulatory asset.

A. Specifically, Statement of Financial Accounting Standards No. 71 (SFAS No. 71), provides the accounting guidelines for establishing and maintaining a regulatory asset. The standard requires that rate actions of a regulator can provide reasonable assurance of the existence of an asset. If certain criteria are met, then a company can capitalize an incurred cost that would otherwise be charged to expense under generally accepted accounting principles (GAAP).

Q. Describe the specific criteria established for creating a regulatory asset.

A. It must be proven to be probable that future revenue will result from inclusion of the specific cost in costs allowed for ratemaking purposes. The criteria for meeting the probability test is to either have a specific order which provides for the specific recovery of the costs or to show that the costs are typically recoverable in the specific regulatory jurisdiction and that there have not been any regulatory actions which would prohibit the recovery of the specific costs. As previously indicated, the regulatory bodies which govern the accounting rules for regulatory assets all concur on the Company's accounting. These bodies include the SEC, the FERC, and the Audit Bureau of the Pennsylvania PUC.

Q. Will you describe the guiding principle under which the Company developed its claims for regulatory assets and other deferred charges?

A. Yes. The Company developed its claim for regulatory assets based on the principle that it was only entitled to a revenue requirement which, on a present value basis, was equal to the revenue requirement which would have been

normally identified and typically recoverable under current Pennsylvania ratemaking practice.

Q. Have you prepared a schedule which demonstrates that the Company's claim for each of its regulatory assets is equal, on a present value basis, to the revenue requirement computed on a present value basis?

A. Yes. Exhibit DJC-15 shows the revenue requirements computed both under traditional ratemaking and as included in the Company's filing for each of the regulatory assets claimed by the Company. Exhibit DJC-15 demonstrates that on a present value basis, the Company's claim is equivalent to (or in some cases, slightly less than) what would have been computed under traditional ratemaking.

Q. Are the categories under which the Company classified its regulatory assets important?

A. No, not particularly. The Company did classify some items as regulatory assets which could have been included in plant or other deferred charges such as the Warwick mine, the cold reserved portions of Phillips and Brunot Island, the present value of the Beaver Valley Unit No. 2 lease payments, SFAS 109 plant, and several other smaller items. Reclassification of these items would not change the Company's stranded cost claim.

Q. Will you identify the recommended adjustments to Duquesne's claims for recovery of regulatory assets as advanced by the other parties in this proceeding?

A. Yes. Exhibit DJC-10 shows the regulatory assets claimed by the Company and the adjustments to these amounts as identified by the other parties in this

proceeding who made more or less comprehensive assessments of the Company's regulatory assets and generating plant values. I have presented all of the proposed adjustments on a consistent basis and have attempted to accurately quantify the positions of the other parties relative to Duquesne's positions. The adjustments made by other parties to the Company's claims were either not quantifiable (e.g., Environmentalists) or less than comprehensive. I will discuss these types of adjustments as appropriate in the sections which follow.

Each of the Company's Disputed Regulatory Asset Claims Are Appropriate

Q. Will you discuss the Company's claim for the SFAS 109 regulatory tax receivable and any proposed adjustments?

A. Yes. The regulatory tax receivable represents the unamortized portion of the regulatory asset which was booked when the Company adopted SFAS 109. Mr. Catlin, on behalf of the OCA, Mr. Kollen, on behalf of DII, and Dr. Weisenmiller, on behalf of HSS/ARI have taken issue with the Company's claim. Mr. Catlin and Mr. Kollen do not dispute Duquesne's right to recover the SFAS 109 regulatory asset nor do they disagree with the amount that Duquesne has recorded as the generation-related portion of this asset. Mr. Catlin has adjusted downward the total claim because the portion relating to "basis differences" is included in nuclear plant balances for determining stranded costs according to the OCA methodology. Mr. Kollen has made a similar adjustment to eliminate any double counting of this asset. Dr.

Weisenmiller of HSS/ARI is the only party to adjust the Company's claimed regulatory tax receivable. Dr. Weisenmiller asserts that the Company has not supported this regulatory asset because the Company has not had a base rate case in ten years, does not have a valid regulatory order for this item, and further, that the Company should not be allowed to earn a return on the unamortized balance. Dr. Weisenmiller concludes his analysis of this item by disallowing the entire balance.

The Company takes exception to Dr. Weisenmiller's testimony. Dr. Weisenmiller introduces a definition and criteria of regulatory assets which conflicts with GAAP, the FERC's accounting guidelines and, most importantly, with the Pennsylvania statute. Dr. Weisenmiller asserts that a "valid regulatory order" is a "basic threshold test" for a regulatory asset. As indicated, however, under the statute the test for regulatory assets is far different from the characterization of Dr. Weisenmiller's "basic threshold test". In Section 2803(1), Transition or Stranded Costs include "regulatory assets and other deferred charges typically recoverable under current regulatory practice" (emphasis added). It appears that the statute contemplates the very situation where a regulatory order has not been received, but future recovery was expected under current regulatory practice.

Under the statute, there are no special rules for companies which have not had a rate case within a specified time such as ten years. Dr. Weisenmiller's attempt to impugn the validity of the Company's balance sheet for this reason

is undermined by his own testimony which indicates that after a recent audit by the PUC staff, only about $2 million of unrecorded retirements were noted on a gross plant value of more than $2.8 billion. Clearly, the PUC staff audit should provide Dr. Weisenmiller with some comfort that the Company's additions since the last rate case are not overstated.

In addition, the amounts disallowed as a regulatory asset meet the definition of regulatory assets under GAAP, as well as under FERC accounting guidelines. Specifically, FERC's audit staff under direction of the FERC's Chief Accountant's office reviewed the Company's adoption of SFAS 109 as a change in accounting method and accepted the Company's adoption.

Further, Dr. Weisenmiller's adjustment is a one-sided accounting entry and is typical of the types of biased adjustments he has proposed on behalf of HSS/ARI. As stated in my direct testimony, if the regulatory asset related to the SFAS 109 tax receivable is removed, then the deferred tax balance for each plant should be increased by a like amount. If both sides of the accounting entry are removed, the net present value of revenue requirements is unchanged and the resulting effect on the Company's stranded cost is zero. If, however, only one side of the accounting entry is removed, as Dr. Weisenmiller does, this will affect revenue requirements and is clearly unfair and biased.

Finally, Dr. Weisenmiller asserts that Duquesne's claim for the entire amount

of the regulatory asset is not justified. He proposes that post-2005 costs are stranded with the relevant portion of the premium amortized over the remaining life of the plant. Dr. Weisenmiller ignores the reality that post-2005, there will be no mechanism for the Company to recover these costs. Under his proposed scenario, the Company would suffer an impairment loss for the post-2005 unamortized balance.

