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February 27, 1998

VIA HAND DELIVERY

Mr. James McNulty, Prothonotary
Pennsylvania Public Utility Commission
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**Re: Application of Pennsylvania Power & Light Company
For Approval of Its Restructuring Plan
Under Section 2806 of the Public Utility Code
Docket No. R-00973954**

Dear Mr. McNulty:

Enclosed for filing in the above-captioned proceeding are an original and nine (9) copies of the Post-Hearing Reply Brief of PP&L, Inc.

As indicated on the attached Certificate of Service, I have served copies of the enclosed Reply Brief on all active parties in this proceeding.

If you have any questions regarding this filing, please call.

Very truly yours,

Paul E. Russell

Enclosures

cc: Certificate of Service

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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

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**APPLICATION OF
PENNSYLVANIA POWER & LIGHT COMPANY
FOR APPROVAL OF RESTRUCTURING PLAN
UNDER SECTION 2806 OF THE PUBLIC UTILITY CODE**

Docket No. R-00973954

**POST-HEARING REPLY BRIEF
ON BEHALF OF PP&L, INC.
TO ADMINISTRATIVE LAW JUDGE GEORGE M. KASHI**

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Dated: February 27, 1998

TABLE OF CONTENTS

TABLE OF AUTHORITIES	v
I. INTRODUCTION.....	1
A. PP&L’s Restructuring Filing is Just and Reasonable and Should be Approved	1
B. The OCA’s Proposed \$1 Billion Stranded Cost Recovery Is Facially Unreasonable, Would Destroy PP&L’s Financial Integrity and Should Be Rejected.....	3
1. PP&L’s Stranded Generating Cost Claim Is \$700 Million Less than Its Net Book Value.....	5
2. Recent Sales of Generating Assets In Other Jurisdictions Demonstrate the Reasonableness of PP&L’s Stranded Cost Claim.....	7
3. PP&L’s Rate Levels and Stranded Cost Claim Are Fully Consistent	8
C. The OCA’s Central Criticisms of PP&L’s Stranded Cost Claim Are Totally Unfounded...9	
1. The OCA’s Criticism of PP&L’s Revenue Requirement Method Is Without Merit.....	10
2. The OCA’s Criticisms of PP&L’s Market Price Forecast Are Not Credible	11
3. The OCA Criticism of PP&L’s Discounting Procedures Is Clearly Wrong and Would Deprive the Company of \$880 Million in Legitimate Standard Cost Recovery.....	13
D. The Reliance of OCA and Others On The PECO Decision is Misplaced	14
II. LEGAL AND POLICY FOUNDATIONS OF STRANDED COST RECOVERY.....	18
A. Legal Standards.....	18
B. Allocation of Stranded Costs.....	18
III. STRANDED COST CALCULATION METHODOLOGY.....	21
A. The Parties’ Arguments In Favor Of The Asset Value Method Are In Error.....	21
1. The Commission’s PECO Order Does Not Preclude Use Of The Regulatory Method.....	21
2. PPLICA’s Distinction Between “Costs” and “Revenues” Is Completely In Error.....	23
3. The Regulatory Method Does Not “Guarantee” Shareholders A Return On Their Investment Any More Than The Asset Value Method Does.....	25
4. The Asset Value Method Does Not Require Fewer Assumptions Than The Regulatory Method.....	26

B. If The Commission Adopts OCA’s And PPLICA’s Proposed Asset Value Method In This Case, Substantial Adjustments Are Necessary To Correct Significant Inconsistencies And Errors In The Parties’ Application	27
IV. MARKET PRICES OF ELECTRICITY	27
A. Price of Capacity	29
B. Price of Energy	31
1. Choice of Models	31
2. Fuel Prices	31
3. Inflation	35
4. Nuclear Capacity Factor	36
5. Variable O&M Costs	37
6. Reserve Requirements	37
7. Plant Life Extensions	38
C. Market Price Conclusion	39
V. REVENUE UNDER REGULATION	39
A. PUC Jurisdictional Allocation	39
B. Cost of Capital	43
C. Regulatory Assets And Liabilities	45
1. Employee Transition Costs And Pension Plan	46
2. Fossil Plant Decommissioning	47
3. Nuclear Plant Decommissioning	48
4. SFAS 109 (Investment Tax Credit)	50
5. Retirement Of Generating Plant	50
D. Other Revenue Issues	50
1. A&G Expenses	50
VI. DETERMINATION OF PRESENT VALUE	51
VII. RECOVERY OF STRANDED COSTS	53

A. Intervenors’ Criticisms of PP&L’s CTC are Without Merit and Should be Rejected	53
VIII. RATE DESIGN AND TARIFFS	55
A. Customized Rate Design	55
B. Interruptible Service Discounts Must Be Limited to Customers Purchasing Electric Energy from PP&L.....	56
C. Economic Development Rates Should Be Continued.....	58
D. Residential Thermal Storage Rates Should Be Limited to Customers Who Obtain Electric Energy Under Regulated Rates	59
E. PP&L’s Proposed Changes to the Terms and Conditions of Interruptible Service Are Appropriate Responses to Changes in the Industry	59
IX. PHASE-IN ISSUES.....	62
X. CODE OF CONDUCT AND COMPETITION ISSUES	66
A. Disclosure of Customer Information.....	66
B. Use of the “PP&L” Name	67
C. Supply Obligations to Customers Not Eligible to Choose Alternative Suppliers During the Phase-In and to Customers Who Choose not to Choose.....	68
D. Metering, Billing and Collection Services.....	69
E. Treatment of Partial Payments by Customers	70
XI. CUSTOMER EDUCATION	71
XII. UNIVERSAL SERVICE.....	73
A. Funding Levels.....	73
B. Availability of Universal Service and Customer Assistance Programs	75
C. Allocation of Universal Service Program Costs	75
D. Other Universal Service and Customer Assistance Program Recommendations	76
XIII. ENVIRONMENTAL ISSUES.....	77

XIV. CONCLUSION.....79

TABLE OF AUTHORITIES

CASES

<i>Bailey v. United States</i> , 116 S. Ct. 501 (1995)	61
<i>Chappell v. Pa. P.U.C.</i> , 57 Pa. Cmwlth. Ct. 17, 425 A.2d.873 (1981)	60
<i>Federal Power Comm'n et al. v. Hope Natural Gas Co.</i> , 320 U.S. 591 (1944)	15
<i>Olympia Equip. Leasing Co. v. Western Union Tel. Co.</i> , 797 F.2d 370 (7th Cir. 1986)	65
<i>Orson, Inc. v. Miramax Film Corp.</i> , 79 F.3d 1358 (3rd Cir. 1996)	61
<i>Pa. P.U.C. v. PP&L</i> , Docket No. R-00943271 (September 27, 1995)	19
<i>Pa. P.U.C. v. Pennsylvania Gas and Water Co.</i> , 492 Pa. 326, 424 A.2d 1213 (1981)	16
<i>Pa. P.U.C. v. Quaker State Telephone Co.</i> , 56 Pa. P.U.C. 324 (1982)	20
<i>Penn Sheraton Hotel v. Pa. P.U.C.</i> , 198 Pa. Super. 618, 184, A.2d 324 (1962)	46
<i>Pike County Light and Power Co. - Electric Division v. Pa. P.U.C.</i> , 77 Pa. Cmwlth. Ct. 268, 465 A.2d 735 (1983)	39
<i>Pike County Light & Power Co. v. Pa. P.U.C.</i> , 87 Pa. Cmwlth. Ct 451, 487 A.2d 118 (1985)	21
<i>Platt v. Union Pacific R. R. Co.</i> , 99 U.S. 48 (1879)	61
<i>United States v. Syufy</i> , 903 F.2d 659 (9th Cir. 1990)	65

STATUTES AND REGULATIONS

66 Pa. C.S. § 1301	15
66 Pa. C.S. § 2803	22, 23, 25, 46
66 Pa. C.S. § 2804(4)	56
66 Pa. C.S. § 2806	60,61

66 Pa. C.S. § 2806(b)(3)	61
66 Pa. C.S. § 2807	67
66 Pa. C.S. § 2807(d)(3)	70
66 Pa. C.S. § 2807(e)(3)	63
66 Pa. C.S. § 2808(a)	73
66 Pa. C.S. § 2808(f)	52
52 Pa. Code § 53.52	39, 68
52 Pa. Code § 53.53	39, 68
52 Pa. Code § 53.52	39, 68

I. INTRODUCTION

On February 12, 1998, PP&L, Inc. ("PP&L") filed its Initial Post-Hearing Brief ("PP&L Brief") in this proceeding. To a very large extent, the issues raised in the intervenors briefs are fully addressed in the PP&L Brief and extensive further argument is not required. There are, however, several areas which require a brief response in order to correct some of the more egregious errors and misstatements in the opposing party briefs.

A. **PP&L's Restructuring Filing is Just and Reasonable and Should be Approved**

The intervenors briefs contain much hyperbole and exaggerated arguments. Stripped of this harsh veneer, however, there is little substance to their attacks. Viewed objectively, the intervenors briefs are little more than a transparent attempt to misuse the Electricity Generation Customer Choice and Competition Act (the "Act"), 66 Pa. C.S. §2801, et seq., and this proceeding to advance their own narrow self interests at the expense of PP&L, its customers and shareholders and the public interest. The Office of Consumer Advocate ("OCA") proposes a virtual total disallowance of PP&L's stranded costs, with the admitted goal of forcing PP&L to divest its generating assets, a result specifically prohibited by the Act. The marketers propose a code of conduct and rate design which, if adopted, would insulate them from the rigors of a competitive market and would deny the benefits of that market to consumers. Industrial customers want to continue to receive massive discounts provided in PP&L's bundled rates for interruptible service even if they buy energy from another supplier and provide no interruptible

load benefits. The Environmentalists simply ignore the Act's goal of establishing a competitive market and propose an extensive new scheme of rate and environmental regulation. The Commission on Economic Opportunity ("CEO") ignores the Act's rate caps and requirement for continued funding of universal service at existing levels and proposes a massive expansion of low income programs that are inconsistent with a competitive market and would provide large discounts to customers who are already paying their bills on time. The American Association of Retired Persons ("AARP") also ignores the Act, proposing an arbitrary "sharing" of just and reasonable stranded costs and massive cost shifting.

PP&L's filing, on the other hand, represents a reasonable and balanced transition from regulation to competition. In its Brief, PP&L set forth four areas for decision in this case: rules for a competitive market, rate unbundling, stranded costs and universal service. With the exception of stranded costs, this case can and should be easily resolved. To establish rules for competition, the Commission should adopt PP&L's proposed code of conduct on an interim basis until a statewide code is adopted. PP&L's proposed unbundling of rates is essentially without controversy except for the phase-out of economic development programs and the proper unbundling of interruptible service rates. PP&L's proposal provides a fair and equitable approach and should be adopted. For universal service, the Act requires utilities to maintain existing funding. Despite the rate caps in the Act, PP&L has proposed to double its funding of these programs.

This leaves for resolution the difficult and controversial issue of stranded cost recovery. In reviewing the Company's claim, several important points should be considered. First, the

Company is not seeking to recover any “new” costs. All of the stranded costs identified by PP&L in this case are already reflected in PP&L’s current rates and have been found to be prudent and used and useful by this Commission. Second, any fair consideration of stranded costs must consider PP&L’s extensive mitigation, both historically and prospectively PP&L Brief, pp. 26-38. Historic mitigation is demonstrated by PP&L’s low current rates. Prospective mitigation is fully demonstrated by PP&L’s \$1 billion of future stranded cost reductions. Third, and more generally, so-called stranded costs reflect only a relatively small portion of the Company’s total projected cost of operation. Most of PP&L’s revenue recovery will come from the market place. The Company’s stranded cost claim in this case is based upon a significant and continuing increase in future market prices and load growth. There is no guarantee that these increases will occur, and there is, therefore, no guarantee that PP&L will recover its actual stranded costs. Finally, the level of stranded cost allowed in this proceeding must permit PP&L to maintain its financial integrity so it can continue to provide safe and reliable service to customers. Under any reasonable standard, the Company’s claim is valid and should be approved.

B. The OCA’s Proposed \$1 Billion Stranded Cost Recovery Is Facially Unreasonable, Would Destroy PP&L’s Financial Integrity and Should Be Rejected

The OCA’s proposed \$1 billion stranded cost recovery is unreasonable for the reasons set forth in the Company’s Brief. Perhaps recognizing the fundamental weakness of its position, the OCA leads off with an extensive argument that PP&L’s stranded cost claim of \$4 billion is

“facially” unreasonable. OCA Brief, pp. 10-19. In fact, the OCA proves nothing of the sort, and quite frankly, its arguments on this point go beyond fair advocacy. Rather, it is the end result of the OCA’s work – a proposed 20% rate decrease for PP&L, - that is facially unreasonable. PP&L’s current rates were approved by the Commission as just and reasonable in 1995. The OCA provides no basis for reducing those rates by 20% less than three years later. Moreover, the OCA does not and cannot explain why it is rational to impose a 20% rate decrease on PP&L, one of the lowest price utilities in the state, when the Commission ordered only a 15% decrease in PECO Energy’s rates, which are the highest in the Commonwealth and were last set in 1991.

The OCA \$1 billion stranded cost and 20% rate decrease proposals would produce a financially devastating result for PP&L, providing it with a negative return on common equity in 1999. The OCA attempts to discredit the Company’s financial analysis, but its arguments are makeweight, at best.¹ Table A to this Brief summarizes the financial results produced by the OCA’s proposal. This is the same analysis presented in the Company’s rebuttal testimony, PP&L St. 8-R, pp. 23-25, adjusted solely to substitute the OCA’s revised 20% rate decrease for its original 32% rate decrease. As shown in Table A, the OCA’s proposal would wipe out almost

¹ The OCA’s principal criticism is that the Company did not include any write-off or accelerated amortization in its calculations. OCA Brief, p. 63. This is a somewhat surprising argument since inclusion of these items would produce even poorer financial results than those presented by the Company and would further prove the devastating effects of the OCA’s proposal. The OCA also argued that the Company’s presentation was flawed because it assumed that the Company’s market price was correct. OCA Brief, p. 64. In fact, PP&L specifically responded to this point and presented two alternative scenarios, using the OCA’s market price forecast. In each scenario, the results were devastating to PP&, producing negative returns on common equity. PP&L Brief, p.41; Tr. 1543-44 (8/27/97).

60% of PP&L's income available for return, would produce an overall return of 3.5% and a negative return of equity.² OCA's contentions notwithstanding, this is simply not a fair result. If adopted by the Commission, it would, instead, be confiscatory and arbitrary and capricious.

Having no response to this analysis, the OCA makes the astonishing assertion that these poor financial results are "a logical outcome" under the Act. OCA Brief, p. 66. PP&L has searched in vain for any indication that the Act was intended to destroy its financial integrity. To the contrary, the Act contemplates a continuing financially viable utility to provide transmission and distribution service (66 Pa.C.S. §2807(a)), universal service (66 Pa.C.S. § 2804(a)), and last resort service (66 Pa.C.S. §2807(c)). In the end, the OCA's motive is clear. The OCA proposal would destroy PP&L's financial integrity and advance the OCA's goal of divestiture. The General Assembly specially withheld that power from the Commission, and cannot do indirectly what the Act says it cannot do directly. The Commission should reject the OCA's approach, carry out its responsibility under the Act and calculate a just and reasonable level of stranded cost recovery.

