

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

APR 26 2007

Hbg-DK

Petition of Duquesne Light Company :
for Approval of Default Service Plan : Docket No. P-00072247
for the Period January 1, 2008 :
through December 31, 2010 :

DOCUMENT
FOLDER

DIRECT TESTIMONY

OF

RICHARD J. HUDSON JR.

DOCKETED
MAY 08 2007

On Behalf of

Strategic Energy, LLC

and

the Retail Energy Supply Association

March 29, 2007

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PA PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND BUSINESS
2 RESPONSIBILITIES.

3 A. My name is Richard J. Hudson Jr. I am the Market Manager-Regulatory Affairs
4 for Strategic Energy, LLC ("Strategic" or "Strategic Energy"). My business
5 address is 2 Gateway Center, Pittsburgh, Pennsylvania, 15222. My
6 responsibilities include managing the regulatory activities of Strategic Energy in
7 the Commonwealth of Pennsylvania.

8 Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND EMPLOYMENT
9 HISTORY.

10 A. I received a bachelor's degree in business and economics from the University of
11 North Carolina at Greensboro. Prior to my employment at Strategic Energy, I
12 was employed by the Federal Energy Regulatory Commission ("FERC") for
13 approximately four years. At FERC, my responsibilities included analyzing
14 FERC jurisdictional regulatory proposals and drafting recommended decisions on
15 these proposals. In this capacity I was immersed in a wide variety of regulatory
16 matters related to the wholesale electricity industry that presented complex
17 technical, legal and public policy issues. My case work in these matters involved
18 topics such as, but not limited to, the following:

- 19 • The development of Regional Transmission Organizations (RTOs),
20 Independent System Operator (ISOs) and independent transmission
21 companies.
- 22 • Inter-RTO and cross-border seams issues including transmission cost
23 allocation and cross-border rate design issues.
- 24 • Infrastructure reliability issues, including cost-recovery for reliability
25 enhancements.
- 26 • Affiliate transactions and affiliate abuse issues.

- 1 • Allocation of Federal Power Act Section 205 filing rights between
- 2 transmission owners and RTOs/ISOs.
- 3 • Incentive ratemaking policies to encourage transmission investment.

4 **Q. HAVE YOU EVER TESTIFIED BEFORE THIS COMMISSION?**

5 A. Yes. I submitted prepared written direct and surrebuttal testimony in the
6 Duquesne Light Holdings, Inc./Macquarie Consortium merger proceeding¹ but,
7 because that case settled and the prepared testimony was stipulated into the
8 record, my testimony was not subject to cross-examination. However, in my prior
9 employment at FERC, I advised senior agency management and FERC
10 Commissioners on a wide variety of contested regulatory proceedings, similar in
11 subject matter and complexity to the matters that come before the Pennsylvania
12 Public Utility Commission ("PUC" or "Commission").

13 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?**

14 A. Part I of my testimony is submitted on behalf of Strategic Energy and the Retail
15 Energy Supply Association ("RESA"). Part II of my testimony is submitted on
16 behalf of Strategic Energy only.

17 **Q. PLEASE DESCRIBE STRATEGIC ENERGY AND ITS ACTIVITIES IN**
18 **THE DUQUESNE SERVICE AREA.**

19 A. Strategic Energy is a licensed electric generation supplier ("EGS"), competing to
20 supply generation service to customers in the Duquesne Light Company
21 ("Duquesne" or "DLC") service area. Strategic Energy competes with other
22 licensed EGSs, including DLC's unregulated affiliated EGS, Duquesne Light
23 Energy ("DLE"). Strategic Energy has actively served commercial and industrial
24 customers in the Duquesne service area since 1999. Strategic Energy is

¹ Docket Nos. A-110150F0035 and A-311233F0002.

1 headquartered in Pittsburgh and employs over 250 employees in sales, energy
2 management, legal, regulatory, customer service and operational functions.

3 **Q. PLEASE DESCRIBE THE RETAIL ENERGY SUPPLY ASSOCIATION.**

4 A. RESA is a nonprofit organization and trade association that represents the
5 interests of a broad and diverse group of retail energy suppliers who share the
6 common vision that competitive retail energy markets deliver a more efficient,
7 customer-oriented outcome than the regulated utility structure. We are devoted to
8 working with all stakeholders to promote vibrant and sustainable competitive
9 retail energy markets for all consumers. RESA members currently serve
10 residential, commercial and industrial ("C&I") and institutional customers in
11 Pennsylvania and throughout jurisdictions in North America that have enacted
12 retail choice.²

13 **Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

14 A. The purpose of my testimony is two-fold. First, I am testifying on behalf of
15 Strategic Energy and RESA to respond to the testimony of Duquesne witness
16 Susan Betta regarding cost allocation issues and the extent to which Duquesne's
17 affiliate EGS, Duquesne Light Energy, is being inappropriately subsidized by
18 other Duquesne companies. I submitted direct and surrebuttal testimony in
19 Duquesne's merger proceeding on these issues, and I incorporate that testimony
20 herein and include it as Exhibits RH-1 and RH-2.³ Furthermore, my testimony in

² RESA's members include Consolidated Edison Solutions, Inc; Direct Energy Services, LLC; Hess Corporation; Reliant Energy Retail Services, LLC; Sempra Energy Solutions, LLC; Strategic Energy, LLC; SUEZ Energy Resources NA, Inc. and US Energy Savings Corp. The opinions expressed in this filing represent the position of RESA as an organization but may not represent the view of all members of RESA.

³ SE/RESA Exh. RH-1 (direct; public version) and SE/RESA Exh. RH-2 (surrebuttal).

1 this proceeding will describe the settlement that Strategic Energy and RESA have
2 reached with Duquesne in the merger case regarding these cost allocation and
3 cross-subsidy issues. This settlement agreement is currently pending review by
4 the Commission. If approved during the course of this proceeding, Strategic
5 Energy and RESA expect these issues to become moot as the terms of the
6 settlement agreement resolve these issues with respect to the instant proceeding.
7 Accordingly, my presentation of these issues here is primarily intended to protect
8 the interests of Strategic Energy and RESA with respect to the cross-subsidization
9 concerns presented in the merger proceeding, much the same way as Duquesne
10 has protected its interests in these issues by submitting Ms. Betta's merger
11 testimony in this case, in the unlikely event that the Commission fails to approve
12 the settlement.

13 Second, I am testifying on behalf of Strategic Energy to describe our
14 position with respect to Duquesne's POLR IV plan and to discuss the
15 modifications that are necessary in order for Duquesne's plan to be consistent
16 with the prevailing market prices standard of the Electric Choice Act in a manner
17 that promotes sustainable retail competition in Duquesne's service territory.

18 **PART I**

19 **(ON BEHALF OF STRATEGIC ENERGY AND RESA)**

20 **Q. PLEASE SUMMARIZE STRATEGIC ENERGY'S AND RESA'S**
21 **CONCERNS REGARDING THE POTENTIAL CROSS-SUBSIDIZATION**
22 **OF DLE BY OTHER DUQUESNE COMPANIES.**

23 **A.** Strategic Energy and RESA are concerned that Duquesne is supporting the
24 competitive operations of DLE through cross-subsidies from other Duquesne
25 companies, thus enabling DLE to consistently undercut its competitors' prices.

1 Although I am not an attorney, it is my understanding that this would violate the
2 Pennsylvania Code of Conduct requirement for electric generation suppliers,
3 which: (1) seeks to “prevent the cross subsidization of service ... between related
4 electric distribution companies and electric generation suppliers”;⁴ and (2)
5 requires that an electric distribution company (“EDC”) operating within
6 Pennsylvania with an affiliated EGS “shall insure that its employees function
7 independently of other related companies.”⁵

8 **Q. DO YOU HAVE ANY EXAMPLES OR EVIDENCE OF HOW DLE IS**
9 **BEING CROSS-SUBSIDIZED?**

10 **A.** Yes, the attached testimony submitted in Duquesne’s merger case provides the
11 detailed examples and evidence of potential cross-subsidization. Here is a brief
12 overview of the examples and evidence presented in that testimony:

- 13 • It is questionable how DLE, with only five employees, has managed to
14 more than double its large C&I load from 2005 to 2006, unless DLE is
15 receiving operational and other business support from other Duquesne
16 companies, and not paying full compensation for such support.
- 17 • DLE shares office space and employees with other Duquesne companies
18 and receives substantial administrative, operational, and other business
19 support from other Duquesne companies. This presents a complicated
20 cost allocation problem whereby DLE fails to compensate other
21 Duquesne companies for the full value of the services and benefits it
22 receives from other Duquesne companies, thus providing DLE with
23 competitive advantages compared to other suppliers in the Duquesne
24 market.
- 25 • Duquesne Power’s joint management of DLE’s load obligations together
26 with Duquesne Light’s POLR load obligations presents significant
27 potential for cross-subsidies or the uncompensated conveyance of
28 services or benefits to DLE.
- 29 • DLE receives direct or indirect credit support from Duquesne Light
30 Holdings, which gives DLE a competitive advantage over other suppliers.

⁴ 52 Pa. Code § 54.121.

⁵ 52 Pa. Code § 54.122(11).

1 Q. PLEASE RESPOND TO WITNESS BETTA'S ASSERTION THAT
2 DUQUESNE LIGHT PROPERLY ALLOCATES COSTS BETWEEN AND
3 AMONG THE DUQUESNE COMPANIES, AND THAT RECENT
4 REGULATORY AUDITS HAVE FOUND NO EVIDENCE OF CROSS-
5 SUBSIDIZATION.

6 A. Strategic Energy and RESA disagree with Ms. Betta's conclusions that the
7 Duquesne companies properly allocate costs between and among these various
8 companies and that the Duquesne companies are not cross-subsidizing Duquesne
9 Light Energy. As Ms. Betta notes, her testimony in this proceeding is
10 substantially the same as her rebuttal testimony in the Duquesne merger
11 proceeding. Therefore, please refer to my surrebuttal testimony from the merger
12 proceeding for a detailed response to Ms. Betta's arguments.⁶ By way of
13 summary:

- 14 • Despite the existence of Duquesne's cost allocation policies, it appears
15 that DLE does not compensate its affiliates for all of the costs and/or fair
16 market value of the credit support, portfolio management, power
17 procurement, and other business functions provided by other Duquesne
18 companies.
- 19 • It appears that Duquesne's cost allocation procedures do not allocate costs
20 to DLE for credit support and other services provided to Duquesne Power
21 that DLE indirectly benefits from as a result of Duquesne Power's joint
22 provision of portfolio management and power procurement services for
23 both DLE and Duquesne Light.
- 24 • Despite Ms. Betta's assertions, the FERC and Pennsylvania Commission
25 audit reports cannot be relied upon as evidence that Duquesne does not
26 subsidize the operations of DLE. The FERC audit report cannot be
27 verified, as it has not been finalized by FERC or submitted. The FERC
28 order on Duquesne's merger made no explicit findings as to the existence
29 of any cross subsidization but, rather, deferred to the Pennsylvania
30 Commission on cross-subsidization issues. The Pennsylvania
31 Commission's audit report is out of date (focusing primarily on the period
32 1999-2003, while DLE did not begin actively marketing until 2004⁷) and

⁶ SE/RESA Exhibit RH-2, pp.9-16.

