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PENNSYLVANIA PUBLIC UTILITY COMMISSION
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Re: Pennsylvania Public Utility Commission
v.
Pennsylvania Power & Light Company
Docket No. R-00973954

Dear Secretary McNulty:

Enclosed please find an original and nine (9) copies of the Main Brief of the Office of Trial Staff (OTS) for filing in the above-captioned proceeding. Copies are being served upon all active parties of record.

Sincerely yours,

Johnnie E. Simms
Senior Prosecutor
Office of Trial Staff

RFF:sjh

c: Honorable George Kashi
Parties of Record

ORIGINAL

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Pennsylvania Public Utility
Commission**

v.

**Pennsylvania Power and Light
Company
(Rate Restructuring)**

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**Docket No.
R-00973954**

**MAIN BRIEF
OF
THE OFFICE OF TRIAL STAFF**

**Before
Administrative Law Judge
George Kashi**

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**Johnnie E. Simms
Senior Prosecutor
Scott H. DeBroff
Prosecutor
Office of Trial Staff**

**Pennsylvania Public Utility Commission
P. O. Box 3265
Harrisburg, PA 17105-3265
(717) 787-1976**

Dated: February 12, 1998

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I. INTRODUCTION

On December 3, 1996, the Electricity Generation Customer Choice and Competitive Act (“Act”), 66 Pa. C.S. §§2801, et seq., was enacted with an effective date of January 1, 1997. Section 2806 of the Act requires all jurisdictional electric utilities in the Commonwealth of Pennsylvania to file restructuring plans for review and approval by the Pennsylvania Public Utility Commission (“Commission”). The Act established a nine-month review process for the Commission to consider a jurisdictional electric utility’s restructuring plan.

On January 24, 1997, at Docket No. M-00960890,F0005, the Commission established a schedule for filing of the restructuring plans. Pursuant to the Commission’s Order, on April 1, 1997, Pennsylvania Power & Light Company (“PP&L” or “Company”) filed an Application for Approval of its Restructuring Plan at Docket No. R-00973954.

In response to PP&L’s Application to Restructure, a number of parties filed Notices of Appearances, Petitions to Intervene and Complaints. As a result of the interest expressed by the respective parties, several days of evidentiary and public input hearings were held before Administrative Law Judge George Kashi. In attendance at all of the evidentiary and public hearings were representatives from the Office of Trial Staff (“OTS”). In addition to attending and participating in the hearings, OTS presented as expert witnesses, Messrs. Deardorff, Gruber and Reed,

for the purpose of offering adjustments and recommendations regarding PP&L's restructuring filing. After an opportunity has been presented to all of the active interested parties to present witnesses and cross-examine other parties' respective witnesses, PP&L's Application for Approval of its Restructuring Plan is ripe for briefing.

Accordingly, this brief is submitted on behalf of the Office of Trial Staff. Since OTS is mindful of Administrative Law Judge Kashi's briefing instructions, this Brief will succinctly address the adjustments and recommendations set forth in the exhibits, direct and surrebuttal testimonies of Messers. Deardorff, Gruber and Reed.

In that regard, OTS has mirrored its Brief to conform to the Briefing Order of Administrative Law Judge Kashi's Order of September 23, 1997. For ease of reference, OTS identifies the following topics that will be addressed in this Brief:

- II. Legal and Policy Foundation of Stranded Cost Recovery
 - E. Allocation of Stranded Costs
- III. Stranded Cost Calculation Methodology
 - A. Regulatory Method
- V. Revenue Under Regulation
 - B. Cost of Capital
 - 1. Equity

- C. Regulatory Assets and Liability
 - 3. Taxes Other Than Income
 - 4. Fossil Fuel Decommissioning
 - 7. Susquehanna Deferred Refueling Costs
 - 11. Rate Case Expenses
- VI. Determination of Present Value
- VII. Recovery of Stranded Costs
 - C. CTC Reconciliation and Tracking
and
 - D. CTC and Rate Cap Extension
- XII. Universal Service and Customer Assistance Program
 - D. Other Universal Service and Customer Assistance Program
Recommendation

Summary of Argument

OTS, through its witness Kevan L. Deardorff, submits that the Commission should allow the Company an overall rate of return of 8.90%, including a return on common equity of 10.25%. In determining the Company's cost of common equity, Mr. Deardorff relied upon the Discounted Cash Flow ("DCF") methodology. In countless proceedings, this Commission has unquestionably upheld the validity of the DCF model as a primary tool for determining a fixed utility's cost of equity. Contrary to Mr. Deardorff's analysis, PP&L witness Moul's analysis is flawed due to the following:

The Barometer group is not appropriate because Mr. Moul's group has 15% nuclear generation while PP&L has 31% nuclear generation.

Inappropriately given weight to the Comparable Earnings, Risk Premium, and CAPM Models.

Inappropriately relied totally on PP&L data at a time of electric deregulation.

Several serious errors in his DCF analysis.

Due to Mr. Moul's analysis having serious flaws, his recommendations should not be adopted.

In addressing the issue of "Taxes Other Than Income", the Company has inappropriately interpreted the Act to allow PP&L to increase taxes other than income for inflation in an otherwise revenue neutral figure. By PP&L's own

witness admission, the Act makes no reference to inflation, thus there is no basis for the Company's position regarding this issue.

In addressing Susquehanna Deferred Refueling Costs and Rate Case Expense, OTS submits that these costs are not regulatory assets that are recoverable through a traditional amortization, but are typical ongoing expenses that, in a regulatory environment, are recoverable in base rates at normalized levels. Accordingly, OTS submits that the recovery of normalized expenses do not extend over a period of years and, therefore, claims for unrecovered normalized expenses in subsequent proceedings cannot exist and must be disallowed.

With respect to recovery of stranded costs as an alternative, PP&L has proposed to track the annual collection pursuant to the Competitive Transition Charge ("CTC"). OTS submits that PP&L's alternative to the reconciliation process of the Act is inappropriate. Section 2808 of the Act requires annual reconciliation of CTC revenues in order to ensure that CTC revenues are no less than, nor greater than, the authorized amount. Moreover, in the event that PP&L's CTC allowance does not permit an upward adjustment on an annual basis, OTS is recommending that the CTC should be tracked and CTC be extended beyond nine years, if necessary. Consequently, any reconciliation of CTC over recovery revenues that does not violate the rate cap imposed by the Act should be made in the subsequent recovery years.

In the area of universal service, it is OTS' belief that the universal service fund charge should be identified on the customer's bill as opposed to the Company's proposal to include the charge as a component of the distribution charge. OTS' recommendation will allow for an easier and open determination of the amount recovered through rates versus the amount actually expended on the programs that comprise the universal service concept as defined in the Act.

The Commission should reduce the Company's stranded cost claim by **\$939,462,000** by using the nine year Treasury note interest rate as the Common Equity Return when determining the Company's stranded costs.

The Commission should order the Company to set up a non-qualified trust fund with the money it collects for fossil fuel decommissioning.

The Commission should order a **90%/10%** sharing of stranded costs between the ratepayers and the stockholder, reducing the CTC allowance for generation plan stranded costs by **\$234,545,000**.

The Commission should determine that the appropriate CTC allowance for Stranded Costs for the Pennsylvania Power and Light Company be set at **\$3,171,875**. This recommendation is shown in OTS Exhibit No. 1 on Schedule 5.

II. LEGAL AND POLICY FOUNDATIONS OF STRANDED COST RECOVERY

E. Allocation Of Stranded Costs

OTS Sharing Of Stranded Costs Recommendation

PP&L has proposed to recover 100% of its stranded costs through a CTC per Kwh from each customer. OTS witness Mr. Gruber has testified that PP&L should not be allowed to recover 100% of its stranded costs, and has recommended that the Commission order the Company to share stranded costs associated with net generating plant between the ratepayer and the stockholder on a 90%/10% split. This sharing proposal excludes the stranded costs associated with the regulatory assets and the non-utility generating contracts.

OTS believes that there should be a sharing of the stranded costs between the ratepayers and the stockholders of the Company because of the “intent” of stranded costs. In his testimony, OTS witness Mr. Gruber contends that if you accept the premise that stranded costs are a utility’s uneconomic costs left over in a competitive environment, and that only after their removal from the utility’s cost of generation can the utility be competitive in the generation of electricity, requiring the ratepayer to absorb all stranded costs would reward the Company for being an inefficient producer of electricity.

PP&L witness Mr. Ronald E. Hill, Chief Financial Officer of the Company, in his Direct Testimony, identified as PP&L Statement No. 2, Pages 5-6, discusses the Company's efforts at past and future mitigation and states that:

“Those utilities who have been successful in controlling costs in the past will have lower current rates and correspondingly lower stranded costs. Conversely, those utilities with a higher cost of service will have higher rates and higher stranded costs. It is my belief that those utilities with high rates and high stranded costs should have more opportunity to “mitigate” stranded costs through future mitigation than utilities with lower costs and lower rates.”

OTS agrees with Mr. Hill and contends that the Commission should provide some incentive for the utility to mitigate stranded costs through the use of a sharing mechanism. It is clear that the inclusion of a company's total stranded costs would reward those utilities who in the past have made less cost efficient judgments in their choices and construction of generation capacity.

In his Direct Testimony at PP&L Statement No. 2, Mr. Hill discusses those mitigation efforts that the Company has already undertaken prior to its restructuring filing. Mr. Hill highlights several of these Company efforts to reduce its costs, including the reduction of the Company's cost of debt by 30% (11.27% in 1985 to 7.97% in 1995), efforts to control its O & M costs, a reduction in the

number of employees, reduced inventory costs, lower capital expenditures, and programs to increase the efficiency of its generating units.

The OTS contends that these efforts are all courses of action that the Company is *expected* to do in a regulated environment. In a regulated environment, a utility, such as PP&L, is responsible for providing safe and reliable service at just and reasonable prices. The Pennsylvania Public Utility Commission is responsible for seeing that the rates charged to the consumer are as low as possible while still providing the utility with its cost of service. All of the “mitigation” efforts mentioned by PP&L witness Mr. Hill are items that the Company should do or should have done in the regulated environment that preceded the passage of the Act. As stated earlier, to allow the Company to claim these actions as mitigation efforts is to reward the Company for doing nothing more than it had the responsibility to do in the first place.

As expressed in OTS witness Mr. Gruber’s direct testimony, the Commission should order a sharing of stranded costs, because if you do not share the costs, the Commission will be penalizing the efficient utility by allowing the inefficient utility to recover all of its inefficiencies in the Competitive Transition Charge (CTC). Even for a utility perceived to be efficient, there are always more ways to become more efficient. Once the Company’s stranded costs are *determined and the recovery period begins*, the Company is in the position that any

future cost savings will accrue to the benefit of the stockholder. As the Company moves to make itself more efficient, it has the ability to increase its profits and it will be the ratepayer who will be contributing those profits. A sharing of the stranded costs, as proposed by OTS, will return the benefits of the cost saving measures to those who bore the costs in the first place, the ratepayers.

For purposes of this restructuring filing, the OTS has chosen a 10% sharing for the stockholder of the Company to absorb. In his testimony, OTS witness Mr. Gruber states that deriving sharing percentages is not an exact science. However, using various percentages for different utilities allows the Commission to make adjustments that will cause less efficient utilities to absorb a greater amount of stranded costs than the efficient utilities. With regard to a specific percentage to be born by the stockholder in this matter, OTS finds 10% to be reasonable for this Company. OTS contends that a 10% absorption by stockholders gives the Company a reasonable goal for making cost savings.

OTS finds the precedence for this 90%/10% (Ratepayer/Stockholder) Split from the instance when the natural gas local distribution companies (LDCs) were faced with having to pay “take or pay” buyout costs of long term gas supply contracts, and the Commission approved a 90%/10% sharing between ratepayer and stockholder as a reasonable solution. The “take or pay” issue was not a “stranded cost” issue, but the costs associated with “take or pay” area similar to

stranded costs because both are buyouts of long term costs which would have been incurred by the utility if the manner in which the utility met its burden to serve had not changed.

OTS requests that the Commission employ a 90%/10% (Ratepayer/Stockholder) Sharing of stranded costs. A 10% absorption by the stockholders will lower the Competitive Transition Charge (CTC for stranded costs associated with generation plant) by **\$234,545,000**. (See OTS Exhibit No. 1, Schedule 4)

III. STRANDED COST CALCULATION METHODOLOGY

A. Regulatory Method

Common Equity Return For The Determination Of Stranded Cost

On December 3, 1996, Governor Ridge signed into law the Electricity Generation Customer Choice and Competition Act (“Act” or “Competition Act”), reduced to law in the Pennsylvania Public Utility Code at 66 Pa.C.S. Section 2801 et. seq. The Competition Act provides a detailed legislative scheme for the restructuring of Pennsylvania’s electric utilities.

In enacting changes, the Pennsylvania legislature recognized that certain generation-related costs would not be recoverable in a competitive generation market. As a result, the Act established certain standards and mechanisms which provide for the recovery of “transition” and/or “stranded” costs found by the Commission to be just and reasonable. Section 2803 of the Act defines the categories of such costs that are eligible for recovery, while Section 2808 (C) sets forth the principles to be followed by the Commission in reviewing stranded cost claims.

According to Section 2803 of the Act, stranded costs are:

an electric utility’s known and measurable net electric generation related costs, determined on a net present value basis over the life of the asset or liability as part of its restructuring plan, which traditionally would be recoverable under a regulated environment but which

may not be recoverable in a competitive electric generation market and which the commission determines will remain following mitigation by the electric company.

Stranded costs exist because of the differences between a regulated and a competitive market. In a regulated environment, an electric utility had an obligation to serve any customer within its geographic service territory. In some instances, the utility was required to make investments and enter into agreements that it would not have made in a competitive environment.

In a regulated environment, the utility is provided the opportunity to recover its costs and earn a return based upon the risk involved in recovering its prudently incurred investment in providing service. In a competitive environment, the rate an energy supplier will receive will be determined by the marketplace and not a regulatory commission.

For calculation purposes, PP&L divided its stranded costs into four categories: nuclear generation, fossil generation, NUG contracts and regulatory assets. For Company-owned generation (nuclear and fossil), PP&L compared the annual revenue requirements on a traditional cost-of-service basis for each plant over its remaining life with the annual revenues each plant is expected to receive from the sale of its output under market prices. The PUC jurisdictional portion of the difference between these two revenue streams was discounted to net present

value at January 1, 1999, using the Company's weighted after-tax cost of capital as the discount rate. The details of these calculations were explained in the testimony of Company witness Joseph R. Schadt.

The Company has claimed a total of \$3,570,180,000 for stranded costs relating to its Generation Plant. Of that total amount, \$2,851,961,000 is the Company's calculation for nuclear plant and \$718,219,000 is its calculation for fossil plant stranded costs. (See PP&L Exhibit JRS-1, Tab B, Page 1 of 117)

OTS witness Mr. Michael J. Gruber submitted testimony regarding the Company's Stranded Cost calculation methodology on behalf of the Office of Trial Staff. Mr. Gruber accepted the methodology used by the Company to calculate the stranded cost numbers, but found one of the inputs used by the Company to be inappropriate for this calculation.

Mr. Gruber testified that the Company used the common equity return allowed by the Commission in its last rate proceeding docketed at R-00943721. The OTS contends, through Mr. Gruber's testimony, that the use of this Common Equity return is inappropriate.

The revenue requirement in the Company's last base rate proceeding was based upon a traditional regulatory environment. In that context, revenues approved by the Commission are not guaranteed. Under regulation, rates are set to provide the Company with the opportunity to recover the calculated revenue

requirement. If a company does not earn the revenues allowed, no allowance is made to alter future rates to insure the collection of the revenues not collected. Therefore, in its calculation of the common equity component of the cost of capital, the Commission allows for a certain amount of risk. As described by PP&L in their testimony in this proceeding, the level of stranded costs determined by the Commission will be amortized over a nine year period with a true up at the end of each year. Therefore, the Company is *guaranteed* recovery of its stranded costs and the risk involved drops to zero. (See 66 Pa.C.S. Section 2808 (F) of the Act)

OTS witness Mr. Gruber has testified that using the Company's recommended 11.5% Common Equity return will have no effect on competition in general. However, it will greatly affect the price that current Company ratepayers will pay for electricity.

Once the level of stranded costs is determined, it will be placed into the Competitive Transition Charge (CTC) and recovered as a non-bypassable surcharge. All ratepayers who receive service from the Company will pay this surcharge regardless of their energy supplier.

As PP&L points out, the price for electric generation energy will be determined by the market. OTS witness Mr. Gruber points out that assuming that the Company has calculated the Market Clearing Price for Generation (MCPG)

accurately, the removal of stranded costs puts the Company on an even footing with the other power suppliers and the price of generation will fluctuate with the market. Every ratepayer will have stranded costs added to their bill, so such a charge should not affect competition directly.

A key factor which plays a role in this argument is the determination of the Competitive Transition Charge. The Act defines the CTC as:

a non bypassable charge applied to the bill of every customer accessing the transmission or distribution network which (charge) is designed to recover an electric utility's transition or stranded costs as determined by the Commission under sections 2804 (relating to standards) and 2808 (relating to competitive transition charges). 66 Pa.C.S. Section 2803

Use of an 11.5% Common Equity return, as claimed by the Company, would insure that the Company will recover a guaranteed profit, in a risk free situation, equal to what it would have had the opportunity to recover in the regulated environment.

In Mr. Gruber's expert opinion, this would raise the CTC to an unacceptable level. He testified that the possibility exists that if you allow the Company to use an 11.5 % Common Equity return, you could give it a competitive advantage. If the Commission were to use that Common Equity return, thereby guaranteeing PP&L's profitability using a risk-derived return during the CTC risk

free time period (something the Commission has never done before), the Company would be in the position of being able to use a lower profit margin for its actual production and sale of its electricity, giving it a disadvantage over the other competitors who may not have the benefit of the CTC for their profit margin.

Using the Company's methodology, with the common equity return at zero, Mr. Gruber determined that the Company's stranded costs drop from \$4,610,961,000 to \$2,404,758,000 in their claim.

If you were to set the common equity return to zero, this would provide a reduction of the overall return to 4.26%. (See OTS Exhibit No.1, Schedule 1, Page 1) Mr. Gruber's Exhibit No. 1, Schedule 1, Page 3 shows a calculation of the difference between the Company's claim using an 11.5% common equity return and the use of a 0% common equity return. From his calculations, \$2,206,203,000 or 47.8% of the Company's stranded cost claim is attributable to common equity return.

Schedule 1 of OTS witness Gruber's Exhibit No. 1 illustrates that if you eliminate profit, the Company's fossil fueled generation would have no stranded costs associated with it. The Company's use of an 11.5% common equity return, produces stranded costs associated with the fossil fueled units of \$718,219,000. However, by using a zero return for common equity, the stranded costs associated

with the fossil fueled units is a negative \$164,489,000 for a *positive* benefit to the ratepayers.

It is not the OTS position the Company not be granted any common equity return. Mr. Gruber has testified that for purposes of this case, he recommends the use of a **6.6%** return for common equity. Mr. Gruber developed the 6.6% rate as supplied to him by OTS witness Kevin Deardorff and is the currently projected interest on a 9 year Treasury note.

One component of the common equity return allowed in a traditional rate proceeding is an allowance for risk. It is the OTS position that the risk faced by PP&L in recovering its stranded costs is near zero, and therefore, the common equity return should reflect a near zero risk. OTS recognizes that some return is necessary or the Company could have trouble getting investors to invest in the Company, and as a result, OTS is using the 9 year Treasury note rate as a zero risk return given that time period. (See OTS Statement No. 3)

The OTS recommended 6.6% common equity cost of capital results in an overall weighted cost of capital of 7.25% and an after tax rate of 5.71%. (See OTS Exhibit No. 1, Schedule 2, Page 1)

As set forth in OTS witness Mr. Gruber's testimony, using the Company's methodology and a 6.6 % return for common equity, the Company's stranded costs are \$3,671,499,000. This number is a decrease of \$939,462,000 (\$4,610,961,000 -

\$3,671,499,000) from the Company's stranded cost calculations (See OTS Exhibit No. 2, Schedule 2, Page 2)

It is OTS' position that the Commission, in reviewing the issue of the appropriate cost rate for Common Equity, should not be concerned that the newly formed generation company does not earn the common equity rate of return permitted by this Commission for a regulated utility in the Company's last rate proceeding. The PA PUC will have no interest or involvement in the degree of profits which an electric generation company will garner in a deregulated competitive environment.

This newly formed Generation Company created by PP&L will either post a profit or it will not. OTS witness Mr. Gruber has reviewed the Company's testimony regarding the Market Clearing Price for Generation (MCPG), and although the MCPG claimed by the Company is the lowest of the companies he has compared them to, he has not made any adjustments. OTS contends that PP&L has made the best estimate of what the future price of electricity will be. Under the competition that is ahead, it is the shareholders of the Company who will have to live with the decisions made by the management and the will of the market to make money.

This Commission's concern with the viability of the generation company is limited to the recovery of the revenue stream determined by the Commission as

stranded under the provisions of the Act relating to the Competitive Transition Charge (CTC). Since the risk involved in the recovery of the CTC is zero, the calculation of stranded costs should also have a zero risk return.

V. REVENUE UNDER REGULATION

B. Cost of Capital

1. Equity

a. Introduction

In the presentation of its filing for restructuring pursuant to the Act, PP&L presented the direct testimony of Paul Ronald Moul. Mr. Moul, in his direct testimony, presented "evidence, analysis and a recommendation concerning the appropriate rate of return on common equity that the Commission should recognize in calculating the transition or stranded costs for PP&L." PP&L St. No. 6 at 1. Mr. Moul's direct testimony addressed two issues in this proceeding. Namely, "what is the appropriate cost of equity for PP&L in the historic base year of 1996, and, is that cost of equity appropriate for calculating the Company's transition or stranded costs extending into the future, which may encompass costs which will be incurred for up to 30 years?"

Mr. Moul expressed the opinion that PP&L's use of an 11.5% rate of return on common equity contained in the calculation of the transition or stranded cost is below the Company's actual cost of equity. PP&L St. No. 6 at 2.¹ Mr. Moul relied upon four methodologies, inter alia, the Discounted Cash Flow ("DCF") model, the

¹ The 11.5% rate of return on common equity is consistent with the Commission's Final Order in the Company's most recent base rate case at Docket No. R-0943271.

Risk Premium analysis ("RP"), the Capital Asset Pricing Model ("CAPM"), and the Comparable Earnings approach for determining that PP&L's cost of equity is at least 12.75%.

Traditionally, in rate proceedings, the parties actively contest the determination of the cost component and the allowed return on common equity. In the instant proceeding, the allowed return on common equity is a contested issue as it relates to the cost of capital, specifically equity and debt. PP&L, through its cost of equity witness Paul Moul, erroneously concludes that a rate of return on common equity to the Company of 12.75% is necessary and proper. The recommendation of witness Moul significantly overstates the cost of equity for PP&L and accordingly, should be rejected by this Commission.²

As set forth below, OTS, through its witness Kevan L. Deardorff, submits that the Commission should allow the Company an overall rate of return of 8.90%, including a return on common equity of 10.25%. OTS St. SR- at 2. OTS witness Deardorff primarily relied upon the Discounted Cash Flow ("DCF") methodology to determine the Company's cost of common equity.

b. Standards Regarding Cost of Capital and Rate of Return

² In this proceeding, only PP&L witness Moul and OTS witness Deardorff presented testimony regarding the appropriate cost of equity for PP&L.

The standard to be used in determining what is a fair rate of return from the investors' perspective, was set forth by the United States Supreme Court in the seminal decision, Bluefield Waterworks & Improvement Company v. Public Service Commission of West Virginia, 262 U.S. 679, 693 (1923). Two decades after the Bluefield decision, the United States Supreme Court reviewed the issue of fair rate of return in Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944), wherein the Supreme Court held that from the investor or company point of view, the return to the equity owner should be commensurate with return on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. Id. at 603. See also, Duquesne Light Company v. Barasch, 488 U.S. 299 (1989), affirming Barasch v. Pennsylvania Public Utility Commission, 516 Pa. 142, 532 A.2d 325 (1987).

In Pennsylvania Public Utility Commission v. Pennsylvania Gas and Water Company - Water Division, 19 Pa. Commw. 214, 233, 341 A.2d 239 (1975), the Commonwealth Court of Pennsylvania delineated the following factors for consideration by this Commission when determining the fair rate of return for a fixed utility: (1) The earnings which are necessary to assure confidence in the financial integrity of the Company and to maintain its credit rating; (2) the need to

pay dividends and interest; (3) the amount of the investment, the size of the utility, its business and financial risks, and the circumstances attending its origin, development and operation. See also, Pennsylvania Public Utility Commission v. Pennsylvania Power Company, 55 Pa. PUC 552, 579 (1982); Pennsylvania Public Utility Commission v. National Fuel Gas Distribution Corporation, 73 Pa. PUC 552, 603-605 (1990).