1. PP&L's Stranded Generating Cost Claim Is \$700 Million Less than Its Net Book Value

OCA contends that PP&L's claim is facially unreasonable because PP&L's stranded cost claim exceeds its book value. OCA Brief, pp. 11-14. The OCA is wrong. The book value of PP&L's generating plant at January 1, 1999 is \$4.1 billion (plant balance and inventories at

² Of course, return on equity cannot actually be "negative." This simply means that under the OCA's proposal there would be insufficient income to pay interest or preferred dividends.

January 1, 1999 using a jurisdictional allocation of 95.8%). Its stranded generation plant cost claim is \$3.4 billion. Thus, PP&L's book value exceeds its stranded generation costs by \$700 million. These are the facts. The OCA's distortion of these facts should be rejected.

The OCA first compares PP&L's \$4.1 billion book value to its total stranded cost of \$4.5 billion. OCA Brief, p. 13. The OCA conveniently fails to mention that the \$4.5 billion figure includes not just generating plant stranded costs, but regulatory assets and non-utility generation as well, which are *not* reflected in the \$4.1 billion book value figure. The Company's stranded cost claim for its generation plant is not \$4.5 billion, it is \$3.4 billion, and the OCA knows it.

In its second example, OCA asserts that PP&L's \$3.5 billion stranded generation cost claim exceeds the jurisdictional book value of its generating assets of \$3.25 billion. OCA Brief, pp. 13-14. Here, the OCA has "cooked the books" by using different jurisdictional allocators in the calculation of stranded costs and book value. The OCA uses its own jurisdictional allocation in calculating the book value figure, but uses PP&L's much higher jurisdictional allocation for stranded generation cost. Obviously, using substantially different jurisdictional percentages produces different and non-comparable results.

On a consistent basis, the Company's book value of \$4.1 billion is \$700 million more than its \$3.4 billion generation stranded cost claim. Thus, PP&L's generating plants, including both nuclear and fossil, have a market value of over \$700 million, not the negative \$250 million stated by OCA.

2. Recent Sales of Generating Assets In Other Jurisdictions Demonstrate the Reasonableness of PP&L's Stranded Cost Claim

Having failed to demonstrate its case on the record, the OCA takes a journey outside Pennsylvania to reference several recent sales of generating plants in other locations where the proceeds have exceeded net book value. OCA Brief, pp. 17-18. The OCA apparently wishes to demonstrate that PP&L has undervalued its plant. First, as explained above, the Company's own calculation's show a positive market value of its generating plant, nuclear and fossil, of \$700 million, not the negative \$250 million used by the OCA, in its comparison of recent sales.

Second, the sales cited by the OCA are simply not comparable. The Northeast region cited by OCA is significantly capacity constrained. The Northwest region is a different market and capacity, therefore commands a much higher price than in the PJM market, which is currently awash in access capacity. Comparing asset sales in different generation markets of the country is similar to comparing the cost of housing in different areas. In generating plants, as in real estate, it is location that counts. Further, and perhaps more importantly, all of the sales referenced by OCA are coal and hydro units. The OCA references no sales of a nuclear unit for any positive value, and there have been none. 75% of PP&L's book value relates to its Susquehanna nuclear plant. Thus, the OCA's figures are *totally irrelevant* to 75% of PP&L's book value. As to the remaining 25%, the OCA has simply shown that PP&L's coal plants may have some future value if they could be picked up and moved to New England, where capacity is

constrained. In fact, PP&L's \$700 million net market value result is completely consistent with the OCA's analysis of other sales of generation.³

3. PP&L's Rate Levels and Stranded Cost Claim Are Fully Consistent

The OCA then returns to Pennsylvania and offers the following syllogism: Low rates should equal low stranded costs; PP&L has low rates; PP&L should have low stranded costs; \$4 billion is a lot of money; PP&L's stranded cost claim is overstated. OCA Brief, pp. 14-16. PP&L appreciates the OCA's recognition that it has low rates. Beyond that, two points are in order. First, there is nothing in the Act which authorizes the Commission to deny PP&L recovery of stranded costs because its rates are low.⁴ PP&L's rates are low despite its stranded costs. Stranded costs make up only a portion of total costs. Despite owning a large nuclear unit, which the PUC has found to be prudent and used and useful, extensive Non-Utility Generator ("NUG") contracts mandated by federal and State laws and significant deferred taxes created by Pennsylvania regulatory policy, PP&L, through aggressive and consistent cost control, has kept its rates low. PP&L should be applauded for this herculean effort. PP&L surely should not be denied stranded cost recovery because it has cut its costs and maintained low rates for its

³ The OCA does cite one Pennsylvania sale – Duquesne Light Company's sale of its one-half interest in the Fort Martin plant to an affiliate of its co-owner, Allegheny Power Systems. OCA Brief, p. 18. The Fort Martin plant is not in PJM, however. In addition OCA offers no proof that the sale to Duquesne's joint owner, Allegheny, (and now acquirer), was a truly arms-lengths, open market transaction.

⁴ PP&L's low rates do, however, prevent it from recovering all of its \$4.5 billion in stranded costs by operation of the rate caps in the Act.

customers. Indeed, the Act instructs the Commission to do the opposite and recognize PP&L's past efforts to control its rates.

Finally, even accepting the OCA "low rates = low stranded costs" logic, PP&L's stranded costs are in line with its rates. For example, PECO's rates are about 10 cents/kwh hour and its calculated stranded costs were about \$7 billion.⁵ PP&L's average retail rates are around 7.5 cents/kwh, which on a proportional basis would yield stranded costs of \$5.25 billion (\$7 billion x .75), which compares very favorably to PP&L's \$4.5 billion stranded cost calculation.⁶

C. The OCA's Central Criticisms of PP&L's Stranded Cost Claim Are Totally Unfounded

The OCA cites three central reasons why it believes PP&L's stranded cost claim is excessive: (1) PP&L's revenue requirement method for calculating stranded costs is flawed; (2) PP&L's market price projection is too low; and (3) PP&L failed to properly discount its stranded costs. OCA Brief, pp. 19-24. Each point is in error.

⁵ See *PECO Order*, pp. 66-67. PECO Energy's stranded cost calculation included \$2.272 billion in regulatory assets, \$233.8 million of nuclear decommissioning \$4.484 billion in generating plant, \$126.9 million for fossil plant decommissioning, \$25 million for consumer education and \$8 million in other transition costs.

⁶ Even using the PUC's final stranded cost allowance for PECO (\$4.942 billion, see *PECO Order on Compliance Filing*, p. 8) would yield an indicated recovery for PP&L of \$3.71 billion, over three times more than the OCA proposal and fully consistent with PP&L's \$4.0 billion proposed stranded cost recovery.

1. The OCA's Criticism of PP&L's Revenue Requirement Method Is Without Merit

PP&L's revenue requirement method is not flawed. As explained in more detail in Section III, the revenue requirement method and the asset value method, applied correctly, produce comparable results. This is not surprising, because they measure the same thing. The revenue requirement model forecasts the revenue requirement to recover book value over time and market revenues, then discounts the difference. The asset value method forecasts market revenue then subtracts projected expenses to calculate net market value and present values that figure to compare to current book value. In both cases, market price and all future expenses must be forecast. In the revenue requirement model, future expenses are included in the revenue requirement side of the calculation. In the asset value method, they are subtracted from market revenue. Consistently applied, these models should, by arithmetic definition, produce comparable results. The Company presented extensive testimony demonstrating that under either the asset value method or the revenue requirement method its total stranded costs are \$4.5 billion. No party has presented any meaningful evidence to refute this conclusion.

The OCA, on the other hand, misapplies the asset value method by leaving out important costs and taxes. The OCA includes revenue from significantly higher future sales, but excludes the cost of capacity clearly required to serve those sales. The OCA treats future capital additions as operating expenses and therefore immediately deductible for tax purposes and thereby understates significantly future tax expenses. The OCA purports to calculate book value at

January 1, 1999, but excludes current Construction Work in Progress (“CWIP”) which will be in service at that date.

The OCA also fails to account for the reversal of deferred taxes. The OCA repeatedly states that the asset value method is designed to determine what PP&L’s assets could be sold for today. However, the OCA has failed to acknowledge that if those assets were sold, significant deferred taxes would be immediately due and payable to the Federal government and would not be available as net proceeds to PP&L.

The problem in this case is not the method used to calculate stranded costs. It is the OCA’s mis-application of the asset value method in a manner designed to shortchange PP&L’s recovery of legitimate stranded costs.

2. The OCA’s Criticisms of PP&L’s Market Price Forecast Are Not Credible

OCA next criticizes the Company’s market price forecast. The many flaws in the OCA’s analysis are set forth below. The central charge is that PP&L engaged in an independent forecast of fuel prices and inflation. OCA Brief, p. 40. The OCA witness instead relied upon forecasts prepared by an independent consultant (DRI). This is not something the OCA should brag about. First; the OCA witness acknowledged on cross examination that he never examined the inputs that went into the DRI forecast, and never bothered to even look at how the forecast was developed. Second, and more importantly, DRI has consistently and grossly overestimated long term fuel prices. It is not clear why the OCA takes comfort in the fact that its witness relied on an independent forecast, when that forecast has consistently been wrong.

The flaw in the OCA analysis is perhaps best shown in its forecast of coal and gas prices, a critical input given PP&L's large number of coal plants. OCA projects different growth rates for gas and coal prices. Over the forecast period, OCA's escalation of coal and gas prices at different rates results in coal prices that are 50% lower than the coal prices that would result if the same escalation rate were used for coal and gas prices. PP&L Brief, p. 73. There are two problems with this result. First, it defies common sense and market economics which indicate that over time coal and gas prices should move together. Second, the sustained differential forecasted by the OCA has never happened before. In fact, PP&L witness Scott Jones compared historic coal and gas prices and found a 92% correlation over time. PP&L Exh. STJ 16a. He also calculated that the odds of the OCA's projection actually occurring, based on history, is 33,000 to one. PP&L St. 7-R, p. 31. The OCA's witness did not dispute these statistical calculations or the degree to which his future forecast departed from any historical precedent.

The OCA market price forecast also contains many other errors. OCA witness Douglas Smith forecasts a dramatic decline in imports from outside the Pennsylvania-New Jersey-Maryland ("PJM") market, but provided no basis for why this should happen. PP&L Brief, p. 60. The OCA forecasts a major life extension of the Keystone and Conemaugh plants, even though no owner of the plants, other than PECO, which does not operate or control the facility, has projected such an extension. *Id.* at 119. The OCA ignores the scheduled retirement dates of PP&L's coal units and simply runs them indefinitely without regard to their age and condition. *Id.* at 86. The OCA arbitrarily assumes that new combustion turbines ("CT") units on the PJM system will burn 50% gas and 50% oil, regardless of the price of these fuels. *Id.* at 59. Finally, in

the ultimate “apples to oranges” analysis, the OCA takes its final market price and inexplicably adds over \$400 million in administrative and general (“A&G”) expenses to the result to determine its final “market” price. *Id.* at 124, n. 61. The OCA does not explain how a seller in a competitive market can magically increase the prices it receives from the market to cover A&G costs.

The many flaws and errors in the OCA market price forecast render it useless in this case. Just as OCA ignores the law of the Commonwealth, it ignores the laws of economics. The record before the Commission in this case requires that the OCA market price forecast be rejected or substantially revised.

3. The OCA Criticism of PP&L’s Discounting Procedures Is Clearly Wrong and Would Deprive the Company of \$880 Million in Legitimate Standard Cost Recovery

The OCA asserts that PP&L calculated its revenue requirement on a pre-tax basis (by including income tax as an expense), but discounted its revenue requirement using an after tax discount rate. OCA Brief, pp. 21-23. The OCA contends that this error caused PP&L to overstate its stranded costs by \$880 million. *Id.* at 21. Again, the OCA’s attack is somewhat surprising since its own witness did exactly the same thing. The OCA included taxes as an operating expense in its future cost projection and discounted its net market revenue using an after tax discount rate. PP&L Brief, pp. 133-34.

The point the OCA seeks to avoid is that stranded cost revenues are taxable just like any other revenues, and income tax expense must be included in any rational stranded cost

analysis. This can be done in two ways: (1) include income taxes as a cost and discount at an after tax rate; or (2) use a pre-tax discount rate and gross up the result for income taxes. Either method is acceptable. What is unacceptable and mathematically erroneous is the OCA's proposed adjustment, which excludes income taxes and would leave PP&L \$880 million short of its fair stranded cost recovery.

D. The Reliance of OCA and Others On The PECO Decision is Misplaced

Having failed to present reliable and persuasive evidence in this case, OCA seeks to rely on the record and decision in the PECO case. Other parties, including PECO, join the chorus and assert that the Commission's decision in PECO must be applied in all aspects to PP&L and other Pennsylvania electric utilities. Doing so would be unfair, would deny PP&L due process, and would be arbitrary and capricious.

First, each case must be decided on its own merits. Due process requires this result, as does the Act itself, which mandates evidentiary hearings for each utility's restructuring case. 66 Pa.C.S. § 2808(d). If PP&L's restructuring case were to be decided based on the PECO record, then evidentiary hearings for PP&L have been a meaningless and hypocritical exercise.

Second, the OCA's fundamental argument that the Commission must use the same market price forecast in both cases is simply wrong. Market price is not an ultimate issue in this case. Under the Act, the Commission does *not* set market prices; the market sets market prices. Market price is simply one of a myriad of inputs employed to calculate stranded costs.

The ultimate issue in this case is to determine a just and reasonable level of stranded cost recovery. "Just and reasonable" is a term well known to the Commission, which has set just and reasonable rates under Section 1301 of the Code, 66 Pa.C.S. §1301, for many years. Just and reasonable has a clear meaning: It is the "end result" that counts, not the individual components. As the U.S. Supreme Court stated in *Federal Power Comm'n et al. v. Hope Natural Gas Co.*, 320 U.S. 591 (1944):

Under the statutory standard of "just and reasonable" it is the result reached not the method employed which is controlling.... If the *total effect* of the rate order cannot be said to be unjust and unreasonable, judicial inquiry is at an end. The fact that the method employed to reach that result may contain infirmities is not then important. 320 U.S. at 603 (emphasis added).

Or, as the Pennsylvania Supreme Court explained in *Pa. P.U.C. v. Pennsylvania Gas and Water Co.*, 492 Pa. 326, 424 A.2d 1213 (1981) (emphasis added):

There is ample authority for the proposition that the power to fix "just and reasonable" rates imports a flexibility in the exercise of a complicated regulatory function by a specialized decision-making body and that the term "just and reasonable" was not intended to confine the ambit of regulatory discretion to an absolute or mathematical formulation but rather to confer upon the regulatory body the power to make and apply policy concerning the *appropriate balance* between prices charged to utility customers and returns on capital to utility investors consonant with constitutional protections applicable to both. 492 Pa. at 337.

* * * *

As we observed in an earlier case:

The ascertainment of the fair value of the property, for rate making purposes, is not a matter of formulas, but it is a matter which calls

for the *exercise of a sound and reasonable judgment* upon a proper consideration of all relevant facts. The commission is not bound to adopt any one method to the exclusion of all others. It may take into consideration various methods, and use its judgment as to the extent to which they shall be employed. 492 Pa. at 339-40. (emphasis supplied).