Q. Will you discuss the Company's claim for unamortized debt costs and any proposed adjustments?

A. Yes. Unamortized debt costs represent premiums and discounts paid by the Company to issue and refinance its debt. Typically this item has been recoverable through interest expense as a reduction to the debt balance outstanding and as an amortization amount included in interest expense. With the move to competition, the generation-related portion of this item will no longer be recoverable through interest expense beyond 2005. As such, the Company has proposed to recover the present value of the post-2005 portion of this item by the end of 2005. The OCA has proposed to exclude the pre-2005 portion of this item from interest expense and would allow recovery of the entire amount as a regulatory asset. A similar adjustment is proposed for the recovery of the premiums and financing costs associated with the Beaver Valley Unit No. 2 lease.

Although on the surface the OCA's adjustment appears to be reasonable, it penalizes the Company in two ways. First, the adjustment lowers the Company's overall cost of capital by lowering the computed debt cost to a level

below that typically allowed under Pennsylvania ratemaking and second, it raises the apparent leverage of the Company to levels which are higher than typically would have been determined under current Pennsylvania ratemaking practice. There is no justification for the adjustments made by the OCA other than to deny the Company a reasonable return.

HSS/ARI admits that these amounts typically would be recoverable under current Pennsylvania ratemaking practice (see Weisenmiller, p. 109, lines 8-10). HSS/ARI offers no reasonable alternative for the recovery of the post-2005 amount of this item and, absent regulation (or divestiture under the HSS/ARI proposal), this amount would have to be written off by the Company. Again, witness Weisenmiller has proposed an unfair adjustment which even he recognizes would have to be dealt with in a divestiture scenario.

DII witness Kollen also would eliminate post-2005 debt premiums because he believes that the Company has unfairly used a higher cost of capital to discount margins beyond 2005 (see Kollen, p. 13, lines 1-9). Both witnesses Weisenmiller and Kollen fail to appreciate that the Company's proposal for determining stranded cost as of December 31, 2005 is based on a future determination of the value (i.e., the final valuation in 2003) of the Company's generating stations and the Company's current cost of capital simply is not relevant to that determination, which will be based on the capital markets at that time. Further, they both ignore the reality that post-2005, there will be no mechanism for the Company to recover these costs. Under their proposed

scenario, Duquesne would suffer an impairment loss for the post-2005 unamortized balance. Also, the Company's calculation beyond 2005 was developed to illustrate that the Company has a relatively wide range of potential stranded costs depending on the future market price of electricity.

Q. Will you discuss the Company's claim for unamortized sale/leaseback premiums and any proposed adjustments?

A. Yes. The Company's position with respect to sale/leaseback premiums is similar to that of debt discounts and premiums. That is, the present value of the post-2005 amounts must be recovered as a regulatory asset. Witness Catlin for the OCA proposes to include the present value of all future lease expense in the generating plant values. The Company has no particular quarrel with this treatment which could result in an amount mathematically equivalent to the amount claimed. However, since the OCA is proposing an equity return disallowance on the Company's stranded generating assets, and would allow a return on regulatory assets, the Company is not indifferent to this adjustment. Under current regulatory practice in Pennsylvania, the Commission could be expected typically to allow operating lease payments in cost of service, including the amortization of any associated financing costs. Since the Company has only claimed the present value of these amounts in its regulatory asset claim, any proposals which exclude amounts beyond 2005 are unfounded since in the future there will no longer be a mechanism to collect these post-2005 costs.

Q. Will you discuss the Company's claim for deferred rate synchronization costs and any proposed adjustments?

A. Yes. The Company's claim for deferred rate synchronization costs or "early window" costs are the costs incurred by the Company at Perry and Beaver Valley Unit No. 2 between the time the plants went into utility service and the time rates which reflected these units went into effect. This item was specifically addressed in the Ft. Martin Plan. In 1996, the Company took a one-time $9 million write-down of this amount and began amortization of the remaining balance over a 10-year period beginning in June 1996. Under the Company's proposal, the Company would amortize the unamortized balance of deferred rate synchronization costs by the end of 2005. The Company's proposed amortization represents approximately a one-year acceleration of what had been approved under the Ft. Martin Plan. Both the OCA and the OTS accept the Company's amount as claimed.

DII proposes to adjust the stranded cost balance to reflect the present value of the amortization which would have been made through 2006 instead of 2005. The proper amount of the adjustment to the Company's stranded cost claim is $0.5 million -- not $8.5 million as DII has proposed (see Exhibit DJC-14). The Company has already excluded the total amount of these regulatory assets from its determination of rate base and did not earn a return on these items. Hence, a minor adjustment to reflect the one-year acceleration of amortization is proper and should be recognized by the Company.

Again, Dr. Weisenmiller introduces a definition and criteria of regulatory assets which conflicts with GAAP, FERC accounting guidelines and the

Pennsylvania statute. The amounts he disallows as a regulatory asset clearly meet the definition of regulatory asset under the relevant accounting and statutory standards.

Q. Will you discuss the Company's claim for deferred employee costs and any proposed adjustments?

A. Yes. Deferred employee costs represent timing differences between the accrual of, and cash payment of, injuries and damages and compensated absences. Under past Commission practice, this item has been required to be placed on the balance sheet and amortized as a regulatory asset. Clearly then, this asset meets the criteria as provided in § 2803(1) as having been typically recoverable. The Company has always been allowed to recover these amounts in each of its previous rate cases. In addition, the Commission has allowed recovery of similar amounts in other utilities more recent rate cases.

DII suggests that it is inappropriate to recover this regulatory asset because it will eventually reverse. DII's witness Mr. Kollen concludes that these costs represent the differences between accrual and cash recognition of expenses, and thus, are not appropriate for recovery. However, Mr. Kollen has failed to realize that all regulatory assets represent the timing difference between accrual and cash recognition of expenses. If Mr. Kollen's standard was applied, no regulatory asset would be recovered.

The Company has sought recovery of this item such that, on a present value basis, the revenue requirement is actually less than what would have been al-

lowed under current regulatory practice (see Exhibit DJC-15). Although the Company could have taken the position that it should gross-up this item, it has claimed only the amortization of this amount over a seven-year period.

HSS/ARI opposes this item on the basis that the Company has not had a recent base rate case, and that the Company has not shown any of the amounts to be generation related. The HSS/ARI adjustment is clearly misguided. The Company has allocated this item on the basis of direct labor dollars. Apparently, HSS/ARI would argue that this is an inappropriate allocator for the item even though this item clearly is related to labor. I can not think of a more reasonable allocation basis, but if it is truly a matter of misallocation, then the Company's transmission and distribution regulatory assets should be increased accordingly, since there has been no proposed adjustment of the Company's total regulatory asset for this item.

Q. Will you discuss the Company's claim for deferred coal costs and any proposed adjustments?

A. Yes. The Company has claimed $13.5 million in deferred coal costs as a regulatory asset. This amount represents costs which historically have been above the cost caps which limited the amounts that could be included in the Company's annual ECR. Several parties (OCA, DII, and HSS/ARI) have indicated that this amount should not be allowed to be recovered in this proceeding because the Company has not shown that its coal costs will be below market at any time in the future. They argue that if this is the case, Duquesne's shareholders, and not its ratepayers, should be responsible for this

cost. Duquesne's Exhibits clearly show that fuel costs are expected to decline in the year 2000 (see Exhibit DJC-3 revised p. 3).