Additionally, Section 523 of the Public Utility Code specifically lists other factors which the Commission may consider when setting just and reasonable rates and the fair rate of return. Several of these factors comprise criteria to evaluate fixed utility performance, including but not limited to: management and operating efficiency as measured by an audit; efficiency and cost-effectiveness of generating capacity; and development of cost-effective energy supply alternatives. 66 Pa. PUC §523 (b)(1), (3) and (4).

c. Capital Structure

PP&L proposed a 9.46 percent cost of capital based upon the Commission allowed rate of return from PP&L's most recent base rate case at docket number R-00943271. For the proposes of this proceeding, OTS witness Deardorff has adopted the Company's recommended capital structure and cost rates of debt and preferred stock. OTS St. 3 at 6.

d. The Disputed Recommendations

In reviewing the record evidence in this proceeding, it appears that OTS' recommendation and that of the Company differs in three areas; the appropriate cost rate of common equity, the overall rate of return and the discount rate.. OTS St. 3 at 7. As previously discussed, OTS witness Deardorff recommended a 10.25% cost rate of common equity in lieu of PP&L witness Moul's 12.75% recommendation and the Company's actual claim of 11.5%. OTS witness Deardorff's overall rate of return is 8.90% in lieu of the Company's 9.46%; concomitantly, OTS witness Deardorff's discount rate is 7.36% in lieu of the Company's 7.92%. As Mr. Deardorff explained, the only reason for the difference in the overall return and discount rate between OTS and PP&L is that the respective parties' cost of equity recommendations are different. Consequently, the sole issue to determine in this area is the cost of common equity.

In that regard, as will be discussed below, OTS witness Deardorff's recommendation was based on giving equal weight to the DCF results of PP&L and a barometer group of electric companies.

e. Cost of Common Equity

1. This Commission Has Placed
Primary Reliance On The Results

Of Validly Conducted DCF
Studies In Determining The
Appropriate Cost Of Common
Equity.

The Discounted Cash Flow (DCF) methodology is a market based technique which is founded upon the principle that the amount an investor will pay for a share of common stock is based upon the present value of anticipated future dividends and appreciation in market price. In theory, the DCF method analyzes what return an investor requires, as opposed to what an investor would like to receive, as a return on the investment made. Pennsylvania Public Utility Commission v. Roaring Creek Water Company, 73 Pa. PUC 373 (1990).

In countless proceedings, this Commission has unquestionably upheld the validity of the DCF model as a primary tool for determining a fixed utility's cost of equity. See e.g., Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company, 68 Pa. PUC 343, 95 PUR4th 470 (1988); Pennsylvania Public Utility Commission v. Equitable Gas Company, 73 Pa. PUC 301 (1990); Pennsylvania Public Utility Commission v. West Penn Power Company, 73 Pa. PUC 454, 119 PUR4th 110 (1990); Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, 75 Pa. PUC 391 (1991); Pennsylvania Public Utility Commission v. York Water Company, 75 Pa. PUC 134 (1991); Pennsylvania Public Utility Commission v. Metropolitan Edison

Company, 78 PA PUC 128 (1993). Most recently, the Commission provided additional insight into its opinion regarding relying primarily on the DCF in its Qualified Rate Order for PECO Energy (Docket No. R-00973877), in pertinent part as follows:

Regarding PECO'S argument that the OTS' cost of equity determination is deficient because it relies solely upon the DCF method, the OTS contends that the ALJ appropriately found that, in numerous cases since 1988, the Commission has utilized the DCF method and informed judgment, citing Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, 71 Pa. PUC 593, 623-632 (1989) and Pennsylvania Public Utility Commission v. Western Pennsylvania Water Company, 67 Pa. PUC 529, 559-570 (1988).

In considering this matter, we note that, in numerous recent proceedings, we have determined a utility's cost of common equity using primarily the DCF (Discounted Cash Flow) method and informed judgment. Pennsylvania Public Utility Commission v. Roaring Creek Water Company, Docket No. R-00943177 (Order entered on May 31, 1995); Pennsylvania Public Utility Commission v. Philadelphia Suburban Water Company, supra. Regardless of the procedure employed in determining the fair rate of return for a utility, we exercise informed judgment. Pennsylvania Public Utility Commission v. West Penn Power Company, supra. Therefore, we reject PECO'S argument that the OTS' reliance solely on the DCF methodology is improper in this proceeding. (emphasis added).

Pennsylvania Public Utility Commission v. PECO Energy Company, R-00973877, slip op. at 56 (May 22, 1997).

OTS submits that the Pennsylvania Public Utility Commission precedent clearly supports a return on equity allowance based upon the DCF methodology. Most notably, on May 22, 1997, the Commission approved a DCF-determined common equity cost rate of 10 percent for PECO Energy Company, an electric utility. Pennsylvania Public Utility Commission v. PECO Energy Company, supra, Tr. 1921-1922, August 28, 1997.³

2. Mr. Deardorff's Selection Process For A Group Of Companies Of Similar Risk To PP&L Is Reasonable.

There should be no dispute that operations similar in risk will provide a better, more accurate basis from which to estimate the equity capital cost of PP&L. In that regard, OTS witness Deardorff listed thirteen (13) electric companies in OTS Exhibit No. 3, Schedule No. 3, that satisfy the following selection criteria: located in the eastern and central United States, similar financial risk to PP&L, and nuclear generating in excess of 30 percent of total generation. OTS St. 3, at 10. As explained by OTS witness Deardorff, there are companies within an industry

³ PP&L has adequate financial and market data available to use in a DCF analysis. OTS St. 3 at 9.

that will certainly differ from one another. Id., at 10. In the instant case, Mr. Deardorff has focused upon the similarities, namely by analyzing some key market information and risk indicators.

Notably, as Mr. Deardorff explained, the barometer group should be similar to PP&L with respect to the percent of nuclear generating capacity to the total generating capacity for the barometer group. OTS St. 3 at 11. This comparison is necessary due to the expected large stranded costs associated with PP&L's nuclear plants. Id., at 11. The record evidence illustrates that the percent of nuclear generation to total generation capacity for the barometer group ranges between 31.1 and 74.0 percent. OTS St. 3 at 11. In comparison, PP&L's nuclear generation is 31.0 percent. Id., at 11. Accordingly, it is clear that all of the electric companies in the barometer group have a large exposure to nuclear generation; however, PP&L's percentage of nuclear generation is at the low end of the range, which indicates a lower risk associated with nuclear than the average. Id., at 11.

Not surprisingly, PP&L's witness Moul appears to disagree "with Mr. Deardorff's assertion that the percentage of nuclear generating capacity is an important criteria for assembling companies for Barometer Group purposes in this case." PP&L St. 6 at 13. Mr. Moul's obvious inconsistency regarding the "barometer group" is quite evident, as Mr. Moul acknowledged on page 2 of PP&L Exhibit PRM 1 that generation mix is an element of risk, yet Mr. Moul's

barometer group failed to include generation mix as a selection criteria when developing a barometer group recommendation for this instant proceeding. An example of Mr. Moul's inconsistency is the evidentiary fact that PP&L witness Moul's barometer group is quite different from PP&L, which is the subject matter of this proceeding. OTS St. 3 at 34. Notably, as previously documented and unrebutted, PP&L's generation mix is 31 percent nuclear compared to 15 percent for Mr. Moul's barometer group. Id., at 34. Most disturbing is the unrebutted evidentiary fact that three of companies in Mr. Moul's barometer group have absolutely no nuclear generation. Id., at 34.

Consequently, any recognition of Mr. Moul's barometer group would result in comparing companies with 15 percent nuclear generation with PP&L, which has 31 percent nuclear generation. Clearly, such a comparison is significantly flawed at the outset of any analysis of an appropriate common equity recommendation for PP&L. An adoption of Mr. Moul's barometer group will result in a flawed recommendation of an appropriate common equity in a case of this magnitude, and thus Mr. Moul's barometer group should be rejected. Simply put, Mr. Moul's selected proxy group does not adequately capture the operating and financial characteristics of PP&L.

Finally, in regard to the issue of an appropriate barometer group, based upon Mr. Deardorff's analysis, PP&L's equity ratio of 45.5 percent is slightly lower

than the barometer group's average of 47.7 percent indicating slightly higher financial risk. OTS St. 3 at 12; OTS Exh. 3, Sch. 3. Additionally, Mr. Deardorff utilized three measures of overall investment risk: Beta, Safety Rank, and Financial Strength. A review of OTS Exhibit No. 3, Schedule No. 3, illustrates that PP&L's beta of .75 indicates slightly lower investment risk when compared to the barometer group's average beta of .76; and PP&L's safety rank of 2.0 also indicates lower investment risk in comparison to the barometer group's average safety rank of 2.4. OTS St. 3 at 12. The financial strength element of the overall investment risk indicates that PP&L's financial strength is identical to that of the barometer group's financial strength of B++. *Id.*, at 12. Aside from the fact that an examination of the overall investment risk indicates that PP&L has slightly lower investment risk in comparison to the barometer group; a complete analysis of Mr. Deardorff's barometer group strongly indicates its appropriateness, as a proxy, to be used in the determination of a market based expected cost rate of common equity for PP&L.

Accordingly, for the purposes of this proceeding, the barometer group recommended by OTS witness Deardorff should be utilized by the Commission in determining the appropriate cost rate of common equity for PP&L.

3. OTS Witness Deardorff Correctly
Conducted A DCF Analysis and Properly

Determined The Company's Cost of
Common Equity To Be 10.25 Percent.⁴

a. Witness Deardorff's DCF Analysis

Based upon his DCF results, and the utilization of sound judgment and considering current and future economic conditions, OTS witness Deardorff determined that a reasonable and appropriate cost of common equity for PP&L is 10.25. See generally, OTS St. 3 at 2-10 and 17-29, OTS SR-3 at 2. Mr.

Deardorff's overall rate of return recommendation would provide PP&L with a pre-tax interest coverage of 3.44 times.⁵ OTS St. 3 at 30; OTS Exh. 3, Sched. 7.

Mr. Deardorff obtained an adjusted dividend yield average based on a 8.35 percent spot and 7.68 percent 52-week average basis, and a growth rate of 2.75, yielding a cost of equity capital recommendation of 10.50 percent (the 10.50 percent revised to 10.25 percent) (10.43 to 11.10 percent range for PP&L; 10.36 to 10.62 percent range for the barometer group). OTS Exh. 3, Sched. 5 at 1 and 2.⁶

b. Witness Deardorff's
Calculated DCF Growth
Rates Are Valid And

⁴ The impact on stranded investment is \$109 million.

⁵ The 3.44 times interest coverage is fairly consistent with the S&P's standard of 3.50 times required for an electric utility with a bond rating of A. PP&L's long-term debt is rated A-. OTS St. 3 at 31.

⁶ During the surrebuttal phase, Mr. Deardorff updated his analysis. A review of OTS Exhibit No. SR-3, Schedule 5, at pages 1 and 2, the DCF results for PP&L are in the range of 10.18 to 10.65 with an average of 10.41 percent. The DCF results for the barometer group are in the range of 9.92 to 10.07 percent with an average of 10.0 percent. OTS St. SR-3 at 2.

Proper Estimated Investor
Expectations.

In arriving at an appropriate dividend growth rate, Mr. Deardorff relied upon several sources. Namely, the growth rate estimates were based upon an evaluation of Value Line estimates, S&P's consensus estimates, and five-year historical growth rates. OTS Exh. 3, Sched. 5 at 3. After an exhaustive analysis, Mr. Deardorff concluded that investors could reasonably expect to achieve a growth rate of 2.5 to 3.0 percent for PP&L. OTS St. 3 at 23; OTS Exh. 3, Sched. 5 at 3.

There are several factors that lead Mr. Deardorff to believe that investors should expect to achieve a growth rate of 2.5 to 3.0 percent for PP&L. As previously discussed, Mr. Deardorff relied upon several sources in his analysis, in that regard, the forecasted growth rates for PP&L were 0.0 percent for dividends, 3.0 percent for S&P earnings growth, and 2.5 percent for Value Line five-year earnings growth, which represents an average growth of 1.8 percent for the three variables. OTS St. 3 at 24.

It is critical in understanding this analysis, that Mr. Deardorff was correct in not giving any weight to PP&L's forecasted dividend growth rate. As the electric utilities proceed to enter a competitive environment, the markets are sensitive to this issue. Accordingly, Mr. Deardorff was correct to conclude that in response to

a perceived increase in business risk resulting from the transition to a competitive environment, dividend growth is being restrained in order to strengthen equity ratios. OTS St. 3 at 24. For example, with respect to PP&L, the equity ratio increased from 40.5 percent in 1990 to 43.1 percent in 1995 and is expected to increase further to 54.5 percent in 2000. *Id.*, at 24; Value Line Investment Survey, (March 14, 1997). Consequently, Mr. Deardorff, for the purpose of this proceeding, correctly concluded that until the transition is complete dividend growth rates will be biased and should be give less weight in a DCF analysis. OTS St. 3 at 24. By giving the forecast of dividend no weight, Mr. Deardorff correctly concluded that investors could reasonably expect to achieve a growth rate in the range of 2.5 to 3.0 percent for PP&L, using earnings growth rates as a proxy for dividend growth rates. *Id.*, at 24. Accordingly, the analysis of PP&L earnings growth rates as presented by Mr. Deardorff should be adopted by the Commission.

As a comparison between PP&L and the barometer group with respect to growth rates, Mr. Deardorff determined that investors could reasonably expect to achieve a growth rate of 3.25 to 3.75 percent for the barometer group. OTS Exh. 3, Sched. 5 at 3, line 14. By using the same three variables with the barometer group as he did with PP&L, Mr. Deardorff concluded that the forecasted growth rates for the barometer group were 2.3 percent for dividends, 3.3 percent for S & P earnings growth, and 3.8 percent for Value Line five-year earnings growth, which

represents an average of 3.1 percent. OTS St. 3 at 25. As with PP&L's forecasted dividend growth rates, Mr. Deardorff correctly gave no weight to the barometer group's dividend growth rates. Id., at 25. An analysis of the barometer group's average equity ratio indicates that the average equity ratio increased from 43.2 percent in 1990 to 46.7 percent in 1995 and is expected to increase further to 52.9 percent in 2000. Id., at 25; Value Line Investment Survey, (March 14 and April 11, 1997). By giving the forecasted dividend growth rates no weight, Mr. Deardorff correctly concluded that until the transition (to competition) is complete dividend growth rates will be biased and should be given less weight in a DCF analysis.

Consequently, Mr. Deardorff properly concluded that investors could reasonably expect to achieve a growth rate in the range of 3.25 to 3.75 percent for the barometer group using earnings growth rates as a proxy for dividend growth rates, and Mr. Deardorff's analysis should be adopted. OTS St. 3 at 26.

- c. Witness Deardorff's
Dividend Yield Analysis
Also Properly
Estimates Investor
Expectations.

As explained by Mr. Deardorff, a proper calculated dividend yield must be analyzed over a time frame that avoids the problems associated with short-term aberrations and stale data series. OTS St. 3 at 19. For ease of reference, the

following table summarizes Mr. Deardorff's dividend yield computations for PP&L and the barometer group:

	Dividend Yields (Adjusted)		
	Spot 5/30/97 (%)	52-week Average (%)	Average (%)
PP&L	8.35	7.68	8.01
Barometer Group	7.12	6.86	6.99

See OTS Exh. 3, Sched. 5 at 1-2.

The 8.35 percent spot dividend yield is extremely high, which suggests that either growth forecasts are overstated or PP&L's current stock price is undervalued. OTS St. 3 at 20. Consequently, as it relates to PP&L's DCF analysis, Mr. Deardorff, in recognition of the spot yield problem, relied more heavily on the 52 week average because the spot yield is being overly influenced by the uncertainty surrounding the current rate restructuring filings.⁷ Id., at 20. As a result of Mr. Deardorff's analysis the average dividend yield for PP&L is 8.01 percent.

⁷ For purposes of the barometer group DCF analysis, Mr. Deardorff placed equal value on the most recent spot and 52 week dividend yields. OTS St. 3 at 20.

d. Conclusion

OTS submits that witness Deardorff's DCF results, which are based on valid applications of the DCF methodology, should be adopted in this proceeding. For the reasons previously discussed, and other reasons provided below, OTS submits that Mr. Deardorff's DCF analysis, as well as the results of his analysis, fairly reflect the investor's expected cost of capital in the market place and should be adopted by the Commission.

By way of summary, the DCF results are based on two assumptions concerning general market conditions. These assumptions are that (1) the payout ratio will remain constant and (2) price/earnings ratios will remain constant. OTS St. 3 at 27. Further, as Mr. Deardorff explained, both assumptions are required in a constant growth DCF model so that both the dividend yield and growth rate can be assigned specific values. *Id.*, at 27. An examination of OTS Exhibit No. 3, Schedule 5 at 4, as it relates to the first assumption illustrates that for PP&L and the barometer group, the historical payout ratios have remained around the ten year averages of 80.3 and 79.9 percent, respectively. As explained by Mr. Deardorff, Value Line expects this stable situation to change significantly in the future, which signals that earnings and dividends are expected to grow at different rates. OTS St. 3 at 27.

The second assumption is that the price/earnings ratio will remain the same from time of purchase to time of sale. Mr. Deardorff acknowledges that it is not his contention that price/earnings will be the same for the prospective period; however, from a rate-making context, such a strict assumption is necessary. Id., at 28. The failure of not making such a strict assumption would make a specific estimate of a rate of return extremely complex for the prospective period.

As Mr. Deardorff examined in detail regarding the two assumptions previously outlined, he correctly concluded that with respect to the barometer group, the price/earnings ratio on average are expected to decrease slightly over the next five years from 11.3 to 10.7. OTS Exh. 3, Sched. 5 at 5. OTS submits that the decreasing price/earnings ratios suggests that earnings are expected to increase faster over the next five years in comparison to most other variables, and that extreme caution must be exercised in the manner suggested by Mr. Deardorff with respect to the growth rate selection process. OTS St. 3 at 28-29.

As previously discussed, Mr. Deardorff exercised extreme caution by not giving any weight to PP&L's forecasted dividend growth rate. Mr. Deardorff was cognizant that as electric utilities proceed into a competitive environment, the markets are sensitive to this issue. Therefore, Mr. Deardorff, in recognition of this sensitivity, concluded that in response to a perceived increase in business risk

resulting from the transaction to a competitive environment, dividend growth is being restrained in order to strengthen equity ratios.

Consequently, as previously discussed, Mr. Deardorff, for the purpose of this proceeding, correctly concluded that until the transition to “competition” is complete, dividend growth rates will be bias and should be given less weight in a DCF analysis.

Consequently, Mr. Deardorff concluded that the price/earning for PP&L is expected to remain relatively stable over the next five years.

4. PP&L's Witness Moul's Cost Of Equity Recommendation Is Greatly Overstated And Should Be Rejected.

Company witness Moul recommends a cost of equity of 12.75 percent for PP&L based upon results of the DCF model, Risk Premium (RP) analysis, Capital Asset Pricing Model (CAPM) and Comparable Earnings approach. PP&L St. 6 at 2. As previously discussed, the Commission has primarily relied upon the DCF model in determining the appropriate cost of equity for utilities in the Commonwealth of Pennsylvania. Most interesting is the fact that in PP&L's most recent base rate case, Mr. Moul utilized the same identical methodologies as utilized by PP&L in the instant case. Namely, in PP&L's most recent base rate case, Mr. Moul utilized the DCF model, RP, CAPM and Comparable Earnings approach in recommending a cost of equity in that proceeding. In its Opinion and Order in Pennsylvania Public Utility Commission, et al. v. Pennsylvania Power & Light Company, R-00943271 (Order entered September 27, 1995), the Commission quoted from Administrative Law Judge Christianson's Recommended Decision in rejecting Risk Premium and CAPM analyses as follows:

[F]irst, we [i.e., the Commission] cannot accept that historic experienced earnings reflect the cost of capital.

We know of no reputable analyst who would seriously argue that experienced earnings represent the cost of equity, except by pure happenstance. But, such is the inherent assumption of each methodology [Risk Premium and CAPM]. Second, we cannot accept, even assuming that historic experience earnings represented the cost of capital that the average premium of an equity investment over a fixed income investment over a period as long as 50 years, represents the investor required premium in today's and tomorrow's market.

Accordingly, we conclude that we can place little credence in the results of these methodologies.

mimeo, at 160-161.

Moreover, Administrative Law Judge Christianson noted in his Recommended Decision in Pennsylvania Public Utility Commission v. Duquesne Light Company, 66 Pa. PUC 518 (1988), that the Commission declared "that the economic environment over lengthy time frames is not representative of current economic conditions and therefore does not produce realistic risk premium results." See, Pennsylvania Public Utility Commission v. Pennsylvania Power & Light Company, R-00943271 (Recommended Decision) at 163. Based upon the record evidence in PP&L's last base rate case, the Administrative Law Judge based his equity return recommendation in that proceeding primarily upon the DCF method and judgment. Id., at 163. Not surprisingly, in that proceeding, PP&L filed Exceptions to Administrative Law Judge Christianson's equity

recommendation. The Commission ruled upon PP&L's Exceptions to the equity recommendation, in pertinent part, as follows:

In its Exceptions, PP&L notes that the Commission in recent years based its rate of return allowances on the DCF method. PP&L urges the Commission to "keep an open mind" on the various methods of calculating an equity return allowance. (PP&L Exceptions at 29).

.....

On the basis of the record before us herein, we conclude that there is no reason for us to divert from our practice of considering the DCF method exclusively for equity rate of return determination. Accordingly, PP&L Exceptions regarding this issue are denied. (Emphasis Added).

mimeo at 184.

OTS submits that the Commission's precedents supports the contention that the Commission in recent years has based its rate of return allowance on the DCF method. Moreover, the record evidence in the instant proceeding supports the conclusion that the Company has provided no credible reason for the Commission to consider any other methods, other than the DCF method exclusively for equity rate of return determination in this proceeding.

With respect to the record evidence in the instant proceeding, OTS witness Deardorff has provided credible testimony as to why Risk Premium and CAPM results should not be given significant weight along with the DCF results. First of all, as Mr. Deardorff explained, the CAPM and Risk Premium methods give

results that indicate to an investor what the equity cost rate should be if current economic and regulatory conditions are the same as those present during the historical period the risk premiums were determined. OTS St. 3 at 36. Even after the Commission's numerous discussions regarding the CAPM and Risk Premium methods, including PP&L's most recent base rate case, PP&L has failed to recognize that the relevance of these methods (CAPM and Risk Premium) does not carry from the investment decision making process to the regulatory process because the Commission, nor anyone else, can ever be certain that economic and regulatory conditions underlying the historical period during which the risk premiums were calculated are the same today or in the future. Id., at 37. OTS submits that the argument against relying upon the CAPM and Risk Premium methods are even more critical in this proceeding due to the electric industry, including PP&L moving through the restructuring process. An acceptance of PP&L's position in this proceeding would be the acquiescence of a rationale that regulatory conditions underlying the historical period, during which the risk premiums were calculated, are the same as a restructure (competitive environment) electric industry. Accordingly, there should be no dispute that economic and regulatory conditions are different from the historical period, and thus the CAPM and Risk Premium methods do not measure the current rate of return on common equity directly as does the DCF model. Simply put, the use of a constant risk

premium fails to capture the effect of changing economic conditions over time.

OTS St. 3 at 38.

Additionally, as indicated in OTS Exhibit No. 3, Schedule 8, an academic article published in the "New York Times" was critical of the CAPM model, in that the model did not do well in predicting actual returns. Accordingly, Mr. Deardorff is of the opinion, and the Commission has previously agreed, that rational investors will give less credibility to expected equity returns that are calculated using the simple CAPM model. OTS St. 3 at 38.

The Risk Premium methods, and Mr. Moul's CAPM rely upon some form of DCF calculation to determine common stock returns from which bond returns are subtracted to determine the equity risk premium. *Id.*, at 39. Consequently, logic dictates that if the Risk Premium and CAPM methods is dependent on some form of the DCF, then the DCF is sufficient to stand alone in providing the necessary calculations in determining a proper cost of equity.

OTS submits that solely relying upon the DCF method in determining a proper cost of equity is sufficient if the analysis has been conducted correctly. In the instant case, PP&L witness Moul has made several serious errors in his DCF analysis. Namely, Mr. Moul inflated his DCF results by making an unwarranted ex-dividend adjustment to his dividend yields and an unwarranted 0.5 percent upward adjustment to his growth rates to reflect "market factors".

Mr. Moul's ex-dividend adjustment should be rejected since there is no academic evidence that supports an ex-dividend adjustment to dividend yields in the context of the DCF model. OTS St. 3 at 34. Moreover, there are no financial publications that provide ex-dividend adjusted dividend yields to investors for their investment decision making purposes. Id., at 34. In addressing the issue of "ex-dividend adjustment to dividend yields" in rebuttal, Mr. Moul's testimony failed to provide any academic sources and/or evidence that supports PP&L's concept that an "ex-dividend adjustment to dividend yields" should be used in a DCF model. See PP&L St. 6-R at 16. On rebuttal, Mr. Moul testifies that publications do provide the following with respect to ex-dividend:

% When a stock trades ex-dividend.

% Ex-dividend dates to investors.

% Ex-dividend dates for all common stocks.

Id., at 16. OTS submits that on rebuttal, Mr. Moul has failed to provide any publication(s) that provides the calculation for "ex-dividend adjustment to dividend yields", which is entirely different from reporting "ex-dividends dates and stock trading ex-dividends". Simply put, if an investor utilizes the dates and market prices of ex-dividend as suggested by Mr. Moul, that investor(s) will need to perform his own calculation for an ex-dividend adjustment to dividend yields in the same manner as performed by Mr. Moul in this proceeding, if that investor(s)

is using the information for investment purposes. Since such a calculation by an investor(s) is unlikely, there is absolutely no independent support, academic or otherwise, for Mr. Moul's "ex-dividend adjustment to his dividend yields" for DCF purposes, and such an adjustment should be rejected.