Viewed in this light, market price and the numerous of other inputs into stranded cost determination are elements of an overall end result of just and reasonable stranded cost recovery. The PECO case aptly demonstrates this point. In that case, the Commission chose a very high OCA market price forecast, found that PECO had not adequately mitigated its stranded costs and yet still permitted PECO 100% stranded cost recovery. PECO Order, pp. 100-01. To reach this result, the Commission obviously balanced a number of important issues, including market price, future costs, mitigation and others to achieve an overall just and reasonable result. It is neither necessary or desirable to use identical inputs in every case.⁷ The Commission need only determine a just and reasonable overall level of stranded cost recovery.

This is particularly true with respect to the PECO market price decision. It is obvious from even a cursory reading of the PECO decision that the Commission was not satisfied with any of the market price presentations in the PECO case, including the OCA's. PECO Order, p. 88. It found that PECO's presentation was so flawed that it could not be used and selected the OCA's forecast, as the best available on that record. This less than ringing endorsement cannot

⁷ Indeed, one could presumably substitute PP&L's market price for the OCA's market price in the PECO case and reach the same end result in *PECO*, i.e., a \$4.9 billion cost stranded cost recovery, given the PUC's conclusion (Order, p. 100) that PECO did not adequately mitigate its stranded costs.

be the basis for using the OCA's market price on a state-wide basis. The fact that PECO failed to present an adequate market price case cannot be used against PP&L and other utilities.

In fact, a number of the market price issues raised by PP&L were simply not litigated in the PECO case. For example, the critical coal price issue discussed above was never raised in the PECO case, presumably because PECO Energy has relatively few coal units. The PUC can and must make an independent determination of PP&L's stranded cost on this record. It must either accept PP&L's market forecast or correct the obvious and essentially unrebutted errors in OCA's forecast. This would have no affect whatsoever on the PECO decision and the PUC's determination that PECO should recover an overall level of stranded cost of \$4.9 billion.

Moreover, the PECO decision is not final. It has been challenged by PECO in Federal court and is currently subject to multiple appeals to Commonwealth Court. In this context, it would particularly inappropriate to apply the PECO decision to other utility cases. In the event that the PECO decision were to be reversed or modified, either on appeal or in the settlement discussions now ongoing before the Commission, then every other case in the Commonwealth would have to be changed as well. At a minimum, all utilities would be required to appeal their restructuring decisions in case the PECO decision were modified so they could take advantage of those changes. A more rational and sensible approach (and one that is consistent with due process and the Act) would be to decide each case on its own merits and to determine in each case a just and reasonable end result level of stranded cost recovery. On this record, PP&L's stranded cost claim is clearly just and reasonable and should be approved.

II. LEGAL AND POLICY FOUNDATIONS OF STRANDED COST RECOVERY

A. Legal Standards

Although many parties to this proceeding have addressed the legal issues regarding stranded cost recovery in this proceeding, there is a base line with which no party can reasonably disagree: PP&L must be permitted a just and reasonable level of stranded cost recovery. Such recovery is required by the Act and is necessary to avoid confiscation of PP&L's property. See PP&L Brief, pp. 24-25.

Clearly, the positions of OCA and PPLICA do not provide for a reasonable level of stranded cost recovery. They conclude that the overwhelming portion of the stranded costs proven by PP&L in this proceeding should be disallowed with a devastating effect upon PP&L's financial condition. Even with the "full" stranded cost recovery claimed by PP&L, its returns will be modest, by any standard, and well below its actual cost of capital. Tr. 1544 (8/27/97).

B. Allocation of Stranded Costs

Certain parties also have proposed that the portion of PP&L's stranded generation costs that can be recovered under the rate cap be "shared" between ratepayers and shareholders. As explained in PP&L's Brief, pp. 38-42, such proposals are contrary to the Act and appellate court decisions interpreting the Public Utility Code that have rejected sharing of costs already determined to be just and reasonable.

OCA (Brief, p. 74) and PPLICA (Brief, p. 11) seek to justify their sharing proposals on the grounds that the stranded portion of PP&L's generation investments is not "used and

useful.” Other parties adopt a “replacement cost” analysis. They assert that PP&L’s facilities are not “used and useful” because, if they were replaced today, the replacement facilities would use different technologies and a different fuel, natural gas. PP&L St. 18-R, p. 22.

These arguments are creative, but totally inconsistent with Commission application of the “used and useful” standard generally and to PP&L specifically. First, as indicated previously, all of PP&L’s generating plants, including its nuclear plant, have already been found to be “used and useful” by the Commission in the Company’s 1995 rate case. *Pa. P.U.C. v. PP&L*, Docket No. R-00943271, pp. 10-21 (Order entered Sept. 27, 1995).

Second, arguments over utility plant obsolescence due to advances in technology are not new to this Commission. For example, in the telephone industry in the late 1970s and 1980s, central office switching equipment using analog or older technologies was retired before the end of its projected service life to make way for more efficient digital switching equipment. In direct response to such advances in technologies, the Commission switched from use of a theoretical, calculated depreciation reserve to use of the book reserve in order to permit utilities to recover investment made obsolete by technological advances. The switch to remaining life depreciation was part of this process. *See generally Pa. P.U.C. v. Quaker State Telephone Co.*, 56 Pa. P.U.C. 324, 326, 335-39 (1982). These changes were part of the overall change from valuation methodologies to a capital recovery method of establishing the plant portion of rate base. Use of capital recovery depreciation assured that utilities would receive a return of and a return on their investments in plant that was included in rate base, regardless of the reason for or time of the plant’s retirement.

In sum, intervenors' "used and useful" arguments are simply wrong and provide no basis for any "sharing" of stranded costs.

The Environmentalists take a different approach, proposing that shareholders bear 57.3 percent of stranded nuclear generation costs because this disallowance, in their view, will produce a "fairly decent" return. Public Interest Parties Brief, p. 23. No legal interpretation of the "fairly decent" standard was proffered, and no cost of capital evidence identifying a "fairly decent" level of return on equity was produced. Not only is there no legal or factual support for the "fairly decent" return concept, but there also is no evidence that such a return exists in fact. The Environmentalists create a fiction of a "fairly decent" return by going back and recharacterizing a substantial portion of historic allowed returns (which investors may or may not have realized) as recovery of capital instead of return.⁸ The Environmentalists' proposal involves rewriting PP&L's financial history commencing with the first day of recovery of investment in nuclear generating facilities. Under the Environmentalists' approach, return is never allowed much less earned; it can always be taken away (regardless of whether it was earned) and recharacterized as recovery of capital in support of an arbitrary disallowance of prudent investment in property that has and will continue to produce electricity for customers. The Environmentalists' contentions are without precedent, logic, or equity and would violate fundamental principles of ratemaking, including principles against retroactive ratemaking. *See,*

⁸ Environmentalist St. 1, pp. 20-23; Public Interest Parties Brief, p. 23.

e.g., Pike County Light & Power Co. v. Pa. P.U.C., 87 Pa. Cmwlth. Ct. 451, 487 A.2d 118 (1985). The Environmentalists' proposal must be rejected.

III. STRANDED COST CALCULATION METHODOLOGY

A. The Parties' Arguments In Favor Of The Asset Value Method Are In Error

PP&L has fully discussed the merits of the regulatory method in its Brief (pp. 42-48). The regulatory method is entirely consistent with the Act, is easy to apply, and properly determines the level of PP&L's overall stranded costs. The OCA and PPLICA attack the regulatory method and assert that the Commission instead should adopt the asset value method to calculate PP&L's stranded costs. OCA Brief, pp. 19-20; Large Customers Brief, p. 23. The arguments raised by these parties are without merit and should be rejected.

1. The Commission's PECO Order Does Not Preclude Use Of The Regulatory Method

As anticipated by the Company (PP&L Brief, pp. 46-47), OCA and PPLICA rely heavily on the Commission's recent Order in the PECO restructuring proceeding in support of their proposal to use the asset value method in this case. OCA Brief, p. 19-20; Large Customers Brief, p. 23. Indeed, PPLICA argues that the PECO Order "specifically rejected the Regulatory Method's lost revenues approach as 'inappropriate.'" Large Customers Brief, p. 23. As explained in PP&L's Brief, the parties' reliance on the PECO order misplaced.

The PECO Order did not, as PPLICA erroneously claims, "specifically reject" the regulatory method. In fact, *the regulatory method was not proposed or even presented by any of*

the parties in the PECO restructuring proceeding. Thus, selection between the regulatory or asset value method did not arise in that proceeding, and the Commission plainly did not have an opportunity to consider this issue fully. Indeed, the Commission did not (and could not) have considered PP&L's specific method because it was not presented in the PECO case. The Commission's brief mention of a non-specific "lost revenues" approach in a single footnote in the PECO Order when the issue was not disputed is at best *dicta* and cannot be viewed as having resolved the merits of a method presented for the *first* time in PP&L's restructuring case.

Moreover, the Act itself does not require the use of any particular method. Instead, the Act defines stranded costs and leaves the selection of a proper calculation methodology up to individual utilities. Section 2803 defines "transition or stranded costs" as:

[a]n electric utility's known and measurable net electric generation-related costs, determined on a net present value basis over the life of the asset or liability 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.

66 Pa. C.S. § 2803. In other words, stranded costs are the present value of net generation-related costs that would be recoverable *under traditional rate regulation*, but which may not be recoverable in a competitive market. Consistent with the plain language of Section 2803, PP&L's proposed regulatory method of calculating generation-related stranded costs compares the annual cost-of-service revenue requirement of each generating facility to the projected annual

revenues each facility would receive from the sale of its output based on market prices for each year from January 1, 1999 to the end of its remaining service life. PP&L St. 8, p. 4.

Finally, it is important to note that both the regulatory method and the asset value method properly applied, should produce comparable results. As explained in PP&L's Brief (p. 46), both methods effectively measure the same costs and revenues. The problem in this case lies in the fact that OCA and PPLICA have applied the asset value method incorrectly, using erroneous and inconsistent assumptions and inputs which drastically understate PP&L's overall stranded costs. If the Commission elects to utilize the asset value method, these errors must be corrected.⁹

2. PPLICA's Distinction Between "Costs" and "Revenues" Is Completely In Error

PPLICA argues that the regulatory method is inconsistent with the plain language of Section 2803 of the Act. Specifically, PPLICA contends that the regulatory method "guarantees" recovery of *revenues*, while the Act provides only for the recovery of generation-related *costs* that may not be recoverable in a competitive market. Large Customers Brief, pp. 24-25.

PPLICA's argument fails to withstand even the most superficial scrutiny.

⁹ OCA's and PPLICA's support for the asset value method can be explained in part by examining the relationship between stranded cost recovery and the return on equity. Under the asset value method, a lower return on equity and, hence, a lower discount rate *increases* the present value of market revenue, thus reducing stranded costs. To achieve the same result under the regulatory method, a higher discount rate would be necessary in order to *reduce* the present value of lost revenue. This, of course, would mean arguing for a higher return on equity — a result the OCA and PPLICA could not support. OCA's "solution" to its dilemma was to argue for a pretax discount rate should the Commission adopt the regulatory method. PP&L demonstrated, however, that this approach is mathematically flawed and would deprive PP&L of \$880 million in legitimate stranded cost recovery. See Section VI, *infra*.

The “revenue” that the Company would receive under traditional rate regulation, i.e., its revenue requirement, simply reflects the sum of the *costs* PP&L would incur to serve its customers. PP&L’s revenue requirement is the sum of all reasonable *costs* incurred in providing service to the public including its “cost” of capital. Thus, PP&L’s regulatory method is completely consistent with the plain language of the Act.

It also is important to note that the asset value method in fact reflects the same types of costs as the regulatory method. The only difference between the two methods is the manner in which such costs are taken into account. Under PP&L’s approach, these costs are used to determine the annual revenue requirement for each generating unit under traditional regulation. This revenue requirement is then compared to the projected annual revenues the Company would receive from the sale of output in a competitive market. Under PPLICA’s approach, the same costs are instead subtracted from the revenues that could be earned from generating plants in a competitive market. The resulting amount is then compared to the current book value of PP&L’s generation-related assets. Thus, if one views each calculation method as consisting of a series of “buckets,” both methods consider the same costs, they just place them in different buckets. PPLICA’s attempt to distinguish between the regulatory method and asset value method thus fails. When properly applied, both methods measure the same values.

3. The Regulatory Method Does Not “Guarantee” Shareholders A Return On Their Investment Any More Than The Asset Value Method Does

Under traditional regulation, PPLICA notes that shareholders are ensured an *opportunity* to earn a return on their investment. Large Customers Brief, p. 25. On this basis, PPLICA argues that PP&L’s proposed regulatory method should be rejected because it “guarantees” shareholders a return on their investment which they might not have received under traditional regulation. *Id.* As a result, PPLICA contends that the regulatory method “permits PP&L shareholders to avoid all consequences of restructuring by computing stranded costs as if traditional regulation continued through the life of each facility.” Large Customers Brief, p. 24.

Similarly, the OCA asserts that the regulatory method is improper because it assumes “perfect ratemaking,” *i.e.*, that “PP&L had a full rate case every year for the next twenty five years, that it was successful in every issue, that there was no regulatory lag, and that the Company actually earned every penny that it was allowed in that year.” OCA Brief, pp. 19-20. The parties’ arguments are in error.

The regulatory method does not provide for the recovery of any different or greater costs than the asset value method. As explained above and in PP&L’s Brief (p. 46), both methods in fact attempt to measure the *same* costs in calculating overall stranded costs, and thus should yield comparable results when properly applied. PP&L St. 19-R, pp. 9-14. To return to the prior “buckets” analogy, the two methods only differ in the fact that the costs are placed in different “buckets” of the calculation. PPLICA and OCA are simply incorrect in arguing that the

regulatory method will provide for the recovery of greater or different costs than the asset value method.

Furthermore, the regulatory method does not “guarantee” greater recovery than the asset value method. Both methods utilize a variety of assumptions and estimates of future costs and conditions, including market price, fuel costs, customer demand and generating plant availability.

The accuracy of the results produced by both methods, therefore, is necessarily delimited by the accuracy of these estimates and assumptions. If these projections turn out to be incorrect, both methods could end up overstating or understating the level of PP&L’s actual stranded costs. To suggest that either method, properly applied, is more accurate or guarantees greater recovery is incorrect and ignores the facts.

4. The Asset Value Method Does Not Require Fewer Assumptions Than The Regulatory Method

Schuykill Energy Resources, Inc. (“SER”) and Gilberton Power Company (“Gilberton”) claim that the asset value method is more reliable because it requires one-half of the long-term estimates used under the regulatory method. SER/Gilberton Brief, pp. 21-23. This argument is absurd and should be rejected. As explained above, the regulatory and asset value methods measure the same costs and use the same types of assumptions regarding future conditions. Indeed, *all* of the considerations noted above by SER and Gilberton, *i.e.*, the cost variables, income variables and the future rate of inflation and discount rate, *also are taken into account under the asset value method.* Thus, both calculation methods “stand or fall” on the accuracy of the same variables and assumptions. Properly applied, both methods are equally reliable.