When the Company entered into the settlements in Docket Nos. P-890386 and P-890387, the Company knew that its fuel costs would decline dramatically once the long-term contracts at Mansfield expired and the Warwick mine costs were recovered, and that recovery of any deferred amounts would be likely to occur in the year 2000. The Company had every right to believe that it would recover these amounts under the terms of the settlements and it should be allowed to recover these amounts in this proceeding.

Further, the Company believes that these assets clearly fall into the definition of a regulatory asset based on the definition specifically provided in § 2803(1) as costs which typically are recoverable. The Company has always been allowed the opportunity to recover its deferred fuel costs. The assertion that there needs to be an assurance of recovery in order to be treated as a recoverable transition/stranded cost does not exist in the statute. In addition, the Company is projecting to be able to recover its deferred fuel cost under traditional rate making policy beginning in 2000. Thus, the Company should be allowed recovery of its deferred fuel costs since absent deregulation, it would have had the opportunity to recover these deferred fuel costs in 2000.

Q. Will you discuss the Company's claim for deferred caretaker costs?

A. Yes. I will address this item with the discussion of cold reserved units elsewhere in my testimony.

Q. Will you discuss the Company's claim for the pre-accrual of nuclear outages and any proposed adjustment?

A. Yes. The Company has proposed to recover a regulatory asset associated with the pre-accrual for nuclear outage costs. The Company believes that this accounting method is preferable in that it more closely matches the expense of outages with the production from the unit. The Company currently uses this method for its fossil stations. In 1993, the Company changed its method of accounting for fossil station outage costs to a preaccrual methodology. This change required an opinion letter by Deloitte & Touche LLP that the new methodology was consistent with GAAP, as well as preferable to any other accounting methodology under GAAP. This opinion letter approving the Company's proposal was reviewed by the SEC and approved. Later, during its normal audit, FERC reached the same conclusion that this was a preferable method of accounting under GAAP based upon its review of other non-regulated industries' accounting practices.

The OCA, DII and HSS/ARI have challenged this proposal as being inconsistent with past practice. The OCA (see Catlin, p. 11, ll. 14-22) has indicated that under its method, the full cash cost of outages should be recognized in the year incurred and hence will not be "double counted." The Company's claim does not double count this item because it is not included in future operating expenses, and it provides a reasonable way for the Company to recover outage costs consistent with preferable accounting methods. If this claim is disallowed, the Company should increase its operating expenses in the years that outages actually occur.

Mr. Kollen's assertion that the deferrals would not exist after generation

supply becomes competitive because it would not be consistent with GAAP is completely inconsistent with the opinions of Deloitte & Touche, LLP, the Company's independent auditors, the SEC and FERC.

Q. Will you discuss the Company's claim for transition costs and any proposed adjustments?

A. Yes. The Company has claimed $18.1 million of transition costs as a regulatory asset and has reduced the amount of depreciation it will accelerate in 1998 by an additional amount of $11.25 million in 1998 due to a higher pilot program incentive credit than was originally anticipated when the Company made its filing on August 1, 1997. DII suggests that it is inappropriate to include restructuring implementation expense as a valid transition cost and excludes $8.3 million from Duquesne's claim. HSS/ARI takes the extreme position that none of the Company's claim is valid because the Company failed to reference the relevant sections of the Act which permit recovery of such items. Recovery of the types of costs identified by the Company are specifically permitted under the Act (Sections 2803 and 2804). The cost of implementation of restructuring is clearly a transition cost which should be allowed. Also, it would be allowed under current ratemaking practices in Pennsylvania which historically have allowed the costs of legislative mandates and rate case expenses to be included in rates. Finally, in response to Mr. Kollen, there are no CARS expenses included in this claim. All of the costs associated with the CARS project have been included as a distribution operating cost.

Q. Will you discuss the Company's claim for recovery of SFAS 106 costs?

A. Mr. Kollen, on behalf of the DII and Dr. Weisenmiller, on behalf of HSS/ARI have proposed to deny all costs associated with SFAS 106. Dr. Weisenmiller provides that only some of the costs are generation related and even these do not qualify for recovery through the CTC because there is no showing that they will not be recovered in the competitive market. Mr. Kollen also believes these costs must be a regulatory liability.

First, there is a misunderstanding as to how SFAS 106 expense is computed. SFAS 106 liability is effectively stated on a present value basis. Second, the transition amount the Company is seeking is a "GAAP" liability which exists today, not a regulatory liability. Because this is a liability incurred during the regulated generation period, the customers should incur the costs of these expenses. Thus, it is appropriate to include these costs in the Company's stranded cost calculations.

Q. Will you discuss the Company's claim for recovery of its Warwick Mine investment?

A. Dr. Weisenmiller, on behalf of HSS/ARI, proposes to deny recovery of Duquesne's Warwick Mine investment. He is the only intervening party who proposes to deny recovery of this item. Dr. Weisenmiller states that because Warwick has been excluded from rate base since 1981, the Company should not be permitted a return unless the cost of the coal is below a previously established cost cap. He also believes that the Company has not exhausted the options to mitigate costs of the mine.

The Company currently has earned a return on its investment in Warwick through the sale of coal. Thus, the Company believes that these clearly fall

into the definition of a regulatory asset based on the definition specifically provided in § 2803(1) as costs which typically are recoverable.

Q. Will you discuss the Company's claim for recovery of its pilot program incentive and customer education expenses?

A. Dr. Weisenmiller, on behalf of HSS/ARI, proposes to deny recovery of these costs. Dr. Weisenmiller believes these costs do not meet the definition as transition costs.

Section 2803 specifically provides for the inclusion of customer education expenses as transition costs. In addition, the Company's pilot implementation order issued by the PUC provides for pilot program incentive recovery through the adjustment of the Company's accelerated depreciation of nuclear generation plants or through the CTC. Thus, it is appropriate to recover this regulatory asset since the Pennsylvania PUC specifically has addressed and allowed the recovery of this item.

Duquesne Should be Allowed to Fully Recover the Cost of Its Cold Reserved Units

Q. Will you identify the claim the Company is making for its cold reserved units?

A. Yes. In the mid-1980s, the Company placed a portion of the Brunot Island power station and all of the Phillips power station into cold reserve status. These units were accounted for as plant held for future use and the Company suspended depreciation and ceased to earn a return on these items. At this time, the Company does not believe that these units can be economically returned to service. As such, the Company is seeking to begin amortizing

these amounts and to include the unamortized amount of these items in its rate base for purposes of computing its equity returns throughout the transition period.

Q. If the Company had been able to return these units to service would ratepayers have received a benefit?

A. Yes. As evidenced by the settlement decision related to the GPU transaction, the Company would have received a regulated return and Duquesne's ratepayers would have received a significant benefit (i.e., a rate reduction through a credit determined annually similar to the Company's ECR mechanism).

Q. Did the Company make other attempts to sell or otherwise maximize the value of the cold reserved units?

A. Yes. For a number of years the Company was trying to make long-term firm power sales which would have allowed the Company to return all or a part of its cold reserved units to service. In recent years, the "For Sale" sign has been out on both Phillips and Brunot Island. To date there have been no offers for either Phillips or the cold reserved portion of Brunot Island.