Another area of concern as previously referenced, is Mr. Moul's 0.5 percent upward adjustment to his growth rates to reflect "market factors". It must be noted that OTS is of the opinion that Mr. Moul's growth estimates of 3.0 percent accounts for "market factors". OTS St. 3 at 35. An examination of the Company's exhibits in this proceeding demonstrates that Mr. Moul has relied upon "analysts projections" as they appear on Schedule 7 of PP&L Exhibit PRM 2. Most important is the fact that analysts projections" are based upon "market factors" listed on page 3 of PP&L Exhibit PRM 1. Id., at 35. Consequently, any additional and independent recognition of "market factors" by Mr. Moul in addition to the "analysts projections" is a double count. Accordingly, the additional 0.5 percent to the 3.0 percent growth rate should be rejected.⁸

⁸ OTS witness Deardorff noted that Mr. Moul failed to provide any evidence that market factors result in positive impact on the growth rate for the electric companies. OTS St. 3 at 35. Mr. Moul concedes that market factors could possibly result in negative growth. PP&L St. 6-R at 17-18. Yet, while conceding, Mr. Moul without any support suggest that such negative growth "only add to investor expectation of higher stock prices in an exuberant "bull" market. Id., at 18.

Finally, OTS submits that Mr. Moul's total and sole reliance upon PP&L's data during this time period is inappropriate. As previously discussed, there is a certain degree of uncertainty as PP&L proceeds through its restructuring filing, which has caused a temporary increase in investment risk to the equity shareholder resulting in aberrations in PP&L's stock price. OTS St. 3 at 39. There should not be a surprise to anyone that equity shareholders are waiting for the Commission's decision in the instant proceeding, before PP&L's stock price are no longer subject to aberrations as a result of restructuring. There should be no dispute that PP&L's short-term investment risk has increased since the beginning of the year. Note that since the beginning of the year, the stock price of PP&L has declined 13 percent compared to a decline in the price of only 6 percent for the barometer group. See "Value Line Investment Survey, Summary & Index", January 3, 1997 and May 30, 1997; OTS St. 3 at 40.

Consequently, there should not be any attempt to use aberrant data in analyzing long-term capital cost rates like Mr. Moul has done in this proceeding. As the current proceeding concludes, many of the uncertainties (e.g, the amount of PP&L's stranded costs) will result in a subsequent decrease in investment volatility and risk.

In conclusion there should no dispute that Mr. Moul's DCF analysis is severely deficient and should be rejected by the Commission.⁹

⁹ Previously discussed in this Main Brief is the fact that PP&L's generation mix has 31 percent nuclear compared to 15 percent for Mr. Moul's barometer group.

C. Regulatory Assets And Liability

3. Taxes Other Than Income

As OTS witness Reed explained, a regulatory asset is defined in the Statement Of Accounting Standard No. 71 (SFAS), Page 1, item 3, in pertinent part, as “that procedure that creates assets (future cash inflows that will result from the ratemaking process), or create liabilities (future cash outflows that will result from the ratemaking process) for the regulated enterprise.” OTS St. 2 at 11. In reviewing the Company’s claim as it relates to “Taxes Other Than Income”, Mr. Reed determined that PP&L included as taxes other than income, the Pennsylvania Capital Stock Tax and the Pennsylvania Public Utility Realty Tax for the purposes of its restructuring filing. OTS St. 2 at 16.

Before there is a discussion regarding how PP&L calculated its 1996 Capital Stock and Public Utility Realty taxes, OTS Reed provided the Commission with definitions for each of the taxes in question. As Mr. Reed explained, the Capital Stock represents the property and assets of a corporation and the underlying corporate property and assets. Id., at 16. The tax is calculated at 12.75 mills times the taxable portion of the capital stock value at the end of the current year. Id., at 17. With respect to the Public Utility Realty Tax (“PURTA”), this tax is collected by the Commonwealth in lieu of local real estate taxes, and is distributed to local taxing authorities. Taxable property consists of the realty

located within the Commonwealth and owned by the utility directly or indirectly through a subsidiary, which is used in rendering a public utility service. Id., at 17-18. The Public Utility Realty Tax is calculated at the rate of 42 mills on the cost of taxable property, less depreciation or depletion, at the end of the preceding calendar year. Id., at 18.

In this proceeding upon reviewing the Company's filing, as previously noted, OTS witness Reed determined that PP&L included a claim for taxes other than income in the revenue requirement used to establish stranded generation costs. The revenue requirement presented by the Company for determining stranded costs included an annual revenue requirement applicable to taxes other than income for both nuclear and fossil Generation. OTS St. 2 at 18. A review of PP&L Exhibit JRS 1 at 4-5, is record evidence that the Company escalated the 1996 Capital Stock and Public Utility Realty taxes relating to nuclear and fossil plants by 2.4 percent annually, over the life of the respective plants. OTS believes that this "escalation" is improper and should be disallowed.

The basis for OTS' belief that PP&L's escalation is improper is that in its calculation of taxes other than income, PP&L assumes that the taxes will increase at the rate of inflation and thereby ignoring the basic elements that comprise both taxes, that is net income and rate base. OTS St. 2 at 19. As Mr. Reed explained, the major elements used to determine both taxes do not have a direct relationship

with inflation, and for stranded cost purposes, actually increase slowly or decrease over the life of the fossil and nuclear plants. Id., at 19. By way of further explanation, it must be noted that the Capital Stock Tax is the average of two components, book income and net worth. Consequently, as the net worth does increase with book income, the other half of the calculation, average book income, decreases each year as a lower income year is added and a greater income year is dropped from the calculation. OTS St. 2 at 20. In the case of the Public Utility Realty Tax, the tax is based on net book value of realty assets, thus the value is reduced each year with depreciation. Id., at 20.

Notably, a review of OTS Exhibit 2, Schedule 3 at pages 1 through 3 provides an overview of the individual components of taxes other than income-nuclear generation. In that exhibit, the ratio of Capital Stock Tax and Public Utility Realty Tax to total tax for nuclear generation was applied to the total taxes other than income (\$20.6 million) for fossil generation. Consequently, the annual revenue requirement for the Capital Stock Tax component of stranded revenue requirement was determined for the 1996 Capital Stock Tax for nuclear generation (\$10.9 million) without an adjustment for inflation. The same procedure was performed by OTS with respect to fossil generation, except the 1996 Capital Stock Tax for fossil generation was allocated among the individual generation units. OTS St. 2 at 21. The allocation of the Capital Stock Tax to individual fossil

generation had the effect of reducing the tax to fossil generation as the individual plants are retired by PP&L. Notwithstanding the enormous record evidence in this proceeding, this adjustment is rather simple. In that regard, OTS' adjustment to PP&L's Capital Stock Tax is essentially the same as the Company's filing. The only difference is that OTS' adjustment accurately reflects the level of Capital Stock Tax as a function of net worth as opposed to "inflation" as proposed by the Company.

In addressing the Public Utility Realty Tax, OTS witness Reed was able to provide the tax for stranded cost purposes by reducing the 1996 taxes other than income relative to the PURTA tax to a factor of net rate base. OTS St. 2 at 22. As Mr. Reed explained, the resulting factor was then applied to the net rate base figures for the remaining plant lives both nuclear and fossil generation facilities. Id., at 22. OTS submits that this method is proper and should be adopted, as there should be no dispute that this method supports the conclusion that the PURTA tax will decrease as a function of net plant as opposed to increasing as a result of inflation.

In the rebuttal phase of this proceeding, PP&L presented the rebuttal testimony of Joseph Schadt at PP&L Statement 8-R, regarding OTS' adjustment to taxes other than income. PP&L witness Schadt is under the mistaken belief that the Act, requires that revenues expected to be collected by the Commonwealth

remain “neutral” and PP&L has interpreted this provision of the Act of allowing the Company to increase taxes other than income for inflation in an otherwise revenue neutral figure. PP&L St. 8-R at 36. OTS submits that Mr. Schadt’s interpretation of the Act, that revenue neutrality include an increase for inflation, cannot be supported by the language of Section 2810 (A) of the Act, which provides in pertinent part as follows:

“It is the intention of the General Assembly to establish this revenue replacement at a level necessary to recoup losses that may result from the restructuring of the electric industry and the transition thereof.”

A proper interpretation of the Act provides a base year amount that the Commonwealth of Pennsylvania’s Department of Revenue should realize and defines a calculation that will either increase or decrease the tax rate of the effected tax calculations to achieve that amount. OTS St. SR-2 at 4. A review of Section 2810 of the Act reveals that there is no reference explicitly, or by implication, that defines the tax rate calculation as a factor for inflation. In fact, on cross examination, Mr. Schadt acknowledges that the Act does not specifically reference the term “inflation”. (Tr. 1592-August 26, 1997) Simply put, the “revenue neutrality” concept applies to the tax revenue realized by the Commonwealth of Pennsylvania’s Department of Revenue not PP&L. Consequently, PP&L’s

calculation of “Taxes-Other than Income” serves no purpose other than to increase the Company’s stranded cost claim, and thus should be rejected.

Another aspect of Mr. Schadt’s rebuttal to OTS’ adjustment to “Taxes-Other than Income” is his concern that the Commonwealth has used tax increases to fund revenue shortfalls in the past and that tax revenues must keep pace. While Mr. Schadt’s concern about the ability of the Commonwealth to raise taxes may be considered admirable, such a concern is not relevant to how this Commission addresses the Company’s Capital Stock Tax and PURTA liability.

Based upon the record evidence and arguments set forth above, OTS witness Reed’s adjustment should be adopted, which reduces PP&L’s stranded costs relative to nuclear plant by \$280.7 million and fossil by \$66.1. See OTS Exh. 1, Sched. 5.

4. Fossil Fuel Decommissioning

Fossil fuel decommissioning is the dismantlement, removal and disposal of the components of a fossil-fired steam generating facility at the end of its useful life. Traditionally, the Commission has allowed a utility to recover the net of the positive salvage and the cost of removal on a current basis for book and ratemaking purposes. The Commission has used a five year average of actually experienced net salvage as a leveling device.

As set forth by PP&L in this matter, they are claiming a net present value of decommissioning expenses for fossil fuel generation plant of \$1,074,961,000. This number is the sum of the Company's fossil decommissioning found on Pages 20-23 of Schedule 117 in PP&L Exhibit JRS - 1.

The Company has included the cost of decommissioning each of its fossil fuel power stations in the stranded cost analysis as a necessary future revenue stream. These dollars have been valued to 1999 dollars and their recovery has been included in the Competitive Transition Charge (CTC).

OTS has made no adjustment to the level of the Company's fossil fuel decommissioning claim. OTS does have a position concerning the treatment of the decommissioning claim after the money has been collected.

With regard to the Company's claim for fossil fuel decommissioning, OTS witness Mr. Gruber has testified that if the Commission allows the Company to include the fossil fuel decommissioning claim in its stranded cost analysis, then OTS recommends that the Company be ordered to segregate the money collected for fossil fuel decommissioning in a separate non-qualified trust fund. This fund would not be accessible to the Company until it actually decommissions a fossil fueled power plant. (See OTS Statement No. 1, Pages 15-16)

Mr. Gruber further testified that if the Company sold a fossil fuel power station in the future, the fund would remain in the custody of the Company. When

the power station that has been sold is decommissioned, the Company would disburse the appropriate amount of funds from its decommissioning fund to the entity responsible for the decommissioning. Mr. Gruber also testified that the Company would only be responsible for the amount of decommissioning expense it had collected while associated with that power plant, to the extent that the cost is greater than the amount in the fund, the Company who owns the station would be responsible to make up the difference.

7. Susquehanna Deferred Refueling Costs

In its filing, the Company has claimed SSES Deferred Refueling Costs as an individual item in its claim for regulatory assets. By way of further discussion, the deferred refueling costs represents incremental maintenance costs incurred during refueling and inspection outages which are deferred and subsequently amortized from the end of the outage until the next scheduled refueling and inspection outage is complete. PP&L Exh. JRS-1, at 12-13; OTS St. 2 at 13-14.

The basis for the Company's claim is its annual PaPUC jurisdictional amortization for both costs for 1999; however, OTS witness Reed is recommending that the Company's claim for stranded costs relating to Regulatory Assets exclude the amounts associated with deferred refueling costs. OTS St. 2 at 14. As Mr. Reed explained, deferred refueling costs are not regulatory assets that

are recoverable through a traditional amortization, but are typical ongoing expenses that, in a regulatory environment, are recoverable in base rates at normalized levels. Id., at 14.

In rebuttal, PP&L suggests that since the Company did propose to recover deferred refueling outage costs in a period after they were incurred, it was necessary to accumulate and defer the actual costs of the first refueling outage on the Company's books and amortize this amount over the period it was to be recovered in rates. PP&L St. 8-R at 46. The Company supports its argument by claiming that an Administrative Law Judge approved PP&L's request to defer its refueling costs on the Company's book and amortize them for book purpose. Additionally, according to PP&L witness Schadt, the Commission at Docket No. R-822169, agreed with the Administrative Law Judge and approved the Company's request to defer refueling outages on the Company's books of account. Id., at 46. Consequently, according to the Company on rebuttal, PP&L has been utilizing this deferral method for both SESS units since 1983.

Since the Company, in its rebuttal, has relied upon a Commission's Opinion and Order at Docket No. R-822169, which is Pennsylvania Public Utility Commission v. Pennsylvania Power & Light Company, 55 PUR4th 185, 228-229 (1983), there is a critical need to review this case carefully and in its entirety. Upon reviewing this case in question, OTS submits that the Commission in its Order

approved PP&L's request to accrue and defer first refueling costs of Unit 1. However, that approval was specifically addressed to the costs of the first Unit 1 outage in 1984 and was for book purposes only. OTS St. SR-2 at 7. Accordingly, no allowance was made for their recovery in rates. The Commission's Opinion and Order simply preserved the Company's right to claim the first Unit 1 outage costs in a future rate proceeding. Id., at 7. PP&L's argument suggesting that the case at Docket No. R-822169, supporting the recovery of Susquehanna deferred refueling costs, in this instant proceeding is incorrect. Moreover, the Commission's Opinion and Order in PP&L's most recent base rate case at Docket No. R-00943271, clearly did not institute an annual amortization for which the Company would be entitled to full recovery, but establish a normalized annual level of expense applicable to the deferred refueling costs that would be included in rates. Simply put, there is not support in Commission Opinions and Orders for the position articulated by PP&L regarding claiming deferred refueling costs as regulatory assets for stranded costs purposes.

On cross-examination, PP&L witness Schadt acknowledged that he, as the Company's expert witness in this area, did not understand for ratemaking purposes, the difference between amortization and normalization. (Tr. 1588-August 26, 1997). OTS submits that this admission is key as to why the Company has made a mistake in claiming deferred refueling costs as a regulatory asset. OTS submits that

in order to fully comprehend the issue of whether it is proper for the Company to claim SESS Deferred Refueling Costs as stranded regulatory assets, the expert witness must understand the difference between normalization and amortization for ratemaking purposes. Obviously, by Mr. Schadt's own admission, he did not understand the difference between normalization and amortization. Interestingly, after OTS witness Reed had provided definitions of amortization and normalization in his direct testimony, Mr. Schadt continued not to understand the difference between the two, yet he appeared as the Company's expert witness on whether PP&L should recover SESS Deferred Refueling Costs as stranded regulatory assets.¹⁰

As Mr. Reed explained, normalization is a ratemaking concept that describes the transformation of an operating expense that recurs at irregular intervals and in irregular amounts into a "normal" annual test year expense allowance. OTS St. 2 at 15. Amortization is an accounting concept that extinguishes an atypical, nonrecurring expense over a pre-determined number of years by charging to operations a pro rata share based on the selected amortization period. *Id.*, at 15. OTS submits that it is critical to understand that recovery of normalization expenses do not extend over a period of years and therefore claims for unrecovered

¹⁰ Mr. Schadt also appeared on behalf of the Company as to whether PP&L should recover its 1994 Rate Case Expense as a stranded regulatory asset.

normalized expenses in subsequent proceedings cannot exist and must be disallowed. Id., at 15. In contrast, an amortization allowance could be claimed in succeeding proceedings as long as there is a remaining unamortized balance. Id., at 15. In applying the definition of normalization and amortization to the issue of deferred refueling costs, OTS submits, and the Commission's Order supports, the conclusion that the Commission did not allow PP&L to amortize the full amount of deferred refueling costs in the Company's last base rate proceeding. The Commission allowed PP&L to reflect a claim for deferred refueling expenses in annual O & M at a normalized level, therefore PP&L's attempt to claim deferred refueling costs as a regulatory asset in this proceeding violates the definition of normalization and should not be allowed.

Accordingly, the effect of disallowing deferred fuel, along with rate case expense reduces the net present value relative to regulatory assets from \$383,911,000 to \$375,384,000, which results in a reduction of \$8,527,000.

11. Rate Case Expenses

Like SESS Deferred Refueling Costs, PP&L is attempting to claim its 1994 Rate Case Expense as a stranded regulatory asset. The Company's claim for Rate Case Expense represents the cost incurred relative to generation as a result of the Company's most recent base rate case. OTS St. 2 at 13. Like SESS Deferred

Refueling Costs, OTS disagrees with PP&L's recovery of 1994 Rate Case Expense as stranded regulatory assets. The reasons for OTS' recommendation are in many aspects similar to the reasons set forth above regarding SSES Deferred Refueling Costs. Despite the similarity, OTS will address certain arguments presented by PP&L in its rebuttal testimony.

In that regard, in rebuttal, PP&L witness Schadt defended the Company's claim for Rate Case expense as a stranded regulatory asset, based on the Company's belief that for accounting purposes, PP&L properly established a regulatory asset in accordance with SFAS 71 . Furthermore, it is this regulatory asset which the Company is recognizing as a stranded cost in this proceeding. PP&L St. 8-R at 39. Mr. Schadt's arguments may be proper for accounting purposes, but are not proper for ratemaking purposes, where certain expenses are normalized. From a ratemaking viewpoint, PP&L is only entitled to include in rates an amount that represents what would normally be incurred in a year for litigating a base rate case. OTS St. SR-2 at 6. As previously discussed, contrary to Mr. Schadt's argument, for ratemaking purposes, the total rate case expenses has no significance beyond the determination of a normal year's expense. Id., at 6. Simply put, as Mr. Reed explained, PP&L is not entitled to recovery of its unamortized rate case expense in this proceeding than it would be in a base rate proceeding in a regulated environment. Id., at 6.

The Act, at 66 Pa. C.S. Section 2803, defines stranded costs in pertinent part as that “which traditionally would be recoverable under a regulated environment but which may not be recoverable in a competitive electric generation market.” Consequently, there is no basis for the Company’s position to recover its 1994 Rate Case Expense as stranded regulatory assets. Since the manner in which PP&L is seeking to recover these costs, the same costs could not be recovered in that manner in a regulated environment. The effect of Mr. Reed’s disallowance of the rate case expense and the deferred fuel results in reduction of \$8,527,000 to the Company’s net present value relative to regulatory assets.

VI. DETERMINATION OF PRESENT VALUE

A. Appropriate Discount Rate

On June 27, 1997, in his Direct Testimony identified as OTS Statement No. 3, and accompanying Exhibit No. 3, OTS witness Kevan L. Deardorff submitted expert testimony on issues including the discount rate, the reasonable rate of return for PP&L and each of the individual components of the rate of return. These components included capital structure, cost rates of long-term debt and preferred stock, and the cost of common equity.

On August 15, 1997, OTS witness Mr. Deardorff submitted Surrebuttal Testimony identified as OTS Statement No. SR-3 and accompanying OTS Exhibit No. SR-3. One of Mr. Dardorff's reasons for presenting Surrebuttal Testimony was for the purpose of revising the OTS recommended Discount Rate to account for changes that have occurred since the preparation of Mr. Deardorff's direct testimony.

The revised Discount Rate recommendation is **7.36 percent**. OTS Exhibit No. SR-3, Schedule No. 1 (Updated) presents this calculation. The decrease in the discount rate is the result of OTS witness Mr. Deardorff's recommended Cost of Equity *decreasing* from 10.50 percent to 10.25 percent. This revision was necessary to account for changes that have occurred in both analysts' growth forecasts and market data and to correct a computer programming error.

With the OTS adjustment in the recommended discount rate going from 7.47 percent to 7.36 percent, the impact on stranded plant is now \$109 Million rather than the \$87 Million that was presented in OTS witness Deardorff's direct testimony.

B. Application of Discount Rate

The OTS recommended discount rate of 7.36 percent was one input that the OTS used and plugged into the Net Present Value model in order to arrive at its Net Stranded Cost calculation.

VII. RECOVERY OF STRANDED COSTS

C. CTC Reconciliation and Tracking and

D. CTC and Rate Cap Extension

For the purpose of this proceeding, the Competitive Transition Charge (“CTC”)

is defined in 66 Pa. C.S. Section 2808 as follows:

“A nonbypassable charge applied to the bill of every customer accessing the transmission or distribution network which (charge) is designed to recover an electric utility’s transition or stranded costs as determined by the Commission under Section 2804 (relating to standards) and 2808 (relating to competitive transition charge).”

Consequently, the amount recovered as a CTC is subject to an annual reconciliation. The reconciliation occurs after the Commission has determined the appropriate amount of stranded costs and the total Kwh sales over which is to be recovered, the electric utilities will reconcile the actual annual Kwh sales to Kwh sales projected in the final order. OTS St. 2 at 8. Any over/underrecovery of stranded costs based on a variation in annual sales will be reflected as an adjustment to the subsequent years CTC. *Id.*, at 9.

In the instant proceeding, PP&L’s filing does not include an annual adjustment to its CTC. As explained by OTS witness Reed, it is the position of PP&L that the rate cap imposed by the Act prohibits the Company from fully

recovering its full level of stranded costs. OTS St 2 at 9. Consequently, any annual reconciliation that resulted in an increase to the CTC would be prohibited by the rate cap. *Id.*, at 9. As an alternative to reconciliation, the Company has proposed to track the annual collections pursuant to the CTC and compare them to the level authorized by the Commission, however, the actual CTC will not be adjusted to reflect any resulting differences. PP&L St. 3 at 17-19. Additionally, PP&L is proposing that near the end of the stranded cost recovery period, the CTC would be adjusted to reflect the net amount of over/undercollections that occurred throughout the stranded cost recovery period. *Id.*, at 9. Based upon PP&L's alternative proposal, depending on whether the amount is net over or underrecovery, the CTC will either be terminated early or extended beyond the maximum nine years specified in the Act. OTS St. 2 at 9-10.

OTS submits that PP&L's alternative to the reconciliation provision of the Act is inappropriate. First of all, PP&L's alternative is premised on the "unlikely" fact that the Commission will allow the Company to recover the full requested amount of its stranded costs. Consequently, if the Commission disallows a portion of PP&L's stranded costs, PP&L's CTC will be below the cap, which will allow PP&L to make annual adjustments to its CTC. OTS St. 2 at 10. Moreover, Section 2808 of the Act requires annual reconciliation of CTC revenues in order to ensure that CTC revenues are no less than, nor greater than, the authorized amount.

In the event that PP&L's CTC allowance does not permit an upward adjustment on an annual basis, OTS is recommending that the CTC should be tracked and the CTC be extended beyond nine years, if necessary. Id., at 10. The difference between the recommendations of OTS and PP&L is that OTS is recommending that any reconciliation of CTC overrecovery revenues that does not violate the rate cap imposed by the Act be made in the subsequent recovery year. Id., at 10. OTS is concerned that under the Company's proposal, a miscalculation or change in Kwh demand could result in overrecovered revenues that would be denied the customers/ratepayers without the benefit of receiving any accrued interest on the overrecovery. Id., at 10. An additional benefit of OTS' recommendation is that recognizing overrecoveries when they occur will provide rate cap relief so that the CTC can be adjusted to recoup any future underrecoveries.

Accordingly, the recommendation of OTS should be adopted by the Commission as being in the public interest.

XII. UNIVERSAL SERVICE AND CUSTOMER ASSISTANCE PROGRAMS

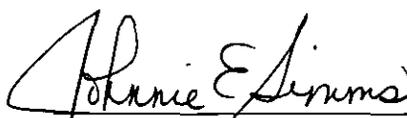
D. Other Universal Service And Customer Assistance Program Recommendations

OTS is recommending that with respect to the universal service fund charge (“USFC”), the USFC should be identified on the customer’s bill as opposed to the Company’s proposal to include the charge as a component of the distribution charge. OTS St. 2 at 7. It is OTS’ belief that due to full-disclosure, the ratepayers are entitled to full and complete knowledge of not only the individual components of its energy bill but also the Kwh charge for each component. Id., at 7. Since the USFC is a non-traditional business expense, OTS’ recommendation will allow for an easier determination of the amount recovered through rates versus the amount actually expended on the programs that comprise the universal service concept as defined in the Act. Accordingly, the Company, and ultimately the Commission, will be positioned for accountability and tracking of the universal service fund and revenues.