⁷ Duquesne St. No. 6 (Betta), p. 12.

1 does not reflect an effective evaluation of Duquesne's current affiliate
2 relationships.

3 **Q. HOW DOES DUQUESNE'S OWN REVIEW OF ITS COST ALLOCATION**
4 **PROCEDURES SUPPORT YOUR CONCERNS THAT THE DUQUESNE**
5 **COMPANIES DO NOT PROPERLY ALLOCATE COSTS AND ARE**
6 **LIKELY SUBSIDIZING THE OPERATIONS OF DLE?**

7 A. Ms. Betta's testimony notes that Duquesne conducted a review of its cost
8 allocation procedures as part of the settlement reached in Duquesne's recent
9 distribution rate case.⁸ As noted in Ms. Betta's testimony, this analysis found
10 instances where affiliates were not being charged for services that they received
11 or benefited from. For example, according to Ms. Betta, Duquesne:

12 "had not historically charged affiliates a general corporate overhead
13 allocation to cover items such as a rent charge for the percentage of space
14 occupied by employees who are not employees of the unregulated affiliate
15 but nonetheless sometimes provide services to an affiliate, and a suppliers
16 charge for supplies the employees may use in providing services to
17 affiliates."

18 Also, Duquesne's analysis found that some costs were allocated to Duquesne
19 Light Holdings instead of directly to the individual affiliates such as DLE.
20 Therefore, Duquesne's own analysis confirms our position that Duquesne's cost
21 allocation procedures have resulted in direct or indirect cross-subsidies or the
22 uncompensated conveyance of benefits to DLE, thus giving it a competitive
23 advantage compared to other suppliers. Given that Duquesne Light's operations
24 as a regulated distribution company and as POLR provider are the primary source
25 of revenue for the Duquesne companies, there is a significant likelihood that these
26 inaccurate cost allocations have lead to Duquesne Light's ratepayers subsidizing

⁸ *Id.*, pp. 7-9.

1 the competitive operations of DLE, and possibly other unregulated Duquesne
2 companies.

3 **Q. DO DUQUESNE'S MODIFIED COST ALLOCATION PROCEDURES**
4 **ADEQUATELY ENSURE AGAINST FUTURE COST ALLOCATION**
5 **AND CROSS-SUBSIDIZATION IMPROPRIETIES ?**

6 A. No. Ms. Betta notes that Duquesne is committing to implement two changes to its
7 cost allocation procedure: (1) Duquesne will implement a general corporate
8 overhead allocation and (2) Duquesne will allocate a portion of costs that would
9 historically have been allocated to Duquesne Light Holdings, Inc. ("DLH"), to
10 individual affiliates. Ms. Betta's testimony provides no details on how Duquesne
11 will determine the corporate overhead cost allocator or how it will determine
12 which costs historically allocated to DLH should be reallocated to DLE or how
13 Duquesne will determine the amount of this reallocation.⁹ Given that DLE
14 appears to be outsourcing every essential business operation and function to an
15 affiliate, it will be very difficult, if not impossible, for Duquesne to accurately
16 identify and determine the value for the services that other Duquesne companies
17 provide for DLE.

18 **Q. DOES DUQUESNE'S RECOMMENDATION TO IMPROVE EMPLOYEE**
19 **COMMUNICATIONS REGARDING ITS CODE OF CONDUCT**
20 **ADEQUATELY ADDRESS YOUR CONCERNS REGARDING**
21 **DUQUESNE'S AFFILIATE RELATIONSHIPS?**

⁹ Under the terms of the settlement agreement reached in Duquesne's merger case, Duquesne is obligated to provide a report in this case setting forth the specifics of the revisions to its corporate cost allocation procedures. On March 27, 2007, Strategic Energy and RESA received work papers supporting Ms. Betta's testimony and, as of the date of this testimony, have not had sufficient time to analyze these documents. Accordingly, Strategic Energy and RESA reserve the right to supplement this testimony after reviewing and analyzing these work papers, or additional materials as they become available, regarding the cost allocation and cross-subsidization issues, if necessary.

1 A. No. The current Pennsylvania Code of Conduct requires employees of regulated
2 utilities, like Duquesne, to ensure that their employees function independently of
3 other related companies.¹⁰ As mentioned above, with Duquesne Light and
4 Duquesne Power appearing to provide all of DLE's essential business functions, it
5 is very questionable whether such arrangements can adequately satisfy the current
6 Pennsylvania Code of Conduct requirement. Therefore, additional employee
7 communications regarding the current Code of Conduct cannot adequately
8 address these affiliate relationship concerns. As discussed further below, a
9 thorough Commission review of Duquesne's affiliate relationships and cost
10 allocation procedures is necessary as a first step toward addressing these issues.
11 Then, a stricter Code of Conduct may be implemented as one option, in addition
12 to other measures, to mitigate the anticompetitive impacts of the inappropriate
13 cross-subsidization of DLE.

14 **Q. HAVE STRATEGIC ENERGY AND RESA REACHED A SETTLEMENT**
15 **AGREEMENT WITH DUQUESNE CONCERNING THESE CROSS-**
16 **SUBSIDIZATION ISSUES?**

17 A. Yes. Strategic Energy and RESA are signatories to a Joint Petition for Settlement
18 that resolves these issues in the Duquesne/Macquarie merger proceeding and in
19 this POLR IV case. Under the terms of the settlement, RESA and Strategic
20 Energy, in addition to RESA members Direct Energy and Hess Corporation,
21 agreed to support (or not oppose) the DLH/Macquarie merger as modified under
22 the terms of the merger settlement agreement. With respect to cost allocation
23 issues, the agreement provides that Duquesne will arrange with an independent

¹⁰ 52 Pa. Code § 54.122(11).

1 third party to conduct an assessment to identify and quantify the cost of the
2 services and business functions provided to DLE by its affiliates, and to provide
3 for the remittance of compensation for services rendered to DLE by other
4 Duquesne companies. The agreement further provides that, for certain power
5 procurement services provided to DLE by unregulated affiliates (such as
6 Duquesne Power), the independent assessment will quantify the cost (essentially,
7 the fair market value) of those services if they had been obtained by DLE from a
8 non-affiliated source.

9 **Q. HAS THIS AGREEMENT BEEN APPROVED BY THE COMMISSION?**

10 A. No. As of the date of this testimony, the Commission has not yet approved the
11 agreement.

12 **Q. WHAT HAPPENS IF THE COMMISSION DOES NOT APPROVE THE**
13 **SETTLEMENT?**

14 A. The settlement is conditioned upon the Commission's approval of the terms and
15 conditions of the settlement, in their entirety and without modification. If the
16 Commission fails to approve the settlement as requested, or approves it with
17 modifications and a Joint Petitioner withdraws from the settlement, the agreement
18 becomes void.

19 **Q. IF THE MERGER SETTLEMENT BECOMES VOID, HOW SHOULD**
20 **THE COMMISSION ADDRESS THE CROSS-SUBSIDIZATION ISSUES**
21 **IN THIS PROCEEDING?**

22 A. First, the Commission should require that DLE procure its generation supply and
23 power procurement functions independent from Duquesne's POLR supply. This
24 can be most effectively accomplished by barring DLE from transacting with its
25 affiliates, including Duquesne Power, for its wholesale procurement, and/or

1 requiring that Duquesne Light's POLR supply be acquired through a transparent
2 competitive procurement process as discussed in Part II of my testimony. In
3 addition, the Commission should initiate a detailed and thorough review of
4 Duquesne's affiliate relationships and cost allocation procedures. This review
5 should not only focus on the allocation of costs between the Duquesne companies,
6 but should also take into consideration the indirect benefits and fair market value
7 that DLE receives from services provided by its affiliates. This is consistent with
8 FERC's Code of Conduct policies designed to prevent affiliate abuse at the
9 wholesale level, which require that goods and services provided by a traditional
10 utility to an unregulated wholesale affiliate be priced at the higher of cost or
11 market value.¹¹

12 Once this review is complete, the Commission should consider the
13 following remedies to address any inappropriate affiliate relationships or cost
14 allocation issues: (1) requiring the structural and/or functional separation of
15 DLE's operations from the other Duquesne companies; and (2) implementing
16 stricter Code of Conduct rules for the Duquesne companies that are specifically
17 designed to prevent the direct or indirect cross-subsidization of DLE by other
18 Duquesne companies and to require that DLE compensate its affiliates at the
19 higher of cost or fair market value for the services provided to DLE by other its
20 affiliates.

¹¹ See FERC publication on its Code of Conduct policies at: <http://www.ferc.gov/legal/maj-ord-reg/land-docs/order2004/resources/codes-conduct.pdf>.

1 **PART II**

2 **(ON BEHALF OF STRATEGIC ENERGY)**

3 **Q. PLEASE SUMMARIZE YOUR UNDERSTANDING OF DUQUESNE'S**
4 **POLR IV PROPOSAL.**

5 A. Duquesne proposes a three-part plan with a different default service pricing
6 structure for each customer group. Duquesne proposes to offer: (1) real time
7 hourly rates as the only default service rates for large C&I customers; (2) annually
8 adjusted fixed rates for small C&I customers; and (3) three-year fixed rates for
9 residential customers. In addition, Duquesne proposes to modify its rate design
10 for residential and small C&I customers and transition over three years to flat per
11 kWh charges for its default service rates. Duquesne proposes to rely on its
12 affiliate, Duquesne Power, to procure the necessary generation supply to meet
13 Duquesne's default service obligations, rather than utilize a transparent
14 competitive procurement process.

15 **Q. HAS THE COMMISSION RECENTLY TAKEN ANY ACTION**
16 **CONCERNING DEFAULT SERVICE?**

17 A. Yes. On February 8, 2007, the Commission adopted an Advanced Notice of Final
18 Rulemaking Order and a Proposed Policy Statement to establish regulations and
19 policies for setting default service rates in Pennsylvania for the post-rate cap
20 period.¹² Taken together, these orders establish a basic regulatory framework for
21 addressing default service plans as Pennsylvania completes the transition from
22 capped rates and stranded cost collection to robust competitive retail markets.

¹² *Rulemaking Re Electric Distribution Companies Obligation to Serve Retail Customers at the Conclusion of the Transition Period Pursuant To 66 Pa.C.S. § 2807(e)(2), Advance Notice Of Final Rulemaking Order, Docket No. L-00040169, Order entered February 9, 2007 "(ANOFR)". Default Service and Retail Electric Markets; Proposed Policy Statement, Docket No. M-00072009, Order entered February 9, 2007.*

1 **Q. WHAT IS STRATEGIC ENERGY'S GENERAL CONCLUSION ABOUT**
2 **DUQUESNE'S POLR IV PLAN AND THE COMMISSION'S DEFAULT**
3 **SERVICE REGULATIONS AND POLICY PROPOSALS?**

4 A. The large C&I customer component of Duquesne's POLR IV plan is consistent
5 with the Electric Choice Act and the Commission's vision for post-rate cap period
6 default service regulations and policies, and will continue to promote sustainable
7 retail competition for this market segment. Duquesne's plans for residential and
8 small C&I customers, including the supply procurement method, are inconsistent
9 with the Electric Choice Act and the Commission's vision for post-rate cap period
10 default service regulations and policies, and will not promote sustainable retail
11 competition for these market segments.