Q. Have the Company's shareholders suffered as a result of the Company placing these units into cold reserve?

A. Yes. The Company's shareholders have suffered because both the recovery of and the return on these units has been forgone for more than ten years.

Q. Will you discuss the caretaker costs associated with these units?

A. Yes. In order to be able to return these units to service, costs were incurred to maintain the units. These are relatively small amounts but were necessary to preserve the option to return the units to service. To deny recovery of these

amounts would further burden shareholders who have already been severely penalized as described above.

Q. What options did the Company have other than to cold reserve the units?

A. The Company could have simply retired the units. As described by Mr. O'Brien in his direct testimony (see p. 15, ll. 5-11), under current regulatory practice, if the Company had retired the units, it would have credited plant and debited the depreciation reserve. This would have had no net effect on the Company's rate base and the Company would have recovered the net book value and a return over the remaining life of the Company's other fossil units.

Q. Why didn't the Company retire the units?

A. Until recently, the Company thought that there would be more value for both ratepayers and shareholders if the units were maintained in cold reserved status.

Q. Has the Company agreed to return any future value which might be derived from these units to ratepayers if the Company's position is adopted?

A. Yes. One hundred percent of any future benefit received from cold reserved units would be passed along to ratepayers. Under the Company's proposal, the cold reserved units would be included in the final valuation and any positive value for these units would be a direct reduction to the Company's stranded cost.

Q. Are other parties to the case recommending that cold reserved units not be allowed in the Company's stranded cost?

A. Yes. The OTS and HSS/ARI are both recommending that cold reserved units be removed from the Company's claim. Also, the OCA make a small adjust-

ment to the cold reserved plant balances based upon its novel interpretation of the Ft. Martin settlement. The OCA's position that the Company somehow agreed to credit $5 million without recovery or return is not supported by the agreement. The OTS takes the position that the Company's cold reserved units should be classified as non-utility property and not included in the Company's determination of stranded costs. HSS/ARI contends that the Company is not entitled to any recovery because the Company has acknowledged that the assets may have to be written off and because the GPU transaction did not go forward (see Weisenmiller, pp. 103 and 104).

Q. Will you summarize the Company's position with respect to its cold reserved units?

A. Yes. The Company's claim for its cold reserved units and the associated caretaker costs represents the only fair treatment for a mitigation strategy of which the Commission was well aware, but that ultimately proved unsuccessful. The Company has pursued a number of successful mitigation strategies and should not be penalized because it was unable to make a silk purse out of a sow's ear on these particular assets.

The Company's treatment of decommissioning is consistent with current regulatory practice

Q. Has the Company made a specific claim for recovery of nuclear or fossil plant decommissioning above currently approved levels during the transition period ending December 31, 2005?

A. No. The Company has only deducted the estimated unfunded portion of its

nuclear decommissioning cost and an estimate of fossil decommissioning cost from the range of present values estimated for its generating stations as of December 31, 2005. Also, please refer to the rebuttal testimony of Mr. LaGuardia on the subject of decommissioning.

Q. How does the Company's final valuation proposal consider fossil and nuclear decommissioning?

A. Under the Company's final valuation proposals, dismantlement of its units would be included in the final market value determination.

Q. Would the final valuation also consider future site value, life extension or other value which would tend to offset or reduce the present value of future decommissioning costs?

A. Yes.

Duquesne has Presented a Fully Mitigated Cost of Service

Q. Will you comment on the suggestions that the Company could further mitigate its stranded costs by shutting down some of its units?

A. Yes. The OCA and other have suggested that the shut down of certain generation stations could be used as a strategy to further mitigate stranded costs. While on the surface this appears to be a reasonable suggestion, it is premature to consider this option. Currently there is a great deal of uncertainty as to the future market price of electricity. Given this uncertainty, it would not be prudent at this time to make such irreversible decisions and, as discussed below, temporary shutdown of units is not technically feasible or financially viable. Also, many of costs shown in the Company's margin analysis are not immediately avoidable and hence should be excluded in a proper shut down

analysis. The economic basis for this analysis was discussed at length in the direct testimony of Mr. Schnitzer.

Q. Has the Company made an analysis of the costs which are truly avoidable for the plants which are recommended for shutdown by the OCA?

A. Yes. Exhibit DJC-13 shows the economic implications of shutting down Elrama, Cheswick, Beaver Valley Unit No. 2 and Perry. Exhibit DJC-13 clearly shows that, when unavoidable costs are considered, Perry, Beaver Valley Unit No. 2, and Cheswick should not be shut down at this time. The present value of the margins of each of these units is positive when only the truly avoidable costs are considered.

Q. What are the implication of the negative margin value for Elrama?

A As a generating unit, the avoidable "to go" economics of Elrama are not favorable even after removing unavoidable costs from the analysis. We have not done a formal option value analysis, although this would tend to reduce the absolute size of the negative margin value, and make an economic shut-down of the unit less likely.

Q. Based on this preliminary analysis, does Duquesne intend to close Elrama?

A. Not at this time. Although the analysis indicates that Elrama has a negative margin value as a generating unit, the impact of closing Elrama on the Duquesne transmission system must be considered. As discussed in Mr. Karl's rebuttal testimony, the Elrama station provides both reactive and real support to the southeast side of Duquesne's transmission system, and serves as a first contingency. A decision to close Elrama would require a significant expenditure of T&D capital to build a new 345 kV line to ensure the contin-

ued reliability of the Duquesne system. Alternatively, Mr. Karl discusses other options that might be less costly and could be completed more quickly, and would provide the necessary real and reactive power on the Duquesne system. These options include a partial shutdown of Elrama, installation of capacitors, and installation of new peaking capacity at the existing site. When the avoided costs of alternative sources of voltage support are considered, a decision to shut down Elrama would be premature as the Company has not made a detailed evaluation of these options. Mr. Marshall, in his rebuttal testimony, has indicated that the Company will commit to providing the Commission with a full shut down analysis for Elrama including an evaluation of the various voltage support options before the end of 1998.

Q. Will you comment on the suggestions of the OCA and others that certain units such as Cheswick could be temporarily removed from service as a viable mitigation strategy?

A. Yes. Temporary shut down of Cheswick is not a practical mitigation strategy at this time. Many costs are not truly avoidable as shown in Exhibit DJC-13 and when the costs incurred to return the unit to service are added, this alternative is even less economically attractive. The Company's own experience with Phillips suggests that it would cost more than $100 million to return this station to service and Brunot Island could cost more than $50 million.

Q. Will the company have the proper incentives to take economic actions under its proposals?

A. Yes, definitely. Under a rate cap with an ROE spillover and a minimum depreciation and amortization commitment the Company will be operating

with all of the incentives needed to ensure that it makes economic decisions.

Q. Would these incentives extend to such actions as plant shutdown and life extension?

A. Yes. The Company would be equally incented to take these and any other actions which would allow it to earn up to its authorized level.