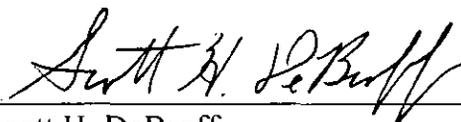
XIV. CONCLUSION

For the reasons set forth in this Main Brief, the Office of Trial Staff respectfully requests the Pennsylvania Public Utility Commission to issue an order allowing Pennsylvania Power & Light Company to recover no more than **\$3,171,875,000** in stranded cost.

Respectfully submitted,



Johnnie E. Simms
Senior Prosecutor



Scott H. DeBroff
Prosecutor

Office of Trial Staff
Pennsylvania Public Utility Commission

P. O. Box 3265
Harrisburg, PA 17105-3265

Date: February 11, 1998

APPENDIX A

**SUMMARY OF
STRANDED COSTS
(\$000)**

	<u>Company Claim</u>	<u>Adjustments</u>	<u>Adjusted Amount</u>
Nuclear	(2,851,961)	769,002	(2,082,959)
Fossil	(718,219)	440,259	(277,960)
NUG	(656,870)	(14,794)	(671,664)
Regulatory Assets	(383,911)	<u>8,527</u>	<u>(375,384)</u>
Total Net Present Value (NPV) in 1999 \$	<u>(4,610,961)</u>	1,202,994	(3,407,967)
OTS Sharing	<u>000</u> <u>(4,610,961)</u>	<u>236,092</u> <u>1,439,086</u>	<u>236,092</u> <u>(3,171,875)</u>

STRANDED COST CALCULATION - FOSSIL
(\$000)

	<u>Company Claim</u>	<u>Adjustments</u>	<u>Adjusted Amount</u>
Revenue Required (1999)	864,533	(52,047)	812,486
Market Revenue (1999)	<u>658,221</u>	<u>0</u>	<u>658,221</u>
Total (Deficiency)/ Excess (1999)	(206,312)	52,047	(154,265)
PUC Jurisdictional Percent (1999)	94.15 %		94.15 %
PUC (Deficiency)/ Excess (1999)	<u>(194,243)</u>	49,002	<u>(145,241)</u>
Summation of (Deficiency)/Excess Amounts (1999-2024)	<u>(950,483)</u>	867,494	<u>(82,989)</u>
Discount Rate	7.92 %		7.36 %
Net Present Value (NPV) in 1999 \$	<u>(718,219)</u>	<u>440,259</u>	<u>(277,960)</u>

STRANDED COST CALCULATION - NUCLEAR
(\$000)

	<u>Company Claim</u>	<u>Adjustments</u>	<u>Adjusted Amount</u>
Revenue Required (1999)	720,851	(83,025)	637,826
Market Revenue (1999)	<u>326,701</u>	<u>0</u>	<u>326,701</u>
Total (Deficiency)/ Excess (1999)	(394,150)	83,025	(311,125)
PUC Jurisdictional Percent (1999)	87.3%		87.3%
PUC (Deficiency)/ Excess (1999)	<u>(344,251)</u>	72,514	<u>(271,737)</u>
Summation of (Deficiency)/Excess Amounts (1999-2045)	<u>(5,669,834)</u>	1,931,583	<u>(3,738,251)</u>
Discount Rate	7.92%		7.36%
Net Present Value (NPV) in 1999 \$	<u>(2,851,961)</u>	<u>769,002</u>	<u>(2,082,959)</u>

**STRANDED COST CALCULATION
NON-UTILITY GENERATION (NUG)
(\$000)**

	<u>Company Claim</u>	<u>Adjustments</u>	<u>Adjusted Amount</u>
Cost of Purchase (1999)	168,576		
Market Value (1999)	<u>63,901</u>		
Cost in Excess of Market Value (1999)	(104,676)		
Less: Buy-out Payments (1999)	<u>(20,732)</u>		
Total (Deficiency)/Excess (1999)	(125,408)		
PUC Jurisdictional Percent (1999)	.9676%		
PUC (Deficiency)/Excess Percent (1999)	<u>(121,345)</u>		
Summation of (Deficiency)/Excess Amounts (1999-2015)	<u>(924,321)</u>		
Discount Rate	7.92%		
Net Present Value (NPV) in 1999 \$	<u>(656,870)</u>	<u>(14,794)</u>	<u>(671,664)</u>

**STRANDED COST CALCULATION -
REGULATORY ASSETS
(\$000)**

	<u>Company Claim</u>	<u>Adjustments</u>	<u>Adjusted Amount</u>
Unrecovered Energy Costs	80,150		80,150
Post-Retirement Benefits	1,032		1,032
Susquehanna Operating Costs	1,834		1,834
Common Plant Nuclear Other Production	715		715
Retired Miners' Healthcare Costs	6,582		6,582
DOE Assessment	2,411		2,411
Deferred Refueling Costs	8,343	8,343	- 0 -
Voluntary Early Retirement Costs	8,680		8,680
Employee Transition Costs	2,359		2,359
Rate Case Expenses	184	184	- 0 -
Taxes Recoverable Nuclear Other Production	13,408		13,408
Regulatory Liabilities Nuclear Other Production	<u>3,619</u>		3,619
Total PUC Amortizations (1999-2024)	<u>122,081</u>		
Net Present Value (NPV) in 1999 \$	<u>383,911</u>	<u>8,527</u>	<u>375,384</u>

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**Pennsylvania Public Utility
Commission**

v.

Pennsylvania Power & Light Company

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**Docket No.
R-00973954**

CERTIFICATE OF SERVICE

I hereby certify that I am serving the foregoing, the Main Brief of the Office of Trial Staff dated February 12, 1998, either personally, by first class mail, express mail or by fax upon the persons addressed below:

Paul E. Russell, Esquire
Pennsylvania Power and Light Company
Two North Ninth Street
Allentown, PA 18101

Scott T. Jones
The Economics Resource Group Inc.
One Mifflin Place
Cambridge, MA 02138

Donald H. Muth
PA Public Utility Commission
Bureau of Fixed Utility Services
P. O. Box 3265
Harrisburg, PA 17105-3265

John F. Povilaitis, Esquire
PA Public Utility Commission
Law Bureau
P. O. Box 3265
Harrisburg, PA 17105-3265

Warren W. Mack, President
AHL Strom Development Corporation
4350 LaJolla Village Drive
Suite 210
San Diego CA 92122

Billie Ramsey, Executive Director
ARIPPA
1300 Market Street
Lemoyne, PA 17043

Donald A. Kaplan, Esquire
Lisa M. Helpert, Esquire
Preston Gates Ellis & Rouvelas Meeds, LLP
Suite 500
1735 New York Avenue NW
Washington, DC 20006

Z. Ahmed Kaloko
PA Public Utility Commission
Bureau of CEEP
P. O. Box 3265
Harrisburg, PA 17105-3265

Craig Burgraff, Esquire
Barrett Sheridan, Esquire
James Mullins, Esquire
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120

David M. Kleppinger, Esquire
Robert A. Mills, Esquire
McNees, Wallace & Nurick
100 Pine Street
P. O. Box 1166
Harrisburg, PA 17108

Alan Kohler, Esquire
Daniel Clearfield, Esquire
Robert Longwell, Esquire
Wolf, Block, Schorr & Solis-Cohen
212 Locust Street
Suite 300
Harrisburg, PA 17101

Craig G. Goodman, Esquire
Senior Vice President, Law
Regulation and Public Policy
Equitable Resources, Inc.
3333 K Street NW
Suite 425
Washington, DC 20007

Glenn Bartron
PA Public Utility Commission
Bureau of Audits
P. O. Box 3265
Harrisburg, PA 17105-3265

Bernard A. Ryan, Jr., Esquire
Office of Small Business Advocate
1102 Commerce Building
300 North Second Street
Harrisburg, PA 17101

Elizabeth R. Benson
Energy Associates
7303 Timber Lane
Falls Church, VA 22046-2735

Richard L. Caplan, Esquire
Caplan and Luber, LLP
40 Darby Road
Paoli, PA 19301

Louis J. Carter, Esquire
7300 City Line Avenue
Philadelphia, PA 19151-2291

Ginny Kreitler
RMMI Inc. 111
Presidential Boulevard
Suite 127
Bala Cynwyd, PA 19004

Stephen J. Baron
J. Kennedy and Associates, Inc.
35 Glenlake Parkway
Suite 475
Atlanta, GA 30328

D. Jane Drennan, Esquire
Sarah T. Tomalty, Esquire
Drennan and Associates
1216 16th Street NW
Washington, DC 20036

James Melia, Esquire
Kirkpatrick and Lockhart
Payne-Shoemaker Building
240 North Third Street
Harrisburg, PA 17101-1507

Attorney of Record
Environmental Energy Project
3700 Vartan Way
Harrisburg, PA 17110

Eric J. Epstein
2308 Brandywine Drive
Harrisburg, PA 17110

Edwin D. Hill
International
Vice-President
IBEW
200 Corporate Center Drive
Suite 301
Corapolis, PA 15108

William T. Hawke, Esquire
Janet L. Miller, Esquire
Todd S. Stewart, Esquire
Norman James Kennard, Esquire
Malatesta, Hawke and McKeon
Harrisburg Energy Center
100 North Tenth Street
P. O. Box 1778
Harrisburg, PA 17105-1778

Joan O. Brandeis, Esquire
Schnader, Harrison, Segal and Lewis
1600 Market Street
Suite 3600
Philadelphia, PA 19103-4252

Robert P. Haynes, III, Esquire
Mette, Evans and Woodside
3401 North Front Street
Harrisburg, PA 17110-0950

William Schmitt
Local 1600 IBEW
540 Grange Road
P. O. Box 470
Trexlerstown, PA 18087

Lisa Yoho, Director
Regulatory Affairs
The Eastern Group, Inc.
2900 Eisenhower Avenue
Suite 300
Alexandria, VA 22314

David A. McCormick, Esquire
Department of the Army
Office of the Judge
Advocate General
901 North Stuart Street
Arlington, VA 22203-1837

Wayne M. Thomas, Esquire
Kohn Nast and Graff, PC
1101 Market Street
24th Floor
Philadelphia, PA 19107

Stephen J. Selden, Esquire
Bethlehem Steel Corporation
Eighth and Eaton Avenues
Bethlehem, PA 18016

Stephen L. Huntoon, Esquire
Mary McFall Hopper, Esquire
PECO Gas Supply Company
2301 Market Street
Philadelphia, PA 19101-8699

John L. Munsch, Esquire
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

Craig A. Doll, Esquire
214 State Street
Harrisburg, PA 17101

Terrance J. Fitzpatrick, Esquire
David M. DeSalle, Esquire
Ryan, Russell, Ogden and Seltzer
800 North Third Street
Suite 101
Harrisburg, PA 17102

Kenneth Zielonis, Esquire
Stevens and Lee
208 North Third Street
Suite 310
Harrisburg, PA 17101

Scott J. Rubin, Esquire
International Brotherhood of
Electrical Workers
Local 1600
3 Lost Creek Drive
Selinsgrove, PA 17870

Michael A. Stosser, Esquire
Adelia Borrasca, Esquire
Heller, Ehrman, White and McAuliffe
815 Connecticut Avenue NW
Washington, DC 20006-4004

Joel D. Newton, Esquire
Paul E. Nordstrom, Esquire
Deborah A. Swanstrom, Esquire
Clinton A. Vince, Esquire
Verner Liipfert Bernhard McPherson and Hand
901 15th Street NW
Washington, DC 20005

Michael Vough, Esquire
Vough and Associate
126 South Main Street
Pittston, PA 18040

Harry S. Geller, Esquire
PA Utility Law Project
118 Locust Street
Harrisburg, PA 17101

Susan M. Shanaman, Esquire
212 North Third Street
Suite 203
Harrisburg, PA 17101

M. Thomas Butler
CNG Retail Services Corporation
625 Liberty Avenue
Pittsburgh, PA 15222-3197

Linda C. Smith, Esquire
Dilworth, Paxson, Kalish & Kauffman, LLP
305 North Front Street
Suite 403
Harrisburg, PA 17101-1236

Joseph A. Dworetzky, Esquire
John J. Lavelle, Jr., Esquire
Hangley, Aronchick, Segal and Pudlin
One Logan Square
12th Floor
Philadelphia, PA 19103

Michael L. Kessler
Vice President and General Counsel
American Energy Solutions, Inc.
111 South Alfred Street
Alexandra, VA 22314

John P. Zinkand
Executive Vice President
Pennsylvania Petroleum Association
Suite 121, Building 2
2001 North Front Street
Harrisburg, PA 17102

Usher Fogel, Esquire
Roland, Fogel, Koblenz & Carr, LLP
1 Columbia Place
Albany, NY 12207

Gary A. Jeffries, Esquire
CNG Energy Services Corporation
One Park Ridge Center
P. O. Box 15746
Pittsburgh, PA 15244-0746

Brian A. Rider
Pennsylvania Retailer's Association
224 Pine Street
Harrisburg, PA 17101-1325

Gordon Smith, Esquire
Joelle Ogg, Esquire
JOHN AND HENGERER
1200 17th Street, NW
Suite 600
Washington, DC 20036-3006

John R. Orr, Esquire
DUKE ENERGY TRADING AND MARKETING, LLC
One Westchase Center
10777 Westheimer
Suite 650
Houston, TX 77042

David W. Francis, Esquire
Powell, Trachtman, Logan, Carrle,
Bowman and Lombardo, P.C.
114 North Second Street
Harrisburg, PA 17101

Roger Clark, Esquire
905 Denston Drive
Ambler, PA 19002-3901

Jerry Mendl
MSB Energy Associates
Suite 200
7505 Hubbard Avenue
Middletown, WI 53562

Andrew Altman, Deputy Director
Clean Air Council
135 South 19th Street
Suite 300
Philadelphia, PA 19103

Gene Stilp, Coordinator
PP&L Ratepayers Association
1550 FCVR
Harrisburg, PA 17112-9240

Randall B. Griffin, Esquire
Delmarva Power & Light Company
800 King Street
P. O. Box 231
Wilmington, DE 19899

Robert D. Knecht
Industrial Economics, Inc.
2067 Massachusetts Avenue
Cambridge, MA 02140

Bruce A. Connell, Esquire
Legal Department
600 North Dairy Ashford, ML-1034
Houston, TX 77079

H. Allan Knopp
Director - Regulatory Affairs
600 North Dairy Ashford, CH-1038
Houston, TX 77079

Anthony C. Adonizio, Esquire
Robert F. Young, Esquire
Allegheny Electric Cooperative, Inc.
212 Locust Street
P. O. Box 1266
Harrisburg, PA 17108-1266

Patricia Armstrong, Esquire
Regina L. Matz, Esquire
Thomas, Thomas, Armstrong & Niesen
212 Locust Street
P. O. Box 9500
Harrisburg, PA 17108-9500

Fred Zalcman, Esquire
Pace University School of Law
78 North Broadway
White Plains, NY 10603

Bruce Biewald, Esquire
Synapse Energy Economics, Inc.
101 Chilton Street
Cambridge, VA 02138

John Gallagher, Esquire
LeBeouf, Lamb, Greene and MacRae
200 North Third Street
Suite 300
P. O. Box 12105
Harrisburg, PA 17108-2105

George F. Denardo
Lucent Technologies
555 Union Boulevard
Allentown, PA 18103

David Boonin
New Energy Ventures, Inc.
200 South Broad Street
Suite 800
Philadelphia, PA 19102

Keith M. Sappenfield, II
Director of Marketing Support
NORAM Energy Management, Inc.
P. O. Box 2628
Houston, TX 77252-2628

David Cruthirds
Electric Clearing House, Inc.
1000 Louisiana
Suite 5800
Houston, TX 77002-5050

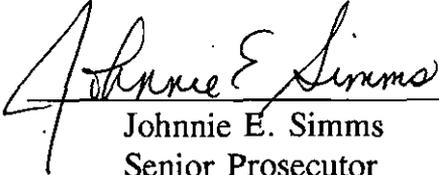
Norma J. Rosner, Esquire
General Counsel
VASTAR Power Marketing, Inc.
200 Westlake Park Boulevard
Houston, TX 77079

John Haucke, Executive Vice President
Pennsylvania Association of Plumbing,
Heating, Cooling Contractors, Inc.
4015 Jonestown Road
Harrisburg, PA 17109-9109

Vickiren S. Aeschleman
Director-Regulatory Policy
QST Energy Inc.
300 Hamilton Blvd.
Suite 300
Peoria, IL 61602

Sheila S. Hollis, Esquire
Mary Ann Ralls, Esquire
Stephanie A. Sugrue, Esquire
Duane, Morris & Heckscher, LLP
1667 K Street, NW
Suite 700
Washington, DC 20006-1608

Honorable George M. Kashi
Administrative Law Judge
PA Public Utility Commission
P. O. Box 3265
Harrisburg, PA 17105-3265



Johnnie E. Simms
Senior Prosecutor
Office of Trial Staff

Date: February 12, 1998
R-00973954

LAW OFFICES
WOLF, BLOCK, SCHORR AND SOLIS-COHEN LLP

212 LOCUST STREET
SUITE 300
HARRISBURG, PA 17101-0213

(717) 237-7160
FACSIMILE: (717) 237-7161

ORIGINAL

ALAN KOHLER
DIRECT DIAL NUMBER: (717) 237-7172
E-MAIL: AKHOLER@WOLFBLOCK.COM

February 12, 1998

VIA HAND DELIVERY

James McNulty, Secretary
Pennsylvania Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

DOCUMENT
FOLDER

RECEIVED
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PA P.U.C.
PROTHONOTARY'S OFFICE

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 please find the original and nine copies of the Supplemental Brief of Enron Power Marketing, Inc. in the above-referenced matter. If you have any questions, please contact the undersigned.

Respectfully,



Alan Kohler
For WOLF, BLOCK, SCHORR and SOLIS-COHEN, LLP

AK/cln
Enclosures
cc: All Parties of Record
Hon. George M. Kashi

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ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Application of PP&L for Approval of :
its Restructuring Plan Under Section 2806 : Docket No. R-00973954
of the Public Utility Code :

SUPPLEMENTAL BRIEF OF ENRON POWER MARKETING, INC.

DOCUMENT
FOLDER

DOCKETED
FEB 13 1998

Daniel Clearfield
Alan Kohler
WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP
212 Locust Street, Suite 300
Harrisburg, PA 17101
(717) 237-7160

Dated: February 12, 1998

RECEIVED
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P.A.P.U.C.
PROTHONOTARY'S OFFICE

I. STATEMENT OF THE CASE

This Supplemental Brief is submitted by Enron Power Marketing, Inc. ("Enron") in the above-captioned matter. Through various Orders issued by the presiding officer in this proceeding, Administrative Law Judge ("ALJ") George M. Kashi has directed that various intervenor groups, including prospective competitors of Pennsylvania Power & Light Company ("PP&L"),¹ filed joint briefs addressing common issues and that each member of the Competitive Intervenors and other intervenor groups may file supplemental briefs addressing party specific issues. This Supplemental Brief is submitted in compliance with the ALJ's directives. In all other respects, Enron adopts by reference the Statement of the Case included in the Competitive Intervenors' Joint Main Brief

II. INTRODUCTION AND SUMMARY OF ARGUMENT

While the issues raised by Enron in this Supplemental Brief are fully consistent with the issue raised by the Competitive Intervenors in their Joint Main Brief, in several instances Enron has introduced evidence into the record of this proceeding which is more detailed than the issues raised by the general intervenor group. In Enron's view these issues are of significant importance since in the early stages of development of a competitive market, attention to detail can make all the difference between emergence of a fully competitive market and all of its associated benefits and a less efficient market with correspondingly less benefits to the consuming public.

¹ The intervenor's group comprised of prospective competitors of PP&L is referred to herein as the "Competitive Intervenors".

Through this Supplemental Brief, Enron addresses the following issues and requests modifications to PP&L's proposed restructuring plan as supported by evidence of record in this proceeding. Summarily, Enron requests the Commission to take the following steps:

- The Commission should unbundle transmission, distribution and generation services in a manner properly allocates costs and assures that only costs directly related to delivery services are recovered by PP&L in distribution or transmission rates.
- The Commission should remove the embedded generation cost of ancillary services from the Company's retail revenue requirement.
- The Commission should adopt a rate design based on voltage differentiation rather than traditional rate classes.
- The Commission should adopt a provision in PP&L's Code of Conduct which prohibits use of PP&L's brand name by affiliated suppliers.
- The Commission should direct PP&L to cooperate in developing a more equitable system of assigning intertie capacity.

III. ARGUMENT

A. **The Commission Should Adopt a Tariff for PP&L which Includes a Proper Allocation of Costs, the Proper Treatment of Ancillary Services and a Proper Rate design.**

As set forth in the Competitive Intervenors Joint Main Brief ("Main Brief"), the Commission, through issuance of its PECO Restructuring Orders,² has interpreted the

² Application of PECO Energy Company for Approval of its Restructuring Plan Under Section 2806 of the Public Utility Code ("PECO Order"), R-00973953 (December 23, 1997); Reconsideration Order (January 16, 1998); PECO Compliance Filing Order (February 5, 1998).

Electricity Generation Customer Choice and Competition Act ("Act")³ to require that electric distribution company rates be unbundled through a "top down" approach. The first step in a "top down" approach is to determine the appropriate level of transmission and distribution ("T&D") rates through review of the EDC's cost of service study to determine if the EDC has properly allocated costs to the T&D functions.⁴

PP&L's proposed unbundling plan must satisfy the requirements of Chapter 13 of the Public Utility Code and the Act and must, at a minimum, unbundle transmission,⁵ distribution and generation services.⁶ Allocation of costs is a critical issue since such

³ 66 Pa.C.S. §2881 et seq.

⁴ The Federal Energy Regulatory Commission ("FCC"), not the Commission, has jurisdiction to establish transmission rates. The only issue with respect to transmission service pertains to identification of the costs associated with transmission service for the purpose of separating it from the rest of the bundled rate. See PECO Compliance Filing Order, p. 9.

⁵ PP&L did not unbundle transmission service in its original proposal restructuring plan, but amended its plan through its rebuttal testimony to correct this deficiency.

⁶ As the Commission stated in Order re: Electric Utility Restructuring Filing Made Pursuant to 66 Pa.C.S. §2806(E), M-00960090F.0003 (February 13, 1997):

Utilities filing restructuring plans must propose tariffs which remove and reallocate non-jurisdictional transmission costs which will be recovered through federally approved tariffs, determine jurisdictional cost responsibility, allocate it properly between regulated local distribution tariffs and generation tariffs.

* * *

The major ratemaking task in these proceedings is not to determine the overall level of revenues, but how revenue

(continued...)

allocation will determine whether costs continue to be recovered by PP&L through its continuing role of monopoly T&D provider or through the competitive market.

In PP&L's proposed restructuring plan, through the cost of service study sponsored by PP&L witness Kleha, it has improperly allocated costs by treating its distribution services as a "catch-all" or "dumping ground" for recovery of costs and has included costs in that category "which have nothing to do with actual delivery of electric power and energy to the ultimate consumer."⁷ For example, the Kleha cost of service study inappropriately assigns the following costs of service categories entirely to the "distribution" function even though the costs are clearly associated with all aspects of PP&L's service:

- (a) Sales expenses;⁸
- (b) Customer information and assistance expenses;⁹

⁶(...continued)

responsibility is to be allocated to generation, transmission, distribution and common costs of service, and how those costs will be borne by existing and new customers and customer classes.

Order, pp. 5, 22.

⁷ Enron St. 3.0 (Reising), p.10.

⁸ Approximately \$5 million in sales expenses are allocated to distribution services despite the fact that these activities are clearly associated with the sale of electricity — a competitive generation function — not the monopoly distribution function. Enron St. 2.0 (Mayo), p. 14. Of course, suppliers will incur their own sales expenses. Enron St. 3.0 (Reising), p. 14. Accordingly, allowing PP&L to foist its sales expenses on distribution customers will enable it to sell energy services in the market without having to recover these costs through its competitive operations like its competitors must do.

⁹ Likewise customer information and assistance expenses will be incurred by suppliers to
(continued...)

(c) Uncollectibles expense.¹⁰

Another allocation issue arises pertaining to ancillary services.¹¹ FERC Orders 808 and 808a require transmission providers, like PP&L, to permit their customers (including suppliers) to self-provide ancillary services to the extent that it is technically feasible under applicable reliability council standards. While PP&L agrees ancillary services must be unbundled and price on the basis of FERC approved rates under the PJM Open Access Transmission Tariff, PP&L fails to recognize that an associated adjustment is required to

⁹(...continued)

"respond to customer inquiries and requests for assistance in parallel with or in lieu of similar services provided by the EDC." Enron St. 3.0 (Reising), p. 14. Accordingly, these costs pertain to distribution, transmission and generation services and should be allocated fairly between those functions not loaded entirely on the distribution function as PP&L proposes.

¹⁰ In an unbundled environment, uncollectibles clearly must be allocated fairly between distribution, transmission and generation services to prevent anti-competitive cross-subsidization. As Enron witnesses Reising explained:

" . . . If an Electric Supplier is responsible for billing all services or billing separately for the services it provides, it will have its own Uncollectible Accounts to deal with. Treating Uncollectible Accounts as part of "distribution" functional costs and continuing to roll these costs into "unbundled" rates will mean that Electric Suppliers, and in turn their customers, will end up paying twice for Uncollectible Accounts — once as a result of their own direct dealing with their customers and a second time in . . ." PP&L's distribution rates.