12 **Q. DOES STRATEGIC ENERGY SUPPORT DUQUESNE'S POLR IV PLAN**
13 **FOR LARGE C&I CUSTOMERS?**

14 A. *Yes. Strategic Energy supports Duquesne's proposal to offer real time hourly*
15 *pricing as the only POLR rate for large C&I customers.*

16 **Q. IS DUQUESNE'S DEFAULT SERVICE PLAN FOR LARGE C&I**
17 **CUSTOMERS CONSISTENT WITH THE ANOFR AND POLICY**
18 **STATEMENT ORDERS?**

19 A. Yes. Duquesne's proposal to offer only hourly pricing for large C&I customers
20 (above 300 kW peak demand) is fully consistent with the default service
21 framework articulated in the recent ANOFR and Policy Statement orders. The
22 ANOFR requires that default service rates adjust at least monthly, but in no way
23 limits the frequency of default service rate adjustments.¹³ In fact, the Proposed

¹³ The ANOFR provides that "[d]efault service rates shall be adjusted on a monthly basis, or more frequently, for all customer classes with a registered peak load of equal to or greater than 500 kW" ANOFR, Annex A, § 54.187(j) (emphasis added).

1 Policy Statement envisions hourly pricing for large C&I customers.¹⁴
2 Furthermore, the elimination of the fixed price option for large C&I customers is
3 also fully consistent with the ANOFR and Policy Statement orders. Although the
4 Proposed Policy Statement would permit a default service provider to propose a
5 large C&I customer fixed-price option for the Commission's consideration,
6 neither the ANOFR nor the Proposed Policy Statement would require a default
7 service provider to do so. Here, Duquesne has correctly opted not to propose a
8 fixed-price option, and the Commission should not require Duquesne to offer one.
9 Experience in the Duquesne service territory shows that hourly pricing has lead to
10 the development of robust competition in the large C&I customer market
11 segment, and that customers desiring budget certainty can contract with
12 competitive suppliers for fixed-price options.¹⁵

13 The Commission's vision for post-rate cap default service as articulated in
14 the ANOFR and Policy Statement orders recognizes that default service structures
15 should evolve as retail markets develop. In the Duquesne Light service territory,
16 the retail market for large C&I customers is already quite developed. Duquesne
17 currently has hourly pricing in place as the default rate for large C&I customers,
18 and it is well known that shopping levels are very high for this market segment –

¹⁴ "Hourly priced or monthly-priced service should be available to [non-residential customers with greater than 500 kW in maximum registered peak load]." Policy Statement order, Annex A, § 69.1805.

¹⁵ See Duquesne January 25, 2007 Press Release announcing the POLR IV filing: "[Duquesne] is confident customers preferring a fixed-price option will be able to obtain alternative choices from energy suppliers."
<http://www.duquesnelight.com/News/NewsReleases/2007/nr070125.pdf>

1 98 percent of current load is shopping,¹⁶ and only 6 out of 871 eligible customers
2 were receiving fixed price default service from Duquesne (as of December 31,
3 2006).¹⁷ Therefore, it is important that Duquesne remain on track to completing
4 the transition to a fully competitive market for this segment. The Commission
5 should reject any proposal that seeks to backpedal on the POLR pricing structure
6 for the large C&I customer market segment in Duquesne's service territory.

7 **Q. WHAT SHOULD THE COMMISSION DO TO ADDRESS YOUR**
8 **CONCERNS WITH THE OTHER ASPECTS OF DUQUESNE'S**
9 **PROPOSAL?**

10 **A.** The Commission should require Duquesne to modify certain aspects its plan in
11 order to further enhance the development of a competitive retail market,
12 especially for smaller customers, in the Duquesne service territory. Specifically,
13 POLR rates for residential and small C&I customers must be more market
14 responsive, and Duquesne should procure its POLR supply through a transparent
15 competitive procurement process. Both of these recommended modifications are
16 consistent with the default service framework set forth in the ANOFR and Policy
17 Statement orders. In addition, Strategic Energy supports the recommendations in
18 Frank Lacey's testimony on behalf of Direct Energy and RESA to modify
19 Duquesne's POLR plan to provide for:

- 20 • Quarterly-adjusted, market-reflective pricing for residential customers
- 21 • Quarterly, or more frequently, adjusted, market-reflective pricing for
- 22 small C&I customers
- 23 • A transparent competitive procurement process for POLR supply
- 24 • A customer referral program

¹⁶ Duquesne POLR IV petition at 3, 13.

¹⁷ *Id.* at 12-13, n.3.

- Designation of a Duquesne employee as a retail choice ombudsman
- Establishment of a customer education program to inform customers about competitive supply options

4 **Q. WHY SHOULD DUQUESNE'S RESIDENTIAL AND SMALL C&I POLR**
5 **IV PLAN BE MODIFIED TO PROVIDE FOR QUARTERLY ADJUSTED**
6 **PRICING?**

7 A. Duquesne's POLR rates for residential and small C&I customers must be both
8 market-reflective and market-responsive in order to provide for sustainable robust
9 retail competition, to satisfy the requirements of the Electric Choice Act and to be
10 more consistent with the Commission's vision for default service as articulated in
11 the ANOFR and Proposed Policy Statement. Mr. Lacey's testimony on behalf of
12 Direct Energy and RESA addresses in detail why market-reflective and
13 responsive pricing is required under the Electric Choice Act – and why it is
14 simply good policy.¹⁸ In addition, I note that shopping levels for both the
15 residential and small C&I customer market segments in Duquesne's service
16 territory pale in comparison to shopping levels for the large C&I customers, who
17 have seen market-reflective and market-responsive POLR rates since January 1,
18 2005.¹⁹ Thus, it is apparent that market-reflective and responsive pricing is the
19 best way to enable sustainable robust retail competition, and that Duquesne's
20 POLR rates for residential and small C&I customers must adjust at least quarterly
21 to be market-reflective and market-responsive.

¹⁸ Direct/RESA St. No. 1, pp. 6-17.

¹⁹ According to Duquesne's Exhibit NSF-1 the migration rate in Duquesne's service territory is 18 percent for residential customers, 19 percent for small C&I customers (under 300 kW), as compared to 98 percent for large C&I customers (300 kW and above).

1 **Q. IS DUQUESNE'S PROCUREMENT METHOD CONSISTENT WITH THE**
2 **ELECTRIC CHOICE ACT, AND THE ANOFR AND POLICY**
3 **STATEMENT ORDERS?**

4 A. No. It is well known that the Electric Choice Act requires a POLR provider to
5 acquire supply in the post-rate cap period at prevailing market prices.²⁰ In
6 addition to this standard and as noted in the ANOFR order, the declaration of
7 policy section of the Electric Choice Act clearly articulates that "[c]ompetitive
8 market forces are more effective than economic regulation in controlling the cost
9 of generating electricity."²¹ Accordingly, the ANOFR provides that "[a]ll electric
10 generation supply should be acquired either through competitive bid solicitation
11 processes, spot market energy purchases, or a combination of both."²² Therefore,
12 Duquesne's proposed procurement method, which relies solely on its Duquesne
13 Power affiliate for its POLR supply, is wholly inconsistent with both the Electric
14 Choice Act and the Commission's preferred procurement method as articulated in
15 the ANOFR and Policy Statement orders.

16 Furthermore, Duquesne's procurement method is unnecessarily
17 complicated. Duquesne witness Neil Fisher analyzes the results of competitive
18 solicitations conducted for several utilities and performs a host of complex and
19 subjective adjustments to these results to justify Duquesne's proposed POLR rates
20 for residential and small C&I customers. If Duquesne wishes to rely on the
21 results of competitive solicitations to meet the prevailing market prices standard,
22 then Duquesne should simply conduct competitive bid solicitations to fulfill its

²⁰ 66 Pa. C.S. § 2807(e)(3).

²¹ 66 Pa. C.S. § 2802(5).

²² ANOFR, Annex A, § 54.186(b)(4).

1 POLR supply. To produce quarterly adjusted market-reflective and responsive
2 pricing for residential and small C&I customers, Duquesne should conduct
3 quarterly competitive solicitations to produce its POLR rates for these market
4 segments.

5 **Q. DOES DUQUESNE'S PROCUREMENT METHOD AFFECT THE CROSS-**
6 **SUBSIDIZATION CONCERNS YOU DISCUSSED IN PART I OF YOUR**
7 **TESTIMONY?**

8 A. Yes. As noted above in my attached testimony from the Duquesne/Macquarie
9 merger proceeding, one of the primary sources of potential cross-subsidies of
10 DLE by other Duquesne companies is the joint portfolio management and power
11 procurement that Duquesne Power does for both DLE's competitive load and
12 Duquesne Light's POLR load:²³

13 It is likely that DLC's POLR rates cover all of the upfront costs
14 of Duquesne Power's provision or arrangement of these power
15 procurement functions because DLE is not allocated any
16 portion of these power procurement costs. As Duquesne Power
17 only has two employees, it is highly unlikely that it is
18 performing all of these functions itself.

19 Duquesne Power may be outsourcing these functions to
20 a wholesale counterparty, to DLC, or to another entity, but
21 because Duquesne Power's full requirements agreement for
22 DLC's POLR load was established *prior* to DLE's agreement
23 with Duquesne Power, it is likely that all of the costs associated
24 with the provision of these portfolio management services are
25 recovered through DLC's POLR rates.¹² While there may be
26 no incremental cost incurred by Duquesne Power to also
27 provide these power procurement functions for DLE's load,
28 there are very real benefits and value to DLE by the provision
29 of these services for DLE, as explained above.
30

31 ¹² If these power procurement services are ultimately being performed
32 by DLC employees, then DLC's distribution rates are recovering the
33 costs of (and unlawfully subsidizing) DLE's portfolio management
34 functions.

²³ SE/RESA Exh. RH-2 at 11-12.

1 If Duquesne Light continues to rely on Duquesne Power for its POLR
2 procurement, this will perpetuate the likelihood and incentive for Duquesne to
3 inappropriately subsidize the operations of DLE through POLR rates.

4 **Q. DOES STRATEGIC ENERGY SUPPORT DUQUESNE'S PROPOSAL TO**
5 **ESTABLISH A PURCHASE OF RECEIVABLES PROGRAM?**

6 **A.** Yes. The Commission should accept the Purchase of Receivables (POR)
7 Agreement and the accompanying revisions to Duquesne's Electric Generation
8 Supplier Coordination Tariff to implement the POR program. Strategic Energy
9 participated in the discussions and negotiations that led to the development of the
10 POR Agreement submitted in this proceeding. Strategic Energy supports the POR
11 Agreement as a mechanism to mitigate, for the term of the POR Agreement, the
12 adverse impacts on competitive retail market development of misallocated default
13 service related costs (specifically, uncollectible debt expense) in Duquesne's
14 distribution rates. As a general policy, however, Strategic Energy supports the
15 inclusion of all default service related costs in default service rates. Therefore,
16 Strategic Energy supports the provisions of the Commission's ANOFR and Policy
17 Statement orders that would require a review of distribution rates to ensure that no
18 default service related costs are being recovered through distribution rates. The
19 proper allocation of uncollectible debt expense associated with default service and
20 the adoption of POR programs should not be viewed as mutually exclusive policy
21 goals. I note that the Commission's ANOFR and Policy Statement orders provide
22 for the furtherance of both of these policy objectives.²⁴

²⁴ ANOFR, Annex A, § 54.187(d); Proposed Policy Statement, § 69.1808(a),(b).