Q. Is it true that the Duquesne would have an incentive 'gold plate' its plants if it was going to earn above the spillover amount in a given year?

A. No. Given the Company's entire proposal, 'gold plating' or accelerating maintenance or capital expenditures would be a zero sum game considering the Company's final valuation. Such expenditures would raise the final value of the Company's plants and would be likely to result in the same stranded cost determination as without the increased expenditures.

Q. If the Company's cost projections are incorrect how are ratepayers protected from an over recovery of stranded costs on the part of the Company?

A. The Company believes that its cost projections are aggressive and represent its fully mitigated costs. The OCA chose to adjust some of Duquesne's cost projections by using a higher inflation rate and lower availability factors for some of the Company's units. As such it will be difficult enough for the Company to reach an 11.5% ROE. On the other hand the ROE spillover gives the ratepayers the benefits of lower costs. It should be reemphasized that the Company has made a <u>minimum commitment</u> to amortization and depreciation and has no recourse should there be worse than expected cost performance. The result is an ROE spillover that gives ratepayers the full benefits of aggressive performance projections. This gives the Company strong incen-

tives to minimize costs and take appropriate economic actions during the transition period.

Q. Are there any other comments you have on the intervenor testimony with respect to regulatory assets or stranded costs?

Yes. Mr. Schoengold for the environmentalists alludes to the fact that Duquesne's stranded costs are overstated because he could not reconcile the minimum amortization of the Company with the net book value calculations at December 31, 2005 (See Schoengold testimony, pp. 26, ln. 15 to 27 ln.6). As shown in discovery ENV-3-148, the Company's claim is completely reconciled when the proper deferred tax effect is applied to the minimum amortization commitment for purposes of determining the Company's net book value as of December 31, 2005. A copy of the response to ENV-3-148 is included as Exhibit DJC-23.

IV. STRANDED COST SHARING PROPOSALS

Return Disallowances are Unfounded

Q. How have the intervenors calculated their estimates of appropriate "sharing" amounts for determining stranded cost disallowances?

A. Most of the intervenors who addressed the issue proposed some form of return disallowance. The OCA has indicated that no return of any kind on stranded generating plant should be allowed because such plant is not used and useful. According to the OCA, economic excess capacity penalties imposed on the Company in the past should be expanded to disallow all return on nuclear units that have stranded costs. DII proposes to disallow an equity return on

stranded generating plant assets for reasons similar to those of the OCA. The environmentalists contend that only a 60% allowance of stranded cost recovery should be approved because the Company's investors would have received a "reasonable" return as calculated by Mr. Shoengold. HSS/ARI does not really address sharing because they propose to disallow nearly all of the Company's stranded cost claims, as discussed previously, thereby mooting the "sharing" issue.

Q. How do you respond to the OCA "sharing" proposal?

A. The OCA, through witness Kahal, has attempted to misapply ratemaking principles which are not applicable to the Company's current circumstances. First a total return disallowance under the used and useful standard is inappropriate. The Company's generating assets (except for its cold reserved units) are serving its customers every day and the prudence of the Company's investment in its generating assets has already been determined. It cannot now be retroactively determined that such investments were somehow imprudent and so long as these assets continue to serve the Company's customers there is no question as to the used and usefulness of these assets to the Company's customers. Further, even if certain assets should be removed from service because they are not economic in a competitive environment (e.g., cold reserved units) this is the very definition of stranded costs. Under the Act, so long as the Company has fully mitigated its costs, the Company is entitled to an opportunity to fully recover its stranded cost including a fair return on its prudently incurred investment. The OCA's second argument is as meritless as its first. To argue that an economic excess capacity penalty

should be applied in a situation where, by definition, the Company's stranded costs are not economic is circular reasoning. It is also interesting to note that witness Kahal went to great lengths to adjust the Company's projections so that it could be shown that the Company's stranded cost is "almost entirely" nuclear related. In the Company's last base rate case economic excess capacity penalties were applied to the Company's new nuclear investment. Even if an economic excess return penalty were found to continue to apply, Mr. Kahal's calculations would be grossly in error because the economic excess capacity penalties from the Company's last base rate case only were applied to the equity related to Beaver Valley Unit No. 2 and the total return on $31.2 million of rate base related to Perry. The Company has since sold Beaver Valley and has almost no equity in the plant, and the depreciated value of the Perry adjustment is currently less than $20 million. Accordingly, there would be a relatively small revenue requirement reduction if this adjustment were calculated properly and would not be a $460 million adjustment to the Company's revenue requirements as shown in Exhibit DJC-12. The OCA's proposed "sharing" plan is nothing more than a thinly veiled attempt to retry the Company's 1988 base rate case and disallow a fair return on prudently incurred investment which is inconsistent with traditional ratemaking in Pennsylvania.

Q. How do you respond to the DII proposal with respect to sharing?

A. The Commission should reject the DII's sharing proposal for the same reasons it should reject the OCA's sharing proposals.

Q. How would the Company respond to Mr. Schoengold's sharing proposal he

presented for the Environmentalists?

A. Mr. Schoengold has attempted to show that with only a 60% allowance of stranded costs (whatever that may be since he has not made a determination of the Company's stranded costs) the Company's investors would receive a reasonable return on their investment because they have already achieved some return and should be allowed enough to repay debt holders. Mr. Schoengold's analysis must be rejected because it attempts to carve out specific assets and assess whether or not investors have received a hypothetical return. This carving out of specific assets to assess investor returns is preposterous. Investors invest in the Company as a whole and intend to earn an overall return. It is not possible to credibly remove any particular group of assets from the Company to assess whether or not investor's have been fairly treated. Since the magnitude of stranded costs is not known under Mr. Schoengold's proposal it is not possible to assess the full financial impact of his proposed "sharing". If, however, the Company's estimate of stranded costs are used, the environmentalist's proposal would be very similar in magnitude to the OCA's proposal as shown in the next section and would have an equally devastating effect on the financial health of the Company. The Environmentalist's proposal must be rejected as it is arbitrary and not consistent with traditional ratemaking in Pennsylvania.

Q. Are there any additional "sharing" amounts which have been proposed by the various parties?

A. Not explicitly. However based on the revenue requirement calculations proposed by OCA witness Lee Smith in Exhibit LS-5 and DII witness Stephen

Baron in Exhibits SJB-3 and SJB-5 there are implicitly additional sharing amounts which are related to the amortization of stranded costs which underlie the proposed revenue requirements related to stranded cost recovery. It is impossible to tell whether these were inadvertent omissions from their revenue requirements calculations or another form of "sharing".

Q. How does this additional "sharing" occur?

A. The amortization amounts from Exhibits LS-5 and SJB-3 were derived based on net plant amounts which are also net of deferred taxes. Although it is proper to derive returns based on net of deferred tax amounts it is not proper to exclude certain deferred taxes for purposes of developing an amortization amount to be included in revenue requirements. The amortization of stranded plant must be on developed using net plant excluding all but the FAS 109 related accumulated deferred taxes. By using a stranded plant amount which is net of all deferred taxes both the OCA and DII have under stated the revenue requirements associated with their own proposals and hence imposed additional sharing amounts on the Company.