Enron St. 2.0 (Reising) pp. 13-14.

¹¹ Ancillary services are the generation support services that are needed, along with transmission services, to maintain reliability within and among control areas affected by the transmission service. Each ancillary service is identified and defined in Enron St. 3.0 (Reising), PDR-1, Exhibit 3.

remove the embedded generation cost of ancillary services from the company's retail rate revenue requirement.¹²

In addition, in a competitive retail environment, the Commission should require EDCs, including PP&L, to progress to a more appropriate rate design which reflects evolving market conditions. Presently, PP&L and other EDCs have designed rates for electric service on the basis of service classifications — residential, general service, large high voltage, lighting, etc. In the restructured industry, the important pricing distinctions between customers will be the timing of electricity consumption, the voltage level at which customers take service and whether that service entails single-phase or poly-phase facilities. Basing an EDC's rate design on voltage level differentiation rather than traditional rate class factors provides a number of advantages, including the following:

- It results in a simplification of rates which better enables the customer to determine the basis for the charges imposed.
- It results in a more direct attribution of costs to the type of facilities actually used by the customer instead of the traditional class-differentiated rates.
- Most of the motivation for class rates has to do with generation-related costs, which will now be provided via a competitive market through which suppliers will be free to establish energy pricing mechanisms to meet specific customer needs and desires.¹³

Finally, Enron witness Reising sponsored a pro forma distribution tariff which includes and demonstrates the appropriate allocation of costs, treatment of ancillary services

¹² Enron St. 3.0 (Reising), p. 16-17; Enron St. 3.1 (Reising), p.1.

¹³ Enron St. 3.0 (Reising), p. 24.

and competitive rate design as outlined above.¹⁴ The pro forma tariff designates distribution rates and revenue cycle credits which result from a proper allocation of costs between transmission, distribution and generation and provides a sample rate design for Energy Delivery Services. Revenue requirements attributed to Energy Delivery Services are summarized into customer and demand related service categories and then are further segregated by customer voltage.

Enron's proposed Distribution Service Tariff is new and different — admittedly. But it also better suits the needs of customers and allows PP&L to track costs in a way that appropriately accommodates the new competitive environment.

B. The Commission Should Bar PP&L's Affiliated Suppliers From Using PP&L's Brand Name.

As stated in the Competitive Intervenors' Main Brief, Enron has strongly advocated an additional provision for PP&L's Code of Conduct which bars the use of PP&L's brand name by PP&L's affiliated supplier(s). In Enron's view, absent such a prohibition, the EDC's affiliated suppliers are provided a significant preference which is not available to other marketplace participants. As Enron witness Dirmeier explained regarding the importance of the use of the name issue:

If it were not important, then the utilities would not so adamantly argue that they should be able to use their name in any manner they want. The principal concern is that an affiliate of an EDC will use its relationship with the EDC to imply to customers that its quality of service will be better, as a result of

¹⁴ Enron St. 3.0, Exhibit 3, PDR-7.

its affiliation with the EDC. For example, some automobile dealers advertise that their repair services are better than others because of their relationship with the manufacturer. Similarly, a generation affiliate could allege that its customers will get preferential T&D treatment, such as faster hookups and more rapid restoration of service after storms, or just superior "electric service" overall because of the affiliation with the EDC. Even with the prohibition of implying superior service by the affiliate or division of the local utility or inferior service by a non-affiliated supplier, use of the utility's name in and of itself creates a value that alters the playing field relative to that entity using the name, logo or affiliation in its market offering.

* * *

With the name recognition of the EDC and its reputation developed over the years of providing regulated electric utility service, the user of that name for the provision of a variety of electric services will have a distinct advantage over its competition in the local jurisdiction of the EDC.

Enron St. 6.0 (Dirmeier), pp. 30, 31.

The fact of the matter is that regardless of restrictions on inaccurate or confusing advertising and dissemination of information, customers will not distinguish between PP&L, the monopoly EDC, and PP&L, the competitive generation supplier.¹⁵ Furthermore, to the extent the affiliated supplier uses the EDC's name, it should compensate the EDC for the obvious value associated with the name. Overall, to assure the "level playing field" the Commission has mandated, PP&L's so-called Generation Supply Group

¹⁵ "Few customers will do anything other than conclude that the merchant service for power is being provided by PP&L [the EDC] and few will understand that there is any distinction between the EDC and the power supplier." Enron St. 6.0 (Dirmeier), p. 32. This is particularly true when, as here, the affiliated supplier is a division of PP&L and is not structurally separated from the EDC.

should be required to "stand on its own two feet" and utilize a name other than the PP&L brand name in its competitive operations.

C. The Commission Should Direct PP&L to Cooperate With Suppliers to Increase the Availability of Ties for Firm Transactions.

PP&L, as a member of the PJM, participates in an arrangement which allocates the intertie capacity, known as capacity benefit margins ("CBMs"), between PJM and adjoining control areas. At present, however, the tie lines between PJM and the surrounding control areas have a maximum total transfer capability of approximately 4000 MW — 3500 MW of which is reserved as a CBM for reliability purposes as a substitute for capacity that would otherwise have to be installed within the PJM control area.¹⁶ These tie benefit margins are allocated between PJM members, including PP&L, based on the absolute size of the member's load.¹⁷ These tie margins are a benefit to transmission owning utilities for which they do not pay.¹⁸

The system of allocation of PJM tie benefits is based on the presumption of a monopoly generation retail market and does not accommodate the evolving retail market in Pennsylvania. These reliability requirements need to be re-evaluated in the context of a competitive retail electric market. EDCs are presently receiving the benefits of these ties through capacity credits while continuing to use the ties for non-firm transactions. Under the

¹⁶ Enron St. 8.1 (Tabors), p. 1. Recently, the allocation factor was modified from one based on load ratio share to one based on actual size of load.

¹⁷ Enron St. 8.1 (Tabors), p. 1.

¹⁸ Enron St. 8.0 (Tabors), p. 3.

current system, new entrants will simply not be able to acquire any significant quantity of firm capacity, placing them at a competitive disadvantage. The Commission should take action to eliminate this unfair situation by requiring PP&L and other PJM utilities to work together with suppliers to produce and equitable solution.

IV. CONCLUSION

Enron respectfully requests the Commission to further modify PP&L's proposed restructuring plan consistent with the foregoing discussion.



Daniel Clearfield
Alan Kohler
WOLF, BLOCK, SCHORR and SOLIS-COHEN LLP
212 Locust Street, Suite 300
Harrisburg, PA 17101
(717) 237-7160

Counsel for Enron Power Marketing, Inc.

Dated: February 12, 1998

ORIGINAL

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing documents upon the participants, listed below, in accordance with the requirements of §1.54 (relating to service by a participant):

James A. Mullins, Esquire
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120

Bernard A. Ryan, Esquire
Office of Small Business Advocate
Suite 1102, Commerce Building
300 North Second Street
Harrisburg, PA 17101

Mr. Robert D. Knecht
Industrial Economics Incorporated
2067 Massachusetts Avenue
Cambridge, MA 02140

Charles F. Hoffman, Esquire
Office of Trial Staff
Pennsylvania Public Utility Commission
P. O. Box 3265
Harrisburg, PA 17105

David M. Kleppinger, Esquire
Robert Mills, Esquire
McNees, Wallace & Nurick
P. O. Box 1166
100 Pine Street
Harrisburg, PA 17108

Elizabeth R. Benson
Energy Associates
7303 Timber Lane
Falls Church, VA 22046-2735

Warren W. Mack, Vice President
Ahlstrom Development Corp.
4350 LaJolla Village Drive
Suite 210
San Diego, CA 92122

132703

98 FEB 12 PM 1:44

RECEIVED
PROTHONOTARY'S OFFICE

Richard L. Caplan, Esquire
Caplan & Lubner, LLP
40 Darby Road
Paoli, PA 19301

Billie E. Ramsey, Executive Director
ARIPPA
1300 Market Street
Lemoyne, PA 17043

Craig G. Goodman, Esquire
Equitable Resources
3333 K Street, N.W.
Suite 425
Washington, DC 20007

Louis J. Carter, Esquire
7300 City Line Avenue
Philadelphia, PA 19151-2291

Ginny Kreidler
RMI, Inc.
111 Presidential Boulevard
Suite 127
Bala Cynwyd, PA 19004

Edwin D. Hill, International Vice President
IBEW
200 Corporate Center Drive
Suite 301
Corapolis, PA 15108

William Schmitt
Local 1600 IBEW
540 Grange Road
P. O. Box 470
Trexlerstown, Pennsylvania 18087

Todd S. Stewart, Esquire
Malatesta Hawke & McKeon
100 North Tenth Street
P. O. Box 1778
Harrisburg, PA 17120

Lisa Yoho
Director of Regulatory Affairs
The Eastern Group, Inc.
2900 Eisenhower Avenue, Suite 300
Alexandria, VA 22314

D. Jane Drennan, Esquire
Sarah E. Tomalty, Esquire
Drennan & Associates
1216 16th Street, N.W.
Washington, DC 20036

David A. McCormick, Esquire
Department of the Army
Office of the Judge Advocate General
901 North Stuart Street
Arlington, VA 22203-1837

James Melia, Esquire
Kirkpatrick & Lockhart
The Payne Shoemaker Building
240 North Third Street
Harrisburg, PA 17101-1507

Joan O. Brandeis, Esquire
Schnader, Harrison, Segal & Lewis
Suite 3600
1600 Market Street
Philadelphia, PA 19103-4252

Wayne M. Thomas, Esquire
Kohn, Nast & Graff, P.C.
1101 Market Street, 24th Floor
Philadelphia, PA 19107

Mr. Craig R. Kuennen
Energy Services Manager
Commission on Economic Opportunity
211 South Main Street
Wilkes-Barre, PA 18701-1596

Roger E. Clark
905 Dennison Drive
Ambler, PA 19002

Robert P. Haynes, III, Esquire
Mette, Evans & Woodside
3401 North Front Street
Harrisburg, PA 17110-0950

Stephen J. Selden, Esquire
Assistant General Counsel
Bethlehem Steel Corporation
Eighth & Eaton Avenues
Bethlehem, PA 18016

Mr. Eric J. Epstein
2308 Brandywine Drive
Harrisburg, PA 17110

Norman J. Kennard, Esquire
Malatesta, Hawke & McKeon
100 North Tenth Street
Harrisburg, PA 17101

Stephen L. Huntoon, Esquire
PECO Gas Supply Company
2301 Market Street
Philadelphia, PA 19101-8699

Noel H. Trask, Esquire
PECO Energy Company
2301 Market Street
Philadelphia, PA 19101-8699

Kenneth Zielonis, Esquire
Stevens & Lee
208 North Third Street, Suite 310
Harrisburg, PA 17101

Paul E. Nordstrom, Esquire
Debbie Swanstrom, Esquire
Verner, Liipfert, Bernhard, McPherson & Hand
901 15th Street, N.W., Suite 700
Washington, DC 20005

John L. Munsch, Esquire
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

Paul E. Russell, Esquire
Pennsylvania Power & Light Co.
Two North Ninth St.
Allentown, PA 18101

Stephen J. Baron
J. Kennedy and Assoc., Inc.
35 Glenlake Parkway, Suite 475
Atlanta, GA 30328

Donald A. Kaplan, Esquire
Lisa M. Helpert, Esquire
Preston Gates Ellis & Ravelas Meeds LLP
Suite 500, 1735 New York Ave., N.W.
Washington, DC 20006

Fred Zalcman, Esq.
Pace University School of Law
78 North Broadway
White Plains, NY 10603

Andrew Altman, Deputy Director
Clean Air Council
135 S. 19th St., Suite 300
Philadelphia, PA 19103

Bruce Biewald
Snyapse Energy Economics, Inc.
101 Chilton St.
Cambridge, MA 02138

Jerry Mendle
MSB Energy Associates
7507 Hubbard Ave., Suite 200
Middleton, WI 53562

Cheryl W. Davis, Dir.
Office of Special Assistants
Penna. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Johnnie Simms, Esquire
Office of Trial Staff
Penna. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Harry Geller, Esquire
Penna. Utility Law Project
118 Locust Street
Harrisburg, PA 17101

Lawrence Goldasky
GPU Energy
100 APC Building
800 North Third Street
Harrisburg, PA 17102

Richard LaCapra
Henry Yoshimura
LaCapra Associates
The Province Building
333 Washington Street
Boston, MA 02108

Neil Talbot
81 Grand Street, No. 5
New York, NY 10013

Gordon J. Smith, Esquire
John & Hengerer
1200 17th Street, NW, Suite 600
Washington, DC 20036

Scott J. Rubin, Esq.
3 Lost Creek Drive
Selinsgrove, PA 17870

Rhonda Hendrickson
100 North 10th Street
Harrisburg, PA 17108

Michael J. Vough, Esquire
Vough & Associates
126 South Main Street
Pittston, PA 18640

Joel E. Newton, Esquire
901 15th Street, NW
Suite 700
Washington, DC 20005

Craig A. Doll, Esquire
214 State Street
Harrisburg, PA 17101

Robert F. Young
Deputy General Counsel
212 Locust Street
P.O. Box 1266
Harrisburg, PA 17108-1266

Michael A. Stosser, Esquire
Heller, Ehrman, White & McAuliffe
815 Connecticut Ave., NW
Suite 200
Washington, DC 20006-4004

Bruce A. Connell
General Counsel
600 N. Dairy Ashford, ML-1034
Houston, TX 77079

Thomas S. Catlin
Exeter Associates, Inc.
Suite 350
12510 Prosperity Drive
Silver Spring, MD 20904

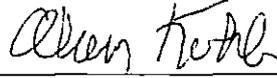
Joseph A. Dworetzky, Esquire
Hangle, Aronchick, Segal and Pudlin
One Logan Square, 12th Fl.
Philadelphia, PA 19103-6933

Linda C. Smith, Esquire
Dilworth, Paxson, Kalish and Kauffman, LLP
305 N. Front Street, Suite 403
Harrisburg, PA 17101-1236

Usher Fogel, Esquire
Roland, Fogel, Loblenz & Carr LLP
1 Columbia Place
Albany, NY 12207

David W. Francis, Esquire
Powell, Trachtman, Logan, Carrle,
Bowman & Lombardo
114 North Second Street
Harrisburg, PA 17101

Terry S. Fitzpatrick, Esquire
David M. DeSalle, Esquire
Ryan, Russel, Ogden & Seltzer LLP
800 North 3rd Street, Suite 101
Harrisburg, PA 17102-2025



Alan Kohler

Dated: February 12, 1998

RECEIVED
98 FEB 12 PM 1:38
PA.P.U.C. OFFICE
PROTHONOTARY'S OFFICE

LAW OFFICES

DILWORTH PAXSON LLP

305 N. FRONT STREET
SUITE 403

HARRISBURG, PENNSYLVANIA 17101-1236
(717) 236-4812 FAX (717) 236-7811

ORIGINAL

PHILADELPHIA, PA.
(215) 575-7000

MEDIA, PA.
(610) 565-4131

CHERRY HILL, N.J.
(609) 663-8877

TURNERSVILLE, N.J.
(609) 227-6100

DIRECT DIAL NUMBER:
(717) 236-4812

Frederick D. Ochsenhirt

DOCUMENT February 12, 1998
FOLDER

RECEIVED
98 FEB 12 AM 10:43
P.A.P.U.C.
PROTHONOTARY'S OFFICE

James McNulty, Prothonotary
PA Public Utility Commission
P. O. Box 3265
Harrisburg, PA 17105

Re: Application of Pennsylvania Power and Light Company for
Approval of Restructuring Plan Pursuant to Chapter 28 of
the Public Utility Code; Docket No. R-00973954

Dear Mr. McNulty:

Enclosed please find the original and nine (9) copies of the Supplemental Brief of the American Association of Retired Persons for filing in the above captioned proceeding. All parties have been served in accordance with the attached Certificate of Service.

Please contact me if you have any questions concerning this filing.

Very truly yours,

Frederick D. Ochsenhirt
Frederick D. Ochsenhirt

FDO:sr
Enclosures

cc: Hon. George Kashi
Certificate of Service

ORIGINAL

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

APPLICATION OF PENNSYLVANIA :
POWER & LIGHT COMPANY FOR APPROVAL : DOCKET NO.
OF RESTRUCTURING PLAN UNDER : R-00973954
SECTION 2806 OF THE PUBLIC UTILITY :
CODE :

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FOLDER

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P.A.P.U.C.
PROTHONOTARY'S OFFICE

SUPPLEMENTAL BRIEF OF THE
AMERICAN ASSOCIATION OF RETIRED PERSONS

DOCKETED
FEB 13 1998

Linda C. Smith, Esquire
ID No. 35868
Frederick D. Ochsenhirt, Esquire
ID No. 75588
Dilworth Paxson, LLP
305 N. Front Street, Suite 403
Harrisburg, PA 17101
(717) 236-4812

Dated: February 12, 1998

I. INTRODUCTION

A. Procedural History

The American Association of Retired Persons ("AARP") has reviewed the Procedural History set forth in the Brief of the Office of Consumer Advocate ("OCA") and adopts OCA's discussion for purposes of this brief.

B. Scope of this Brief

This Supplemental Brief is submitted in accordance with Administrative Law Judge George Kashi's Briefing Order issued February 2, 1998. Pursuant to Judge Kashi's Order, AARP shall address the issues of stranded costs and universal service. For all other issues, AARP adopts the positions set forth in the Brief of the Office of Consumer Advocate, and incorporates such positions herein by reference.

II. ARGUMENT

A. Universal Service¹

- 1. Eligibility for Universal Service benefits should be entirely income-based.**

The General Assembly has declared that it is the policy of the Commonwealth that, at a minimum, "the protections, policies and services that now assist customers who are low-income to afford electric service" must be continued. 66 Pa. C.S. §2802 (10). Thus, all restructuring plans under Chapter 28 of the Public Utility Code must contain provisions to ensure universal access to electric service is maintained. 66 Pa.C.S. §2804 (9).

¹ This discussion tracks issue XII(B) on Judge Kashi's Commonality of Issues Identification contained in the Briefing Order issued September 12, 1997.

In its restructuring proposal, the Pennsylvania Power & Light Company ("PP&L") proposed that eligibility for its universal service programs be based on two criteria. First, customers must have household income at or below 150 percent of poverty. PP&L St. 16 at 19. Second, such customers must have a demonstrated inability to pay their electric bill unless they are able to establish mitigating circumstances showing special need for inclusion in the universal service program. Id. These eligibility criteria are unnecessary and improper and must be changed so as to effectuate the policy goals underlying the Choice Act.

A properly constructed universal service program will use income as its sole eligibility criterion. AARP St. 1 at 53. To do otherwise leads to unintended consequences and unnecessarily increases the administrative costs of the program. PP&L's proposal, which requires that customers be payment-troubled in order to be included, encourages customers to skip payments so as to be eligible for universal service benefits. See, OCA St. 6 at 23-24. This most assuredly was not the intention of the General Assembly. Many customers who are within the class of Pennsylvanians universal programs are intended to assist have not missed payments to PP&L because they have elected to forego other necessities in order to stay current with their electric bills. Id. These customers should not be punished merely because they have attempted to pay their bills.

In addition, requiring customers be payment-troubled adds a layer of administration to the program which is not required.

There are undoubtedly a number of PP&L customers who have difficulty making payments, but who have been able to make partial payments to PP&L. If payment histories are relevant in determining eligibility, it will be necessary to determine at what point a partial payment should be treated as non-payment for purposes of universal service eligibility. Such a layer of bureaucracy is not necessary if eligibility is entirely based upon income.

PP&L's proposal also provides that customers be permitted to establish special need to be eligible for universal service benefits. While AARP has no objection to permitting customers to establish special needs for universal service benefits, these customers should not be required to have missed payments in order to qualify.

2. **Once the Eligible Class is Determined, the Universal Service Benefit Should be Based Upon a Fixed Discount off of Tariffed Rates, Rather than a Percentage-of-Income Methodology.**

Once eligibility for universal service benefits has been determined, there are two basic means by which the actual benefit may be calculated. First, eligible customers may be required to pay a fixed percentage of their household income. This method, referred to as a percentage-of-income program ("PIP"), recognizes that as income decreases, the proportion of income that must be spent upon necessities such as food, housing and medical care increases. This method would thus be the preferred approach, but for the fact that such programs have traditionally been difficult to implement. AARP St. 1 at 24.

An alternative method, which attempts to approximate the effect of a PIP while decreasing administrative costs and increasing program efficiency, involves providing deep discounts from tariffed rates for eligible households. AARP St. 1 at 25. In order to approximate the PIP approach, the discount should be calculated based upon the percentage of income spent upon electricity by median income households. Id. The discount should then be calculated so that low-income households do not spend more than that median percentage of income on electricity. Id.

B. Stranded Costs²

1. Ratepayers Should be Accorded the Benefit of Rate Reductions Promised Under Current Regulation.

In its last rate case, decided by the Commission in 1995, PP&L was directed to provide to ratepayers a rate reduction totaling \$100 million per year for ten years. Pennsylvania Public Utility Comm'n v. Pennsylvania Power & Light Co., Docket No. R-00943271 (Order entered September 27, 1995) ("PP&L Order"). However, in its calculation of stranded costs, PP&L failed to take these rate reductions into consideration. AARP St. 1 at 64-65. Unless these rate reductions are properly included in the stranded cost calculation, ratepayers will lose \$1 billion due to deregulation and restructuring. Id. This was certainly not the intention of the legislature in declaring that market forces are more effective than traditional regulation in controlling the cost of electricity. 66 Pa. C.S. 2802 (5).

² This discussion tracks issues II(A), (D) and IV from Judge Kashi's Commonality of Issues Identification.

2. The Commission Must Reject the "Make Whole" Stranded Cost Calculation Proposed by PP&L.

In its restructuring proposal, PP&L begins with the proposition that it is entitled to recover the full value of its investment in generating assets which are now "stranded" due to the shift to a competitive market. PP&L St. 1 at 12-13. This is so because PP&L treats the statutory rate cap as a rate floor, resulting in a Competitive Transition Charge ("CTC") which is the residual between the market price and the cap. AARP St. 1 at 63. This assumption is premised upon the allegation that full recovery was the touchstone of traditional rate regulation, referred to by PP&L as the "regulatory compact." PP&L St. 1 at 11. This historic view, however, ignores the fact that utilities were always presumed to bear the risk of under-recovery of investment.

Incumbent utilities such as PP&L have traditionally been provided a rate of return well in excess of the market rate. Thus, in its last rate case, PP&L was granted a return on common equity of 11.5%. PP&L Order at 262. This rate is well in excess of the market rate in 1995, and reflects a risk premium provided to PP&L for bearing risks such as demand-side reductions in energy use or below-forecast growth in energy use. AARP St. 1 at 67. Even given the risk premium provided to the utilities, full recovery of investment was never a given, as inefficient management or production could result in under-recovery. Id.

Traditional rate regulation was intended to be a substitute for the natural pressures present in a truly competitive market. AARP St. 1 at 68. That is, just as all market players

face the risk of sunk investment, so too did incumbent utilities face the risk that investment would never be recovered. Therefore, it is fallacious to claim, as PP&L now does, that the change from artificial market control through regulation to the more efficient control of a competitive market amounts to a change in circumstances so as to allow PP&L to receive a supra-competitive return through a "tax" on ratepayers. As the General Assembly correctly concluded, competition merely amounts to a more precise means of determining what costs are economic, just as regulation had attempted to do. Competition did not create a new obligation that utilities be economic; rather, competition merely changes the means by which costs are analyzed. Id.

Not only is PP&L's make-whole approach unsupported by the history of traditional rate regulation, but the practical effect of such an approach clearly contravenes the intent of the legislature in providing for electric competition. PP&L assumes that every penny of the capital cost and expense for its uneconomic assets must be recovered first. PP&L St. 2 at 5. These capital costs are collected from the ratepayers in the form of a tax, the CTC. Only after the utility is made whole does PP&L calculate the market price, which determines whether ratepayers receive any benefit from competition.

PP&L's proposal takes a "bottom-up" approach in which the market price is the residual between the CTC recovered by the company and the rate cap provided by the statute. PP&L Ex. SFT-8. That is, once PP&L is made whole, all other market participants are

to sell into the market at a huge loss for a decade, after which they will be permitted to compete. AARP St. 1 at 64. This proposal, besides being improper on its face, makes a mockery of electric deregulation. Rather than easing Pennsylvania consumers into a competitive market, PP&L's proposal creates a decade-long corporate welfare program in which incumbent utilities receive huge sums from ratepayers while being insulated from both traditional regulatory oversight and the restraining forces of a competitive market. Id. This was clearly not the intent of the General Assembly, which saw competition as a means of reducing Pennsylvania's high electric rates in a manner fair to the utilities, consumers, local communities and non-utility generators. 66 Pa. C.S. §2802 (4), (8).

3. PP&L Should Not Be Granted Credit for Past Mitigation Due to Efficient Operation.

The Choice Act allows incumbent utilities to receive credit in the calculation of the Competitive Transition Charge (CTC) for past efforts to mitigate stranded costs; such mitigation efforts are required on a going-forward basis. 66 Pa. C.S. §2808 (c)(4). PP&L claims it has engaged in just such mitigation efforts prior to the enactment of Chapter 28 because "cost control and efficient management have been an integral part of the Company's corporate culture for many years." PP&L St. 2 at 6. However, the Commission must not be swayed by this rhetoric, and must examine all mitigation claims closely.