1 Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?

2 A. Yes.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Duquesne Light Company :
for Approval of Default Service Plan : Docket No. P-00072247
for the Period January 1, 2008 :
through December 31, 2010 :

SE/RESA EXH. RH-1

NON-PROPRIETARY (PUBLIC) VERSION

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

DIRECT TESTIMONY OF
RICHARD J. HUDSON JR.

On Behalf of Strategic Energy, LLC and
The Retail Energy Supply Association

Application of Duquesne Light Company and DQE Communications Network
Services, LLC For Certificates of Public Convenience Under Section 1102(a)(3) of the
Public Utility Code Approving the Acquisition of Duquesne Light Holdings, Inc. by Merger

Docket Nos. A-110150F0035 and A-311233F3002

December 21, 2006

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND BUSINESS
2 RESPONSIBILITIES.

3 A. My name is Richard J. Hudson Jr. I am the Market Manager-Regulatory Affairs
4 for Strategic Energy, LLC ("Strategic" or "Strategic Energy"). My business
5 address is 2 Gateway Center, Pittsburgh, Pennsylvania, 15222. My
6 responsibilities include managing the regulatory activities of Strategic Energy in
7 the Commonwealth of Pennsylvania.

8 Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND EMPLOYMENT
9 HISTORY.

10 A. I received a bachelor's degree in business and economics from the University of
11 North Carolina at Greensboro. Prior to my employment at Strategic Energy, I
12 was employed by the Federal Energy Regulatory Commission ("FERC") for
13 approximately four years. At FERC, my responsibilities included analyzing
14 FERC jurisdictional regulatory proposals and drafting recommended decisions on
15 these proposals. In this capacity I was immersed in a wide variety of regulatory
16 matters related to the wholesale electricity industry that presented complex
17 technical, legal, and public policy issues. My case work in these matters involved
18 topics such as, but not limited to, the following:

- 19 • The development of Regional Transmission Organizations (RTOs),
20 Independent System Operator (ISOs) and independent transmission
21 companies.
- 22 • Inter-RTO and cross-border seams issues including transmission cost
23 allocation and cross-border rate design issues.
- 24 • Infrastructure reliability issues, including cost-recovery for reliability
25 enhancements.
- 26 • Affiliate transactions and affiliate abuse issues.

1 • Allocation of Federal Power Act Section 205 filing rights between
2 transmission owners and RTOs/ISOs.

3 • Incentive ratemaking policies to encourage transmission investment.

4 **Q. HAVE YOU EVER TESTIFIED BEFORE THIS COMMISSION?**

5 A. No, but in my prior employment at FERC, I advised senior agency management
6 and FERC Commissioners on a wide variety of contested regulatory proceedings,
7 similar in subject matter and complexity to the matters that come before the
8 Pennsylvania Public Utility Commission ("PUC" or "Commission").

9 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?**

10 A. I am testifying on behalf of Strategic Energy and the Retail Energy Supply
11 Association.

12 **Q. PLEASE DESCRIBE STRATEGIC ENERGY AND ITS ACTIVITIES IN**
13 **THE DUQUESNE SERVICE AREA.**

14 A. Strategic Energy is a licensed electric generation supplier ("EGS"), competing to
15 supply generation service to customers in the Duquesne Light Company
16 ("Duquesne" or "DLC") service area. Strategic Energy competes with other
17 licensed EGSs, including DLC's unregulated affiliated EGS, Duquesne Light
18 Energy ("DLE"). Strategic Energy has actively served commercial and industrial
19 customers in the Duquesne service area since 1999. Strategic Energy is
20 headquartered in Pittsburgh and employs over 250 employees in sales, energy
21 management, legal, regulatory, customer service and operational functions.

22 **Q. PLEASE DESCRIBE THE RETAIL ENERGY SUPPLY ASSOCIATION.**

23 A. The Retail Energy Supply Association ("RESA") is a nonprofit organization and
24 trade association that represents the interests of a broad and diverse group of retail
25 energy suppliers who share the common vision that competitive retail energy

1 markets deliver a more efficient, customer-oriented outcome than the regulated
2 utility structure.¹ We are devoted to working with all stakeholders to promote
3 vibrant and sustainable competitive retail energy markets for residential,
4 commercial and industrial consumers. RESA members currently serve
5 residential, commercial and industrial customers in Pennsylvania and throughout
6 jurisdictions in North America that have enacted retail choice.

7 **Q. WHAT IS STRATEGIC ENERGY'S AND RESA'S POSITION WITH**
8 **RESPECT TO THE PROPOSED ACQUISITION OF DUQUESNE BY THE**
9 **MACQUARIE CONSORTIUM?**

10 A. We oppose the merger as it is currently proposed. We are concerned with how
11 the proposed acquisition will impact the competitive retail marketplace in the
12 Duquesne service territory. Without substantiated protections and assurances that
13 the acquisition will not result in a material reduction in retail competition, we
14 cannot support it. Although I am not an attorney, it is my understanding that the
15 Electric Competition Act requires that a merger proposal must not result in
16 anticompetitive effects that will prevent retail electricity customers from
17 obtaining the benefits of a properly functioning and workable competitive retail
18 electricity market. Our position is that the merger, as currently proposed, may
19 have anticompetitive effects that will frustrate the continued development of a
20 competitive retail market for electricity in Duquesne's service territory. My
21 testimony examines these potential anticompetitive effects and recommends
22 measures for the Commission to consider to mitigate these effects so that the

¹ RESA member companies include Consolidated Edison Solutions, Inc.; Direct Energy Services, LLC; Hess Corporation; Reliant Energy Retail Services, LLC; Sempra Energy Solutions; Strategic Energy, LLC; SUEZ Energy Resources, NA, Inc.; and U.S. Energy Savings Corporation. The opinions expressed in this filing may not represent the views of all members of RESA.

1 merger complies with the requirements of the Electric Competition Act and
2 Section 1103 of the Public Utility Code.

3 **Q. PLEASE SUMMARIZE YOUR TESTIMONY.**

4 A. I first present an overview of the potential anticompetitive effects of the proposed
5 merger. Next, I address issues regarding the anticompetitive effects of the direct
6 or indirect cross-subsidization of DLE by other Duquesne companies, and the
7 extent to which the proposed merger may exacerbate these effects. Then, I address
8 the anticompetitive effects of Duquesne's proposed economic development
9 discounted rate program. Finally, I suggest steps the Commission should take to
10 address and mitigate these anticompetitive effects.

11 **I. OVERVIEW OF POTENTIAL ANTICOMPETITIVE EFFECTS**

12 **Q. PLEASE DESCRIBE THE PROPOSED ACQUISITION OF DUQUESNE**
13 **BY THE MACQUARIE CONSORTIUM.**

14 A. According to the Application, Duquesne requests Commission approval for a
15 certificate of public convenience approving the acquisition of the Duquesne
16 companies by a group of investors called the Macquarie Consortium
17 ("Macquarie"). Under the proposed transaction, the Macquarie Consortium will
18 purchase all outstanding shares of Duquesne Light Holdings' ("DLH") common
19 stock for \$20.00 per share, and will also assume DLH's consolidated preferred
20 and preference shares along with DLH's short- and long-term debt.

21 **Q. PLEASE PROVIDE AN OVERVIEW OF THE POTENTIAL**
22 **ANTICOMPETITIVE EFFECTS OF THE PROPOSED MERGER**

23 A. According to the Application, the Macquarie Consortium is acquiring the
24 Duquesne companies at a premium of over 21 percent above the DLH share price

1 reported at the time that the transaction was announced.² The equity market value
2 of the merger consideration of \$1.592 billion (as of July 3,2006) is nearly 2.5
3 times the book value of the stock of \$644 million (as of June 30, 2006). Because
4 revenue growth related to Duquesne's core utility business as a "wires company"
5 is likely to be limited for the immediate future as a result of the recently
6 concluded rate case, we are concerned that Macquarie intends to rely on growing
7 Duquesne's generation supply business in order to produce the returns necessary
8 to justify its acquisition of Duquesne at a significant premium.

9 Therefore, we submit that the proposed transaction is predicated on a
10 business strategy that is likely to have anticompetitive effects with respect to
11 Duquesne's Provider of Last Resort ("POLR") pricing plans, and the operations
12 of Duquesne's unregulated affiliated EGS -- DLE. Furthermore, the economic
13 development discounted rate program proposed by Duquesne/Macquarie is
14 inherently anticompetitive because the proposed discount would be available only
15 to those customers taking at least a portion of their generation supply from
16 Duquesne, thus limiting the ability of competitive suppliers to serve these
17 customers.

18 **Q. HOW IS THE PROPOSED TRANSACTION LIKELY TO RESULT IN**
19 **ANTICOMPETITIVE EFFECTS WITH RESPECT TO DLE?**

20 **A.** As discussed in more detail below, we have reason to believe that Duquesne is
21 supporting the competitive operations of DLE through cross-subsidies from other
22 Duquesne companies, thus enabling DLE to consistently undercut its competitors'
23 prices. We are concerned that Duquesne, either directly or indirectly, is cross-

² Application at p. 13.

1 subsidizing the operations of DLE in order to retain its large commercial and
2 industrial ("C&I") customer base and recapture the margin it has lost due to the
3 current POLR design for that segment. In its 2005 Form 10-K, Duquesne states
4 that it no longer earns a margin on its POLR supply to large C&I customers, and
5 also states that:

6 "In response to the change in large customer POLR service, DLE
7 has begun to offer competitive electric generation (EGS) service to
8 customers in the Duquesne Light service territory."³

9 Therefore, it appears that Duquesne is utilizing DLE to retain the customer base it
10 lost due to the transition to a pro-competitive POLR design for large C&I
11 customers within its service territory. As noted in Duquesne's 2005 Form 10-K,
12 DLC has articulated a strategic priority to "[m]aximize large commercial and
13 industrial customer retention through our unregulated retail electric generation
14 supplier, DLE."⁴ While Strategic fully support open competition from other
15 EGSs, that competition must be on a level playing field – and no EGS should be
16 subsidized by the regulated distribution or POLR rates of an affiliated utility.

17 **Q. HOW IS THE PROPOSED TRANSACTION LIKELY TO RESULT IN**
18 **ANTICOMPETITIVE EFFECTS WITH RESPECT TO DUQUESNE'S**
19 **POLR PLANS?**

20 **A.** In order to meet return targets required by the premium built into the acquisition
21 price Duquesne/Macquarie have an incentive to propose a POLR IV plan that
22 protects the margin Duquesne receives from its POLR supply business. In fact,
23 according to a Highly Confidential response to a RESA interrogatory, ****BEGIN**

³ SE/RESA Exhibit RH-1 at 1 (excerpts from DLH/DLC 2005 Form 10-K); the entire document can be found at:
<http://www.sec.gov/Archives/edgar/data/30573/000095015206001802/j1863601e10vk.htm>

⁴ *Id.* at 3.