Q. Have you quantified the additional revenue requirement which would be need to amortize the OCA and DII quantifications of stranded cost?

A. Yes. On Exhibit DJC-12 have quantified the amount of amortization which would be required given the DII stranded cost amount on page 2 of 4 and the OCA amount on page 4 of 4. I have also computed the present value of revenue requirements differences between the unadjusted and full revenue requirement amounts and have shown the difference at the bottom the page as "sharing".

Q. Why do the estimated stranded plant amounts on Exhibit DJC-12 differ from the amounts shown on DJC-10.

A. The amounts on DJC-10 were developed to put each of the different stranded cost estimates on a basis consistent with the Company's presentation of its stranded costs. The amounts shown in Exhibit DJC-12 were taken directly from the Exhibits of the OCA and DII.

V. IMPACT OF INTERVENOR PROPOSALS ON FINANCIAL INTEGRITY

The Intervenor Proposals would Harm the Financial Health of the Company

Q. Have you estimated the effects of adopting the intervenor proposals with respect to stranded cost and stranded cost recovery on the financial integrity of the Company?

A. Yes. I have examined the impacts of the proposals of the OCA, OTS, DII and HSS/ARI on the financial integrity of the Company.

Q. Will you summarize the results of your examination?

A. Yes. All four of the proposals related to stranded cost and stranded cost recovery including "sharing" would have a negative impact on the financial health or financial integrity of the Company. The OCA, DII and HSS/ARI proposals would severely damage the financial integrity of the Company. Specifically:

- The OCA, OTS, DII and HSS would cause write-offs of $658 million, $181 million, $461 million and $1.8 billion in 1998.
- The OCA, DII and HSS/ARI write-offs would cause Duquesne to be in default of its BV2 sale/leaseback agreement which would also trigger a cross-default of other debt and bank agreements.
- Given the OCA, DII or HSS/ARI proposals, the credit rating agencies would likely downgrade the Company's debt to "junk bond" level.

This downgrade would severely impact the Company's ability to access the financial markets.

- Earnings per share and cash flow would drop putting a strain on any effort to raise capital in the equity markets.

These negative financial impacts would have a detrimental effect on Duquesne's ability to access capital markets and attract investors and to provide reliable service to its customers.

Q. Please describe the term "financial integrity".

A. Financial integrity relates to the financial "health" of a company or the ease (or difficulty) with which a firm can continue to finance both its operations and new construction. This is accomplished through internal cash generation and by access to the debt and equity capital markets. For capital intensive industries such as electric utilities, access to the capital markets is critical.

Q. How do you measure financial integrity?

A. The most common and important measures of a capital intensive firm's financial integrity are its internal cash flow and access to capital markets. Many times this can be judged by a firm's securities ratings which measure its creditworthiness. Major credit rating agencies such as Standard & Poor's, Moody's, Fitch and Duff & Phelps rate a company's debt and preferred securities. Generally, the rating agencies make an annual reviews using current and projected public and non-public financial data and Company forecasts. The agencies publish reports on the Company's debt and preferred securities, and ascribe ratings on scales which range from AAA (highest) to D (lowest) or other similar scales. Other important indicators of financial integrity are total return to equity investors and a company's level of internal cash generation.

Q. Please describe the Company's current credit ratings.

A. Exhibit DJC-16 lists Duquesne's current ratings from the four principal credit rating agencies who rate the Company's debt and preferred securities.

Q. What does the Company's current BBB+ rating by Standard & Poor's mean?

A. Standard & Poor's states that an obligation rated BBB "exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation". A "BBB-" rating is the lowest rating that is considered investment quality; below that (BB or lower) an obligation is considered a "junk bond". Standard & Poor's further states that "obligations rated BB, B, CCC, CC and C (below investment grade) are regarded as having significant speculative characteristics". Standard & Poor's comments that these obligations "will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions".

Q. How does the Company's BBB+ rating compare to the industry?

A. Of the roughly 120 electric utilities rated by Standard & Poor's, approximately 60% have ratings of A- or better. These ratings are superior to Duquesne's BBB+.

Q. Please describe a rating agency's criteria for determining creditworthiness?

A. Standard & Poor's, one of the four agencies that rate the company's debt, has a two pronged approach to analyzing a company; business profile and an analytical financial profile. The business profile focuses on the qualitative characteristics of regulation, markets, operations, competitiveness and man-

agement. Business profiles are expressed on a scale of 1 (strong) to 10 (weak). Duquesne's current business profile is 6, a below average rating. The financial profile focuses on analytic measures determining the company's ability to generate cash flow to finance operations, service debt and to fund new investment. The financial profile utilizes five key analytical measures:

- Funds from operations as a percentage of total debt.
- Funds from operations interest coverage.
- Net cash flow as a percentage of capital expenditures.
- Funds from operations interest coverage.
- Total debt to total capitalization.

Both business and financial profiles are used to determine the overall rating.

Q. Have you analyzed the effect of the intervenors' proposals on Duquesne's *creditworthiness*?

A. Yes. All four of the proposals result in an adverse effect on the Company's credit quality ratios. The OCA, DII and HSS proposals have a severe effect on the financial health of the Company going forward. Exhibit DJC-17 summarizes key financial data. In terms of revenue requirements, OCA recommends a 39% disallowance of the revenue requirement that Duquesne would otherwise be entitled to earn under the rate cap. DII recommends a 15% disallowance of this revenue requirement and OTS recommends an 11% disallowance of this revenue requirement. HSS recommends a confiscatory 96% disallowance. Under GAAP, the intervenors' proposals would require Duquesne to write-off in 1998 $658 million, $181 million, $461 million and $1.8 billion for OTC, OTS, DII and HSS, respectively. In addition, earnings would drop from $6 to $60 million annually, a drop of 5% to almost 50 percent compared to 1996 actual Duquesne's earnings. Cash flow would

also be negatively effected by all proposals. The combined effect would be devastating to financial integrity and Duquesne's ability to access the capital markets.

Q. What effect would the intervenors' proposals have on financial ratios and bond ratings?

A. Based on the intervenors' proposals, I have calculated the 5 key financial ratios for the term of the transition period (1999-2005). On a pro forma basis, these ratios are shown in Exhibit DJC-18 along with anticipated bond ratings which would likely result from those ratios. The bond ratings are estimates using Standard & Poor's published guidelines. For the OCA, DII and HSS proposals, it is anticipated that Duquesne's debt will fall to the "junk bond" level. This would have severe consequences in terms of Duquesne's financial integrity.

Q. Please describe the effect on the Company's financial health should the securities drop to "junk bond" status.

A. A below investment grade rating would impair the Company's ability to readily access the debt market. Most investment funds are limited in the amount of junk bonds allowed in their portfolio and many funds, especially pension and retirement funds, are precluded from investing in junk bonds. Junk bonds are often used to finance speculative ventures or start-up companies. Junk bond status is clearly not consistent with a financially healthy firm that has a continuing obligation to deliver and to be supplier of last resort. Public utility debt (also called fixed income securities) is often purchased by pension and retirement funds and individuals for financial security for their

retirement. Junk bond status is inconsistent with their investment goals.