It is clear that the legislature viewed efficient operation as a requirement, rather than the sort of extra-statutory

effort which may be considered in the calculation of the CTC. Thus, efforts to reduce consumer rate levels are to be considered only to the extent such efforts were undertaken while maintaining safe and efficient operations. 66 Pa. C.S. §2808 (c)(5). Therefore, efficient operation does not amount to mitigation, but is rather exactly what PP&L was expected to do in the first place. AARP St. 1 at 69-70. Not only should PP&L not be rewarded for a base level of efficiency, but all inefficient management decisions should result in disallowances. Id. at 70.

4. Once Stranded Costs Are Calculated, the Commission Must Disallow Recovery of Certain Inefficient and Uneconomic Costs.

As discussed above, under the statute PP&L is only entitled to recover those stranded costs which reflect the efficient and reasonable cost of production. Thus, once the stranded costs are calculated in accordance with the general principles set forth previously, the Commission should reduce the amount to be recovered through the CTC for those costs which were not efficiently and economically incurred. AARP St. 1 at 71. There are two basic standards for the economic costs of production which should be considered.

The first standard is the "most efficient producer standard." This standard reflects generally-accepted routine assumptions regarding competitive market behavior. Thus, economic costs are calculated by determining at what price competitive supply clears the market. Id. This price is described by PP&L witness Kalt as the "all-in" price. In a truly competitive market,

all producers must continually monitor their means of production to ensure they are using the most efficient technology available. Any producer using inefficient technology faces the prospect of losses or inadequate returns until they lower their costs of production. Id. The maximum return on investment is thus achieved only by efficient producers.

The second standard by which uneconomic costs may be assessed is "the most efficient utility standard." This standard reflects the fact that in a traditional regulatory environment, utilities were required to take actions that a profit maximizer in a truly free market would not take. Id. at 71-72. For example, for public policy reasons the Commission has required utilities such as PP&L to maintain a larger reserve margin or higher standard of reliability than might otherwise be the case in a competitive environment. Nevertheless, utilities were expected to act efficiently within the constraints of the policy requirements. In other words, that a utility was required to maintain excess capacity may be attributed to a policy obligation; that the utility paid too much for that excess capacity is a management mistake which must be excluded from stranded cost recovery as inefficient and uneconomic. Id. at 72.

As set forth in the testimony of AARP witness Mark Cooper, under either standard PP&L is producing electricity at costs that are well above efficient levels. PP&L's production costs exceed those of the lowest cost producer in Pennsylvania by twenty percent, exceed the national average cost of production by

the same percentage, and meet the state-wide average only because the state-wide average includes the even more inefficient PECO. AARP St. 1 at 72-73.

To determine the magnitude of the inefficient costs, Dr. Cooper accepted, for purposes of discussion, PP&L's estimate of regulatory costs. AARP has not analyzed in detail PP&L's claims, and the estimate was used for discussion purposes only. Because PP&L set its market clearing price so low, the disallowance under the most efficient producer analysis should be set equal to the return on investment. AARP St. 1 at 73. This return is approximately \$2.6 billion. Id.; AARP Ex. MNC-5.

Under a most efficient utility standard, the uneconomic production costs for nuclear facilities are approximately \$0.011 per kwh. AARP Ex. 1 at 73; AARP Ex. MNC-5. As a result, approximately 56 percent of PP&L's stranded cost claim, or \$1.6 billion, should be disallowed.

The effect of this disallowance is to preclude PP&L from recovering a return on its capital investment if its "distressed" market price is used as the standard. There are very good reasons for this disallowance. To begin with, PP&L has attempted to absolve itself of all risk through its bottom-up, make-whole definition of stranded costs. Clearly, if PP&L has no risk, it should not receive the reward of a return on investment. AARP St. 1 at 75.

In addition, PP&L's prediction of a distressed market in generation that clears at the variable cost of production allows

neither the recovery of or return on capital by non-utility generators (who are presumed to sell into the market at a loss). Therefore, the Commission must not allow PP&L to receive a return on investment. Clearly, no rational economic actor would commit capital to such a market, and inasmuch as the cost recovery provided to PP&L is intended to reflect the future market based upon rational economic activity, there is absolutely no reason to provide PP&L a return on capital.

This disallowance is required only if PP&L's extremely low distressed price is used as the market price. Certainly other calculations of stranded costs and market price are possible which fully take into account the allocation of risk and responsibility for inefficient and uneconomic decisions made by PP&L. Nevertheless, if the Commission accepts PP&L's calculation of stranded costs and market price, a disallowance of at least \$1.6 billion is required.

Regardless of the means by which stranded costs are calculated, the final step is to allocate responsibility for such costs between PP&L's ratepayers and the company and its investors. The Legislature approximated just such a division when it determined that ratepayers should be responsible for the stranded cost of regulatory assets, which represent sunk investment over which management could exercise no discretion. 66 Pa. C.S. §2808 (c)(1); See AARP St. 1 at 75. Likewise, company management must bear responsibility for those stranded costs which are the result of managerial discretion. In the absence of a precise allocation

of responsibility, ratepayers should be responsible for no more than 50 percent of the company's stranded costs; the company and its investors should be responsible for the remaining 50 percent. AARP St. 1 at 23. Furthermore, depending on an evaluation of management responsibility, legal requirements and financial factors, it may be appropriate to hold ratepayers responsible for less than 50 percent. Id.

III. CONCLUSION

For the reasons set forth herein, AARP submits that the Commission should modify PP&L's Universal Service proposal so as to determine eligibility for program benefits solely upon income and to calculate benefits based upon a deep discount from tariffed rates. In addition, the Commission should reject PP&L's make-whole stranded cost calculation and should disallow at least \$1.6 billion in stranded costs if PP&L's market price forecast is used and should hold ratepayers responsible for no more than 50 percent of stranded costs.

Respectfully submitted,



Linda C. Smith, Esquire
ID No. 35868
Frederick D. Ochsenhirt, Esquire
ID No. 75588
Dilworth Paxson, LLP
305 North Front Street, Suite 403
Harrisburg, PA 17101
(717) 236-4812

Attorneys for the American
Association of Retired Persons

Dated: February 12, 1998

RECEIVED

CERTIFICATE OF SERVICE

98 FEB 12 AM 10:43

I, Frederick D. Ochsenhirt, hereby certify that I have this day caused a true copy of the foregoing to be served on the parties of record in Docket No. R-00973954 in accordance with the requirements of 52 Pa. Code Section 1.54 (relating to service by a participant), in the manner and upon the parties listed below.

Dated at Harrisburg, Pennsylvania, February 12, 1998.

VIA FEDERAL EXPRESS ON FEBRUARY 11, 1998

Paul E. Russell
Associate General Counsel
Pennsylvania Power & Light Company
Two North Ninth Street
Allentown, PA 18101

Lisa Helpert and Donald Kaplan
Preston, Gates, Ellis & Rouvelas
1735 New York Ave, NW
Suite 500
Washington, DC 20006

VIA HAND DELIVERY

Craig R. Burgraff
Barrett C. Sheridan
James A. Mullins
Tanya McCloskey
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120

Angela Jones
Commerce Building, Suite 1102
300 North Second Street
Harrisburg PA 17101

Roger Clark
3700 Vartan Way
Harrisburg, PA 171102

Craig A. Doll, Esquire
214 State Street
Harrisburg, PA 17101

Johnnie E. Simms
Scott H. Debroff
P. O. Box 3265
Harrisburg, PA 17105

Harry S. Geller, Esquire
118 Locust Street
Harrisburg, PA 17101

Robert Mills
David M. Kleppinger
Pamela C. Polacek
100 Pine Street
Harrisburg, PA 17108

Daniel Clearfield, Esquire
Alan Kohler, Esquire
Robert Longwell, Esquire
212 Locust St., Ste 300
Harrisburg, PA 17101

Christopher B. Craig, Esquire
Senator Vincent J. Fumo
Room 545 Main Capitol Bldg.
Harrisburg, PA 17120

Billie Ramsey
Executive Director
1300 Market St., Ste 7
Lemoyne, PA 17043

William R. Hawke, Esquire
Janet Miller, Esquire
Todd S. Stewart, Esquire
Harrisburg Energy Center
P. O. Box 1778
Harrisburg, PA 17105

Terrance J. Fitzpatrick, Esq.
David M. DeSalle
Ryan, Russell, Ogden, Seltzer
800 N. Third St., Ste 101
Harrisburg, PA 17102

Robert P. Haynes, III, Esq.
Mette, Evans and Woodside
P. O. Box 5950
Harrisburg, PA 17110

Robert Young, Esq.
Andrew S. Tubbs, Esq.
212 Locust Street
P. O. Box 1266
Harrisburg, PA 17110

John Gallagher, Esq.
200 N. 3rd St., Ste 300
P. O. Box 12105
Harrisburg, PA 17108

Susan Shanaman
CEED
212 North Third St., Ste 203
Harrisburg, PA 17101

John P. Zinkand
Penna Petroleum Association
2001 N. Front Street
Suite 121, Bldg 2
Harrisburg, PA 17102

Patricia Armstrong
Regina Matz
Anthony C. Adonzio, Jr.
212 Locust St., Ste 500
Harrisburg, PA 17108

Brian A. Rider
Pennsylvania Retailer's Association
224 Pine Street
Harrisburg, PA 17101-1325

VIA FIRST CLASS MAIL

Joel D. Newton, Esquire
Paul E. Nordstrom
901 15th Street, NW
Washington, DC 20005

Michael T. Vough, Esquire
Greater Pittston Pro. Ctr.
126 South Main Street
Pittston, PA 18640

Randall V. Griffin, Esquire
800 King Street
P.O. Box 231
Wilmington, DE 19899

Gene Stilp
1550 FCVR
Harrisburg, PA 17112

Joan O. Brandeis, Esq.
Schnader Harrison Segal & Lewis
1600 Market St Ste. 3600
Philadelphia, PA 19103

Lisa Yoho
Director of Regulatory Affairs
The Eastern Group, Inc.
2900 Eisenhower Ave., Ste 300
Alexandria, VA 22314

David A. McCormick
Regulatory Law Office
901 N. Stuart St. Room 713
DAJA-RL 3949
Arlington, VA 22203

Scott J. Rubin, Esquire
3 Lost Creek Dr.
Selinsgrove, PA 17870

Mary McFall Hopper
2301 Market Street, s23-1
Philadelphia, PA 19103
P.O. Box 1778
Harrisburg, PA 17105

Gordon E. Goodman
600 North Dairy Ashford, CH-1081
Houston, TX 77079

John L. Munsch, Esquire
800 Cabin Hill Drive
Greensburg, PA 15601

Stephen M. Hladik
40 Darby Road
Paoli, PA 19301

Stephen J. Baron
J. Kennedy & Associates, Inc.
35 Glenlake Parkway, Suite 475
Atlanta, GA 30328

Michael L. Kessler
111 S. Alfred St.
Alexandria, VA 22304

Usher Fogel
Roland, Fogel, Koblenz & Carr
1 Columbia Place
Albany, NY 12207

George F. Denardo
555 Union Blvd.
Allentown, PA 18103

Bruce A. Connell, Esquire
Legal Department
600 N. Dairy Ashford, ML-1034
Houston, TX 77079

John H. Koch
428 Robin Road
Allentown, PA 18104

Wayne Thomas, Esq.
Kohn Nast and Groff, PC
1101 Market St., 24th Fl.
Philadelphia, PA 19102

Eric Joseph Epstein
2308 Brandywine Drive
Harrisburg, PA 17110

Michael Stosser, Esquire
Adelia Borrasca, Esquire
Heller Ehrman White & McAuliffe
815 Connecticut Avenue, NW
Suite 200
Washington, DC 20006

Richard L. Caplan, Esquire
Caplan & Luber
40 Darby Road
Paoli, PA 19301

David W. Francis
114 N. Second St.
Harrisburg, PA 17101

Gary A. Jeffries
One Park Ridge Center
P.O. Box 15646
Pittsburgh, PA 15244

Joseph Dworetzky, Esq.
Hangle, Aronchick, Segal and Pudlin
One Logan Sq - 12th Floor
Philadelphia, PA 19103-6933

Scott T. Jones
Economic Resource Group, Inc.
One Mifflin Place
Cambridge, MA 02138

Bruce Biewald
Synapse Energy Economics, Inc.
101 Chilton Street
Cambridge, MA 02138

Gordon Smith
John & Hengerer
1200 17th St., Ste 600, NW
Washington, CD 20036-3006

Paul Nortstrom, Esq.
Verner and Liipfert, Bernhard
McPherson and Hand
910 15th St., NW
Washington, DC 20005

David M. Boonin
New Energy Ventures, Inc.
1845 Walnut St, Ste 2525
Philadelphia, PA 19103

Fred Zalcman, Esq.
Pace University School of Law
78 North Broadway
White Plains, NY 10603



Frederick D. Ochsenhirt

SUSAN M. SHANAMAN

ATTORNEY AT LAW

212 North Third Street
Suite 203
Harrisburg, PA 17101-1505
(717) 236-2055
(717) 236-2070 FAX

DOCUMENT
FOLDER

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PROTHONOTARY'S OFFICE

February 12, 1998

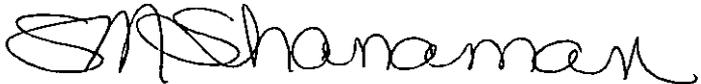
James McNulty, Prothonotary
PA Public Utility Commission
PO Box 3265
Harrisburg, Pennsylvania 17105-3265

RE: Pennsylvania Power & Light Company's Restructuring
Plan at Docket No. R-00973954

Dear Mr. McNulty:

Enclosed for filing please find an original and nine (9) copies of the Main Brief of the Center for Energy and Economic Development in the above-captioned proceeding. A copy of this document has been served on Administrative Law Judge Kashi and all parties of record as shown by the attached certificate of service.

Sincerely,



Susan M. Shanaman

cc: Hon. George Kashi (w/diskette)
All parties of record

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BEFORE THE
COMMONWEALTH OF PENNSYLVANIA
PUBLIC UTILITY COMMISSION

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P.A.P.U.C.
PROTHONOTARY'S OFFICE

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

DOCKET NO. R-00973954

MAIN BRIEF
OF THE
CENTER FOR ENERGY AND ECONOMIC DEVELOPMENT

DOCUMENT
FOLDER

Susan M. Shanaman, Esquire
212 North Third Street, Suite 203
Harrisburg, Pennsylvania 17101
717-236-2055

Dated: February 12, 1998

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INTRODUCTION AND SUMMARY OF ARGUMENT

The Center for Energy and Economic Development ("CEED") is nonprofit organization formed in 1992 to educate the public and policymakers about the new technologies and broad economic benefits of coal when used to generate electricity. Many of CEED's members are directly involved in generating power, and supplying fuel and fuel transportation services to electric power generators serving electric customers in the Commonwealth of Pennsylvania.

As an intervenor in the restructuring proceedings of Pennsylvania Power & Light Company, CEED appreciates the opportunity to submit this brief on the environmental issues raised in this proceeding.

Based upon a review of the record, CEED generally finds that the record addresses many of the issues that will be key to a successful electric industry restructuring effort. However, there are a number of areas in the record that CEED believes deserve the very careful scrutiny of the Commission due to the economic impact on emerging markets and, ultimately, upon the State's electric consumers. Positions have been put forth that would suggest that the Commission become the arbitrator in Pennsylvania for the maintenance of environmental quality. It is CEED's belief that the newly enacted Consumer Choice legislation does not give the Commission any direct authority to regulate the implementation of clean air standards through the guise of restructuring the electric utility industry; nor does the Act of 1996 give the Commission any indirect authority to become a superboard of directors for

environmental policies.

ARGUMENT

1. The Commission, lacking any clear legislative authority, should not embark into potentially costly and duplicative efforts to promote environmental goals.

Although the goal of promoting environmental improvement is a worthy one, the goal of restructuring should be to increase the economic efficiency of electric service markets.

In its Declaration of Policy, the General Assembly has stated as follows:

"The General Assembly finds and declares as follows:

...

(3) Because of advances in electric generation technology and federal initiatives to encourage greater competition in the wholesale electric market, it is now in the public interest to permit retail customers to obtain direct access to a competitive generation market as long as safe and affordable transmission and distribution service is available at levels of reliability that are currently enjoyed by the citizens and businesses of this Commonwealth.

...

(12) The purpose of this chapter is to modify existing legislation and regulations and to establish standards and procedures in order to create direct access by retail customers to the competitive market for the generation of electricity, while maintaining the safety and reliability of the electric system for all parties. Reliable electric service is of the utmost importance to the health, safety and welfare of the citizens of the Commonwealth. Electric industry restructuring should ensure the reliability of the interconnected electric system by maintaining the efficiency of the transmission and distribution system." 66 Pa. C.S. § 2802(3) and (12).

Thus, it is clear that the Legislature believed that

competition can be, and should be, implemented in a manner that ensures that all customers are no worse off than under the present system. Imposing requirements on the emerging competitive market that go well beyond any regulation or law - economic or environmental - that currently underscores the operations of today's electric services industry will represent a wide departure from the way in which markets work today. Such actions will only burden competition and promote higher electric prices before there is any real evidence that the proposed environmental measures will be necessary or will produce any measurable environmental benefits. The generation of such economic impacts will directly contradict the stated legislative goal that customers be no worse under competition than they are under the present system of economic regulation.

CEED strongly urges the Commission to rely on markets first to pursue a market-oriented approach to support additional environmental proposals before the Commission determines that regulation is warranted due to a market failure to address these issues effectively.

2. The imposition of environmental standards on competitors in the Pennsylvania energy market is counterproductive to the goal of increased economic efficiency.

In order to promote effective, efficient competition, the price and performance implications of environmental initiatives must be balanced through a careful and comprehensive review of the impacts of these initiatives on Pennsylvania's economy as well as

its environment. The potential value of broader competition should not be sacrificed by putting artificial and inappropriate barriers on the Pennsylvania market without creating any significant environmental or pricing benefit for the State's consumers.

The primary goal of any market structure adopted by the Pennsylvania Commission for the electric service industry should be to obtain and sustain an electric industry that promotes competitive pricing, and reliable and inovative product and service options. CEED points out that it is the primary jurisdictional responsibility of the Commission to implement economic regulatory policies that ensure that customers are provided with reliable supplies of electricity at a reasonable cost.

CEED respectfully suggests that the Commission take its cue from the Federal Energy Regulatory Commission's ("FERC") Order 888, and the Final Environmental Impact Statement in that proceeding, and defer environmental regulation to the Pennsylvania Department of Environmental Protection and the EPA who possess the resources, knowledge and statutory authority to impose environmental regulations that are found to be efficient and effective. The PDEP and the EPA do, and should, have primary jurisdictional responsibility for ensuring that utility environmental performance is consistent with requirements, such as the nitrogen dioxide emission reductions prescribed by the Ozone Transport Commission ("OTC") in its existing Memorandum of Understanding ("MOU") between the twelve northeastern states, attainment and maintenance of National Ambient Air Quality Standards ("NAAQS"), and so forth. In

the absence of any market failure at this time, the Commission should not be imposing unnecessary regulation upon the emerging marketplace.

Developing sound and reasonable policies for assuring the economic benefits of utility restructuring in Pennsylvania need not require the Commission to engage in backdoor environmental regulation. The Commission should resist the entreaties of interest groups who may seek to distract attention from the real purpose of this proceeding by introducing issues that properly lie within the jurisdiction of sister agencies, such as the PDEP.

For the Commission to assert jurisdiction over the environmental performance of the Pennsylvania electric market invites just the kind of regulatory duplication and jurisdictional conflicts that FERC successfully avoided in Order 888. In addition, CEED cautions the Commission that the imposition of equal environmental standards on participants in the electric supply market by the State will encourage an interstate commerce challenge¹ that could significantly delay State efforts to implement restructuring, thus compromising the Commission's

¹ When a state regulation is challenged as a violation of the dormant Commerce Clause, it will be subjected to one or two tests, depending upon the discriminatory nature of the statute. The first test applies if a statute is discriminatory on its face or in practical effect. The state bears the burden of justifying the discrimination by showing the following: (1) the statute has a legitimate local purpose; (2) the statute serves this interest; and (3) non-discriminatory alternatives, adequate to preserve the legitimate local purpose, are not available. See Hughes v. Oklahoma, 441 U.S. 322, 336 (1979); Hunt v. Washington State Apple Advertising Comm'n, 432 U.S. 333, 353 (1977); Dean Milk Co. v. City of Madison, 340 U.S. 349, 354 (1951).

objectives in this regard.

Finally, it is not economically efficient for the Commission to adopt policies that isolate electric generation as an emissions source,² or that isolate Pennsylvania's electric service industry through the imposition of requirements that apply solely to State generators, retail suppliers and their customers. These type of requirements only impede the development of competition within the State, discouraging participation in the State's competitive power industry and potentially generating significant additional costs for Pennsylvania consumers before it is even determined that such policies are required or that these policies will produce the desired environmental improvements in a cost-effective manner.

Respectfully submitted,



Susan M. Shanaman, Attorney for
The Center for Energy and Economic
Development

212 North Third Street, Suite 203
Harrisburg, Pennsylvania 17101
717-236-2055
717-236-2070 (fax)

Dated: February 12, 1998

² In addition to the NOx MOU Pennsylvania has demonstrated commitment to a number of other programs to reduce ozone levels and enhanced vehicle inspection and maintenance program in nonattainment areas in the state; additional industrial air pollution controls through RACT (Reasonable Achievable Control Technology) requirements and New Source Review requirements for all major sources; Title V operating permits for major sources at the lowered thresholds to inventory, monitor and control emissions of NOx and volatile organic compounds; and Stage II gasoline volatility requirements, or other alternative fuel strategies throughout the state.

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CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the enclosed document upon the active participants listed on the following pages in accordance with the requirements of 52 Pa. Code § 1.54 (relating to service by a participant).