B. If The Commission Adopts OCA's And PPLICA's Proposed Asset Value Method In This Case, Substantial Adjustments Are Necessary To Correct Significant Inconsistencies And Errors In The Parties' Application

As noted in PP&L's Brief (pp. 47-48), the Company recognizes that the Commission may decide to utilize the asset value method in this case as it did in the PECO restructuring proceeding. Because the asset value method is not in the record, PP&L provided a series of tables with its Brief to aid the ALJ and the Commission. These tables provide a consistent application of the asset value method and a reconciliation of that method with PP&L's preferred regulatory method. As explained in detail in PP&L's Brief (pp. 47-48), if the Commission elects to adopt the asset value method proposed by OCA and PPLICA, critical errors and inconsistencies must be corrected to properly reflect PP&L's overall level of stranded costs. These errors include the parties' proposed adjustments for A&G expenses, increased productivity, land value escalation, capital additions, CWIP, taxes recoverable and deferred taxes. These issues are discussed fully in Section V.D of PP&L's Brief.

IV. MARKET PRICES OF ELECTRICITY

PP&L has addressed in its Brief all of the issues concerning the projections of market prices of electricity. PP&L will respond in this Reply Brief only to those contentions which either are not based upon evidence or seek to ignore the evidence in this proceeding.

In this regard, several parties argue that the market prices of electricity should be determined in this case simply by the reference to the Commission's decision in *PECO*. In effect, the record on market prices in this case would be rendered a nullity. While such an

approach would clearly be favorable to those parties, they do not provide any compelling reason why the record in this proceeding should, or can, be ignored.

PP&L notes that the Commission, in adopting the market price projections of Douglas Smith on behalf of OCA in *PECO*, was careful to note that Mr. Smith's projections were the best available in *that record*. The Commission stated as follows:

Though there is no single proposal that we find completely convincing on every component of its analysis, we adopt the testimony of OCA witness Smith as the most reasonable determination of future market value *in the record* . . .

PECO p. 88, emphasis added. The Commission also stated that its “. . . conclusion requires the exercise of judgment based on the evidentiary record.” *PECO*, p. 87.

As noted in the introduction to this Reply Brief, several critical issues concerning market prices simply were not addressed in *PECO*. In particular, there was no dispute in *PECO* about the projected fuel prices used in the market price analysis because all witnesses used either the DRI or EIA forecasts, which are essentially the same. The record in this proceeding, however, demonstrates that such forecasts are clearly flawed both as to overall prices and as to the spread between coal prices and gas and oil prices. These “unresolved” issues clearly must be resolved based on the record in this case.

Other issues “resolved” in *PECO* must be considered again in light of different evidence in this proceeding. For example, as explained subsequently, the Commission resolved the issue of nuclear capacity factor in *PECO* by adopting an average capacity factor in excess of that actually experienced by *PECO*, thereby increasing stranded costs. However, to do so for PP&L

would have the opposite result because PP&L's nuclear capacity factor is above average. Similarly, adopting the service life extensions used by PECO, a minority non-controlling owner, for the Conemaugh and Keystone stations is both opposed in this case and unsupported by the record.

Finally, the impact on PP&L of market prices adopted by the Commission must be considered. For example, as explained in its Brief, pages 71-72, PP&L's greater use of coal generation as compared to PECO makes the spread between coal prices and oil and gas prices, an unaddressed and relatively unimportant issue in *PECO*, a major issue in this case.

The ALJ should reject the urgings by other parties to ignore the record in this case and decide this case on the *PECO* record.

A. Price of Capacity

In its Brief, PPLICA argues that PP&L's witness, Dr. Jones, did not employ a model to develop capacity prices and criticizes his use of actual contracts as the starting point for his projection of capacity prices.

PPLICA's criticisms demonstrate the problem with its approach to this case. In PPLICA's view, theory is elevated over reality. It is the model that is important and reality is avoided no matter what the cost.

In contrast, PP&L faces the real world of competition for sales of electricity today. It is therefore both logical and reasonable to begin an analysis of capacity prices with the prices currently paid to PP&L in the real market. No rational business person would start elsewhere.

After starting with actual capacity prices in the market, PP&L then increased these prices to the level needed, when combined with projected energy prices, to justify the addition of new capacity. In this manner, capacity is added when it is needed to meet demand. Again this is a practical, real world approach. In a *competitive market*, capacity will be added when there is, or expected to be, sufficient demand to produce prices that are sufficient to convince investors that they will earn an adequate return on an investment in new capacity.

As explained in PP&L's Brief, pages 51-55, the prices projected by Dr. Jones for capacity and energy that will be produced by new combined cycle units during the hours that they operate will be sufficient to produce returns on common equity in excess of 13%. The higher capacity and energy prices projected by PPLICA and OCA, therefore, are simply in excess of that which is necessary to encourage installation of new units as needed. Faced with these facts, PPLICA can only offer the "criticism" that Dr. Jones analysis is based on reality.¹⁰

¹⁰ PPLICA also argues that Dr. Jones use of a heat rate of 7000 BTU/kWh is unreasonably low and decreases capacity prices. However, PP&L Exh. STJ-28R shows that the heat rates of many existing units are *already* below 7000 BTU/kWh, and Dr. Jones explained that heat rates will likely decline further as technology improves. As heat rates decline *even further* below the conservative 7000 BTU/kWh used by Dr. Jones, less and less fuel will be needed to produce each kWh and even lower capacity prices than those projected by Dr. Jones will be necessary to encourage construction of new generating units.

B. Price of Energy

1. Choice of Models

PP&L has addressed in its Brief, pages 55-64, issues concerning the model to be used in projecting energy prices. Both OCA and PPLICA contend that PP&L's application of the EGEAS model does not account for so called start-up and no load costs. While PP&L will not repeat the explanations in its Brief, PP&L notes that neither party, in raising this criticism, even acknowledges that Dr. Jones responded in rebuttal to these criticisms and demonstrated that the *maximum* effect of such criticisms would be to lower PP&L's stranded costs by \$37 million. See PP&L Brief, pp. 61-64; PP&L St. No. 7-R, pp. 14-15. This issue is nothing more than a red-herring.

As noted in PP&L's Brief, either OCA's ENPRO model, though deficient,¹¹ or the EGEAS model can be used to develop a reasonable and reliable market price of energy, *provided that* the correct inputs to the model are employed. In fact, when consistent inputs are used, the EGEAS and ENPRO models produce essentially the same result. PP&L Exh. STJ-33. These inputs will be addresses in the following sections of this Reply Brief.

2. Fuel Prices

As noted by PP&L, OCA and PPLICA in their respective briefs, the critical factor in developing market prices is the projection of fuel prices.

¹¹ The principal defect of the ENPRO model is that it can model far less than the actual number of units in PJM. See PP&L Brief, p. 59.

OCA and PPLICA argue in their briefs that the Commission must accept the projections of fuel prices used in their models simply because they are based upon “independent” published fuel prices. They also argue that PP&L’s forecast of fuel prices *must* be biased because it was prepared by PP&L’s witness.¹²

This critical issue cannot be decided by innuendo; it must be decided based on evidence. Stunning by its absence is *any* attempt by OCA or PPLICA to refute, or even respond to, the *record* evidence in this proceeding that the DRI fuel price forecast used by OCA and the EIA forecast used by PPLICA have been demonstrated to have consistently overstated fuel prices. PP&L St. 7-R, pp. 53-59. Faced with no evidence to respond to this deficiency, or even any evidence to explain the basis for their forecasts,¹³ OCA, and particularly PPLICA, must resort to an *ad hominem* attack on PP&L’s witness.

PPLICA would have the ALJ believe that Dr. Jones simply made up a fuel price forecast, without any support, that was designed to support PP&L’s claim for stranded generation costs. Such a contention is not only without support, but belied by the record. Dr. Jones’ testimony and exhibits demonstrate that real oil and gas prices will not rise because real oil prices are in fact mean reverting to about \$15.50/barrel in 1996 dollars. PP&L St. 7-R, p. 47; PP&L Exh. STJ-

¹² Of course, OCA’s and PPLICA’s witnesses could be presented as being equally biased in their selection of a forecast. However, PP&L prefers that the ALJ make his decision based upon evidence.

¹³ Both OCA’s and PPLICA’s witnesses admitted that they did not investigate and could not identify, the basis for the forecasts that they selected. Tr. 1403 (8/25/97); Tr. 1517-18, 1750 (8/25/97). In contrast, Dr. Jones’ fuel prices are supported by a study of historical fuel prices and an analysis of the statistical relationship between prices of competing fuels. PP&L Exh. STJ-18 and PP&L Exh. STJ 16a.

16. The ALJ should note that current prices of West Texas Intermediate Crude, a high grade oil, are about \$15.18/barrel in 1998 dollars (*The Wall Street Journal*, February 20, 1998, p. C1).¹⁴ The oil prices used in the forecasts in this proceeding are for lower grade less expensive oil. Accordingly, current prices are well below the long term average of \$15.50 in 1996 dollars thereby demonstrating that prices are, in fact, mean reverting to about \$15.50/barrel as Dr. Jones testified. Nevertheless, Dr. Jones used \$18.00/barrel (representing the 10-year average oil price) as the starting point to escalate oil prices. PP&L St. 7-R, p. 54. Therefore, oil prices must rise significantly from current levels just to reach Dr. Jones' starting point.¹⁵

If this were not sufficient evidence concerning the validity of Dr. Jones' fuel price projections, and it is, Dr. Jones' view is fully supported by the leading expert in mineral economics, Dr. M. A. Adelman. Dr. Adelman concludes that “. . .[p]ractically all [mineral prices] have been flat or actually declining in the long run.”¹⁶ Taken to its logical conclusion,

¹⁴ OCA also argues that Dr. Jones did not use actual 1996 prices as a starting point. Dr. Jones used 1996 prices through November 1996 because that was all that was available to him. However, as noted in the text and in the record, actual prices have declined since 1996. PP&L St. 7-R, p. 43.

¹⁵ In its Brief, p. 39, OCA states that Dr. Jones' fuel prices increase at less than his 2.5% general rate of inflation. This is true only because Dr. Jones held fuel prices constant from their relatively high levels in 1996 until 1999 and then escalated those prices at 2.5%. As noted in the text and in the record (PP&L St. 7-R, p. 43), fuel prices peaked in 1996 and have continued to *decline* since then. As a result, a projection of flat prices until 1999 is conservative. As a further demonstration of declining fuel prices, PP&L notes that the EIA short-term (8/97) forecast used by PPLICA was revised downward once during the record, which unexplainably produced no change in forecast of market prices by PPLICA (Tr. 1751-52 (8/25/97)) and has since been revised downward (2/98) even further (EIA Short Term Energy Outlook, Third Quarter 1997 (updated August 1997 and February 1998)). The current EIA forecast projects oil prices through 1999 lower than those used by Dr. Jones. One problem with these forecasts is that they are dramatically influenced, as evidenced by recent changes, by current prices and current events. PP&L St.-R, pp. 40-46.

¹⁶ Tr. 1405-06 (8/25/97).

PPLICA must be presumed to conclude that Dr. Adelman is also biased and one of the PP&L co-conspirators.

PPLICA also criticizes Dr. Jones' projected spread between coal prices and oil and gas prices contending that it ". . . depicts the best situation for PP&L in this proceeding." PPLICA Brief, p. 45. Clearly, the spread between coal prices and oil and gas prices affects the calculation of stranded generation costs. However, it cannot be concluded that Dr. Jones is biased simply because he projected a lesser spread than DRI or EIA. The issue is what spread is justified by the evidence. As explained in PP&L's Brief, pages 71-74, coal price increases and oil and gas price increases are highly correlated over time. This is both supported by historic fact and by logic in that these are competing fuels which can be substituted in many applications. Dr. Jones' forecast maintains the historic relationship between coal prices and oil and gas prices. PP&L Exh. STJ-16a. In contrast, the DRI and EIA forecasted coal prices are not correlated with forecasted oil and gas prices, and there is no explanation why these forecasts predict such a deviation from experience. Again, having no evidence to support its position, PPLICA must argue bias.

Neither OCA nor PPLICA has provided any evidentiary basis to criticize Dr. Jones' fuel price forecast or any evidentiary basis to support the assumptions of the DRI and EIA forecasts. The DRI and EIA forecasts have been proven to consistently overstate fuel prices. Faced with these facts, OCA and PPLICA argue that fairness and equity require that the DRI forecast be used in this proceeding because it was used in *PECO*. PP&L notes that the validity of the DRI fuel price forecast was not at issue in *PECO*. Principles of due process and fundamental fairness require that the issue of the appropriate fuel price forecast to be used in determining market

prices and stranded generating costs *for PP&L* must be decided based on the record in *this* proceeding. As explained above, there is no reason whatsoever why input assumptions must be identical in the two cases. It is the result in both cases that must be fair.

3. Inflation

Both OCA and PPLICA challenge the inflation projections included in Dr. Jones' forecasts of energy prices. As explained in PP&L's Brief, page 65, the projection of inflation affects fuel prices because they are projected, at least by Dr. Jones, in terms of the increase in real fuel prices and increases in fuel prices due to inflation.¹⁷ Inflation projections also affect the projection of other costs, such as operation and maintenance ("O&M") expenses, which must be projected to determine future market prices.

PPLICA contends that Dr. Jones' projection that inflation will proceed at 2.5% per year is understated and argues that since DRI and EIA used 3.4% and 3.3% and these numbers are close, they must be correct. Large Customers Brief, p. 46. The problem is that the DRI and EIA forecasts are interrelated and have always been wrong, together, in the past. There is no reason to believe that they will be correct in the future. PP&L Exh. STJ-7-R, pp. 57-59; PP&L Exhs. STJ-14a, 14b, 19. As explained in PP&L's Brief, pp. 74-77, Dr. Jones' inflation rate is probably somewhat high given current circumstances and modern economic policy and the likely effects

¹⁷ As a further illustration of the effects of inflation on fuel prices, it was recently stated by the prominent oil economist John Lichtblau that current gasoline prices of about \$1.00 per gallon are lower in *real* terms (after excluding inflation and taxes) than at any time in the last 15 years (CNN Business Day, Feb. 24, 1998).

of restructuring on the electric power industry. The DRI and EIA forecasts not only are proven to have been wrong and in excess of the current inflation rate but also are totally without support in the record.

4. Nuclear Capacity Factor

OCA notes at page 34 of its Brief that the Commission concluded in *PECO* that OCA witness Smith's use of a market-wide nuclear capacity factor of 75% was conservative and increased *PECO*'s stranded costs as compared to use of the lower actual capacity factor experienced by *PECO*.¹⁸ While all of this is true, it provides no basis to use 75% in this case where PP&L's actual capacity factor exceeds 75%. See PP&L Brief, pp. 78-79; PP&L St. 7-R, pp. 105-106; Exh. STJ 30. If 75% were used here, the opposite result would occur for PP&L. PP&L's allowed stranded costs would be less than the stranded costs that would result from use of PP&L's higher market-wide capacity factor. Thus, while use of 75% by Mr. Smith in *PECO* was conservative and favorable to *PECO*, use of 75% here would understate PP&L's stranded costs and provides no basis to conclude that Mr. Smith provided a "balanced" analysis in this case.

¹⁸ Since nuclear units produce energy at relatively low energy prices, when they run more (i.e., higher capacity factor) the market prices of energy are lowered by displacing higher cost units.

5. Variable O&M Costs

At page 31 of its Brief, OCA states that PP&L escalated O&M expenses at 2.5% after 2001 and claims that productivity improvements should cause O&M expenses to rise more slowly than inflation.