1 **II. CROSS-SUBSIDIZATION OF DLE BY OTHER DUQUESNE COMPANIES**

2 **Q. WHY DO YOU SUSPECT THAT DLE IS BEING SUBSIDIZED BY**
3 **OTHER DUQUESNE COMPANIES?**

4 The attached testimony of Ronald Carrier submitted Duquesne's recent
5 distribution rate case at in Docket No. R-00061346 provides an introduction to the
6 cross-subsidization issues that we are raising here.¹⁰ As discussed in that
7 testimony, it is questionable how DLE has managed to acquire a substantial
8 amount of large C&I load in the Duquesne service territory despite having only a
9 few employees. As noted in DLH's 10-Q for the quarter ended September 30,
10 2006, DLE served 1,346,000 MWhs for the first nine months of 2006.¹¹ This is
11 up from 639,000 MWhs for the first nine months of 2005. Yet DLE has only five
12 employees.¹²

13 By way of comparison, it was reported in the KEMA Retailer Yearbook
14 for 2005 that a similarly situated supplier that also targets large C&I customers as
15 DLE, and serves approximately half the amount of load as DLE, has 35
16 employees.¹³ In my experience, and having reviewed trade publications and
17 industry assessments, most suppliers of similar size and operations as DLE
18 require significantly more than 5 employees to carry out the day-to-day operations
19 of a competitive supply business. Therefore, the logical question is how has DLE
20 been able to obtain and manage its sizeable customer load obligation with such

¹⁰ Mr. Carrier's direct and surrebuttal testimony from that proceeding are attached as SE/RESA Exhibits RH-3 and RH-4, respectively.

¹¹ SE/RESA Exhibit RH-5 (excerpt from DLH Form 10-Q).

¹² SE/RESA Exhibit RH-6 (Duquesne Response to Strategic I-3).

¹³ SE/RESA Exhibit RH-7 (excerpt from 2005 KEMA Retailer Yearbook).

1 few resources without receiving direct or indirect financial or operational support
2 from other Duquesne companies?

3 **Q. CAN YOU QUANTIFY THE SPECIFIC PRICE ADVANTAGE ENJOYED**
4 **BY DLE AS A RESULT OF THIS APPARENT CROSS-SUBSIDIZATION?**

5 A. While I cannot provide a concrete quantification of the value of the direct cross-
6 subsidization of DLE, the need for further examination of this issue cannot be
7 understated. The U.S. Department of Justice's Guidelines on non-horizontal
8 mergers specifically recognize that some instances of cross-subsidization can be
9 hard to prove but are nonetheless a cause for concern. These guidelines state:

10 "The use of common facilities and managers may create an
11 insoluble cost allocation problem and provide the opportunity to
12 charge utility customers for non-utility costs, consequently
13 distorting resource allocation"¹⁴

14 As the record in this case shows, DLE shares office space and employees with
15 DLC,¹⁵ so many of the cost and resource allocation problems discussed in the
16 Department of Justice guidelines may be present here. As discussed earlier, it is
17 questionable how DLE manages its operations with so few employees and,
18 according to interrogatory responses, DLE only compensates DLC minimally for
19 the support functions it provides.¹⁶

20 In addition, academic papers have examined this issue and determined that
21 there inherently exists a profit maximization motive than can lead to direct or
22 indirect cross-subsidization and/or cost shifting between regulated utilities and

¹⁴ U.S. Department of Justice Non-Horizontal Merger Guidelines at n. 35; this document is available at: <http://www.usdoj.gov/atr/public/guidelines/2614.htm>.

¹⁵ SE/RESA Exhibit RH-3 (Direct Testimony of Ronald Carrier from Docket No. R-00061346, specifically the attachments to the testimony) and SE/RESA Exhibit RH-8 (DLC/Macquarie Response to Strategic I-4).

¹⁶ SE/RESA Exhibit RH-8 (DLC/Macquarie Response to Strategic I-4).

1 their unregulated marketing affiliates, and that these occurrences can be difficult,
2 if not impossible to identify and rectify.¹⁷

3 **Q. CAN YOU PROVIDE ANY EXAMPLES OF POSSIBLE CROSS-**
4 **SUBSIDIES BETWEEN DLE AND OTHER DUQUESNE COMPANIES?**

5 A. Yes. As discussed below, there are two clear examples of areas in which other
6 Duquesne companies are likely subsidizing DLE, either directly or indirectly.
7 These are power procurement functions and credit support.

8 **Q. HOW ARE DLE'S POWER PROCUREMENT FUNCTIONS LIKELY**
9 **BEING CROSS-SUBSIDIZED?**

10 A. With only five employees it is highly unlikely that DLE is performing all the
11 necessary power procurement functions to meet its customer load obligation.
12 Strategic Energy employs dozens of people to perform all of the forecasting,
13 scheduling, hedging and Regional Transmission Organization settlement and
14 reconciliation functions necessary to fulfill its load service obligations.
15 According to interrogatory responses and other evidence, it appears that DLE
16 purchases substantially all of its power supply from its affiliate, Duquesne
17 Power.¹⁸ Duquesne Power also supplies DLC's residential and small commercial
18 POLR load. Consequently, it appears that Duquesne Power manages the load
19 obligations of DLE together with those of DLC. In fact, Duquesne's 2005 Form
20 10-K confirms this, stating:

¹⁷ "An economic analysis of marketing affiliates in a deregulated electric power industry" by Jason Abel for the National Regulatory Research Institute; this document is available at: <http://www.nrri.ohio-state.edu/dspace/bitstream/2068/565/1/98-07.pdf>

¹⁸ SE/RESA Exhibit RH-9 (Duquesne Responses to Strategic I-5 and I-7); SE/RESA Exhibit RH-1 at 2 (excerpts from DLH/DLC 2005 Form 10-K).

1 "Duquesne Power manages the DLE supply requirements together
2 with the Duquesne Light residential and small commercial
3 customer POLR supply requirements."¹⁹

4 First, it is questionable how Duquesne Power, with only 2 employees itself,²⁰ is
5 able to perform all of the necessary procurement functions to fulfill DLE's load
6 service obligations, let alone those of DLC, without some type of support from
7 DLC resources or staff. Second, even assuming that Duquesne Power is
8 legitimately managing DLE's and DLC's load, and assuming that DLE is actually
9 charged the prevailing market price for the power that Duquesne Power provides,
10 DLE – solely as a result of its relationship to DLC– is given an inherent
11 competitive advantage over other suppliers in the Duquesne service area. By
12 pooling the load obligations associated with DLE's unregulated business with
13 DLC's POLR load, Duquesne Power is able to achieve economics of scale that are
14 not available to other suppliers in the Duquesne market.

15 Finally, the fact that Duquesne Power manages all of DLE's load along
16 with DLC's POLR load, presents a complicated cost allocation problem. How
17 does Duquesne Power appropriately measure and allocate the costs and risks
18 associated with meeting the load obligations of both DLC and DLE without some
19 level of cost shifting? It is apparent that DLE possesses an unfair competitive
20 advantage with respect to its power procurement functions over other retail
21 suppliers because of its relationship to DLC. And this unfair advantage is likely
22 due to direct or indirect cross-subsidies from DLC's regulated distribution or
23 POLR rates. An example of an indirect subsidy would be if Duquesne Power is

¹⁹ SE/RESA Exhibit RH-1 at 1 (excerpts from DLH/DLC 2005 Form 10-K).

²⁰ SE/RESA Exhibit RH-6 (Duquesne Response to Strategic I-3).

1 providing or paying for a service (such as scheduling, forecasting, balancing, or
2 RTO/ISO settlement or reconciliation) for both DLC and DLE, but charging or
3 allocating the cost of that service only to DLC.

4 **Q. HOW ARE DLC AND/OR OTHER DUQUESNE COMPANIES LIKELY**
5 **SUBSIDIZING DLE THROUGH CREDIT SUPPORT?**

6 A. First, DLH provides direct credit support to DLE in the form of a guarantee to
7 support DLE's RTO membership activities.²¹ Second, it appears that DLE is able
8 to avoid posting credit for its wholesale power purchases because Duquesne
9 Power manages DLE's load along with that of DLC, and Duquesne Power's
10 wholesale supply contracts are backed by guarantees from their mutual parent,
11 DLH.²² This alone gives DLE a significant advantage because other suppliers
12 typically have to provide collateral or post some type of credit to back their power
13 purchases. To date, there is no record evidence that DLE posts collateral with
14 Duquesne Power, or compensates DLH for the value of its corporate guarantees.

15 In addition, DLH/DLC 2005 Form 10-K shows that DLH guarantees
16 Duquesne Power's ability to deliver energy associated with its supply contracts.²³
17 Presumably, this guarantee covers Duquesne Power's supply contract with DLE.
18 Therefore, it seems that not only does DLE receive the benefit from the avoided
19 cost of posting credit for its wholesale supply purchases, but it also bears no risk
20 from having Duquesne Power as its only supplier because DLH has provided
21 guarantees that support Duquesne Power's ability to delivery contracted power to
22 DLE.

²¹ SE/RESA Exhibit RH-10 (Duquesne Response to Strategic I-6).

²² SE/RESA Exhibit RH-1 at 4-5 (excerpts from DLH/DLC 2005 Form 10-K).

²³ SE/RESA Exhibit RH-1 at 6 (excerpts from DLH/DLC 2005 Form 10-K).

1 Finally, it is important to note that the value of these parental guarantees
2 from DLH is ultimately derived from the secure revenue stream associated with
3 DLC's regulated operations. Thus, the direct and indirect credit support from
4 which DLE benefits is yet another example of an anticompetitive advantage that
5 DLE has due solely to its relationship to DLC.

6 **Q. HAS STRATEGIC ENERGY OR RESA RAISED ANY OF THESE ISSUES**
7 **BEFORE?**

8 A. Yes. In Duquesne's most recent distribution rate case at Docket No. R-00061346,
9 Strategic Energy witness Ronald Carrier presented direct, rebuttal and surrebuttal
10 testimony on the possible cross-subsidization of DLE by DLC or other Duquesne
11 affiliate companies.

12 **Q. WHAT WAS THE RESULT OF THAT PROCEEDING WITH RESPECT**
13 **TO THE DLE CROSS-SUBSIDIZATION ISSUES?**

14 A. The parties to the proceeding reached a comprehensive settlement that was
15 accepted, or not opposed, by all parties. The settlement provides that Duquesne,
16 in its upcoming POLR IV filing to establish POLR rates to be effective January 1,
17 2008, will submit an analysis addressing whether any portion of DLC's operations
18 is subsidizing its affiliates, including DLE. Both Strategic Energy and RESA are
19 signatories to the settlement.