Susan M. Shanaman, Attorney for
The Center for Energy and Economic
Development

212 North Third Street, Suite 203
Harrisburg, Pennsylvania 17101
717-236-2055
717-236-2070 (fax)

Dated: February 12, 1998

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F.A.P.U.C. OFFICE
PROTHONOTARY'S OFFICE

Paul E. Russell
Pennsylvania Power & Light Co.
Two North Ninth St.
Allentown, PA 18101

Lisa M. Helpert
Preston Gates Ellis & Rouvelas Meeds, LLP
1735 New York Ave., NW, #500
Washington, DC 20006

Irwin A. Popowsky
Office of Consumer Advocate
1425 Strawberry Square
Harrisburg, PA 17120

Johnnie E. Simms
Office of Trial Staff
Pa. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

David M. Kleppinger
McNees, Wallace & Nurick
P.O. Box 1166
Harrisburg, PA 17108

Elizabeth R. Benson
Energy Associates
7303 Timber Lane
Falls Church, VA 22046-2735

Billie E. Ramsey
ARIPPA
1300 Market St.
Lemoyne, PA 17043

Robert Longwell
Wolf, Block, Schorr and Solis-Cohen
212 Locust Street, Suite 300
Harrisburg, PA 17101-1236

Richard L. Caplan
Caplan & Luber, LLP
40 Darby Road
Paoli, PA 19301

Todd S. Stewart
Norman J. Kennard
Malatesta Hawke & McKeon
P.O. Box 1778
Harrisburg, PA 17120

Craig G. Goodman
Equitable Resources
3333 K St., NW, #425
Washington, DC 20007

David A. McCormick
Department of the Army
Office of the Judge Advocate General
901 North Stuart St.
Arlington, VA 22203-1837

Joan O. Brandeis
Schnader, Harrison, Segal & Lewis
1600 Market St., #3600
Philadelphia, PA 19103-4252

Robert P. Haynes, III
Merte, Evans & Woodside
3401 North Front St.
Harrisburg, PA 17110-0950

J. Kennedy and Associates, Inc.
35 Glenlake Parkway #475
Atlanta, GA 30328

Attorney of Record
Environmental Energy Project
3700 Vartan Way
Harrisburg, PA 17110

Eric J. Epstein
2308 Brandywine Dr.
Harrisburg, PA 17110

Stephen L. Huntoon
PECO Gas Supply Co.
2301 Market St.
Philadelphia, PA 19101-8699

Hon. George M. Kashi
Office of Administrative Law Judge
Pa. Public Utility Commission
P.O. Box 3265
Harrisburg, PA 17105-3265

Paul E. Nordstrom
Verner & Liipfert, Bernhard, McPherson &
Hand
901 15th St., NW
Washington, DC 20005

John L. Munsch
Allegheny Power
800 Cabin Hill Dr.
Greensburg, PA 15601

Harry S. Geller
Pa. Utility Law Project
118 Locust St.
Harrisburg, PA 17101

Terrance J. Fitzpatrick
Ryan Russel Ogden and Seltzer
800 N. Third St. #101
Harrisburg, PA 17102

William Schmitt
IBEW Local 1600
P.O. Box 470
Trexlerstown, PA 18087

Bernard M. Ryan
Office of Small Business Advocate
300 North Second St. #1102
Harrisburg, PA 17101

Michael Vough
Vough and Assoc.
126 South Main St.
Pittston, PA 18040

Craig A. Doll
214 State St.
Harrisburg, PA 17101

Michael L. Kessler
American Energy Solutions, Inc.
111 South Alfred St.
Alexandria, VA 22304

David W. Francis
Powell, Trachtman, Logan, Carrie, Bowman &
Lombardo, PC
114 N. Second St.
Harrisburg, PA 17101

Gary A. Jeffries
CNG Energy Services Corp.
P.O. Box 15746
Pittsburgh, PA 15224-0746

Rhonda Hendrickson
100 North 10th St.
Harrisburg, PA 17108

Robert F. Young
Allegheny Electric Cooperative, Inc.
P.O. Box 1266
Harrisburg, PA 17108-1266

Bruce Connell
General Counsel
600 N. Dairy Ashford, ML-1034
Houston, TX 77079

Michael Stosser
Heller Ehrman White & McAuliffe
815 Connecticut Ave., NW Suite 200
Washington, DC 20006-4004

Linda Smith
Dilworth, Paxson, Kalish & Kauffman LLP
305 N. Front St., Suite 403
Harrisburg, PA 17101-1236

David Cruthirds
Electric Clearinghouse, Inc.
100 Louisiana, Suite 5800
Houston, TX 77002-5050

David Boonin
New Energy Ventures, Inc.
200 S. Broad St., Suite 800
Philadelphia, PA 19102

Gordon Smith
John & Hengerer
1200 17th St., NW Suite 600
Washington, DC 20036-3006

Susan Shanaman
212 North Third St., Suite 203
Harrisburg, PA 17101-1505

Joseph Dworetzky
Hangley Aronchick Segal & Pudlin
One Logan Square, 12th Floor
Philadelphia, PA 19103-6933

Usher Fogel
Roland, Fogel, Koblenz & Carr, LLP
1 Columbia Place
Albany, NY 12207

James Steffes
Enron Corp.
P.O. Box 4428
Houston, TX 77002

Robert Knecht
Industrial Economics, Inc.
2067 Massachusetts Ave.
Cambridge, MA 02140

Jerry Mendl
MSB Energy Associates
7507 Hubbard Ave., Suite 200
Middleton, WI 53562

James Norris
Eckert Seamans Cherin & Mellott
600 Grant St., 42nd Floor
Pittsburgh, PA 15219

Randall Griffin, Esq.
Delmarva Power & Light Co.
P.O. Box 231
Wilmington, DE 19899

Mid-Atlantic Power Supply Assoc.
620 Herndon Parkway, Suite 200
Herndon, VA 20170

Patricia Armstrong
Thomas, Thomas, Armstrong & Niesen
P.O. Box 9500
Harrisburg, PA 17108-9500

Andrew Altman
Clean Air Council
135 South 19th St., Suite 300
Philadelphia, PA 19103

Roger Clark
905 Denston Drive
Ambler, PA 19002

Sheila Hollis
Duane Morris & Heckscher LLP
1667 K Street, NW
Washington, DC 20006-1608

Fred Zalcman
78 N. Broadway
White Plains, NY 10603

VERNER · LIIPFERT
BERNHARD · McPHERSON & HAND
CHARTERED

901 - 15TH STREET, N.W.
WASHINGTON, D.C. 20005-2301
(202) 371-6000
FAX: (202) 371-6279

ORIGINAL

Deborah A. Swanstrom
(202) 371-6137

February 12, 1998

BY HAND

James J. McNulty
Prothonotary
Pennsylvania Public Utility Commission
North Office Building
North Street and Commonwealth Avenue
Harrisburg, PA 17105-3265

Re: **Application Of Pennsylvania Power
And Light Company For Approval Of Its
Restructuring Plan Under Section 2806
Of The Public Utility Code,
Docket No. R-00973954**

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Dear Mr. McNulty:

Enclosed for filing in the above-captioned proceeding are an original and nine copies of the Supplemental Initial Brief of Allegheny Power. Counsel for GPU Energy has authorized us to state that GPU Energy also joins in Section II.A. of this Brief.

Also enclosed is an additional copy to be stamped and returned to us in the enclosed self-addressed envelope. Thank you for your assistance.

Very truly yours,



Deborah A. Swanstrom
Attorney for Allegheny Power

cc: The Honorable George M. Kashi (by hand)
Service List (Via facsimile)

HOUSTON, TEXAS
1111 BAGBY, SUITE 4700
HOUSTON, TEXAS 77002
(713) 225-7200
FAX: (713) 752-2199

AUSTIN, TEXAS
SAN JACINTO CENTER
98 SAN JACINTO BLVD., SUITE 1440
AUSTIN, TEXAS 78701
(512) 703-6000
FAX: (512) 703-6003

HONOLULU, HAWAII
HAWAII TOWER-AMFAC CENTER
745 FORT STREET, SUITE 600
HONOLULU, HAWAII 96813
(808) 566-0999
FAX: (808) 566-0995

MCLEAN, VIRGINIA
8280 GREENSBORO DRIVE
SUITE 601
MCLEAN, VIRGINIA 22102
(703) 749-6000
FAX: (703) 749-6027

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**APPLICATION OF PENNSYLVANIA POWER AND :
LIGHT COMPANY FOR APPROVAL OF ITS :
RESTRUCTURING PLAN UNDER SECTION 2806 : DOCKET NO. R-00973954
OF THE PUBLIC UTILITY CODE :**

**SUPPLEMENTAL INITIAL BRIEF
OF ALLEGHENY POWER**

Clinton A. Vince
Paul E. Nordstrom
Deborah A. Swanstrom
Joel D. Newton
Verner, Lipfert, Bernhard,
McPherson and Hand
901 15th Street, NW, Suite 700
Washington, DC 20005
(202) 371-6000

Attorneys for Allegheny Power

John L. Munsch
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601
(412) 838-6210

February 12, 1998

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LEGISLATIVE HISTORY

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**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

**APPLICATION OF PENNSYLVANIA POWER AND :
LIGHT COMPANY FOR APPROVAL OF ITS :
RESTRUCTURING PLAN UNDER SECTION 2806 : DOCKET NO. R-00973954
OF THE PUBLIC UTILITY CODE :**

SUPPLEMENTAL INITIAL BRIEF OF ALLEGHENY POWER

Pursuant to 52 Pa. Admin. Code §§ 5.501, 5.502, Allegheny Power hereby submits its Initial Brief. Allegheny Power requests that the Judge honor the Legislature's decision, in the Electricity Generation Customer Choice and Competition Act ("Competition Act"), to allow electric utilities to recover their stranded costs. If the transition to competition is to proceed fairly, as the Legislature intended, the stranded cost disallowances proposed by intervenors in this proceeding -- which arbitrarily penalize utility investors -- must be rejected.

It would be particularly unfair for the Commission to apply these same stranded cost disallowances, due to any precedent set in this proceeding, to Allegheny Power's operating subsidiary, West Penn Power Company ("West Penn"). Each Pennsylvania utility has a different record of mitigating costs that must be examined in that utility's own restructuring proceeding. In view of West Penn's history of maintaining rates below those of all other Pennsylvania utilities and the national average, a one size fits all approach is wholly inappropriate. As U.S. Supreme Court Justice Frankfurter once wrote: "There is no greater inequality than the equal treatment of unequals." *Dennis v. United States*, 339 U.S. 162, 184 (1950).

SUMMARY OF THE ARGUMENT

Consistent with its traditional obligation to serve and in anticipation of customer choice, Allegheny Power has operated efficiently and maintained low costs. Allegheny Power should be well positioned to compete in the new marketplace so long as the transition to competition proceeds fairly.

as the Legislature intended. Allegheny Power is concerned, however, that several proposals submitted by intervenors in this proceeding are not fair and, if subsequently applied to West Penn, would have a devastating effect.

The Pennsylvania Power and Light Industrial Customer Alliance (“PPLICA”), Office of Consumer Advocate (“OCA”), Office of Trial Staff (“OTS”), Environmentalists, and American Association of Retired Persons (“AARP”) have requested that PP&L be denied the opportunity to recover a large portion of its stranded costs. After quantifying the level of PP&L's stranded costs, these parties seek to arbitrarily shift additional costs to PP&L's investors by: (1) denying a common equity return on PP&L's stranded generation plant costs; (2) adopting cost sharing percentages for purposes of dividing stranded generation costs between ratepayers and shareholders; or (3) offsetting PP&L's stranded regulatory assets and NUG costs with the alleged potential net market value of PP&L's generating units. Allegheny Power opposes these stranded cost disallowances, and urges their rejection, because they violate the Competition Act. The disallowances advocated by the intervenors lack a rational nexus to the mitigation efforts of PP&L and constitute unlawful penalties against utility investors, contrary to the Legislature's intent.

Allegheny Power also urges the Judge to rule cautiously on the appropriate methodology to be used to calculate PP&L's stranded costs. PP&L, OCA, and PPLICA proposed methodologies that rely on long-term projections of future market prices. History has demonstrated that this type of long-term price forecasting is uncertain. It is particularly dangerous to rely upon long-term predictions about the competitive retail electricity market because the market has not yet developed. Therefore, in its own restructuring proceeding, West Penn proposed an alternative stranded cost methodology that is based on actual market prices.

The Environmentalists, New Energy Ventures ("NEV"), and Mid-Atlantic Power Supply Association ("MAPSA") also have proposed alternative methodologies for calculating PP&L's stranded costs that do not depend on long-term forecasts of future market prices. If the Judge declines to adopt this type of alternative methodology for purposes of calculating PP&L's stranded costs, Allegheny Power respectfully requests that he rule in a narrow manner that does not impair the Commission's ability to approve West Penn's own unique proposal in West Penn's restructuring proceeding.

ARGUMENT

I. CONTEXT OF RESTRUCTURING

A. ECONOMIC AND COMPETITIVE BACKGROUND

When the Legislature passed the Competition Act, it recognized that:

Rates for electricity in this Commonwealth are on average higher than the national average, and significant differences exist among the rates of Pennsylvania electric utilities.

66 Pa. C.S.A. § 2802 (4). At the time the Act was passed, West Penn had -- and it continues to have residential rates that are significantly below those of all other Pennsylvania utilities -- including PP&L -- and the national average. *See* Legislative Journal - Senate, No. 62, at 2693 (Nov. 25, 1996); Pennsylvania Public Utility Commission, "Electric Power Outlook for Pennsylvania 1995-2015" (July 1996).

B. LEGAL AND LEGISLATIVE BACKGROUND

During floor debate on the Competition Act, Senator Fumo -- one of the Legislature's staunchest consumer advocates -- commended West Penn for its efforts to reduce costs. *See* Legislative Journal - Senate, No. 62, at 2693 (Nov. 25, 1996). Senator Fumo stated:

[W]e recognize that there are some power companies in Pennsylvania that have extremely low rates. West Penn Power comes to mind. Their shareholders and management did not go on the foolhardy experiment of billions and billions of dollars for nuclear power plants. They said all we want to do is provide enough power for the people who use it and do it as cheaply as possible.

Id. at 2686. Thus, the Legislature recognized that not all Pennsylvania utilities are alike.

**C. ELECTRICITY GENERATION COMPETITION
AND CUSTOMER CHOICE ACT**

1. Concerns Addressed By The Customer Choice Act

In view of the fact that, under traditional regulation, most Pennsylvania utilities were charging rates in excess of the national average, the Legislature concluded that competitive market forces would be “more effective than economic regulation in controlling the cost of generating electricity.” 66 Pa. C.S.A. § 2802 (5). The Legislature decided to transition the electric industry from its regulated structure to a structure under which consumers would have direct access to a competitive generation market. *Id.* at § 2802(13). In setting the ground rules for this transition, the Legislature emphasized two key points:

- (1) THE TRANSITION MUST BE FAIR TO ALL AFFECTED PARTIES -- INCLUDING ELECTRIC UTILITIES AND THEIR INVESTORS.**
- (2) SAFETY AND RELIABILITY OF THE ELECTRIC SYSTEM MUST BE MAINTAINED.**

66 Pa. C.S.A. §§ 2802, (8), (12), (13), 2804 (1), (14). Contrary to the Legislature’s intent, several of the proposals submitted by intervenors in this proceeding are not fair to electric utilities or their investors. In addition, they would jeopardize the safety and reliability of the electric system.

II. LEGAL AND POLICY FOUNDATIONS OF STRANDED COST RECOVERY

A. LEGAL STANDARD

One of the Legislature's fundamental concerns about the *transition* to competition was that utilities be provided "with a fair opportunity to fully recover" their stranded costs, including the "just and reasonable" level of each utility's generation-related stranded costs. 66 Pa. C.S.A. § 2804 (14). The Legislature acknowledged that utilities had an obligation to serve customers and, consistent with that obligation, made long-term investments and entered into long-term supply agreements to meet their customers' needs. These investments and agreements created costs which may not be recoverable in a competitive market. 66 Pa. C.S.A. § 2802 (15). Therefore, to ensure utilities would be compensated fairly for their stranded investments, the Legislature empowered the Commission to determine the level of stranded costs incurred by each utility and to provide a mechanism -- in the form of a competitive transition charge ("CTC") -- for the recovery of each utility's stranded costs. 66 Pa. C.S.A. § 2802 (15).

1. Statutory

The Competition Act directs the Commission to apply the following principles for purposes of determining the level of stranded costs that a utility may recover through the CTC:

(1) The commission shall allow recovery of regulatory assets and other deferred charges typically recoverable under current regulatory practice, the unfunded portion of the utility's projected nuclear generating plant decommissioning costs and cost obligations under contracts with nonutility generating projects that have received a commission order.

* * *

(2) The commission shall allow recovery of an electric utility's prudently incurred costs related to cancellation, buyout, buydown or renegotiation of nonutility generating projects consistent with section 527 (relating to cogeneration rules and regulations).

(3) The commission shall determine the level of other generation-related transition or stranded costs that may be recovered through the competitive transition charge.

(4) The commission shall consider the extent to which the electric utility has undertaken efforts to mitigate generation-related transition or stranded costs by appropriate means in a manner that is reasonable under all of the circumstances, including consideration of whether mitigation has been commensurate with the magnitude of the electric utility's generation-related transition or stranded costs. During the transition period, electric utilities shall have the duty to mitigate generation-related transition or stranded costs to the extent practicable.

* * *

(5) Of equal importance to the mitigation efforts under paragraph (4), the commission shall consider efforts undertaken over time, prior to the enactment of this chapter, to reduce or moderate customer rate levels while maintaining safe and efficient operations.

66 Pa. C.S.A. § 2808 (c).

As evidenced by the mandatory language used by the Legislature, it intended to require the Commission to allow every utility to fully recover regulatory assets and other deferred charges, unfunded nuclear plant decommissioning costs, and NUG costs. 66 Pa. C.S.A. § 2808(c)(1), (2). However, the Legislature declined to adopt a one size fits all approach for the recovery of other "generation-related" stranded costs. It directed the Commission to consider the mitigation efforts undertaken by each utility for purposes of determining the just and reasonable level of a utility's generation-related stranded costs. 66 Pa. C.S.A. § 2808(c)(4).

C. EFFECT ON INVESTORS

Contrary to the Legislature's intent, several intervenors have requested that PP&L be denied a fair opportunity to fully recover its stranded costs. PP&L projects that its stranded costs will total \$4.5 billion. See Exhibit STJ-7 (Revised). PPLICA and OCA, however, contend that the Commission should adopt drastically lower estimates of PP&L's stranded costs. PPLICA quantifies a total level of only \$661 million and OCA of only \$383 million. PPLICA St. 1 at 9; OCA St. 1 at 19.

Along with the adoption of these lower stranded cost estimates, several intervenors want the Judge to require PP&L shareholders to bear an additional share of its generation-related stranded costs. Their proposals are summarized below:

- o **PPLICA's Proposal:** According to PPLICA's own calculations, PP&L has a total level of generation-related stranded costs of \$180.588 million. However, PPLICA requests that PP&L be denied the opportunity to recover \$47.482 million of these costs through the disallowance of an equity return on PP&L's stranded generation plant costs. PPLICA St. at 6-13.
- o **OCA's Proposal:** Based on its projections of future market prices, OCA claims that PP&L's generation plants have a market value that is greater than their book value and, therefore, PP&L should not be allowed to collect any generation-related stranded costs. OCA also asks the Judge to preclude PP&L from recovering stranded regulatory assets and NUG costs by offsetting these costs with the alleged net market value of PP&L's generating plants. In the event that OCA's stranded cost calculation is rejected -- and PP&L's calculation is accepted -- OCA requests that PP&L be denied an equity return on its stranded generation plant costs. OCA St. No. 1 at 30, 32.
- o **OTS's Proposal:** OTS recommends a "90%/10% split" for purposes of dividing generation-related stranded costs between PP&L ratepayers and shareholders. OTS asserts that PP&L was an inefficient electric producer and therefore PP&L should not be rewarded by requiring ratepayers to absorb all of its stranded costs. In OTS's opinion, this cost sharing by PP&L shareholders should be required because: "If you do not share the cost, the Commission will be penalizing the efficient utility by allowing the inefficient utility to recover all of its inefficiency in the CTC." OTS St. 1 at 20.
- o **The Environmentalists' Proposal:** The Environmentalists recommend a "42.7% customer/57.3% shareholder split" of PP&L's generation-related stranded costs. Env. St. 1 at 19. They assert that PP&L shareholders should bear this share of PP&L's costs because "stockholders have already received a fairly decent return on their investment in generating assets, even though much of that investment has turned out to be valueless to the customers." *Id.*
- o **AARP's Proposal:** AARP has taken the position, on a nationwide basis, that ratepayers should be responsible for no more than 50% of any utility's stranded costs. AARP St. 1 at 23. In PP&L's case, AARP wants to deny PP&L the opportunity to recover at least 56% of its generation-related stranded costs. AARP claims that PP&L has not operated efficiently because its production costs "are about 20 percent above the lowest cost producer in Pennsylvania" and "are about 20 percent above the national average." AARP St. 1 at 72-76. Therefore, PP&L's shareholders should bear this large portion of its costs.

Allegheny Power opposes these stranded cost disallowances because they are unjust and unreasonable and violate the Competition Act. The intervenors' proposals are arbitrarily designed to shift costs away from ratepayers and onto the backs of utility investors, without any rational nexus to the specific mitigation efforts (or lack thereof) undertaken by PP&L. Thus, the proposals are no more than unlawful penalties against utility investors, contrary to the Legislature's intent.

**THE LEGISLATURE DID NOT INTEND TO PENALIZE UTILITY INVESTORS,
AS THE INTERVENORS NOW PROPOSE**

The Legislature did not intend to penalize investors as the intervenors now propose, but instead was careful to protect their interests. As Senator Brightbill stated, “there are a lot of moms and pops and grandmas and grandpas” in Pennsylvania who rely upon income they receive from investments in utilities. These investors are not “fat cats” who can afford to sustain large financial losses. “[M]any common people, either directly or through their pension funds or through their IRAs or through their mutual funds, have made such investments.” *Legislative Journal-Senate*, No. 62, at 2691 (Nov. 25, 1996).

In fact, when the Competition Act was enacted, the Legislature considered **and rejected** a proposal which would have required utility shareholders to bear an additional percentage of each utility’s costs. For purposes of holding shareholders responsible for a utility’s decision to invest in high-cost nuclear plants and relieving ratepayers from having to bear this stranded cost burden, Senator Fumo proposed an amendment to the Competition Act which would have required a 10% reduction in the rates charged by all utilities. *Legislature Journal-Senate*, No. 62, at 2684-86. This amendment was defeated. Therefore, it would be improper for the Commission to now do indirectly what the Legislature decided not to do directly.

As a result of the rate cap imposed by the Competition Act, PP&L’s shareholders are already at risk for approximately \$500 million of PP&L’s stranded costs. PP&L Exhibit STJ-7 (Revised); PP&L St. 2 at 18. To go further and automatically require an additional sharing of these costs by PP&L’s shareholders, without any rational nexus to the mitigation efforts undertaken by PP&L, would violate the Competition Act. As PPLICA’s witness Baron admitted, the just and reasonable standard does not require that a downward adjustment be made from the total level of each utility’s

stranded costs. Tr. 1665 (Aug. 26, 1997). Instead, the Commission must consider whether or not the utility made reasonable efforts to mitigate its costs for purposes of determining the just and reasonable amount of costs that will be recovered from ratepayers. Tr. 1657 (Aug. 26, 1997).

Where a utility has mitigated its costs in a manner that is commensurate with the magnitude of those costs, it is unlawful to prevent the utility from recovering the costs that remain following mitigation. *See* 66 Pa. C.S.A. §§ 2808(c), 2804.

THE INTERVENORS' STRANDED COST DISALLOWANCES ARE ARBITRARY AND LACK A RATIONAL NEXUS TO PP&L'S MITIGATION EFFORTS

Rather than analyzing the specific mitigation measures undertaken by PP&L and any additional mitigation measures that PP&L should have undertaken, but failed to, the intervenors propose to arbitrarily shift costs to utility investors. PPLICA expressly states that it is not challenging PP&L's mitigation efforts. PPLICA St. 1 at 16. Its proposed denial of a return on stranded generation plant costs bears no relationship to PP&L's mitigation efforts. In clear violation of the Competition Act, PPLICA's proposal would appear to have universal application to all Pennsylvania utilities, even if those utilities properly mitigated their costs.

OTS similarly concedes that its selection of a 10% stranded cost sharing level is not based on any "exact science." OTS St. 1 at 20. This simply is a percentage reduction which OTS thought would be reasonable for PP&L's shareholders to absorb. OTS even acknowledges that PP&L made efforts to mitigate its costs prior to the enactment of the Competition Act. However, OTS claims that PP&L should not get any credit for these mitigation efforts because PP&L was required to mitigate its costs even in the regulated environment and should not be rewarded for doing nothing more than what it already had responsibility to do. OTS St. 1 at 19. The Commission cannot ignore PP&L's past mitigation efforts, as OTS suggests. The Commission has a duty, under the

Competition Act, to consider a utility's "efforts undertaken over time, prior to the enactment of this chapter, to reduce or moderate customer rate levels....." 66 Pa. C.S.A. § 2808(c)(5).

The disallowance proposed by the Environmentalists also lacks a rational nexus to the mitigation efforts of PP&L. The "42.7% customer/57.3% shareholder" sharing level devised by the Environmentalists is arbitrarily premised on the Environmentalists' claim that PP&L's shareholders have already received "a fairly decent return" on their investment and that a 42.7% recovery would allow shareholders to maintain the returns achieved to date without requiring them to now generate their own funds to pay debt holders. Env. St. 1 at 19-23. The "fairly decent return" standard advocated by the Environmentalists has no legal foundation. The Competition Act does not state that the Commission should determine the level of generation-related stranded costs to be recovered in a utility's CTC based on whether or not shareholders would receive a "fairly decent return." It directs the Commission to analyze the mitigation efforts undertaken by a utility for purposes of determining the just and reasonable level of these costs.^{1/}

AARP's proposed 56% stranded cost disallowance similarly constitutes an unlawful and arbitrary penalty against utility investors. In accordance with its national policy, AARP began with the premise that no utility should be allowed to collect more than 50% of its stranded costs. AARP then backed into this predetermined result. Nowhere in its testimony does AARP discuss the specific mitigation efforts undertaken by PP&L.

^{1/} Even if the Competition Act did endorse a "fairly decent return" standard, the Environmentalists failed to prove that a 42.7% recovery would allow shareholders to recoup their investment along with a "fairly decent return." The Environmentalists do not know how much money PP&L shareholders already have received for their investment in its stranded generation assets. Nor do they know whether or not the shareholders have actually earned the Commission-authorized return on this investment. Env. St. 1 at 19, 22.

OCA did discuss the mitigation efforts undertaken by PP&L and suggested some additional mitigation measures that it believes PP&L should be required to undertake. OCA St. 1 at 23-29. However, when it came down to recommending a disallowance of PP&L's generation-related stranded costs, OCA abandoned this analysis. OCA concluded that the "most effective way" to address a utility's mitigation efforts is not to "quarrel" about the dollar amounts associated with mitigation, but simply to develop a mechanism for sharing costs between ratepayers and shareholders. OCA proposes to share these costs by denying PP&L a return on its stranded generation plant costs. OCA St. 1 at 29-30.

While OCA may believe that the denial of a return on stranded generation plant costs is the "most effective way" to deal with the determination of the just and reasonable level of a utility's generation-related stranded costs, this was not the Legislature's belief. Even if it involved some "quarreling," the Legislature envisioned that the adjustments, if any, made to a particular utility's generation-related stranded costs would be based on that individual utility's failure to undertake mitigation efforts in a reasonable manner that is commensurate with the magnitude of its stranded generation costs.

THE COMPETITION ACT PROHIBITS THE COMMISSION FROM DENYING A UTILITY A RETURN ON ITS STRANDED GENERATION PLANT COSTS SIMPLY BECAUSE THE PLANTS ARE NO LONGER ECONOMICALLY USED AND USEFUL IN THE COMPETITIVE MARKET

OCA and PPLICA argue that it is appropriate to deny PP&L a return on its stranded generation plant costs because these plants are no longer economically used and useful in the competitive market. PPLICA and OCA do not dispute that PP&L constructed its generation plants to meet its regulatory obligation to serve consumers. PPLICA and OCA also do not dispute that PP&L would have received a return on its generation plants if traditional regulation had continued. They claim only that, under past

regulatory policy, the Commission has denied utilities a return on facilities that are not used and useful to ratepayers and, therefore, it is appropriate for the Commission to similarly do so here. PPLICA St. 1 at 16; OCA St. 1 at 30.