There are two problems with this statement. First, it is factually incorrect. Dr. Jones projected variable O&M at 2% for 1997-2000, at 1.5% for 2001-2005, and at 2.5% only after 2006. This was done precisely to reflect productivity in a competitive market. PP&L St. 7, pp. 41-42.

The second problem is that OCA cannot have it both ways. It cannot complain that Dr. Jones' inflation rates are too low and then argue that variable O&M will be less than Dr. Jones' inflation. If the ALJ were incorrectly to adopt OCA's inflation of 3.5%, any productivity savings would have to be derived from this starting point. Nevertheless, Dr. Jones has demonstrated the reasonableness of his analysis by reflecting productivity gains.

There is a more fundamental problem with OCA's criticism. OCA states, correctly, that competition will produce incentives to reduce O&M costs. PP&L agrees and has reflected such savings in its market price analysis. However, Mr. Smith's projection of ever increasing market prices does not reflect the effects of competition on market prices. Again, OCA cannot have it both ways.

6. Reserve Requirements

OCA also notes in its Brief that its witness used an 18% reserve requirement, again implying that this demonstrates a conservative analysis. In fact, as explained in PP&L's Brief,

pp. 81-82, a decrease in the current PJM reserve requirement from 20% to 18%, if achievable, would increase market prices and reduce stranded costs. This is the result because maintaining the higher reserve requirement would result in construction of more new efficient plants sooner and lower energy prices. PP&L St. 7-R, pp. 73-76. Thus, it is Dr. Jones, not Mr. Smith, who has been conservative in applying the 18% reserve requirement in developing market prices and stranded costs.¹⁹

7. Plant Life Extensions

OCA also contends in its Brief, pages 31-32, that life extensions for the Keystone and Conemaugh generating stations should be employed in the market price analysis consistent with the proposal adopted in *PECO*. As explained in PP&L's Brief, pp. 119-120, PECO does not operate Keystone and Conemaugh. The facilities are operated by GPU, subject to oversight by the Keystone-Conemaugh Projects Office. In fact, PECO, like PP&L, is merely a joint owner. Any decision regarding a life extension of these facilities must be approved by 75% of all ownership shares. As a 20% owner, PECO cannot unilaterally extend the lives of these facilities.²⁰ PP&L St. 10-R, p. 37. OCA has offered no evidence whatsoever to demonstrate that: (1) any proposal or study has been considered or conducted by the joint owners to extend

¹⁹ Mr. Smith states in his testimony that the 18% reserve requirement might not be achievable by 2000. OCA St. 2, p. 18.

²⁰ Moreover, it should be noted that the Commission lacks jurisdiction over five of the owning companies whose ownership shares exceed 25%. The Commission, therefore, cannot require investments to extend the lives of these facilities. PP&L St. 10-R, p. 37.

the lives of these facilities; (2) any such proposal or study is planned; or (3) any capital is being set aside to extend the lives of these facilities. Moreover, lengthened lives are inconsistent with the depreciation lives approved for PP&L by the Commission in PP&L's last base rate case at Docket No. R-0094327.

C. Market Price Conclusion

PP&L's projections of the market prices of electricity are the only prices that are supported by the evidence in this proceeding. Dr. Jones' forecast is the best available forecast in this proceeding. It must, therefore, be adopted and employed by the ALJ in arriving at the calculation of stranded generation costs.

V. REVENUE UNDER REGULATION

A. PUC Jurisdictional Allocation

As explained in PP&L's Brief (p. 88), the Company began its determination of PUC jurisdictional allocation factors with the cost allocation study in PP&L Exhibit JMK 1. That study is completely consistent with the Commission's Order in PP&L's last base rate case at Docket No. R-0094327, and provides the basis for the Company's existing retail tariff rates. PP&L St. 3-R, p. 13. PP&L then adjusted its PUC jurisdictional allocation factors to reflect known and measurable changes to its wholesale bulk power contracts, its partial requirements wholesale contract with UGI Utilities, Inc. - Electric Division, and its full requirements contracts

with wholesale municipal customers. PP&L St. 3-R, p. 9.²¹ The Company's proposed, adjusted PUC jurisdictional allocation factors are shown in PP&L Exhibit JRS 1. These adjusted ratios were used to determine PP&L's overall level of stranded costs.

The OCA continues to press its recommendation that the Commission reject PP&L's proposed PUC jurisdictional allocation factors and instead use, without modification, the factors approved by the Commission in the Company's last base rate proceeding in 1995 to determine PP&L's jurisdictional book value at January 1, 1999. OCA Brief, pp. 26-29. In support, OCA relies heavily on the fact that in that proceeding, the Commission refused to reflect the full costs of the aforementioned future returning capacity in PP&L's former Energy Cost Rate ("ECR"). In OCA's view (OCA Brief, p. 28) (emphasis added):

The Commission rejected this proposal to allow ratemaking recognition *in advance* of the return of the capacity associated with wholesale contracts. It correctly viewed this request as a continuation of the excess capacity question and declined to prematurely judge whether this capacity would be used and useful in the future.

The OCA's reliance is completely misplaced.

Under traditional cost-of-service regulation, an electric utility's revenue requirement is determined based upon a complete review of its operations over the course of a "test year." See 52 Pa. Code §§ 53.52, 53.53 and 53.36. Generally, expenses incurred outside of the test year are

²¹ The changes include expiration of the following bulk power contracts according to the following schedules: (1) Jersey Central Power & Light Company -- ratably over a five-year period ending December 31, 1999; (2) Atlantic City Energy Company -- March 20, 1998; and (3) Baltimore Gas and Electric Company -- May 31, 2001. PP&L St. 3-R, p. 9.

excluded from recovery. *See, e.g., Pike County Light and Power Co. - Electric Division v. Pa. P.U.C.*, 77 Pa. Cmwlth. 268, 277, 465 A.2d 735, 739 (1983) (excluding changes in wholesale rates after the end of the historic test year in determining alternative purchase power expenses). In its last base rate case, PP&L originally proposed to recover through the ECR the costs associated with capacity returning from JCP&L *after* the end of the test year over a future five-year period. The Company's proposal was designed to avoid the need to submit periodic base rate filings. The Commission, however, refused to allow ratemaking recognition of the returning capacity because the capacity would return during a time period outside the test year at issue.

The Commission's Order in PP&L's last base rate case does not support OCA's recommendation in this proceeding. First, as explained above, the Commission's refusal to include the costs associated with future returning capacity was based on traditional test year ratemaking techniques. In this case, however, the limitations of the traditional test year concept no longer apply. Indeed, a fundamental goal of this restructuring proceeding is to determine the Company's future generation-related costs and revenues over the remaining life of its generating assets. Therefore, by its very nature, this proceeding clearly is intended to capture known and measurable changes in the future, including the returning capacity opposed by OCA.

Second, and perhaps more importantly, the OCA's recommendation is completely inconsistent with its own projections of future load growth. Specifically, OCA projects future load growth in PP&L's service area. The OCA's load growth projection increases the market revenues that PP&L will receive from future sales of electricity which, in turn, reduces PP&L's overall stranded costs. With respect to PP&L's proposed PUC jurisdictional allocation ratios,

however, the OCA reverses course and asserts that the Company's returning capacity cannot be reflected in the calculation of stranded costs because such capacity has not been shown to be necessary to provide future service to customers.

The OCA's approach is blatantly and fundamentally inconsistent and self-serving. Either PP&L's load will increase or it will not. If the Company's load increases (as the OCA itself contends), it will need additional capacity, including the returning capacity at issue, to serve that load.²² The ALJ should reject OCA's inconsistent arguments designed to deny PP&L recovery of appropriate stranded costs.

Third, as explained in PP&L's Brief (pp. 89-90), the record evidence plainly demonstrates that the returning capacity at issue is needed to address future capacity deficiencies and to maintain adequate reserves for reliability. PP&L St. 10-R, p. 29.²³ As costs which would have been recovered under traditional regulation, the costs associated with the Company's returning capacity should be fully reflected in the calculation of stranded costs.

²² It should be noted that PP&L originally entered into the wholesale contracts as a result of its 1982 base rate case at Docket No. R-822169. In that case, the Commission determined that PP&L had excess capacity as a result of the addition of Susquehanna Unit No. 1 to its system. The Commission disallowed recovery of all return on a 945 MW slice of PP&L's system. As a result of the Commission's 1982 Order, PP&L entered into medium-term capacity contracts. These contracts are designed to expire as PP&L needed additional capacity to meet increasing load. As explained in PP&L's Brief (pp. 88-90), the Company's plan to address the excess capacity resulting from the addition of Susquehanna Unit No. 1 has proven successful. The returning capacity is now needed to meet growing demand.

²³ Indeed, even with the returning capacity, PP&L's reserve margin will decline to the low end of the Commission's acceptable range at the end of the ten-year planning period. PP&L St. 10-R, p. 32.

Finally, while attacking PP&L's jurisdictional allocation, the OCA fails to provide any support for its own proposal to use 1995 jurisdictional allocation factors to determine book value in 1999. There is simply no rational basis for this mismatch. The OCA's use of a 1995 jurisdictional split to determine 1999 book value is nothing more than a blatant attempt to deny PP&L reasonable stranded cost recovery.

B. Cost of Capital

As noted in the Company's Brief (pp. 90-91), PP&L is entitled under traditional rate regulation to an opportunity to earn a fair rate of return on its investment in assets dedicated to public service. PP&L therefore included a return on its unrecovered investments in calculating its stranded costs. The Company's proposed rate of return is summarized in Table F of its Brief. As shown therein, PP&L's proposal reflects an 11.5% cost of common equity, which is identical to that allowed by the Commission in the Company's last base rate case at Docket No. R-00943271.

Several parties have proposed different cost of equity rates. The parties' specific recommendations are addressed fully in PP&L's Brief. As the Company explained (pp. 91-97), its proposed cost of common equity is reasonable, and in fact is 125 basis points lower than the 12.75% rate indicated in the independent analysis conducted by Mr. Paul R. Moul. *See* PP&L St. 6. While PP&L already has discussed and refuted the majority of the parties' recommendations, the Company believes that further discussion is necessary to clarify the erroneous approach adopted by the OTS in this case.

OTS calculated PP&L's stranded costs using an overall weighted average cost of capital that reflects a 6.6% cost of equity instead of the 11.5% rate proposed by PP&L. OTS Exh. 1, Sch. 2, p. 1; OTS Brief, p. 18. OTS utilized a 6.6% cost of common equity to reflect the reduced risk that PP&L allegedly will face in recovering its stranded costs through the CTC. The OTS' proposal would reduce PP&L's overall stranded costs by \$939.462 million. OTS Exh. 2, Sch. 2, p. 2; OTS Brief, p. 6. In determining the discount rate to be used in calculating the net present value of PP&L's stranded costs, however, OTS uses a 10.25% cost of common equity. OTS St. 3, pp. 3, 8-10; OTS Brief, p. 63.

First, as explained in PP&L's Brief (pp. 94-96), OTS' proposed use of a risk-adjusted cost of common equity to calculate PP&L's stranded costs is completely inappropriate. OTS' proposal confuses the cost of common equity relevant to the calculation of PP&L's stranded costs on the one hand, with the carrying charge relevant to the CTC and the recovery of such stranded costs on the other. The risk associated with the recovery of stranded costs through the CTC is irrelevant to the return on PP&L's unrecovered assets that should be reflected in calculating the Company's revenue requirement under traditional regulation.²⁴

Second, the OTS' recommended 6.6% cost of common equity is completely improper because it prevents PP&L from measuring its stranded costs based on full book value. PP&L St.

²⁴ Furthermore, as explained in detail in PP&L's Brief (pp. 95-96), OTS witness Gruber is incorrect in arguing that PP&L faces near zero risk in recovering its stranded costs through the CTC. The record evidence demonstrates that PP&L in fact faces a significant risk that it will not recover the full measure of its stranded costs.

19-R, p. 26. Indeed, the evidence demonstrates that OTS' proposal effectively reduces PP&L's relevant book value by 26.3%. *Id.*

The OTS' recommendations have the combined effect of substantially understating PP&L's overall stranded costs. OTS first applies an inappropriately low cost of common equity in calculating PP&L's underlying stranded costs, then compounds its error by discounting those costs to present value using a higher cost of equity. The OTS provides no rational basis for using one equity cost figure to calculate revenue requirements and a different (higher) rate to discount those revenue requirements to present value.

C. Regulatory Assets And Liabilities

The Company included \$354.326 million of generation-related net regulatory assets in its calculation of stranded costs.²⁵ PP&L Exh. JRS 1A, p. 1. Several parties have proposed a variety of adjustments, the majority of which are discussed fully in the Company's Brief (pp. 98-131). For the sake of brevity, PP&L will not repeat its discussion of the following issues in this Reply Brief: unrecovered energy costs (PP&L Brief, Section V.C. 1), taxes other than income (PP&L Brief, Section V.C.3), Department of Energy assessments (PP&L Brief, Section V.C.6), Susquehanna deferred refueling expenses (PP&L Brief, Section V.C.7), earnings on recovered SFAS 106 costs (PP&L Brief, Section V.C.8), rate case expenses (PP&L Brief, Section V.C.11),

²⁵ As explained in PP&L's Brief (p. 98, n.44), Section V of the briefing outline includes a number of issues that are not technically regulatory assets and liabilities. To ensure uniformity of presentation, however, the Company followed the outline but identified in its Brief those items that are not regulatory assets.

Safe Harbor (PP&L Brief, Section V.C.12), productivity adjustment (PP&L Brief, Section V.D.2), land escalation (PP&L Brief, Section V.D.3), capital additions (PP&L Brief, Section V.D.4), CWIP (PP&L Brief, Section V.D.5), taxes recoverable (PP&L Brief, Section V.D.6), and deferred taxes (PP&L Brief, Section V.D.7). As explained in PP&L's Brief, these claimed assets and liabilities are fully supported by substantial evidence and should be approved.

Several parties, however, raise arguments on brief which require a further response. These arguments are addressed below.

1. Employee Transition Costs And Pension Plan

PP&L's claimed stranded costs include additional severance and pension costs that the Company expects to incur from 1997 to 2001 resulting from a projected decline in the number of employees as PP&L prepares for a competitive market. PP&L determined a five-year amortization of the costs incurred in each year, and included the net present value of the generation-related deferred costs (\$17.106 million) in its calculation of stranded costs. PP&L St. 8, pp. 25-26; PP&L Exh. JRS 1, Tab F, p. 40.

PPLICA argues that the Commission should adopt a regulatory liability to reflect PP&L's alleged overfunded pension plan. Large Customers Brief, pp. 55-56. In support of its recommendation, PPLICA relies on the Commission's recent Order in the PECO restructuring proceeding, which created a regulatory liability equal to the amount by which PECO's pension plan was overfunded. *Id.* PPLICA's reliance is in error. As explained in PP&L's Brief (p. 103), PECO filed a Petition for Reconsideration of this issue. On reconsideration, the Commission

reversed its prior Order, eliminated the regulatory liability and increased PECO's stranded costs by \$217.347 million. PECO Order on Reconsideration, slip op, p. 14. The Commission explained (*id.*):

While we continue to agree that overfunding of pension expense can be credited to customers as a regulatory liability, we are persuaded to reconsider our decision. PECO's approach is reasonable under the circumstances because PECO has provided an alternative methodology to credit customers with the economic benefit of the overfunding through the increased valuation of its stranded assets. We decline to retain the regulatory liability

In the instant case, the evidence establishes that PP&L has fully credited customers with the economic benefit of its pension plan overfunding by reducing its annual claimed pension expense. PP&L St. 8-R, pp. 31-32. Therefore, PPLICA's proposed adjustment should be rejected consistent with the Commission's Order on Reconsideration in the PECO proceeding.