20 **Q. WHY ARE STRATEGIC ENERGY AND RESA RAISING THE SAME**
21 **ISSUES HERE?**

22 A. While we still support the submittal of an analysis of these issues in Duquesne's
23 upcoming POLR filing, it is important that this issue be addressed in the context
24 of this proceeding because, as discussed earlier, it appears that Duquesne and
25 Macquarie have an incentive to rely on Duquesne's generation supply segment,

1 including DLE, to produce the returns necessary to justify the premium built into
2 the merger price. This presents the potential that any pre-existing cross-subsidies
3 could be exacerbated as a result of the merger. Additionally, other jurisdictions
4 have recognized the importance of addressing issues of cross-subsidization in
5 merger and acquisition proceedings. For example, the Energy Policy Act of 2005
6 specifically requires FERC to consider issues of cross-subsidization in exercising
7 its merger review authority.²⁴

8 **Q. WHAT ARE THE ANTICOMPETITIVE EFFECTS OF THIS CROSS-**
9 **SUBSIDIZATION?**

10 **A.** The anticompetitive effects of these cross-subsidies are clear. They create an
11 unfair competitive advantage that enables DLE to undercut competitors prices,
12 possibly at the expense of DLC's POLR and distribution ratepayers. This
13 competitive advantage could clearly be enhanced and expanded if
14 Duquesne/Macquarie had an opportunity to do so. The short and long term
15 effects of this will be to stifle the development of a competitive electricity market
16 in the Duquesne service territory, essentially re-monopolizing the retail generation
17 supply market for the benefit of the incumbent utility.

18 **III. ECONOMIC DEVELOPMENT RATE PROGRAM**

19 **Q. PLEASE DESCRIBE THE SO CALLED "ECONOMIC DEVELOPMENT**
20 **RATE PROGRAM."**

21 **A.** In its Application, Duquesne states that it will establish an economic development
22 program to provide discounted electricity to support new, or expanded, industrial

²⁴ Section 203 (a)(4) of the Federal Power Act now provides that, when reviewing applications for the transfer of jurisdictional assets, FERC will consider "whether the transaction will result in cross-subsidization of non-utility affiliate companies or the encumbrance of or pledge of utility assets for the benefit of associate companies."

1 operations in the Duquesne service territory. Duquesne proposed to offer a 50
2 MW block of energy, sourced from its ownership interests in the Keystone and
3 Conemaugh power plants, to support a \$3/MWh discount below market prices to
4 industrial projects that increase load by 10 MW demand and create at least 2 new
5 full-time jobs per MW.

6 **Q. IS THIS PROGRAM ANTICOMPETITIVE?**

7 **A.** Yes. While Strategic Energy and RESA fully support and are vigorously
8 committed to the promotion of economic development in the greater Pittsburgh
9 region, it is imperative that any economic development programs are structured in
10 a competitively neutral way. As proposed by Duquesne, customers planning to
11 locate new industrial facilities, or expand existing ones, in the Duquesne service
12 area will be required to take at least the discounted portion of their generation
13 service from Duquesne. This inhibits the ability of competitive suppliers, like
14 Strategic Energy and other RESA members, to compete for new industrial load on
15 the Duquesne system, and it restricts customer choice. Furthermore, my
16 understanding is that one of the legal standards for approving a merger transaction
17 is a showing of affirmative public benefits. It appears that Duquesne is
18 attempting to satisfy this standard with an economic development rate program
19 that violates the other merger approval standard, which is that the transaction not
20 result in anticompetitive effects that prevent retail electricity customers from
21 obtaining the benefits of a properly functioning and workable competitive retail
22 electricity market.

23

1 **IV. RECOMMENDED MEASURES TO MITIGATE THE**
2 **ANTICOMPETITIVE EFFECTS OF THE MERGER**

3 **Q. HOW SHOULD THE COMMISSION ADDRESS AND MITIGATE THE**
4 **ANTICOMPETITIVE EFFECTS OF THE PROPOSED TRANSACTION**
5 **WITH RESPECT TO DUQUESNE'S POLR PLANS?**

6 **A. In order to comply with applicable legal requirements and the Commonwealth's**
7 **clear policy goals of protecting and ensuring the development of competitive**
8 **markets, merger approval must be conditioned on Duquesne submitting a POLR**
9 **IV plan which provides an open and transparent competitive procurement process**
10 **that results in market responsive pricing. In addition, Duquesne Power should be**
11 **precluded from participating in that process. As discussed earlier, Duquesne**
12 **expects to propose a POLR IV plan that does not allow for a competitive**
13 **procurement process as envisioned by the Electric Competition Act and in the**
14 **Commission's proposed POLR regulations.²⁵**

15 In the alternative, the Commission should hold its consideration of the
16 proposed merger in abeyance until Duquesne submits its upcoming POLR IV
17 filing, which Duquesne has stated publicly it expects to file within the 1st quarter
18 of 2007. At that time the Commission should consolidate the instant proceeding
19 with Duquesne's POLR IV case. It is imperative that the Commission
20 understands Duquesne/Macquarie's intentions with respect to Duquesne's
21 upcoming POLR plan before acting on the proposed merger. The only way to be
22 able to fairly judge whether Duquesne/Macquarie will be able to exercise market
23 power and act anti-competitively in the POLR IV period is to know what the
24 POLR pricing structure will be. If the POLR market design enhances competitive

²⁵ Page 6, line 11 – p. 7, line 11.

1 opportunities (such as market responsive pricing plan for all customers), then the
2 combined company will have far less opportunity to use its position as POLR to
3 increase market share and harm competition. Conversely, if Duquesne
4 successfully implements long-term point-in-time pricing, with Duquesne Power
5 as the sole procurement source for DLC's POLR supply, Duquesne's ability to
6 harm competition will be enhanced.

7 **Q. HOW SHOULD THE COMMISSION ADDRESS THE**
8 **ANTICOMPETITIVE EFFECTS OF THE CROSS-SUBSIDIZATION**
9 **ISSUES?**

10 **A.** My understanding is that Pennsylvania law requires a level playing field for
11 competitors and that certain Code of Conduct rules specifically address cross-
12 subsidization.²⁶ Therefore, we recommend that the Commission initiate an
13 investigation into the relationships between and among the Duquesne companies
14 to determine the extent to which DLE's unregulated operations are being
15 supported, either directly or indirectly, by other Duquesne companies, specifically
16 DLC. The Commission should condition its approval of the proposed merger on
17 the outcome of this investigation. Once these issues have been thoroughly
18 evaluated, there are a number of remedies that the Commission should consider,
19 including: (i) requiring the structural and/or functional separation of DLE's
20 operations from the other Duquesne companies; (ii) implementing stricter Code of
21 Conduct rules; and (iii) requiring that DLE be barred from transacting with its
22 affiliates, including Duquesne Power, for its wholesale power procurement.

²⁶ "The purpose of these competitive safeguards is to . . . prevent the cross subsidization of service . . . between related electric distribution companies and electric generation suppliers . . . and to establish and maintain an effective and vibrant competitive market in the purchase and sale of retail electric energy in this Commonwealth." 52 Pa. Code § 54.121.

1 Q. **HOW SHOULD THE COMMISSION ADDRESS THE**
2 **ANTICOMPETITIVE EFFECTS OF THE ECONOMIC DEVELOPMENT**
3 **RATE PROGRAM?**

4 A. One clear way to modify the program to make it competitively neutral would be
5 to require Duquesne to offer either a rebate to qualifying customers or to provide
6 the \$3/MWh discount on the "wires" charges of the customer's bill. If structured
7 this way, any qualifying industrial customer would be free to shop for electric
8 generation service from competitive suppliers and still receive the benefit of the
9 economic development program. Such an arrangement would be revenue neutral
10 to Duquesne as it would allow Duquesne to sell the 50 MW blocks of energy
11 sourced from the Keystone and Conemaugh generation plants into the market at
12 full market value and fund the economic development rebates or discounts from
13 these revenues.

14 Q. **DOES THIS CONCLUDE YOUR DIRECT TESTIMONY?**

15 A. Yes it does.

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Under the POLR II arrangement that ended December 31, 2004, Duquesne Light earned a margin on each MWh sold to its large commercial and industrial customers. During the twelve months ended December 31, 2004, Duquesne Light earned net income of \$4.6 million in the supply business related to sales to its large commercial and industrial customers. Under the POLR III arrangement that became effective January 1, 2005, Duquesne Light no longer earns a margin in the supply business on these sales.

In response to the change in large customer POLR service, DLE has begun to offer competitive electric generation (EGS) service to customers in the Duquesne Light service territory. Duquesne Power manages the DLE supply requirements together with the Duquesne Light residential and small commercial customer POLR III supply requirements.

2006 Supply Business Realignment. Effective December 31, 2005, Duquesne Power was transferred from Duquesne Light to another Holdings subsidiary. The operations of Duquesne Power will only be reported as part of the Holdings electricity supply segment beginning January 1, 2006. The transfer of Duquesne Power was completed to strategically align our unregulated businesses outside of Duquesne Light in order to provide flexibility to capitalize on future supply opportunities. The transfer will effectively eliminate the net income included in Duquesne Light's supply segment.

If this transfer had taken place on January 1, 2003, the net effect to Duquesne Light's earnings would have been an increase of \$0.1 million in 2003 and \$6.0 million in 2004. Earnings in 2005 would have decreased \$27.2 million. In 2003, Duquesne Power was just being formed and had minimal activity. The 2003 increase would have been caused by a decrease in other operating and maintenance expense. The 2004 increase would have been caused by the removal of the acquisition termination cost associated with the cancelled Sunbury acquisition and other costs. The 2005 decrease would have been caused primarily by the removal of some revenue and an increase in operating expenses, the effect of which would eliminate Duquesne Power's margin on its sales to Duquesne Light and DLE.

Changes to the balance sheets would have been immaterial in 2003 and 2004. There would be no change to the 2005 balance sheet as the transfer took place at close of business on December 31, 2005.

Landfill Gas Business. Our landfill gas business (a part of our Financial business segment) is comprised of investments in 20 landfill sites around the country and the ownership of Waste Energy Technologies, LLC (WET), which was acquired in the fourth quarter of 2004. WET has provided landfill gas collection system engineering, design and construction services to the landfill business for over 20 years. Our 20 sites are comprised of three that currently produce pipeline quality gas sold at market rates; five sites where unprocessed landfill gas production is currently sold at significantly lower unit prices than pipeline quality gas, but due to lower operating costs and capital requirements, still provide the opportunity to earn modest returns, and 12 passive investment sites we do not project to be involved with beyond 2007 due to the scheduled expiration of Section 29 tax credits.

We have made small, strategic capital investments to maximize our existing production capacities and improve the throughput of the landfill gas processing sites we expect to continue to operate, and have focused our efforts to streamline and minimize our operating costs. These sites also have sufficient quantities of available gas to remain viable beyond the expiration of Section 29 tax credits on December 31, 2007.

We are a significant producer of pipeline quality landfill gas in the United States. The majority of our earnings from our landfill gas business are derived from the three pipeline quality production sites. Our contract at one of these sites located in New York City is scheduled to terminate on June 30, 2006; our earnings for 2005 included \$7.4 million related to this site. We expect to operate our other two pipeline quality landfill gas sites for approximately 15 more years. In December 2005, we have also entered into a price swap agreement for approximately 60% of our anticipated 2006 pipeline quality landfill gas sales in order to lock in the recent unprecedented increases in natural gas prices.

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select an alternative generation supplier pay for generation charges set by that supplier, and pay Duquesne Light both transmission and distribution charges. In connection with these POLR III transactions, Duquesne Light retains the risk that such customers will not pay for the POLR generation supply. Duquesne Light procures the energy and capacity needed to serve these residential and small commercial customers under a full-requirements contract with Duquesne Power. Failure or delay by Duquesne Power to provide the energy and capacity anticipated in the contract could require Duquesne Light to incur additional expenses to meet the needs of its POLR III customers.