Q. What would be the cost to the Company of a "junk bond" rating?

A. As the Company's current debt matures and as new capital expenditures require the issuance of new debt, the ability to issue cost effective debt is affected by the credit rating. This is key to controlling costs in a regulated environment as well as a major distinguishing feature in a competitive business environment. Junk bond status would substantially increase the Company's cost of debt. As Exhibit DJC-18 shows, the increase in coupon rate is required by the capital markets as credit quality changes. The increase in cost is especially pronounced when a company's securities drop below BBB-, the lowest rating which is still investment grade. For example, a drop from the current level of BBB+ to BB- taken over the Company's $1.4 billion long term debt would require the Company to pay a coupon rate 160 basis points higher. This translates into an increased interest expense of $22.5 million per year, the equivalent of an almost 2% across the board rate cut or the equivalent of 375 full time positions.

Q. Who are the holders of the Company's debt?

A. Some is held directly by individuals; most is held by pension and retirement or other funds, many of which are owned by Pennsylvania residents.

Q. So wouldn't the effect of the intervenors' proposals hurt the people the intervenors want to protect?

A. Yes. On one hand, the ratepayer who is a bondholder would see a drop in his monthly electric bill, but on the other hand see an increased risk to the stream of payments used to pay for his retirement.

Q. What about access to the equity markets?

A. The equity markets view the attractiveness of a company's common stock in terms of total return; the prospect of dividends plus an increase in the stock's price. Key drivers to this aspect of financial integrity are earnings per share and dividends, as well as cash flow. Variations to these factors determine the attractiveness of a company's stock and thus, the firm's ability to access the equity markets.

Q. Does a negative bond rating affect access to the equity markets?

A. Yes. Equity analysts often use credit rating agency reports in their stock valuation analysis decisions since under SEC rules, rating agencies are "insiders" and have access to non-public financial forecasts. Therefore, a negative rating may not only impact access to the debt market, but the equity market as well.

Q. What other financial effects would the intervenors' proposals have?

A. Duquesne has a number of financial covenants as part of its bank loan and other debt agreements. In the letter of credit reimbursement agreement related to the sale lease-back of the Beaver Valley II Nuclear Plant, among other covenants, the company is required to maintain a minimum consolidated net worth of $825 million. The proposals by OCA, DII and HSS would require the company to write-off $658 million and $1.8 billion after-tax. This would fall below the minimum requirement specified and thus put Duquesne in default of the agreement. Most of the company's other loan debt and loan agreements contain cross-default insurance wherein if the company defaults on any other agreement, the other agreements are judged to be in default.

Putting the agreements in default could force the company into bankruptcy. Therefore, the resulting impact of the write-offs caused by the intervenors' proposals could cause a devastating series of financial events to occur.

Q. Would a common dividend cut solve the financial problems caused by the intervenors' proposals?

A. No. Duquesne's parent DQE already has one of the lowest dividend payout ratios in the industry. Further, in 1986 when the steel industry in Pittsburgh severely contracted, Duquesne cut its dividend 30%, one of the first electric utilities ever to do so. The current effective dividend rate has still not reached the 1986 level. Investors therefore still penalize DQE stock for that cut. A further cut would severely impact the financial community's view of the stock and severely impair the Company's access to the equity market.

VI. ASSET SECURITIZATION

The Company Should not be Required to Securitize its Stranded Costs

Q. Should the Company be required to securitize its stranded costs?

A. No. Witness Kollen for DII has suggested that the Commission should require asset securitization to further mitigate the Company's stranded cost. The Company has shown that replacing its relatively low cost debt with higher cost debt would not be economic. Also, the Company currently has the highest degree of debt leverage of any electric utility in the state. When the Company's leverage is further adjusted by the sale/leaseback debt the Company is even more highly leveraged than the Company's balance sheet would indicate. The Company has already achieved many of the benefits which others might be able

to achieve through asset securitization by employing high leverage. These benefits are already reflected in the Company's cost of service and its proposed transition plan.

Q. Could the Company reduce it common equity beyond what is shown in its transition plan without adverse consequences?

A. No. The Company has shown that over the transition period that it will reduce its common equity from $940 million to $636 million. If the Company tried to reduce its equity below the levels already contemplated, the covenants under the sale/leaseback would be violated and the Company would be in default under the terms of the sale/leaseback. To have the operative covenants revised would require approval of the both the BV-2 lessors and bondholders. At best, the necessary approvals would be costly to obtain because both the lessors and bondholders would want to be paid for granting approval. At worst, such approval would not be granted at all.

Q. Under the Act, can the Commission require the Company to securitize its stranded assets?

A. Not in my opinion. There are no provisions under the Act which allow the Commission to mandate securitization. The Commission can consider the effects of securitization in determining whether or not the Company has fully mitigated its stranded costs. The Company believes that its record on mitigation is strong and many of the benefits which others may be able to achieve through securitization have already been achieved by the Company through other means. The Company has indicated that it will continue to review asset securitization and may request approval to securitize all or a portion of its stranded costs at

some time in the future if it can be shown that such action is beneficial.

VII. OTHER ISSUES

Rebuttal to Mr. Weisenmiller

Q. Mr. Weisenmiller contends that past studies of the value of Duquesne's generating assets conflict with Duquesne's current estimates. Mr. Weisenmiller also claims that the price of the Ft. Martin sale should be used to set the value all Duquesne's generating units. What is your response?

A. Mr. Weisenmiller's claims are less than credible and they are not even internally consistent. I will first comment on his use of past assessments of the market value of Duquesne's generating assets (some performed by Duquesne and others by third parties). These studies contained wide ranges of predicted market value. These ranges of value were influenced by a number of factors, including the expected market price of power, as the documents themselves indicate. It is thus not surprising that the documents predict a positive value for Duquesne's plants when market prices are assumed to be high, while also predicting no value if market prices are assumed to be low. Mr. Weisenmiller's testimony, however, avoids mentioning this. In his zeal to characterize the Company has having billions of dollars in market value, he apparently found it unhelpful to provide the reader a more balanced characterization of these studies.

I also find it surprising that he would even rely on the valuation and market price projections contained in these documents. His testimony is apparently predicated on the belief that such predictions are inherently speculative. (In this regard, he

agrees with the Company.) I thus cannot understand why he places great weight on (selected portions of) prior projections, but no weight at all on current projections. If his point is simply that Duquesne's assets will have positive value if market prices are substantially above the high end of Mr. Schnitzer's range, he could have done so without such a laborious (and one-sided) review of these documents.

Q. Mr. Weisenmiller also contends that the market value of all Duquesne's assets should be set on the basis of the value received from the Ft. Martin sale. Please comment.

A. I also find this assertion not credible and it also is inconsistent with other statements of the witness. In contrast to his claim in testimony that the Ft. Martin sale should be used to value all the assets, he readily conceded on deposition that the sale of one fossil unit does not set the value for the remaining fossil units (much less the nuclear units); rather, it would only provide one "data point":

> Q. Would an auction of one fossil asset provide an accurate valuation of the remaining fossil assets?
> A. Depending upon how representative that one asset was, it might at least give you a data point, but it would not be as indicative as an auction of all of those assets.

