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April 10, 2013

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Ms. Rosemary Chiavetta, Secretary
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

Re: Duquesne Light Company Focused Management and Operations
Audit Recommendation on Dividend Payouts (D-2011-2269361)

Dear Secretary Chiavetta:

In accordance with the Implementation Plan to address the Focused Management and Operations Audit of Duquesne Light Company (DLC or the Company), the following is a detailed explanation regarding dividend payouts that exceeded 85% of DLC's net income during the 2009 to 2011 audit period.

DLC's dividend payments exceeded 85% of net income in 2010 (110.0%) and 2011 (88.0%). DLC's total dividends in 2009 were below 85% at just 66.8% of net income, however, the 2009 data has been included in this report since it was in 2009 that DLC established a goal to achieve a more normalized capital structure which is relevant to this report.

As of December 31, 2008, DLC was capitalized with 72.3%¹ common equity, which is higher than the typical operating utility company. In early 2009, DLC set a target to attain, and then maintain, an equity capitalization of between 52% and 56%. DLC wanted to lower the amount of common equity in its capital structure because common equity is consistently the most expensive form of financing and to have a capital structure that is similar to other peer electric utilities.

Moreover, during 2009 to 2011, DLC had capital expenditures that totaled \$689.1 million that required funding. This high level of capital expenditures far exceeded depreciation for this time period. To fund this level of capital spending, DLC would either need to retain net income and not pay any dividends, which would further increase its common equity capitalization, or fund such expenditures with debt. However, DLC did not want to issue debt externally, which could have

¹ The equity capitalization reported above reflects percentages as reported by the Company in its financial reports to the Pennsylvania Public Utility Commission. These percentages differ slightly from the equity percentages reported in Exhibit V-2 (Page 24) of the Focused Management and Operations Audit of Duquesne Light Company Report due to a difference in the methodology used in the calculation.

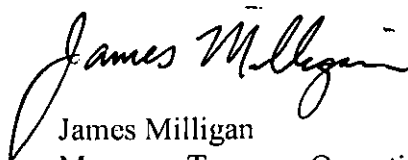
jeopardized the credit quality of DLC based on certain credit metrics. Retaining net income would have further increased the already high equity capitalization.

As a solution, DLC used intercompany debt to fund capital expenditures. Intercompany debt is treated differently by the major rating agencies, therefore the use of intercompany debt did not jeopardize DLC's credit ratings, and allowed DLC to decrease the equity capitalization in its capital structure. In order to allow its parent, Duquesne Light Holdings, Inc. (DLH), to have the necessary funds to provide intercompany loans to DLC, the Company paid dividends to DLH that approximated net income, and DLH reinvested 100% of the dividend proceeds back into DLC in the form of intercompany loans. From 2009 to 2011, dividends on common equity totaled \$295 million, while overall intercompany loan balances with DLH increased by \$300 million, proving that all of the dividend proceeds were recirculated back into DLC.

The addition of \$300 million of intercompany loans helped to decrease the percentage of DLC's equity capitalization from 72.3% at year-end 2008 to the target range of 52%-56.0% by year-end 2011. This allowed DLC to achieve a more typical utility capital structure and benefited ratepayers by decreasing the proportion of capital related to equity in DLC's capital structure. Simultaneously, DLC was able to fund a substantial capital expenditure program in support of its commitment to provide safe and reliable service to its customers.

Thus, the Company did have a payout ratio above 85% in both 2010 and 2011, but these dividends were reinvested back into DLC by its parent company in a manner that provided DLC with a capital structure that is more typical with peer electric utilities.

Sincerely,



James Milligan
Manager, Treasury Operations

cc: Mr. Dennis Hosler, Pa. PUC (via email)
Mr. Vernon Edwards, DLC

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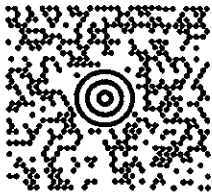
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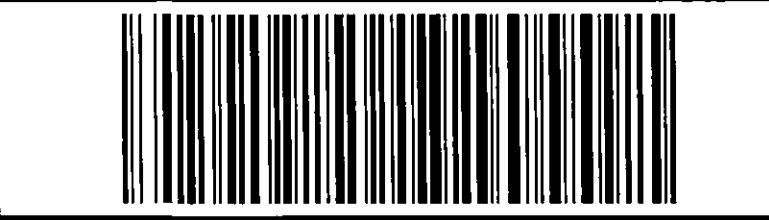
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