We are subject to risks associated with procuring energy and capacity for Duquesne Light's small customers and DLE's customers.

In addition to supplying the energy and capacity needs of Duquesne Light's small customers, Duquesne Power also has a full-requirements contract with its affiliate DLE to provide all of its large commercial and industrial customers' energy and capacity needs. During 2004 and 2005, Duquesne Power entered into wholesale power purchase contracts that have been structured primarily to begin and end during the POLR III time period. The net result of these transactions is that, as of December 31, 2005, Duquesne Power has secured a substantial portion of the combined expected load obligation for its full-requirements contracts with Duquesne Light and DLE through 2007.

Actual load may differ from expected load due to weather, customer switching, economic and other factors. If Duquesne Power did not have sufficient supplies, Duquesne Power would be required to procure the requirements in the energy markets. If market prices were higher than the rates to be paid by Duquesne Light and DLE to Duquesne Power under the full-requirements contracts, Duquesne Power could potentially be acquiring the energy or capacity at a loss, and any such losses could have a material adverse effect on our consolidated results of operations and financial condition. Likewise, if Duquesne Power has contracted for supplies in excess of its needs, Duquesne Power could potentially be selling energy or capacity at a loss, and any such losses could have a material adverse effect on our consolidated results of operations and financial condition. Duquesne Power's energy commodity contracts contain provisions designed to mitigate potential losses by requiring that Duquesne Power post collateral depending on changes in energy or capacity prices. Because Holdings guarantees these contracts, any such collateral postings would reduce cash and/or the availability under Holdings' credit facility.

The pending acquisition of ownership interests in the Keystone and Conemaugh generation stations will subject us to risks that we do not currently face.

The acquisition and ownership of an interest in a generation station involves numerous risks, including:

- the plants' ability to operate at expected capacity factors;
- unforeseen operating problems and capital and other expenditures, including unforeseen environmental compliance costs;
- equipment failures;
- the ability to comply with applicable regulations;
- unanticipated cost increases;
- labor force matters;
- weather-related incidents;
- the impact of changes in environmental laws and regulations; and

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- File a distribution rate case with the PUC.
- File a transmission rate case with the FERC.

Energy Supply Opportunities:

- Continue to actively manage supply requirements for both Duquesne Light's residential and small commercial POLR III customers and DLE's customers, through Duquesne Power or our other unregulated subsidiaries, using sound risk management policies.
- Maximize large commercial and industrial customer retention through our unregulated retail electric generation supplier, DLE.
- Strategically align our unregulated energy supply subsidiaries outside Duquesne Light to provide greater flexibility to capitalize on opportunities that may arise.
- Proceed with closing the planned acquisition of the interests in the Keystone and Conemaugh power plants, providing a physical hedge to complement our portfolio of energy commodity contracts for our supply plan.
- Continue to evaluate additional power plant acquisitions.

Complementary Businesses:

- Focus on expanding landfill gas and related businesses to capitalize on current market conditions utilizing our existing position within the marketplace, while helping to solve a growing environmental challenge.
- Identify and develop other unregulated investments that are both closely aligned with our business strategy and that provide reasonable prospects for a fair return and moderate growth.
- Continue to divest non-core investments that are not consistent with our overall business strategy, while maximizing sale proceeds.

Financing:

- Use the most cost efficient sources of funds to finance the continued infrastructure investment, proposed acquisition of power plant interests, landfill gas investments and general corporate purposes.
- Continue to improve credit quality and maintain acceptable levels of liquidity.

OVERVIEW OF BUSINESS SEGMENTS

Duquesne Light reports the following business segments: (1) transmission and distribution of electricity (electricity delivery business segment), (2) supply of electricity by Duquesne Light (Duquesne Light supply business segment), and (3) collection of transition costs (which were fully collected as of December 31, 2005) (CTC business segment).

Holdings reports the following business segments: (1) transmission and distribution of electricity (electricity delivery business segment), (2) supply of electricity (which includes the Duquesne Light supply business segment and, beginning in 2005, supply by DLE) (electricity supply business segment), (3) collection of transition costs (which were fully collected as of December 31, 2005) (CTC business segment), (4) DES' development, operation and maintenance of energy facilities and, for a single customer, synthetic fuel facilities (Energy Solutions business segment), (5) DQE Financial's collection and processing of landfill gas and management of structured finance and alternative energy investments (Financial business segment), and (6) DQE Communications' operation, maintenance and leasing of its fiber optic based network (Communications business segment). We also report an "all other" category to include our other subsidiaries below the quantitative threshold for disclosure. These subsidiaries provide corporate administrative functions, financing, and insurance

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

The following Notes present information on both Duquesne Light Holdings, Inc. (Holdings) and Duquesne Light Company (Duquesne Light). Information on Holdings and its subsidiaries (not including Duquesne Light and its subsidiaries) shall not be deemed to be included as part of Duquesne Light's Notes. Specifically, information on the Energy Solutions, Financial and Communications business segments, the all other category, and discontinued operations is not so included.

References in the Notes to "we," "us" and "our" are to Holdings and its subsidiaries, collectively.

1. Accounting Policies

CONSOLIDATION

Holdings is an energy services holding company. Our subsidiaries include those discussed below.

The consolidated financial statements of Holdings and Duquesne Light include their accounts and their wholly and majority owned subsidiaries. The equity method of accounting is used for 20% to 50% interests in other companies. Under the equity method, original investments are recorded at cost and adjusted by our share of undistributed earnings or losses of these companies. All material intercompany balances and transactions have been eliminated in the consolidation.

In addition, effective March 31, 2004, we consolidate variable interest entities for which we are the primary beneficiary in accordance with Financial Accounting Standards Board (FASB) Interpretation No. 46R, "Consolidation of Variable Interest Entities" (revised December 2003) (FIN 46R), regardless of the ownership percentage held by us.

Continuing Operations

Duquesne Light is an electric utility engaged in the supply (through its provider-of-last-resort service (POLR)), transmission and distribution of electric energy.

Duquesne Power, LLC (formerly Duquesne Power, L.P.), an unregulated subsidiary, maintains a portfolio of energy commodity contracts to provide full-requirements energy supply contracts for both (i) Duquesne Light's residential and small commercial POLR customers and (ii) Duquesne Light Energy, LLC's large commercial and industrial customers. These energy commodity contracts are with unrelated parties and include payment guarantees from Holdings. This entity was a subsidiary of Duquesne Light until December 31, 2005, at which time ownership was transferred to another Holdings subsidiary. The transfer of Duquesne Power, at recorded book value, was completed to strategically align our unregulated businesses outside of Duquesne Light in order to provide flexibility to capitalize on future supply opportunities. The transfer will effectively eliminate the net income included in Duquesne Light's supply segment. The Holdings supply segment will not be affected by the realignment.

Duquesne Light Energy, LLC (DLE) is an unregulated, competitive, retail electric generation supplier that offers customized solutions tailored to meet its customers' specific electricity needs. DLE's primary focus is on the large commercial and industrial customer market segment in Duquesne Light's service territory.

Duquesne Energy Solutions, LLC (DES) is an energy facilities management company that provides energy outsourcing solutions including operation and maintenance of synthetic fuel and energy facilities. During 2005, DES sold three investments in on-site energy facility management projects.

DQE Financial Corp. owns, operates and maintains landfill gas collection and processing systems, and is an investment and portfolio management organization focused on structured finance and alternative energy

Guarantee is reduced daily, based on the passage of time, through January 1, 2016, at which time the Repayment Guarantee expires. The estimated liability for the fair value of the Repayment Guarantee is not material.

Holdings has guaranteed portions of the obligations of Duquesne Power under its energy commodity contracts in order to use Holdings' stronger credit profile to obtain better pricing and contract terms for Duquesne Power. In general, if Duquesne Power is required to make a payment under these contracts and fails to do so, Holdings would be required to make such payment. The notional value of the contracts (and consequently the guarantee amounts) changes as additional energy commodities are bought or sold, and as Duquesne

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Power pays for its energy commodity deliveries. As of December 31, 2005, the maximum amount of Holdings' payment guarantee related to the purchase and capacity obligations totaled \$687.1 million, or approximately 86%, of the total remaining notional value under these contracts. In addition, Holdings guarantees Duquesne Power's obligations to deliver energy under the energy sales contracts, to the extent that Duquesne Power would be obligated to compensate the counterparty for the difference in the counterparty's cost to procure the energy and the contract price. As of December 31, 2005, no guarantee amount has been recorded as a liability on the consolidated balance sheets. In addition, Holdings posts collateral on behalf of Duquesne Power as needed under the energy commodity contracts. As of December 31, 2005, no collateral was outstanding.

In conjunction with certain transactions, primarily divestitures, we provide routine indemnifications (e.g., retention of previously existing environmental, tax and employee liabilities) whose terms range in duration and often are not explicitly defined. Where appropriate, an obligation for such indemnifications is recorded as a liability. Because the obligated amounts of these types of indemnifications often are not explicitly stated, the overall maximum amount of the obligation under such indemnifications cannot be reasonably estimated. Other than obligations recorded as liabilities at the time of divestiture, historically we have not made significant payments for these indemnifications.

EMPLOYEES

Duquesne Light is a party to a labor contract with the International Brotherhood of Electrical Workers, which represents more than 71% of Duquesne Light's approximately 1,400 employees. This contract expires in September 2010.

LEGAL PROCEEDINGS

Shareholder Class Action. In October and November 2001, a number of putative class action lawsuits were filed by purported shareholders of Holdings against Holdings and David Marshall, our former chairman, chief executive officer and president, in the United States District Court for the Western District of Pennsylvania. These cases were consolidated under the caption *In re DQE, Inc. Securities Litigation*, Master File No. 01-1851 (W.D. Pa.), and the plaintiffs filed a second consolidated amended complaint on April 15, 2002. The complaint alleged violations of Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act") and Rule 10b-5 promulgated thereunder, and Section 12(a)(2) of the Securities Act of 1933 (the "Securities Act"). The complaint also alleged controlling person liability under Section 20(a) of the Exchange Act and Section 15 of the Securities Act. The complaint alleged that between December 6, 2000 and April 30, 2001, the defendants issued a number of materially false and misleading statements concerning investments made by our subsidiary, DQE Enterprises, Inc., and the impact that these investments would have on our current and future financial results.

In March 2005, we reached an oral agreement in principle with counsel for the plaintiffs to settle all claims of the class and sub-class. In October 2005, the court approved a settlement of all claims of the class and sub-class. The settlement was covered in full by our insurance.

SECTION 29 TAX CREDITS AND SYNTHETIC FUEL

Holdings recognizes Section 29 credits from DQE Financial's landfill gas operations and an investment in a synthetic fuel partnership. DES operates synthetic fuel facilities for a single customer, earning fees based on production.

Section 29 tax credits are subject to a phase-out provision that could reduce tax credits as the average annual wellhead price per barrel of domestic crude oil increases into an inflation-adjusted phase-out range. For 2004, the tax credit would have begun to phase-out if the annual average wellhead price per barrel of domestic crude oil exceeded \$51.35 per barrel and would have been completely phased out if the annual average wellhead price of

SE/RESA EXHIBIT RH-3

Strategic Energy St. No. 1

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

DIRECT TESTIMONY OF
RONALD CARRIER

On Behalf of Strategic Energy, LLC

Duquesne Light Company Base Rate Case
Docket No. R-00061346

July 7, 2006

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND BUSINESS
2 RESPONSIBILITIES?