Weisenmiller Deposition at 5. It is thus inconceivable to me why he would recommend using the Ft. Martin sale to value all the remaining assets -- particularly when this "data point" is contrary to every other market price projection in this case. Moreover, his contention regarding the indicative value of Ft. Martin is undermined by his own admission in testimony that the price paid by APS was based on market price projections that bear no resemblance to current market conditions. See Weisenmiller Testimony at 23. Here too, all he

has demonstrated is that if one assumes high market prices, one will assume low (or no) stranded costs for Duquesne's plants. That contention was made in the Company's case, and hardly required 150 pages of responsive testimony from Mr. Weisenmiller.

In conclusion, I find Mr. Weisenmiller's assertions to be meritless. I would add, however, that the Company's proposal to auction its generating assets in 2003 (or earlier if there is a triggering event) should moot any dispute with HSS/ARI over the valuation of the assets. Mr. Weisenmiller has stated that his preferred method of valuation is divestiture (testimony at 141).

Rebuttal to Mr. Hughes

Q. Please describe the topic you address in the next portion of your testimony.

A. In this portion of the testimony, I address certain points made by Mr. Hughes regarding the Perry and Beaver Valley 2 (or BV2) plants. Mr. Hughes makes a number of points, which I will address in turn.

Q. Please address the first point.

A. Mr. Hughes, by his own admission, devotes a significant portion of his testimony to "historical issues" relating to these units (Hughes Test. at 6), including the need to construct those units, the prudence of construction and their economics. It is Duquesne's view, however, that these historical issues are simply that: issues of historical interest, not matters that have any relevance to this case.

Q. Please explain.

A. The issues of whether (i) the construction of Perry and BV2 was prudent, and (ii)

the units represented economic excess capacity were both decided in Duquesne's last base rate proceeding (R-870651). I will recite the relevant findings briefly. As to prudence, the Commission determined that (i) all of Perry's construction costs had been prudently incurred, and (ii) found that a relatively small amount of Duquesne's share of BV2 costs were imprudent (approx. $12 million), but no adjustment to rate base was necessary due to Duquesne's sale and leaseback of the facility at a book value loss in excess of that amount. With respect to economic excess capacity, the Commission held that both units represented economic excess capacity. As to Perry, the Commission imposed a disallowance (removal of Elrama 1 and a portion of Elrama 2 from rate base) that had a revenue requirement impact of approximately $5 million annually. As to BV2, the Company agreed to a settlement with the OCA and OTS that, among other things, imposed a disallowance of the equity return on BV2 and accepted a sale-leaseback of the unit which mitigated the cost impacts of the disallowance.

Q. Is Mr. Hughes attempting to raise these issues again here?

A. It is not clear. While he does not specifically so contend, he (i) devotes significant attention to whether these units were needed to serve load reliably, (ii) contends that he will supplement his testimony with further analysis of whether these units were needed, and (iii) contends that this case "presents yet another opportunity for the Commission to address the issue of the just and reasonable-ness of Duquesne's base rates." Page 10. From this, I can only conclude that he is contending that these issues should be relitigated in this proceeding. As indicated, however, I strongly disagree.

Q. Mr. Hughes devotes significant attention to a quotation from your direct

testimony regarding the loss of steel industry load and contends that he will submit additional testimony on this issue. What is the relevance of this testimony?

A. As should be obvious from its context, this portion of my direct testimony was included for the purpose of explaining the rather obvious fact that the loss of steel industry load had a significant revenue impact on Duquesne. Its purpose was not to relitigate whether Duquesne, and the other CAPCO companies, were reasonable in planning to construct significant nuclear capacity, as Mr. Hughes seems to portray it.

Q. Did Mr. Hughes' 1994 complaint attempt to relitigate these prudence issues or other matters related to the 1987 rate case?

A. No, as Mr. Hughes then stated: "I am not asking the Commission to revisit its decision in the prudency or rate base cases. . . ." (See David Hughes Response to Duquesne Light Company's Supplemental Brief at 3, Pa. PUC Dkt. No. C-00945953 (May 7, 1996).)

Q. Does Mr. Hughes make any specific recommendations regarding the rates that should be approved in this proceeding?

A. No. His only statement is that the Commission has a range of options, including the disallowance of costs associated with Perry and BV2. Testimony at p. 10.

Q. What is your response?

A. His rather vague suggestions should be rejected for all the same reasons as discussed in my testimony, as well as the testimony of Messrs. Marshall and Schnitzer, regarding proposals to disallow the recovery of prudently incurred stranded costs.

Q. OCA witness Kahal has opposed the Company's proposal to roll its approved ECR of 14.7 mills into base rates under Section 2804(4)(v). Please comment.

A. The Company's position is that it is entitled under Section 2804(4)(v) to roll in the 14.7 mills approved in the Fort Martin settlement which is cost justified (see Exhibit DJC-24). However, even if we assume witness Kahal is correct that the 14.7 mill level cannot currently be rolled into base rates, it does not follow that Duquesne is limited to roll-in only the 12.822 level currently being charged to Duquesne's customers based on 1995 data.

Q. Please explain. What ECR did the Company propose in its filing on February 28, 1997?

A. The Company's filing sought an adjustment to the ECR of negative 2.369 mills from the 16.45 mills currently in base rates. The net effect of this adjustment would have been to set the ECR at 14.081 for 1997. However, the Commission in its March 27, 1997 Order effectively deferred any adjustment to the ECR pending resolution of the restructuring case.

The negative 2.369 mill adjustment included .428 mills of correction for over-collection in 1996. Under traditional regulatory treatment of the ECR, when there is an adjustment to base rates any corrections for over- or under-collection are not included in the rolled-in amount. In this case, Duquesne is proposing to roll-in the ECR under Section 2804(4)(v). Therefore, if the roll-in were based on the 1997 filing – which produced an ECR below the 14.7 level approved under

Fort Martin - the appropriate treatment would be to exclude the over-collection amount of .428 mills grossed-up to include GRT. The result would be a total ECR of 14.529 mills to be rolled-in to rates.

Q. Assume that witness Kahal is correct and the ECR based on 1995 data should be used to determine the rate cap under the restructuring legislation. Is 12.822 mills the correct number or does a similar adjustment for over-collection need to be made?

A. Based on 1995 data, an ECR adjustment of negative 3.628 mills reduced the ECR from the base rate amount of 16.45 mills to 12.822. But, the 1995 data included an even larger adjustment for over-collection of .851 mills. Grossing-up this over-collection amount for GRT and netting it from the 3.628 mill adjustment would result in an ECR of 13.712 for purposes of the roll-in. Even if witness Kahal is right that the 1995 data should be used for the roll-in, he has conveniently ignored the well recognized Pennsylvania regulatory practice of not including amounts for over-collection or under-collection when rolling ECR adjustments into base rates.

Q. Does this conclude your testimony?

A. Yes it does.