2. Fossil Plant Decommissioning

A number of parties oppose the Company's claim for fossil plant decommissioning costs. Generally, these parties recommend that the Commission deny PP&L's claimed fossil decommissioning costs, arguing that the Superior Court's decision in *Penn Sheraton Hotel v. Pa. P.U.C.*, 198 Pa. Super. 618, 184 A.2d 324 (1962), precludes the recovery of such future costs under traditional regulation. *See* OCA Brief, pp. 46-47; Large Customers Brief, pp. 56-60 and Appendix A, p. 2. The parties' proposed adjustment is in error and should be rejected.

First, the parties ignore the plain language of the Act. As explained in PP&L's Brief (p. 106), Section 2803 of the Act plainly defines stranded costs as including the "retirement costs

attributable to the utility's existing generating plants" other than nuclear decommissioning costs.

66 Pa.C.S. § 2803. Therefore, the Act unambiguously provides for the recovery of fossil decommissioning costs. Indeed, OCA witness La Capra conceded this point on cross-examination. Tr. 1787-1788 (8/27/97).

Second, the parties' reliance on *Penn Sheraton* is misplaced. In fact, *Penn Sheraton* supports the Company's claim. As explained in PP&L's Brief (pp. 107-108), *Penn Sheraton* precluded the advance recovery of retirement costs *but allowed the recovery of actual retirement costs*. Under PP&L's proposed regulatory method of calculating stranded costs, the Company's claimed fossil plant decommissioning costs are reflected *at the point in time when they actually would be incurred*. PP&L St. 3-R, pp. 31-32. Therefore, the *timing* concerns raised in *Penn Sheraton* are fully addressed by PP&L's proposal. In any event, to the extent that *Penn Sheraton* is inconsistent with the Act, it is no longer good law.

3. Nuclear Plant Decommissioning

The OCA and PPLICA oppose both the Company's claimed nuclear decommissioning costs and the Company's proposal to recover such costs over the remaining life of its nuclear units through a "wires" charge.²⁶ OCA Brief, pp. 58-59; Large Customers Brief, pp. 60-61. Although PP&L has largely addressed the concerns raised by the parties in its Brief (pp. 109-113), two points must be emphasized.

²⁶ This item is an operating cost, not a regulatory asset.

First, OCA asserts that PP&L's proposed distribution charge is unnecessary because the Company will be able to recover fully its nuclear decommissioning costs over the seven-year CTC period. OCA Brief, p. 59. The OCA's recommendation, however, necessarily assumes that its proposed market price and stranded cost calculation are correct. If OCA's proposed market price turns out to be overstated, PP&L may not recover all of its nuclear decommissioning costs. The OCA's proposal risks underrecovery of PP&L's nuclear decommissioning costs, is contrary to the public interest and should be rejected.

Indeed, acceptance of the OCA's recommendation would jeopardize PP&L's current exemption from Nuclear Regulatory Commission financial assurance requirements. Because the OCA's proposal fails to ensure the recovery of nuclear decommissioning costs through rates established by the Commission, PP&L could be forced to pre-fund such costs. This additional obligation would impose a significant burden on customers. PP&L St. 3-R, pp. 29-30.

Second, the Environmentalists continue to recommend that the Commission adopt an "incentive framework" under which nuclear decommissioning costs are shared between shareholders and customers. Public Interest Parties Brief, p. 33. This proposal is clearly inconsistent with the Act, which states that the Commission "*shall*" provide for recovery of nuclear decommissioning costs. 66 Pa.C.S. § 2808(c)(1) (emphasis added). The Act makes absolutely no mention of a sharing of these costs between shareholders and customers. The Environmentalists' proposal is inconsistent with the Act and the public interest, and therefore should be rejected.

4. SFAS 109 (Investment Tax Credit)

As explained in PP&L's Brief (p. 118), the methodology utilized by the Company to reflect the effect of its investment tax credit ("ITC") regulatory liability is unopposed. However, OCA proposes an adjustment to the Company's claim to reflect OCA's recommended jurisdictional allocation factors. OCA Brief, p. 45. As explained in Section V.A above and in PP&L's Brief (pp. 88-90), the OCA's proposed adjustment to PP&L's jurisdictional allocation factors is inappropriate and should be rejected. Consequently, the Company submits that its claimed ITC regulatory liability should be approved.

5. Retirement Of Generating Plant

The OCA continues to recommend that the Commission adopt life extensions for both the Keystone and Conemaugh generation facilities consistent with its recent Order in the PECO restructuring case. OCA Brief, pp. 31-32. The OCA's proposal is completely inappropriate and unsupported.

D. Other Revenue Issues

1. A&G Expenses

OCA recommends that the Commission exclude \$402.7 million of PP&L's claimed generation-related Administrative and General ("A&G") expenses. OCA St. 4, p. 13; OCA St. 1, p. 16. Instead, in calculating stranded costs under the asset value method, OCA adds these costs to its projected market price of energy. OCA St. 4, pp. 13-14. Although PP&L's Brief (pp. 122-

124) addresses the OCA's proposal, the Company believes that further discussion of this issue is necessary.

As its name suggests, the market price of energy will be determined by competitive market forces. It makes absolutely no sense to suggest, as OCA does, that suppliers will be able to "add" costs to the market price and sell at the adjusted price. The market will set the price for energy. Suppliers, including PP&L, will be "price takers." If a supplier cannot recover all of its costs through the market price, it will be unable to participate in the market, or will have to participate at a loss.

The OCA's recommendation erroneously attempts to import traditional ratemaking concepts into a competitive environment. As explained above, however, PP&L will not be able to increase the market price of energy to include these costs. The market price of energy cannot be adjusted in the same manner as regulated rates. OCA's proposal, therefore, will effectively disallow PP&L's claimed, unavoidable A&G expenses.

VI. DETERMINATION OF PRESENT VALUE

The OCA asserts that PP&L overstates its overall level of stranded costs by \$880 million because the Company applied an *after-tax* discount rate to calculate the present value of its *pre-tax* revenue requirement. OCA Brief, pp. 21-23. The evidence establishes that the OCA's proposed adjustment is in error and would substantially understate PP&L's stranded costs.

As explained by PP&L witness Guth, stranded costs are analogous to economic damages because they represent the decrease in value caused by the transition to a competitive market. PP&L St. 19-R, p. 20. As the equivalent of economic damages, the purpose of stranded costs is to compensate PP&L and restore the Company to its prior position, *i.e.*, to make PP&L “whole.” PP&L St. 19-R, p. 21. To achieve this result, two facts must be taken into account. First, future cash flows and the return earned on those cash flows are taxable. Thus, future cash flows must be discounted to present value using an after-tax discount rate to account for these tax effects. Second, because damage awards are taxable, cash flows also must be adjusted to pre-tax levels so that PP&L is made whole after taxes are paid. PP&L St. 19-R, p. 21. Consistent with Mr. Guth’s testimony, the record evidence establishes that PP&L’s proposed application of an *after-tax* discount rate to its *pre-tax* revenue requirement streams calculates the exact amount of stranded costs necessary to meet its ongoing obligations, including the income taxes due on equity returns.

PP&L witness Schadt provided a simple example on rebuttal that clearly illustrates this point. Mr. Schadt’s example assumed a generating plant with a book value of \$150 and a tax basis with 3 years of depreciable life remaining. Further, Mr. Schadt assumed PP&L’s tax rate of 41.4935% and assumed PP&L’s proposed capital structure, 9.46% weighted cost of capital and 7.92% after-tax weighted cost of capital. Finally, Mr. Schadt assumed annual market revenues of \$60 and annual O&M costs of \$10. PP&L St. 8-R, pp. 10-11.

Using these assumptions, Mr. Schadt calculated PP&L’s stranded costs using *pre-tax* revenue requirement streams (*i.e.*, grossed up for income taxes), and discounted the resulting

amounts to present value using the Company's proposed 7.92% *after-tax* weighted average cost of capital. Under PP&L's proposed regulatory method, the Company's stranded costs in this example are \$20.31 in year 1, \$12.54 in year 2 and \$5.81 in year 3, for a total of \$38.66 on a net present value basis. PP&L St. 8-R, p. 12. *The evidence demonstrates that this amount (if collected in the first year), combined with market revenues, would be sufficient to meet PP&L's obligations, including income taxes, over the entire three-year period of the example with \$0 left over.* PP&L St. 8-R, p. 13.

In sum, PP&L's proposed method properly determines the *exact* amount of stranded costs required to meet the Company's obligations, including income taxes. In contrast, the OCA's proposal would effectively preclude recovery of stranded costs sufficient to cover PP&L's future income tax obligations on future equity returns. In essence, the OCA's proposal would reflect income taxes in the revenue requirement, but would offset those amounts by discounting stranded costs to present value using a higher, pre-tax discount rate. The OCA's recommendation substantially understates PP&L's overall stranded costs and fails to provide sufficient revenues to cover the Company's future tax obligations.

VII. RECOVERY OF STRANDED COSTS

A. Intervenors' Criticisms of PP&L's CTC are Without Merit and Should be Rejected

In their briefs, several intervenors criticized PP&L's design of its CTC. These criticisms are directed toward PP&L's proposal that stranded costs be recovered as rapidly as practical under the Act.

The Environmentalists contend, at page 30 of their Brief, that PP&L's CTC should be "level" over the recovery period. In support of their contention, the Environmentalists cite Section 2808(f) of the Act, which addresses reconciliation. A review of this section, however, reveals no support for the Environmentalists' contention; the matter is simply not addressed.

The Environmentalists, at page 30 of their Brief, also contend that a "level" CTC most closely resembles the market. This contention also is clearly incorrect. Indeed, the CTC does not represent market forces at all. Instead, it is a vestige of regulation that will disappear at the end of the transition period. Completion of stranded cost recovery at the earliest practical date will provide customers with unfettered access to a competitive generation market. Indeed the Environmentalists themselves at page 31 of their Brief indicate that the CTC is "a distortion of the true competitive market, [and] it should be with us no longer than necessary."

OCA, at pages 70-72 of its Brief, attempts to support its proposal that the CTC be designed using a blend of a levelized CTC method and a levelized percentage method. Using OCA's stranded costs, this proposal generates a 20% reduction in PP&L's rates from present rate levels in the first year of the transition, followed by steady rate *increases*, so that, by the end of the transition period in 2005, rates would be only 13 percent below present levels. As PP&L explained, such an approach is likely to cause customer confusion and dissatisfaction in addition to causing severe financial hardships for PP&L. PP&L Brief, p. 138. Customers will not be expecting to receive rate increases under competition.

AARP criticizes PP&L's "bottom up" design of the CTC. AARP's argument erroneously assumes that under PP&L's rate design, the projected market price of energy is the residual

component of the total rate and is established only after PP&L has recovered all of its stranded costs. AARP Brief, pp. 5-7. Reference to the exhibit cited by AARP, however, demonstrates the erroneous nature of AARP's contention. In fact, the CTC is the residual component of the total rate remaining *after* the transmission and distribution charges and the projected market price of electric energy have been subtracted. Indeed, because PP&L made the CTC the residual component of the rate, Commission approval of PP&L's Restructuring Plan would leave more than \$400 million of PP&L's stranded costs unrecovered.

VIII. RATE DESIGN AND TARIFFS

A. Customized Rate Design

At page 9 of its Brief, the Pennsylvania Petroleum Association and the Pennsylvania Association of Plumbing, Heating, Cooling Contractors, Inc. ("PPA") criticize PP&L's customized rate design ("CRD") under which one-half of stranded cost would be recovered through a fixed monthly CTC with the remaining half recovered through a usage-based rate. PPA contends, without evidentiary citation, that PP&L's proposed CRD "destroys the nexus between cost incurrence and cost recovery." PPA Brief, p. 9. In making this contention, PPA ignores the fact that a substantial portion of PP&L's stranded generation costs are related to its *investment* in generating facilities, which give rise primarily to a fixed, not variable, annual revenue requirement consisting of depreciation accruals, return, income taxes, property taxes, payroll, *etc.* Therefore, contrary to PPA's contentions, PP&L's CRD reflects cost incurrence more accurately than a CTC that recovers stranded costs solely through a usage charge.

At page 84 of its Brief, OCA criticizes PP&L's CRD based on OCA's assumption that the marginal cost of transmission and distribution facilities is greater than the embedded cost of such facilities. In essence, OCA contends that PP&L's CRD is not economically efficient because it may encourage increases in consumption, as compared with a traditional usage-based rate design for a CTC, which may cause the need for additional transmission or distribution facilities. OCA continues that such additional facilities may require future rate increases if incremental transmission and distribution costs exceed embedded transmission and distribution costs. In making these contentions, however, OCA has simply ignored PP&L's response – PP&L is not planning any significant investments in its transmission and distribution systems. Tr. 824-25 (8/19/97). Therefore, there is no basis for any conclusion that increased electric usage by customers during the transition period, when the CTC is in effect, will cause increases in rates. In any event, economic development in Pennsylvania, which often is associated with increased electricity consumption, is a major objective of the Act. That goal is furthered, not hindered, by the CRD.

B. Interruptible Service Discounts Must Be Limited to Customers Purchasing Electric Energy from PP&L

At pages 71-77 of its Brief, PPLICA persists in its contention that PP&L must be required to offer deep generation-related rate discounts to customers who purchase their generation from other suppliers. Despite a lengthy and strident argument, PPLICA does not address the fundamental flaw in its contention. PPLICA does not dispute the basic proposition that deep discounts for interruptible service are justified only to avoid the cost of constructing

additional generation to meet peak load and to avoid the incremental cost of generation at times when purchased power is expensive or the units with highest operating costs are on line. Under PPLICA's erroneous contention, customers with interruptible service would receive a deep discount in PP&L's rates for transmission and distribution service and the same customers would be able to negotiate a second discount from their electric energy provider for interruptible generation service. While second discount may be justified, a transmission and distribution service rate discount based on generation-related benefits, clearly is not.

Contrary to PPLICA's contentions, PP&L is proposing to continue discounted interruptible service for customers currently receiving such service. Those interruptible service customers, however, would be required to purchase their electric generation from PP&L so that PP&L and its last resort customers would receive the benefits from interruptible service.

PPLICA, at page 72 of its Brief, cites the Commission's Order in *PECO* in support of its position. It must be emphasized, however, that PP&L's position, that interruptible service discounts providing the benefits of interruptibility be available only to customers who purchase their electric energy from PP&L, is, with only one exception, consistent with the Commission's Order in *PECO*. That is, the Commission ordered PECO to implement an interruptible service rate for customers who purchase their electric energy from others, although the discount would be limited to transmission and distribution savings. *PECO*, pp. 117-18. PP&L agrees with this approach in principle, but such savings on the PP&L system are essentially non-existent and the associated rate discount would be extremely small. PP&L St. 11-R, p. 8.

PPLICA contends erroneously at page 72 of its Brief that: "The smaller stranded cost liability associated with current interruptible customers is evidenced by the lower CTC contained in the PP&L's proposed 'unbundled' interruptible rate schedules compared to PP&L's firm rate schedules." Contrary to PPLICA's unsupported contentions, the lower CTC costs in PP&L's interruptible service rate schedules are merely a result of PP&L's bottom-up method for calculating the residual CTC. It is an arithmetic fact that subtracting a projected market price from a discounted bundled rate will produce a lower CTC than subtracting the same projected market price from an undiscounted rate. This arithmetic fact does not justify PPLICA's position.