Past regulatory policy, however, does not control the recovery of a utility's stranded generation plant costs. The Competition Act controls this recovery. The very purpose of the CTC, mandated by the Competition Act, is to recover costs associated with generation facilities that are no longer economically used and useful in the competitive market. The term "transition or stranded costs" is even defined in the Act to expressly include "any costs attributable to physical plants no longer used and useful because of the transition to retail competition." 66 Pa. C.S.A. § 2803. Thus, the Legislature clearly intended to allow the recovery of these costs, and the proposals of PPLICA and OCA must be rejected.

THE COMPETITION ACT PROHIBITS THE COMMISSION FROM DENYING A UTILITY FULL RECOVERY OF ITS STRANDED REGULATORY ASSETS AND NUG COSTS

OCA's alternative proposal to preclude PP&L's recovery of stranded regulatory assets and NUG costs, by offsetting these costs against the potential net market value of PP&L's generating plants, also must be rejected. The Competition Act expressly mandates that the Commission "shall" allow the recovery of regulatory assets, cost obligations under NUG contracts, and prudently incurred costs related to cancellation, buyout, buydown, or renegotiation of NUG projects. 66 Pa. C.S.A. § 2808 (c) (1), (2). Consequently, the Commission lacks the authority to preclude utilities from recovering these particular costs.

The Competition Act and its history make clear that the Legislature did not intend to net a utility's stranded costs related to its own generating assets against other types of stranded costs. The Legislature was careful to distinguish the recovery of a utility's own generation-related stranded costs --

which involves an exercise of Commission judgement as to the proper level of costs to be recovered -- from the recovery of stranded regulatory assets and NUG costs -- which is mandatory. Indeed, the Legislature even included an exception to the rate cap to ensure that utilities fully recovered their NUG costs. 66 Pa. C.S.A. § 2804(4)(iii)(B).

The Commission's "Report and Recommendation to the Governor and General Assembly on Electric Competition" dated July 1996, which served as the blueprint for the Competition Act, further demonstrates that neither the Legislature nor the Commission contemplated the netting of utility-owned generation stranded costs against other stranded costs. The Commission recommended netting only in the context of a utility's own generating assets. In subsection (ii) of the Report, the Commission discussed utility-owned generation and recommended that: "utility generation assets not mitigated during the transition period, which have book values above market, should be netted against utility generation assets that have book values below market." Commission Report at 21. In contrast, in subsection (ii) of the Report, which discusses NUG contracts, the Commission did not recommend any netting. Instead, it recommended that: "utilities be authorized to collect the costs of currently effective and approved NUG contracts as they are incurred. . . . Since NUG contracts were required by law, utilities will have the opportunity to request recovery of the unmitigated prudent costs of such contracts within the cost recovery mechanism." Commission Report at 20.

Moreover, Section 527 of the Public Utility Code, which is incorporated into Sections 2804(4)(iii)(B) and 2808(c)(2) of the Competition Act, requires the Commission to allow the recovery of NUG costs in utility rates. 66 Pa. C.S.A. § 527. Federal law also requires full recovery of NUG costs. In *Freehold Cogeneration Associates, L.P. v. Board of Regulatory Commissioners*, 44 F.3d 1178 (3d Cir.), *cert. denied*, 116 S. Ct. 68 (1995), the Court ruled that the Public Utility Regulatory

Policies Act requires the full pass-through of NUG costs once a state commission has approved a NUG contract. Once a commission approves a contract, “any action or order by the [commission] to reconsider its approval or to deny the passage of those rates to [the utility’s] consumers under purported state authority [is] preempted by federal law.” *Id.* at 1194. Thus, neither the Commission nor the Pennsylvania Legislature has the authority to preclude a utility from fully recovering costs incurred under a Commission-approved NUG contract.

IT WOULD BE PARTICULARLY INAPPROPRIATE TO APPLY THE STRANDED COST DISALLOWANCES SUBMITTED IN PP&L’S PROCEEDING ON A UNIFORM BASIS TO OTHER LOWER COST UTILITIES

It would be particularly inappropriate to apply the stranded cost disallowances advocated by intervenors in PP&L’s proceeding on a uniform basis to other lower cost utilities, such as West Penn. As OTS recognized, the Commission should not penalize the efficient utility. OTS St. 1 at 20. As Senator Fumo also acknowledged, West Penn cannot afford to take a reduction in its rates. *Legislature Journal-Senate*, No. 62, at 2692 (Nov. 25, 1996). Because it is financially lean, West Penn cannot absorb the same percentage of stranded costs as other higher cost utilities. West Penn would be especially disadvantaged by OTS’s suggestion that the Commission not take into account any prior mitigation efforts by a utility. West Penn does not have the same ability as other higher cost utilities to undertake additional mitigation measures because it already has cut costs aggressively.

THE INTERVENORS’ STRANDED COST SHARING PROPOSALS WOULD IMPAIR THE RELIABILITY OF ELECTRIC SYSTEM IN VIOLATION OF THE COMPETITION ACT

In addition to violating Section 2808 of the Competition Act, which governs stranded cost recovery, the intervenors’ proposals violate the Legislature’s command, in Section 2804 of the Act, that the safety and reliability of the electric system shall be maintained. 66 Pa. C.S.A. §§ 2804. PP&L

demonstrated that if the intervenors' proposals were adopted, its financial integrity would be destroyed. As a result, PP&L may be unable to meet its continuing obligation to serve as a supplier of last resort or to maintain the safety and reliability of its distribution system. PP&L St. Nos. 2-R at 5 and 8-R at 25-26. Moreover, if the intervenors' proposals were adopted here, an adverse precedent might be set that jeopardizes the financial integrity of other utilities and places the reliability of the entire Pennsylvania electric system at risk.

III. STRANDED COST CALCULATION METHODOLOGY

Several different methodologies were proposed for calculating PP&L's stranded costs. Allegheny Power does not intend to advocate the adoption of a particular methodology for use in PP&L's proceeding. However, Allegheny Power is concerned that any methodology which relies on long-term projections of future market prices will not produce accurate results. Therefore, in its own restructuring proceeding West Penn submitted an alternative methodology that is based on actual market prices, rather than simply long-term projections of future market prices.

Both the regulatory methodology used by PP&L here, and the asset value methodology used by OCA and PPLICA, depend upon long-term forecasts of future market prices. It is virtually impossible for anyone to predict, with accuracy, what an energy price is going to be 20 years or more into the future.^{2/} Therefore, both methodologies share the risk that the forecasts will be in error, and that PP&L's stranded costs will be overstated or understated. *See* Tr.1866-67 (Aug. 28, 1997).

^{2/} Tr. 711 (Aug. 19, 1997); Tr. 792-93 (Aug. 19, 1997); Tr. 1829 (Aug. 27, 1997); Tr. 1505 (Aug. 25, 1997); Tr.1435 (Aug. 25, 1997).

As the witnesses in this proceeding recognized, forecasting future electricity prices is a complex endeavor. Tr.1721 (Aug. 26, 1997). An enormous number of assumptions must be made upon which reasonable experts will disagree. OSBA St. 1 at 34, 10. Each of these underlying assumptions, standing alone, is uncertain. Tr. 1727-29 (Aug. 26, 1997). Moreover, modest changes in the assumptions can lead to markedly different projections of stranded costs. OSBA St. 1 at 34, 8-10; Env. St. 1 at 7.

The expert witnesses for PP&L, PPLICA, and OCA could not agree on the assumptions to be used and each presented different projections of future market prices. These parties also have extremely different opinions regarding the level of generation-related stranded costs that will be incurred by PP&L. PP&L predicts it may have \$3.57 billion in stranded generation costs whereas PPLICA predicts it may have \$180 million. OCA predicts that PP&L may not have any stranded generation costs, but instead PP&L's generation plants may have a net positive market value of \$500 million. PP&L St. 8 at 31-32; PPLICA St. 1 at 10; OCA St. 1 at 19. The wide variations in these parties' calculations demonstrate that future market prices for electricity, and the actual level of a stranded costs which will be incurred by a utility, cannot be predicted accurately at this time.

History also demonstrates that future energy prices cannot be predicted accurately. Over the years, "the electric industry has missed the mark quite often" when attempting to predict future market behavior. Tr. 1724 (Aug. 26, 1997). In the 1970s, there were predictions that oil prices would reach \$100.00 a barrel. That never happened. There also were predictions that the U.S. was running out of natural gas reserves. That never happened. Similarly, there were predictions that nuclear power would be too cheap to meter. That too never happened. Electric industry predictions about the costs which could be avoided through the use of long-term NUG contracts also proved to be false. Tr.1721-24 (Aug. 26, 1997).

The market price forecasts presented by the witnesses in this proceeding suffer from the same frailties as these prior forecasts. As MAPSA's witness Johnstone testified:

[I]t's very difficult to have a reliable forecast for an extended period of time. Whether it's an avoided cost forecast or a market price forecast, they both go to much the same point.

Tr. 709 (Aug. 19, 1997). As PP&L's renowned witness, Dr. Alfred Kahn, also conceded:

No one who [has] lived through or been intimately involved with the widely mistaken estimates and projections of energy prices over the last three decades or so can have any confidence that the projections the Commission is now called upon to embody in policy on a once-and-for-all basis may not prove equally widely off the mark.

PP&L St. 18-R at 49-50. *Accord* PP&L St. 20-R at 22.

Indeed, forecasts of future electricity prices are even more uncertain than other past projections of energy prices because the competitive retail electricity market has not yet developed. Tr. 793 (Aug. 19, 1997). The parties to this proceeding are attempting to predict how a new and immature market will operate. Yet, no party really knows how that market is going to work in practice.^{3/} What we do know, however, is that actual market prices are going to differ from the projections made in this case. Inevitably, the long-term forecasts submitted in this proceeding will turn out to be wrong.^{4/}

IT IS AN INAPPROPRIATE REGULATORY POLICY TO BASE A UTILITY'S CTC ON INHERENTLY UNCERTAIN, LONG TERM MARKET PRICE PROJECTIONS

In view of this uncertainty, West Penn submitted a unique methodology for calculating stranded costs in its own proceeding that does not rely upon long-term forecasts of future market prices. Three intervening parties in PP&L's proceeding -- the Environmentalists, NEV,

^{3/} Tr. 1724-25 (Aug. 26, 1997); Tr. 1506 (Aug. 25, 1997); Env. St. 1 at 10.

^{4/} Tr. 706 (Aug. 19, 1997); Tr. 1505 (Aug. 25, 1997); PP&L St. 7-R at 44.

and MAPSA -- similarly have proposed their own unique methodologies for calculating PP&L's stranded costs that do not rely upon long-term forecasts of future market prices.

The Environmentalists proposed two alternative methodologies. Under the first methodology, PP&L would auction its generation plants to the highest bidders. The resulting sales prices for the plants would be the market value of the plants. The Commission would then net that market value against the book value of the plants in order to determine PP&L's stranded generation costs. Env. St. 1 at 12-13. The Environmentalists recognized, however, that the Competition Act does not specifically grant the Commission the authority to order PP&L to sell its generating plants. Env. St. 1 at 15. Allegheny Power concurs that the Competition Act does not provide this authority. In fact, the Act expressly prohibits the Commission from mandating the divestiture of a utility's generation plants. 66 Pa. C.S.A. § 2804.

Under the Environmentalists' second methodology, a short-term, pro forma market price would be adopted initially by the Commission in this proceeding. PP&L's CTC would be developed based on this temporary, pro forma market price. Env. St. 1 at 17. A tracking account would then be used to adjust PP&L's CTC based on actual market prices that occur during the transition period. Env. St. 1 at 14-17; Tr. 1806-807, 1812-23 (Aug. 26, 1997).

NEV proposed the use of both a generation charge and a CTC which vary in relationship to actual market prices. Under NEV's proposal, PP&L's CTC would be split into two components: (1) generation; and (2) non-generation. As the prevailing market price for generation changes, PP&L's unbundled generation rate and the generation-related component of the CTC also would change. NEV St. 1-2, 9-10.

MAPSA recommended that PP&L's CTC be reviewed not less than every two years during the transition period. MAPSA St. 1 at 19. Under MAPSA's proposal, PP&L's CTC would be established in this proceeding for the year 1999. The CTC would then be recalculated in the years 2001 and 2003 based on actual experience in the marketplace and more current, short-term price forecasts. Tr.711-712 (Aug. 19,1997).

In view of PP&L's opposition to these alternative methodologies, Allegheny Power does not intend to endorse a particular intervenor's proposal for use in PP&L's proceeding. Allegheny Power concurs, however, with the premise underlying these proposals: **It is an inappropriate regulatory policy to attempt to construct a CTC today which is based on uncertain projections of the future price of electricity over the next 20 to 30 years.** If the Judge declines to adopt the intervenors' alternative proposals for use in PP&L's proceeding, Allegheny Power respectfully requests that the Judge rule narrowly to ensure that no adverse precedent is established which might impair the Commission's ability to approve West Penn's unique proposal in West Penn's own restructuring proceeding. Unlike PP&L, West Penn cannot afford to base its CTC on speculation about what the future will hold. If West Penn's actual losses turn out to be far different than projected, it does not have the same ability as other higher cost utilities to cushion this financial blow. Therefore, West Penn voluntarily agreed to recalculate its CTC.

WHEREFORE, Allegheny Power requests that the Judge deny the stranded cost disallowances proposed by intervenors and clarify that his rulings in this proceeding are based solely upon the facts presented in PP&L's case and are not intended to prejudice the Commission's rulings in the individual restructuring proceedings of other utilities.

Respectfully submitted,



Clinton A. Vince
Paul E. Nordstrom
Deborah A. Swanstrom
Joel D. Newton
Verner, Liipfert, Bernhard,
McPherson and Hand
901 15th Street, NW
Washington, DC 20005
(202) 371-6000

Attorneys for Allegheny Power

John L. Munsch
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601
(412) 838-6210

February 12, 1998

**BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION**

Application Of Pennsylvania Power :
And Light Company For Approval Of Its :
Restructuring Plan Under Section 2806 : **Docket No. R-00973954**
Of The Public Utility Code :

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a true copy of the foregoing document upon the participants, listed below, in accordance with the requirements of § 1.54 (relating to service by a participant).

Paul E. Russell, Esq.
Associate General Counsel
Pennsylvania Power & Light Company
Two North Ninth Street
Allentown, PA 18101-1179

Bernard Ryan, Esq.
Karen Oill Moury, Esq.
Office of Small Business Advocate
Suite 1102, Commerce Building
300 North 2nd Street
Harrisburg, PA 17101

John R. Orr, Esq.
Duke Energy Trading and Marketing LLC
One Westchase Center
10777 Westheimer, Suite 650
Houston, TX 77042

Irwin A. Popowsky, Esq.
James A. Mullins, Esq.
Craig R. Burgraff, Esq.
Office of Consumer Advocate
14th Floor, Strawberry Square
Harrisburg, PA 17120

Johnnie E. Simms, Esq.
Scott H. DeBroff, Esq.
Prosecutors, Office of Trial Staff
Pennsylvania Public Utility Commission
PO Box 3265
Harrisburg, PA 17105-3265

David M. Kleppinger, Esq.
Pamela C. Polacek, Esq.
McNees, Wallace & Nurick
PO Box 1166
100 Pine Street
Harrisburg, PA 17108

Elizabeth R. Benson
Energy Associates
7303 Timber Lane
Falls Church, VA 22046-2735

Warren W. Mack
Vice President
Ahlstrom Development Corp.
4350 LaJolla Village Drive
Suite 210
San Diego, CA 92122

Daniel Clearfield, Esq.
Alan Kohler, Esq.
Robert J. Longwell, Esq.
Wolf, Block, Schorr and Solis-Cohen
Locust Court Building, Suite 300
212 Locust Street
Harrisburg, PA 17101

Billie E. Ramsey
Executive Director
Arippa
1300 Market Street
Lemoyne, PA 17043

Louis J. Carter, Esq.
7300 City Line Avenue
Philadelphia, PA 19151

Edwin D. Hill
International Vice President
IBEW
200 Corporate Center Drive
Suite 301
Corapolis, PA 15108

Stephen J. Baron
J. Kennedy and Associates, Inc.
Suite 475
35 Glenlake Parkway
Atlanta, GA 30328

Lisa Yoho
Director of Regulatory Affairs
The Eastern Group, Inc.
2900 Eisenhower Avenue, Suite 300
Alexandria, VA 22314

Richard L. Caplan, Esq.
Mary Huwaldt, Esq.
Caplan & Luber, LLP
40 Darby Road
Paoli, PA 19301

Craig G. Goodman, Esq.
Equitable Resources
3333 K Street, NW
Suite 425
Washington, DC 20007

Ginny Kreidler
RMI, Inc.
111 Presidential Boulevard
Suite 127
Bala Cynwyd, PA 19004

William Schmitt
IBEW Local 1600
540 Grange Road
PO Box 470
Trexlerstown, PA 18087

William T. Hawke, Esq.
Todd S. Stewart, Esq.
Malatesta Hawke & McKeon
100 North Tenth Street
PO Box 1778
Harrisburg, PA 17120

D. Jane Drennan, Esq.
Sarah E. Tomalty, Esq.
Drennan & Associates
1216 16th Street, NW
Washington, DC 20036

David A. McCormick, Esq.
Department of the Army
Office of the Judge Advocate
901 North Stuart Street
Arlington, VA 22203-1837

James Melia, Esq.
Kirkpatrick & Lockhart
The Payne Shoemaker Building
240 North Third Street
Harrisburg, PA 17101-1507

Joan O. Brandeis, Esq.
Schnader, Harrison, Segal & Lewis
Suite 3600
1600 Market Street
Philadelphia, PA 19103-4252

Wayne M. Thomas, Esq.
Kohn, Nast & Graff, PC
1101 Market Street, 24th Floor
Philadelphia, PA 19107

Mr. Craig R. Kuennen
Energy Services Manager
Commission on Economic Opportunity
211 South Main Street
Wilkes-Barre, PA 18701-1596

Roger E. Clark, Esq.
905 Denston Drive
Ambler, PA 19002

Robert P. Haynes, III, Esq.
Mette, Evans & Woodside
3401 North Front Street
Harrisburg, PA 17110-0950

Stephen J. Selden, Esq.
Assistant General Counsel
Bethlehem Steel Corporation
Eighth & Eaton Avenues
Bethlehem, PA 18016

Mr. Eric J. Epstein
2308 Brandywine Drive
Harrisburg, PA 17110

Stephen L. Huntoon, Esq.
PECO Gas Supply Company
2301 Market Street
Philadelphia, PA 19101-8699

Mary McFall Hopper
PECO Energy Company
2301 Market Street, S23-1
Philadelphia, PA 19101

Noel H. Trask, Esq.
PECO Energy Company
2301 Market Street
Philadelphia, PA 19101-8699

Kenneth Zielonis, Esq.
Stevens & Lee
208 North Third Street
Suite 310
Harrisburg, PA 17101

Donald A. Kaplan
Lisa M. Helpert
Preston Gates Ellis & Rouvelas
Meeds, LLP
1735 New York Avenue, NW
Suite 500
Washington, DC. 20006

Scott J. Rubin, Esq.
Counsel for IBEW 1600
3 Lost Creek Drive
Selinsgrove, PA 17870

John F. Povilaitis, Esq.
PA PUC Law Bureau
PO Box 3265
Harrisburg, PA 17105-3265

Glenn Barton
PA PUC Bureau of Audits
PO box 3265
Harrisburg, PA 17105-3265

Michael A. Stosser, Esq.
Heller Ehrman White & McAuliffe
815 Connecticut Avenue, NW
Suite 200
Washington, DC 20006-4004

Fred Zalcman, Esq.
Pace University School of Law
78 North Broadway
White Plains, NY 10603

Bruce Biewald
Synapse Energy Economics, Inc.
101 Chilton Street
Cambridge, MA 02138

Gene Stilp
Coordinator
G. Stilp & PP&L Ratepayers' Assn.
1550 FCVR
Harrisburg, PA 17112

Donald H. Muth
PA PUC Bureau of FUS
PO Box 3265
North Office Building
Harrisburg, PA 17105-3265

Zahmed Kaloko
PA PUC CEEP
PO Box 3265
Harrisburg, PA 17105-3265

Craig A. Doll, Esq.
Delmarva Power and Light Company
214 State Street
Harrisburg, PA 17101

Harry S. Geller, Esq.
PA Utility Law Project
118 Locust Street
Harrisburg, PA 17101

Andrew Altman
Deputy Director
Clean Air Council
135 S. 19th Street, Suite 300
Philadelphia, PA 19103

Jerry Mendl
MSB Energy Associates
Suite 200
7507 Hubbard Avenue
Middleton, WI 53562

Gordon E. Goodman, President
Bruce A. Connell, Esq.
DuPont Power Marketing, Inc.
600 N. Dairy Ashford, CH-1081
Houston, TX 77079

John A. Alzamora, Esq.
Patricia Armstrong, Esq.
Thomas, Thomas, Armstrong & Niesen
212 Locust Street
PO Box 1266
Harrisburg, PA 17108-1266

Gary A. Jeffries, Esq.
CNG Energy Services Corporation
One Park Ridge Center
PO Box 15746
Pittsburgh, PA 15244-0746

Robert Knecht
Industrial Economies, Inc.
2067 Massachusetts Avenue
Cambridge, MA 02140

David W. Francis
Powell, Trachtman, Logan, Carrle,
Bowman & Lombardo, PC
114 North Second Street
Harrisburg, PA 17101

The Center for Energy and
Economic Development
John Paul, President
500 Burton Avenue, Suite 2-A
Northfield, NJ 08225

Michael T. Vough, Esq.
Greater Pittston Professional Center
126 South Main Street
Pittston, PA 18640-1793

Mary Margaret King, Esq.
Randall V. Griffin, Esq.
Delmarva Power & Light Company
800 King Street
PO Box 231
Wilmington, DE 19899

John H. Koch
428 Robin Road
Allentown, PA 18014-6724

Ronda Hendrickson
100 North 10th Street
Harrisburg, PA 17108

Thomas S. Catlin
Exeter Associates, Inc.
Suite 350
12510 Prosperity Drive
Silver Spring, MD 20904

Michael L. Kessler
Vice President & General Counsel
American Energy Solutions, Inc.
111 S. Alfred Street
Alexandria, VA 22304

Susan M. Shanaman, Esq.
212 North Third Street
Suite 203
Harrisburg, PA 17101

Gordon J. Smith, Esq.
John & Hengerer
1200 17th Street, NW
Suite 600
Washington, DC 20036-3006

Walter W. Cohen, Esq.
Cathy Corran Myers, Esq.
Obermayer Rebmann Maxwell & Hippel
One Pen Center, 19th Floor
1617 John F. Kennedy Boulevard
Philadelphia, PA 19103-1895

John L. Munsch, Esq.
Allegheny Power
800 Cabin Hill Drive
Greensburg, PA 15601

Usher Fogel, Esq.
Roland, Fogel, Koblenz & Carr, LLP
1 Columbia Place
Albany, NY 12207

Linda C. Smith, Esq.
Dilworth, Paxson, Kalish & Kauffman LLP
305 N. Front Street
Suite 403
Harrisburg, PA 17101-1236

James D. Steffes
Enron Corp.
1400 Smith Street
PO Box 4428
Houston, TX 77002

Mid-Atlantic Power Supply Association
Suite 200
620 Herndon Parkway
Herndon, VA 20170

Sheila S. Hollis, Esq.
Mary Ann Ralls, Esq.
Stephanie A. Sugrue, Esq.
Duane, Morris & Heckscher LLP
1667 K street, NW, Suite 700
Washington, DC 20006

Joseph A. Dworetzky, Esq.
Hangley Aronchick Segal & Pudlin
One Logan Square, 12th Floor
Philadelphia, PA 19103-6933

Robert F. Young, Esq.
Anthony C. Adonizio, Esq.
Allegheny Electric Cooperative, Inc.
212 Locust Street
PO Box 1266
Harrisburg, PA 17108-1266

David Cruthirds
Electric Clearinghouse, Inc.
1000 Louisiana
Suite 5800
Houston, TX 77002-5050

James H. Norris, Esq.
Eckert Seamans Cherin & Mellott
42nd Floor
600 Grant Street
Pittsburgh, PA 15219

Vickiren S. Aeschleman
Director - Regulatory Polich
QST Energy, Inc.
300 hamilton Boulevard, Suite 300
Peoria, IL 61602

Paul R. Bonney, Esq.
PECO Energy Company
2301 Market Street
Philadelphia, PA 19101

Attorney of Record
Environmental Energy Project
3700 Vartan Way
Harrisburg, PA 17110

Terrance J. Fitzpatrick, Esq.
Ryan, Russell, Ogden & Seltzer LLP
800 North Third Street
Suite 101
Harrisburg, PA 17102

Dated this 12th day of February 1998.



Deborah A. Swanstrom
Verner, Liipfert, Bernhard,
McPherson and Hand
901 15th Street, NW
Suite 700
Washington, DC 20005

Attorney for Allegheny Power