C. Economic Development Rates Should Be Continued

As PP&L explained at pages 150-53 of its Brief, the Company has proposed that its economic development rates, including EDI, IDI, Price Response Service and the Demand Free billing option, be continued to the end of the transition period. OCA, however, has proposed that these rates be terminated under the existing schedule as set forth presently in PP&L's tariff for bundled rates. PP&L's proposal to continue these rates through the transition period is based on its interpretation of Section 2804(4) of the Act, which establishes caps on a utility's rates through the end of the transition period. These rates caps are set at levels equal to the utility's total charges approved by the Commission as of the effective date of the Act, January 1, 1997. For a customer receiving service under one of PP&L's economic development rates on January 1, 1997, elimination of that rate will cause the customer's total charges to increase. Assuming PP&L's proposals in this case are approved by the Commission, that increase will cause the

customer's total rates to exceed the January 1, 1997 rate cap level. Accordingly, the OCA's proposal should be rejected.

D. Residential Thermal Storage Rates Should Be Limited to Customers Who Obtain Electric Energy Under Regulated Rates

At pages 3-4 of their Brief, SER and Gilberton contend that PP&L's proposal to limit the availability of the Residential Thermal Storage ("RTS") rate to customers who obtain their electric energy under regulated rates is unreasonable. In making these contentions, SER/Gilberton ignore the rationale for the existence of the RTS rate.

The RTS rate was implemented by PP&L in the 1980s to decrease on-peak utilization and increase off-peak utilization of PP&L's generation resources. By decreasing on-peak utilization, construction of additional generating facilities could be delayed. By increasing off-peak usage, fixed costs could be spread over a greater number of billing units, thereby benefiting customers. PP&L St. 11-R, p. 15. As explained above in conjunction with other rate schedules and billing options, it makes no sense for PP&L to offer a rate discount designed to encourage customers to use generation efficiently to customers who obtain their electric energy from other suppliers. It is those other suppliers who will benefit from the load shift created by the RTS service, not PP&L or its last resort customers.

E. PP&L's Proposed Changes to the Terms and Conditions of Interruptible Service Are Appropriate Responses to Changes in the Industry

In its Brief, at pages 84-89, PPLICA challenges certain rules and conditions of interruptible service. Some of these rules and conditions are new, others are not.

One of the rules about which PPLICA complains is the existing tariff rule that permits PP&L to interrupt service for economic reasons. PPLICA complains about such interruptions despite the fact that economic interruptions have been permitted for many years. PP&L Exh. OGK 1, pp. 30B, 30D. At page 85 of its Brief, PPLICA argues that such interruptions did not occur prior to 1997. Although PPLICA's factual statement may be correct, PP&L's forbearance in prior years did not create any entitlement by PPLICA to indefinite forbearance of economic interruptions of electric energy. Interruptible service customers receive substantial rate discounts in return for agreeing to interruptions of service under specified circumstances. They cannot now complain when these interruptions occur.

At pages 86-87 of its Brief, PPLICA contends that PP&L's proposed tariff rule governing an interruptible service customer's right to "buy through" an economic interruption is unreasonable. PP&L's present tariff rule calls for an interruptible service customer to pay the PJM billing rate applicable to energy used by the customer during the "buy through" period. PP&L has proposed to change the tariff rule to require the interruptible service customer to pay the applicable estimated spot price of energy on the PJM system during the "buy through" period. Interestingly, PPLICA never contends that the PJM billing rate does not reflect PP&L's actual cost, nor does PPLICA contend that charging a spot price would be economically incorrect. Rather, PPLICA contends only that use of a spot price is unfair because interruptible service customers may not know in advance what the spot price will be. PPLICA's objections should be rejected for two reasons. First, the spot price is more reflective of actual circumstances than a pre-established rate. Second, the PJM tariff currently is being reviewed by FERC, and the

final provisions governing sales and purchases needed to cover electric usage by interruptible service customers during economic interruptions have not been determined. PP&L St. 12-R, p. 3. Therefore, reference to a spot price in PP&L's tariff is appropriate.

PPLICA also contends that the spot price provision will violate the rate caps in the Act. PPLICA's concerns are difficult to understand because a presently unknown spot price may or may not exceed a presently unknown PJM billing rate, if one even continues to exist under the PJM tariffs that are currently being reviewed at FERC. There is no legitimate rate cap issue here. The real issue is whether a spot price provides an appropriate basis for pricing power purchased by an interruptible service customer to "buy through" an economic interruption. Because such a "buy through" is a short-term, unplanned transaction, a spot price properly reflects the conditions under which the purchase is made, and is an appropriate basis for establishing the "buy through" payment.

PPLICA's only other complaint on the proposed spot price "buy through" provision is that PP&L may not accurately estimate the spot price. PPLICA assumes, without basis, that any estimating error would be high to the detriment of the interruptible service customer. Large Customers Brief, p. 87. There is no reason to believe that any estimating errors will be either substantial or one-sided. PP&L will, in good faith, estimate the spot price as accurately as possible. The only alternative would be to wait until actual spot prices are known which may be long after the transaction has taken place, thereby defeating the ability of large customers to weigh the "buy through" option against an interruption. PP&L's proposed rule change is an

appropriate response to changes in the electric generation market on the PJM system and should be approved.

IX. PHASE-IN ISSUES

Various parties argued that the Commission should adopt in this proceeding the accelerated phase-in schedule adopted by the Commission in the PECO Order. *PECO Order*, pp. 46-49. *See, e.g., Large Customers Brief*, pp. 93-95; *Competitive Intervenors Brief*, pp. 26-27. Under that phase-in plan, two-thirds of PP&L's customers would have choice "as of" January 2, 1999; all of its customers would have choice "as of" January 2, 2000. Even though a similar phase-in was adopted in *PECO*, it must be rejected here. In the absence of PP&L's concurrence with such a phase-in, the General Assembly's intent is clear — the phase-in schedule set forth in the Act must govern. 66 Pa.C.S. § 2806(b).

The analysis set forth in the Electric Distributors Brief, pp. 7-12, is in accord with PP&L's interpretation of Section 2806 and should be adopted. *See PP&L Brief*, pp. 159-61. While the Commission is normally accorded a great deal of discretion in administering and interpreting the Public Utility Code, *see, e.g., Chappell v. Pa. P.U.C.*, 57 Pa. Cmwlth. Ct. 17, 425 A.2d. 873, 875 (1981), the phase-in of choice was clearly one of the central compromises that supported passage of the Act. A post-hoc change in that phase-in schedule breaks faith with the basic bargain that permitted customer choice to be adopted in the first place.

Sound principles of statutory interpretation require legislative language not be treated as a nullity:

The object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly. Every statute shall be construed, if possible, to give effect to all of its provisions.

66 Pa.C.S. § 1921. *See Orson, Inc. v. Miramax Film Corp.*, 79 F.3d 1358, 1374 (3rd Cir. 1996) (“The courts give effect to all sections of an act rather than interpreting the language in such a way that one clause is rendered superfluous or meaning less for the benefit of another.”) Indeed, the Supreme Court recently re-emphasized that “Judges should hesitate . . . to treat as [surplusage] statutory terms in any setting. . .” *Bailey v. United States*, 116 S. Ct. 501 (1995) (citing *Ratzlaf v. United States*, 510 U.S.135 (1994)). The Court specifically applied “the cannon of construction that instructs that ‘a legislature is presumed to have used no superfluous words.’” (citing *Platt v. Union Pacific R. R. Co.*, 99 U.S. 48, 58 (1879)).

There is no way to give *all* customers choice on January 2, 2000, without treating Section 2806(b)(3) of the Act as nothing more than legislative *dicta*. No court or agency has authority to do that.

Finally, there is simply no basis to apply in this case the Commission’s decision to accelerate the phase-in adopted in *PECO*. First, this issue was never addressed in *PECO*. Indeed, all parties that signed the partial settlement and the supplier coalition that challenged that settlement accepted the accelerated schedule ultimately adopted by the Commission. The Commission was not required to address the fundamental principles of an “orderly” transition to competition that permeate the Act and underlie the phase-in established by Section 2806. *See* 66 Pa.C.S. § 2804(14). Second, while *PECO*’s high rates might have supported a more rapid

transition to competition, PP&L's low rates do not provide any basis for ignoring the straight-forward statutory scheme.

The Large Customers renew PPLICA's proposal for a pro-rata reduction of load for industrial customers where, after a "first-come-first served" phase-in, a rate class is oversubscribed. They argue that this would eliminate competitive distortions that may arise from the phase-in. *See* Large Customers Brief, pp. 93-94. PP&L already addressed this proposal. *See* PP&L Brief, p.161. The Large Customers add nothing new to their argument. Rather, as before, they are seeking to solve a problem that may never exist. The Commission can address any issues of competitive distortion that may arise in "other appropriate administrative proceedings." 66 Pa.C.S. § 2806(b)(4). Unless and until such cases emerge and those cases cannot be resolved by PP&L in cooperation with the affected customer, there is no need for any Commission action, particularly one, such as suggested by the Large Customers, that would turn the transition into an administrative nightmare.

OCA argues that during the phase-in all PP&L customers, including those not yet eligible for choice, should be charged market-based generation rates. *See* OCA Brief , pp. 81-83. The OCA would have the Commission reject its conclusion adopted in *PECO* and reaffirmed on reconsideration that non-shopping customers will continue to pay regulated rates. *PECO* Order at 133-34; *PECO* Reconsideration Order at 21-22. In the *PECO* Reconsideration Order, the Commission carefully laid out a basic truth that OCA ignores — there is nothing wrong or unfair in charging lawful, tariffed regulated rates approved by the Commission:

PECO, as an EDC, remains a regulated utility and may only offer Commission-approved, tariffed rates. In this proceeding, no party

provided evidence that PECO's regulated rates should be reduced under traditional ratemaking. Protected by the statutory rate caps, customers who do not shop remain regulated rate customers of PECO on the same terms and conditions of services unless changed by Commission Order. As summarized on page 46 of the December 23, 1997 Order, the "shopping credit" is not relevant to a customer who does not shop. Customers who do not shop pay the approved tariffed rate divided into unbundled generation, transmission, and distribution charges. PECO Reconsideration Order, p. 21.

By providing for generation rate caps that can last as long as nine years, the General Assembly has amply protected non-shopping last resort customers. *See* 66 Pa.C.S. § 2804(4). If capped regulated rates were adequate to protect non-shopping PECO customers, they are more than adequate to protect non-shopping PP&L customers. *See* PP&L Brief, pp. 26-38.

PP&L urges the Commission to do what the Act calls for — adopt regulations defining the manner and price of last resort service to be effective at the end of the phase-in period after it has had an opportunity to carefully consider the best way to protect these customers consistent the transition to a competitive market.²⁷

²⁷ As explained in PP&L's Brief, PP&L proposed a Purchase Generation Cost Rate ("PCGR") that would include the market price of electricity purchased for last resort service customers and the costs of administering the Company's electricity procurement program. *See* PP&L St. 3-R, p. 40. PP&L's proposal is fully consistent with Section 2807(e)(3), which provides that the provider of last resort service shall acquire energy at "prevailing market prices" and recover "all reasonable costs." The PGCR would not become effective until the end of the phase-in period. Until that time, PP&L would continue to charge non-shopping customers its Commission-approved, tariffed rates.

X. CODE OF CONDUCT AND COMPETITION ISSUES

As described in PP&L's Brief, pp. 162-181, and in the testimony of PP&L witnesses Robert M. Geneczko, Joseph P. Kalt and Alfred E. Kahn, PP&L's Retail Access Code of Conduct, coupled with its FERC-approved Order No. 889 Code of Conduct, adequately protect against the types of abuses envisioned by a number of the intervenors. The Competitive Intervenors support the code of conduct adopted by the Commission in the PECO decision (Enron alone would add a provision prohibiting the use of the PP&L name by the generation supply group). They propose that the Commission adopt the PECO interim Code of Conduct for application to PP&L, with an additional section addressing joint marketing.

Because PP&L's proposed Code of Conduct contains adequate safeguards, and because this issue is being addressed on a state-wide basis (*see*, Commission's Notice of Proposed Rulemaking Regarding the Establishment of Competitive Safeguards for the Pennsylvania Electric Industry, at Docket No. L-980132), the Commission should refrain from rewriting PP&L's proposed interim Code of Conduct in this case. Many of the issues that concern the Competitive Intervenors are more than adequately addressed in PP&L's Code of Conduct and soon will be examined on a state-wide basis through the Commission's rulemaking proceeding.

PP&L addressed all of the intervenor's concerns in its Brief. The following discussion clarifies PP&L's position on certain issues raised by intervenors.

A. Disclosure of Customer Information

The Large Customers emphasize in their Brief that customer information, including electricity usage, load profile and electricity price, must be subject to strict confidentiality

constraints; they propose that such information must be revealed only at the request of the customer and only to the parties authorized by the customer. Large Customers Brief, pp. 95-96. PP&L's proposed Retail Access Code of Conduct addresses this concern. It provides that the electric distribution company ("EDC") will release information to a supplier concerning individual customer account history and individual customer consumption only after written approval from the customer. PP&L St. 13-R, Exh. RMG-4.

B. Use of the "PP&L" Name

The Competitive Intervenors ask the Commission to bar PP&L's competitive affiliates from using PP&L's brand name. To the extent an affiliated supplier uses PP&L's name, the Competitive Intervenors propose that the electric generation supplier ("EGS") should compensate the EDC for the value associated with the name.

As described more fully in PP&L's Brief, pp. 169-173, *prohibiting* PP&L's Generation Supply Group from using the PP&L name will lead to customer confusion and may deceive customers. Mandating the use of a different name would deprive consumers of the added assurance of quality and price derived from putting the parent company's reputation at stake. Moreover, the name "PP&L" and the good reputation associated with the name are shareholder assets, and, as such, are not included in the rate base. Ratepayers, thus, have no claim to these assets and cannot be harmed if PP&L continues to use its name, or if PP&L's affiliate uses the name.

The Act, like the antitrust laws, does not mandate that the various advantages and disadvantages of different EGSs be leveled. *See, e.g., United States v. Syufy*, 903 F.2d 659, 668 (9th Cir. 1990); *Olympia Equip. Leasing Co. v. Western Union Tel. Co.*, 797 F.2d 370, 374 (7th Cir. 1986). The Act was designed to yield benefits to consumers, not to be an assistance program for allegedly disadvantaged competitors.

As described in PP&L's Brief, Enron's suggestion that the Generation Supply Group pay for the use of the PP&L name is inappropriate for several reasons. First the utility's name is not a ratepayer asset, as discussed above. Second, a percentage royalty, which is one type of royalty that has been proposed in other jurisdictions, does not bear any relationship to costs or benefits from the association of the affiliate with the utility and would be difficult, if not impossible, to value. It is also questionable whether the Commission has the authority to require an unregulated, private business to pay a royalty to an affiliated utilities' utility's ratepayers.

C. Supply Obligations to Customers Not Eligible to Choose Alternative Suppliers During the Phase-In and to Customers Who Choose not to Choose

The Competitive Intervenors would have the Commission require that all customers who are ineligible for choice or who do not choose must be served by PP&L's Electric Delivery Group under tariffed rates, not by PP&L's Generation Supply Group. Competitive Intervenors Brief, p. 16, n.30. The Competitive Intervenors' concern is misplaced. PP&L will continue to serve customers not yet eligible to choose under traditional regulated rates. Tr. 743 (8/19/97). This treatment is consistent with that adopted in the PECO Order. PECO Order, pp. 132-134; Order on Reconsideration, pp. 20-21.

D. Metering, Billing and Collection Services

The Competitive Intervenors argue that the Commission should fully unbundle metering and billing and customer service. These intervenors assert that there is no potential downside for customers which could result from the fully competitive provisioning of billing services. PP&L; the Electric Distributors and the International Brotherhood of Electrical Workers, Local 1600 -- (“IBEW”) oppose these proposals. PP&L Brief, pp. 177-78 Electric Distributors Brief, pp.14-18; IBEW Brief, pp. 3-23.²⁸

As noted by the Commission in the PECO Order, the Commission has addressed these issues through various working groups, rulemakings and Orders. Although section 2804(3) of the Act provides that “the Commission may require the unbundling of other services” in addition to basic unbundling of transmission, distribution, and generation services, the Commission concluded in the PECO Order that Section 2807 of the Act, which sets forth the duties of electric distribution companies, does not assume that any additional unbundling is required and that “EDCs continue to have the duty to provide all distribution services, including metering and billing, in compliance with existing Commission requirements.” PECO Order pp. 138-39. The record established in this proceeding mandates the same conclusion.

The Commission also recognized in the PECO Order that there may be potential benefits to unbundling billing but concluded that it is inappropriate to unbundle billing based on the record presented in that proceeding. The Commission directed PECO to provide all billing

²⁸ Of course, if the Commission unbundles metering and billing, EDCs must be allowed to recover the associated stranded costs.

services, including billing for generation services, unless a customer indicates a preference to receive a separate bill directly from the supplier for generation services. PECO Order p. 139.

The record here mandates the same conclusion.

As indicated the Commission's rulemaking at Docket No. L-00970120, the Commission has decided that it is unnecessary to unbundle metering as a competitive service at this time. In that rulemaking, the Commission outlined the standards and procedures to ensure that customers have real options for competitive metering while retaining all physical work related to metering as a regulated EDC function.

New Energy Ventures ("NEV") argues that PP&L should be required to implement consolidated billing for multiple meter customers in accordance with the Commission's decision in PECO. According to NEV, customers with multiple meters are discriminated against compared to customers with similar loads served through a single meter. NEV Brief, pp. 1-5. Contrary to NEV's contention that "although its proposal is silent on th[is] issue, PP&L apparently does not contest its adoption by the Commission," NEV Brief, pp. 4-5, PP&L does object to this proposal, in part because it would lead to cost-shifting prohibited by the Act. NEV's proposal should be rejected.

E. Treatment of Partial Payments by Customers

The Competitive Intervenors argue that when the EDC provides a single bill, partial payments should be applied on a pro rata basis. As discussed in PP&L's Brief, p. 179-80, the Commission has already considered and rejected the pro rata payment approach advocated by

Enron and the other Competitive Intervenors. *See* Final Order Re: Guidelines for Maintaining Customer Services at the Same Level of Quality Pursuant to 66 Pa. C.S. § 2807(D), and Assuring Conformance with 52 Pa. Code Chapter 56 Pursuant to 66 Pa. C.S. § 2809(E) and (F) (entered July 11, 1997) (“Customer Services Order”). Instead, the Commission decided that the “priority” method of applying partial payments is preferable to the “pro rata” method, particularly in terms of administration and compliance with applicable Chapter 56 regulations. Customer Services Order at 32-33.

XI. CUSTOMER EDUCATION

Several of the intervenors, including CEO, the Environmentalists, and SER and Gilberton, advocate changes to PP&L’s customer education program that are skewed to their individual interests and, more importantly, that misconstrue the purpose of the consumer education requirements imposed by the Act.²⁹ As described below, both the General Assembly and the Commission have been quite clear in their consumer education directives. The Commission should resist what is essentially an attempt by these intervenors to use PP&L’s restructuring plan proceeding to rewrite this portion of the Act.

As explained by Dawn G. Lennon, PP&L Sts. 17 and 17-R, and in PP&L’s Brief, pp. 181-186, PP&L’s Customer Choice Education Program satisfies the Act’s consumer

²⁹ As PP&L anticipated in its Brief, several of the intervenors raised additional issues, such as the adequacy of PP&L’s consumer education budget and participation in a statewide consumer education program. PP&L addressed these issues in pp. 183-184 of its Brief.

education mandate and is clearly focused on carefully developing and providing customers with educational materials that will give them the information they need to make informed choices.

CEO would have PP&L include in its customer education materials and programs information on the efficient use of heating, hot water, appliance and air conditioning; the meaning, environmental effects and availability of “green power” generating choices; health and safety measures; customer rights and responsibilities; multilingual materials; budget management counseling; targeted energy education for children; a specific component for high usage and remedial needs customers; and certification/training for education providers. Public Interest Parties Brief, p. 49.

The Environmentalists have a different “wish list,” which is equally outside the scope of the Act. Under the Environmentalists’ proposal, PP&L would be required to undertake a comprehensive program of consumer education on the environmental effects of electricity production and use. Public Interest Parties Brief, p. 46-48. Further, the Environmentalists recommend that the Commission not approve a customer education plan for PP&L until mechanisms are in place to inform consumers of the environmental implications of their supply choice and of the clean alternatives that may be available to them in the competitive marketplace. Public Interest Parties Brief, p. 72.

The Act does not require PP&L to engage in this type of general, far-reaching consumer education. Section 2807(d)(3) of the Act clearly and narrowly defines PP&L’s consumer education obligations:

each electric distribution company, in conjunction with the Commission, shall implement a consumer education program *informing customers of the changes in*

the electric utility industry. The program shall provide consumers with information necessary to help them make appropriate choices as to their electric service. (Emphasis added).

Consistent with this provision of the Act, PP&L's consumer education program is tailored to inform customers of the changes in the electric utility industry.

OCA witness Ms. Alexander also confuses the purpose of the Act's consumer education mandate when she explicitly criticizes PP&L's consumer education plan for "fail[ing] to motivate customers to participate in the market." OCA Brief, p. 91. The Environmentalists support this position and emphasize that that a consumer education plan must be designed to motivate customers to shop. Public Interest Parties Brief, p. 47. As evidenced by the language of the Act set forth above, however, the central purpose of a consumer education plan is to *inform* consumers how to deal with the changes in the electric industry, not motivate them to shop. PP&L's proposed consumer education plan fully satisfies this statutory obligation and intervenors' attempts to improperly expand the Act's requirements should be rejected.

XII. UNIVERSAL SERVICE

While PP&L addressed many of the intervenors' universal service proposals in its Brief, several points bear repeating here.

A. Funding Levels

The Environmentalists, CEO and OCA propose massive increases in the size of and funding levels for PP&L's universal service and energy conservation programs. Again, these intervenors would have the Commission impose obligations on PP&L that are clearly not

envisioned under the Act or under the Commission's Final Order Re: Guidelines for Universal Service and Energy Conservation Programs Made Pursuant to 66 Pa. C.S. § 2803, § 2807(17), 2804(8) and 2804(9), (Order entered July 11, 1997) ("Final Guidelines for Universal Service"). CEO attempts to justify its proposed funding increases – which in some cases are quadruple PP&L's proposed funding levels — by contending that both the Act and the Final Guidelines for Universal Service permit an increase in total universal service spending as long as the rate caps are maintained. Public Interest Parties Brief, p.62. The fact that the Act does not prohibit the Commission from requiring PP&L to increase universal service program funding levels, however, does not mean that the Act requires the Commission to expand programs to an inappropriate and unmanageable size.

As PP&L clearly demonstrated in this proceeding, its proposed increase of over \$7 million in funding for universal service programs is appropriate. PP&L Brief, p. 188. Additional funding is not necessary and could not be implemented efficiently. PP&L St. 16-R, p. 10. Accordingly, Intervenors' proposals should be rejected.

OCA and CEO suggest that PP&L's current level of write-offs and credit and collection expenses associated with non-OnTrack low-income customers could be "transferred" to fund an expanded OnTrack Program, in essence reducing PP&L's billings to these customers. OCA Brief, pp. 113-114; Public Interest Parties Brief, pp.62-63. As described in more detail in PP&L's Brief, p. 192, these proposals should be rejected because they are based on the false assumption that low-income customers do not pay any portion of their PP&L bills. To the

contrary, however, PP&L's experience shows that low-income customers, even those that are payment-troubled, often do pay some amount toward their electricity bills. Tr. 1948 (8/29/97).

B. Availability of Universal Service and Customer Assistance Programs

Like the OCA, CEO suggests that PP&L should expand WRAP to include more baseload customers and recommends a more than quadruple increase in the program size. As explained in PP&L's Brief, p. 191, PP&L's WRAP efforts are tailored to meet the needs of its service area. Unlike Duquesne Light Company, which enrolls a higher level of baseload customers in its weatherization program, PP&L has the highest electric heat saturation rate among the Pennsylvania electric utilities. PP&L's WRAP program properly takes this into account by focusing weatherization activities on electric heat customers.

AARP would impose income-based only eligibility requirements for PP&L's universal service programs, AARP Brief, p. 2. CEO proposes that reasonable terms for low-income PP&L electricity service should not exceed customer charges in excess of 8% of annual household income for electric heat customers, 5% for baseload water heat customers; and 4% for baseload only customers. Public Interest Parties Brief, pp. 55-56. As explained by PP&L witness Timothy Dahl, the eligibility requirements for PP&L's programs are designed to be flexible and take into account more criteria than just income. PP&L St. 16-R, p. 7.

C. Allocation of Universal Service Program Costs

Despite the Commission's holding to the contrary in the Final Guidelines on Universal Service at p. 20, OCA and the Environmentalists continue to recommend that universal service

charges should be assessed on a fixed Kwh basis upon all end users, at the same tariff rate regardless of customer class. As described in PP&L's Brief, pp. 154-156, 191, this type of allocation runs contrary to the Final Guidelines on Universal Service and would lead to cost-shifting, in violation of Section 2808(a) of the Act.

D. Other Universal Service and Customer Assistance Program Recommendations

Not surprisingly, CEO recommends that PP&L should transfer all LIURP/WRAP programs to Community Based Organizations ("CBOs"). Public Interest Parties Brief, p. 60. CEO provides no justification for the wholesale transfer of these programs. Moreover, its proposal is not supported by the Act, which encourages the use of CBOs, but recognizes the need for Commission and utility oversight:

The Commission shall encourage the use of community-based organizations that have the necessary technical and administrative experience to be the direct providers of services or programs which reduce energy consumption or otherwise assist low-income customers to afford electric service. Programs under this paragraph shall be subject to the administrative oversight of the Commission which will ensure that the programs are operated in a cost-effective manner.

66 Pa. C.S. § 2804(9).

The Environmentalists propose that PP&L should be required to set up an energy loan fund with an initial capitalization equal to 2% of its stranded cost award. Public Interest Parties; Brief, p. 67. Based on PP&L's stranded cost claim of \$4 billion, this proposal would require an

initial funding level of \$80 million. PP&L is a utility, not a bank. The record in this proceeding does not support the establishment of such a fund, nor is such a fund required by the Act.

XIII. ENVIRONMENTAL ISSUES

The Environmentalists propose that retail sellers should be required to disclose fuel mix and emission rates of NO_x, SO_x and CO₂, citing the fact that Vermont, Massachusetts and Maine have imposed mandatory disclosure requirements. Public Interest Parties Brief, p. 71. In addition, to the extent other major environmental impacts, such as waste creation, can be quantified, the Environmentalists recommend that these impacts be included as well and that a standardized point of comparison, such as the regional average level of pollution per kWh, should be indicated for reference. This recommendation goes far beyond the Commission's recently-proposed rules on Customer Information Disclosure for Electricity Providers, Docket No. L-00970126 (Order entered December 4, 1997), and imposes unreasonable and unnecessary disclosure requirements on retail sellers. The Commission should reject the Environmentalists' proposals in this proceeding and proceed with its proposed rulemaking to establish state-wide requirements in this area.

Both OCA and the Environmentalists advocate the development of a renewables pilot. OCA recommends an initial funding level of \$750,000, whereas the Environmentalists recommend a funding level of \$1 million. As described in Mr. Dahl's testimony, developing, implementing, and evaluating these pilots would be time-consuming and expensive for the level of benefits received. PP&L St. No. 16-R, p. 17. Because of the long payback period, the

complexity of the systems, the difficulty of installation and maintenance, the likely resistance from landlords, and the Commission's direction in its Final Guidelines for Universal Service, the OCA's recommendation to fund renewable energy pilots should be rejected

The Commission should also reject the Environmentalists' proposal that the Commission implement uniform environmental standards that all retail suppliers must meet in order to sell power in Pennsylvania. As discussed in PP&L's Brief, pp. 194 - 197, the Commission lacks the authority to impose or enforce environmental standards, particularly in this area, which is being actively regulated by both state and federal environmental agencies.

XIV. CONCLUSION

For all of the reasons set forth in its Initial Brief and in this Reply Brief, PP&L, Inc. respectfully requests that the Pennsylvania Public Utility Commission approve its Restructuring Plan in its entirety.

Respectfully submitted,



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Dated: February 27, 1998

PP&L, Inc.
PUC Results of Operations
As of December 31, 1996 and Pro forma

Thousands of dollars

	Actual 12 months ended 12/31/96	Accelerated Amortization Reg Assets/NUGs	Pro forma	OCA-proposed 20% base rate reduction	Pro forma
Operating revenues	\$2,563,242		\$2,563,242	(\$498,208)	\$2,065,034
Operating expenses					
Operation & maintenance	1,362,047	\$26,054	1,388,101		1,388,101
Annual depreciation	316,035	(70,180)	245,855		245,855
Taxes-other than income*	189,960		189,960	(21,921)	168,039
Income taxes	218,772		218,772	(200,233)	18,539
State income tax-current	51,589		51,589	(51,589)	0
Federal income tax-current	167,183		167,183	(148,644)	18,539
Deferred income taxes/ITC**	(793)	64,572	63,779		63,779
Total operating expenses	<u>2,086,021</u>	<u>20,446</u>	<u>2,106,467</u>	<u>(222,154)</u>	<u>1,884,313</u>
Income available for return	<u>\$477,221</u>	<u>(\$20,446)</u>	<u>\$456,775</u>	<u>(\$276,054)</u>	<u>\$180,721</u>
Rate of return-overall	9.42%		9.02%		3.57%
Rate of return-debt	7.89%		7.89%		7.89%
Rate of return-preferred equity	7.09%		7.09%		7.09%
Rate of return-common equity	11.42%		10.52%		-1.54%

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Application of Pennsylvania Power & Light :
Company For Approval of Its Restructuring : Docket No. R-00973954
Plan Under Section 2806 of the Public Utility :
Code :

CERTIFICATION OF SERVICE

I hereby certify that on February 27, 1998, I served a true copy of the Post-Hearing Reply Brief of PP&L, Inc. upon counsel for the active participants, listed below, in accordance with the requirements of 52 Pa. Code § 1.54 (related to service by a participant):

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