3 A. My name is Ronald Carrier. I am the Manager of Regulatory and Legislative Affairs for
4 Strategic Energy, LLC ("Strategic" or "Strategic Energy"). My business address is 2316
5 Anchor Court, Holt, Michigan, 48842. My business responsibilities include managing
6 the legislative and regulatory activities of Strategic Energy in the states of Illinois,
7 Michigan and Pennsylvania.

8 Q. PLEASE DESCRIBE YOUR EDUCATIONAL AND EMPLOYMENT HISTORY.

9 A. I received a mechanical engineering degree from the University of Michigan and an
10 MBA from Central Michigan University. Prior to my employment at Strategic Energy,
11 Consumers Energy/CMS Energy employed me for over 20 years. At Consumers and
12 CMS, my responsibilities ranged from a plant engineer at a nuclear facility to the
13 Program Manager for their Electric Customer Choice program. I have been employed by
14 Strategic Energy for two and a half years, serving as the Manager of Regulatory Affairs
15 for their Mid-American region.

16 Q. HAVE YOU EVER TESTIFIED BEFORE THIS COMMISSION?

17 A. No, but I have testified as an expert before the Michigan Public Service Commission on
18 several cases pertaining to customer choice issues.

19 Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

20 A. I am testifying on behalf of Strategic Energy, LLC ("Strategic Energy" or "Strategic").

21 Q. PLEASE DESCRIBE STRATEGIC ENERGY AND ITS ACTIVITIES IN THE
22 DUQUESNE SERVICE AREA.

23 A. Strategic Energy is a licensed electric generation supplier ("EGS"), competing for the
24 generation supply business of Duquesne Light Company ("Duquesne" or "DLC")
25 customers along with other licensed EGSs such as Duquesne Light Energy ("DLE").

1 Q. WHAT ISSUES DOES STRATEGIC RAISE IN THIS CASE?

2 A. Strategic is raising issues of cross-subsidies to Duquesne Light Energy ("DLE") from
3 Duquesne's distribution service and rates.

4 Q. WHY DOES STRATEGIC RAISE THESE ISSUES IN THIS CASE?

5 A. Strategic has been in business in DLC's service territory as an EGS since 1999. Strategic
6 operates an energy management center in Pittsburgh twenty four hours a day, seven days
7 a week, and employs approximately 200 people in its Pittsburgh office as sales
8 representatives, traders, lawyers, regulatory staff, billing and pricing staff, and computer
9 support technicians, among other functions. Strategic competes with DLE for DLC's
10 large commercial and industrial ("C&I") customers. However, despite having only a few
11 employees and limited work area (DLE occupies only a small percentage of Duquesne's
12 headquarters),¹ and providing EGS service since January 1, 2005, DLE has been able to
13 obtain, as far as we can determine, a substantial share of DLC's large C&I customer load,
14 in many cases, by consistently undercutting Strategic's (and, we believe, other EGSs')
15 prices. The question raised is how has DLE been able to do so much in such a short time
16 with so little? While it can be said that Strategic Energy serves customers in several
17 states, so it requires a larger staff, the disparity between the relative size of the two
18 companies is too large to ignore. Strategic embraces retail electric competition, but it
19 must be on a level playing field if EGSs are going to be able to deliver the benefits of
20 competition to customers. I am also advised by counsel that a level playing field is
21 required in the post-transition period by the Electric Competition Act requirement that the
22 competitive activities of the incumbent utilities must be fair. One manifestation of this

¹ Strategic Energy Exh. RC-1 (DLC answer to Direct Energy Set II-7 (Revised)).

1 requirement is the Code of Conduct that Duquesne is required to adhere to in its dealings
2 with its affiliate EGS as well as other EGSs operating in its service territory. Among
3 other things, the Code of Conduct generally seeks to prevent the utility from subsidizing
4 the activities of its affiliated EGS.² To the extent that DLC's distribution rates include
5 costs that – either directly or indirectly – benefit and, therefore, should be paid for by
6 other DLC affiliates, such as Duquesne Light Holdings ("DLH"), Duquesne Power
7 ("DP"), the playing field is not level. The customers utilizing DLC's distribution system,
8 both POLR and choice, should not subsidize the marketing efforts of DLE.

9 **Q. IS THERE ANY EVIDENCE THAT THE COSTS THAT DUQUESNE IS**
10 **SEEKING TO INCLUDE IN ITS DISTRIBUTION RATES MAY BE**
11 **OVERSTATED BECAUSE OF DLE COSTS?**

12 **A.** Yes, here is one example. Duquesne's 2005 Form 10-K states that POLR supply
13 procurement for DLC and supply for DLE's customers is performed by DP, and that DP
14 "has secured a substantial portion of the combined expected load obligation for its full-
15 requirements contracts with Duquesne Light and DLE through 2007."³ It appears
16 therefore that power purchasing, scheduling and coordination and planning are done
17 jointly by Duquesne Power for both DLE and Duquesne's POLR load. As Direct Energy
18 witness Lacey explains, Duquesne's distribution revenue requirement includes all costs
19 associated with providing POLR service other than the actual purchased power costs and

² "The purpose of these competitive safeguards is to . . . prevent the cross subsidization of service . . . between related electric distribution companies and electric generation suppliers . . . and to establish and maintain an effective and vibrant competitive market in the purchase and sale of retail electric energy in this Commonwealth." 52 Pa. Code § 54.121. "An electric distribution company which is related as an affiliate or division of an electric generation supplier . . . ; and any electric generation supplier which is related as an affiliate or division of any electric distribution company . . . , shall insure that its employes function independently of other related companies." 52 Pa. Code § 54.122(11).

³ DLC Attachment DFR-III-F-1b, pp. 5-6, 11.

1 related taxes. This means that all other costs that are charged to DLC distribution from
2 DP (or which DLC incurs directly) related to planning, scheduling and coordinating its
3 POLR supply are being claimed in its distribution rates. So far, we have not been
4 provided with any evidence that DP is allocating to DLE any of the costs of procuring
5 power (other than the cost of the power itself). If these costs are being claimed in
6 distribution rates, it would give DLE a distinct and unfair cost advantage in the
7 competitive retail market. We agree with Direct Energy witness Lacey that all costs of
8 providing POLR service should be removed from distribution rates and allocated to the
9 appropriate service.

10 Another example of a clear potential subsidy to DLE is raised by Duquesne
11 Holding's 2005 Form 10-K. It states that DP's supply procurements are backed by
12 guarantees from DLH. This guarantee is sufficient because generators know that,
13 through its utility operation, DLH has a steady and secure revenue stream that secures
14 any liability DP might incur. Such a guarantee is tremendously valuable, as it eliminates
15 the need for DP, and, indirectly, DLE, to post credit when it purchases power to serve its
16 customers. I am confident that the ability of DLE to avoid having to post credit for its
17 power purchases provides it with yet another cost advantage when it competes with
18 companies like Strategic, who are usually required to post credit for such purchases. Yet
19 it is not clear that DLE ever compensates any DLC affiliate, including the utility, for this
20 guarantee. In our view, if DLE does not compensate DLC for the "avoided cost" of not
21 having to post credit, Duquesne and its customers are subsidizing DLE's competitive
22 operations.

1 Examples like this are ways that DLC may be using its regulated cost recovery
2 mechanisms to pay for DLE procurement costs in order to subsidize its retail affiliate and
3 keep competitive EGSs out of the market. The logical end result of this would be an
4 unregulated monopoly serving all of the customers in the market.

5 **Q. DOES STRATEGIC HAVE EVIDENCE THAT CROSS-SUBSIDIZATION BY**
6 **DUQUESNE DISTRIBUTION CUSTOMERS IS DEFINITELY OCCURRING?**

7 A. At this point we have only the circumstantial evidence mentioned above, because we
8 have not received answers to all relevant discovery requests and because the timeline on
9 which a base rate case like this is tried makes an in-depth exploration of this issue
10 extremely difficult. We reserve the right to supplement this testimony based upon receipt
11 of answers.

12 **Q. DOES DLC OR DLH HAVE A REASON TO USE CROSS-SUBSIDIES TO ITS**
13 **ADVANTAGE AND TO THE DETRIMENT OF RETAIL COMPETITION?**

14 A. Yes, as disclosed in their 10-K filing. This filing lists as DLC's first Business Strategy
15 under the "Energy Supply Opportunities" heading to "[c]ontinue to actively manage
16 supply requirements for both Duquesne Light's residential and small commercial POLR
17 III customers and DLE's customers, through Duquesne Power or our other unregulated
18 subsidiaries"⁴ DLC's second strategic priority under the "Energy Supply
19 Opportunities" heading is to "[m]aximize large commercial and industrial customer
20 retention through our unregulated retail electric supplier, DLE." I also note that DLC
21 has budgeted an increase in its purchased power expense for 2006 "due to higher
22 budgeted POLR retention for both residential and commercial customers."⁵ Since DLC

⁴ *Id.* (emphasis added).

⁵ DLC Attachment DFR-II-D-8, p. 4 of 8.

1 made no attempt in this case to allocate POLR costs to POLR, the same relevant costs are
2 not going to be allocated to DLE. I conclude that DLC and DLH are going to use a cross-
3 subsidy from regulated rate recovery to help fund both the POLR and the DLE
4 businesses.

5 **Q. WHAT SHOULD THE COMMISSION DO ABOUT THIS PROBLEM?**

6 A. The Commission should fully investigate cross-subsidies that occur in any way – directly
7 or indirectly – by requiring DLC to do a study that discloses all instances of cost or risk
8 sharing among all the DLC affiliates and DLE. Then the Commission and interested
9 stakeholders would be in a position to fully allocate all costs of the DLH companies' to
10 the appropriate services. This would produce a level playing field for retail competition
11 as envisioned by the Electric Competition Act. An example of an indirect subsidy would
12 be if DP is providing or paying for a service (such as scheduling, or balancing and
13 ancillary services) for both DLC and DLE, and charging only DLC. This arrangement
14 could appear appropriate on the surface, but either DP should also charge DLE or DLE
15 should compensate DLC for DLE's portion of the costs.

16 I recommend that the Commission order Duquesne to produce such a study within
17 sixty (60) days following the issuance of the Commission's order in this case, which
18 study should be circulated for analysis, further discovery and review in an on-the-record
19 hearing by all interested parties. If the end result of the investigation is an identification
20 of costs included in Duquesne's distribution rates which should either be recovered in its
21 POLR charges or recovered in the prices charged by DLE, the Commission should order
22 the appropriate adjustments in DLC's distribution and/or POLR rates.

23 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

24 A. Yes, subject to receipt of discovery answers as stated above.

Duquesne Light Company
Docket No. R-00061346

DES-II-7 (Revised)
Clare Ott
Page 1 of 1

Direct Energy Services, LLC
Interrogatories Set II

7. Please provide copies of the floor plans for the premises occupied by Duquesne Light Company and its affiliates at 411 Seventh Avenue in Pittsburgh and indicate and describe the portions of the premises occupied by Duquesne Light Company and each affiliate.

Response:

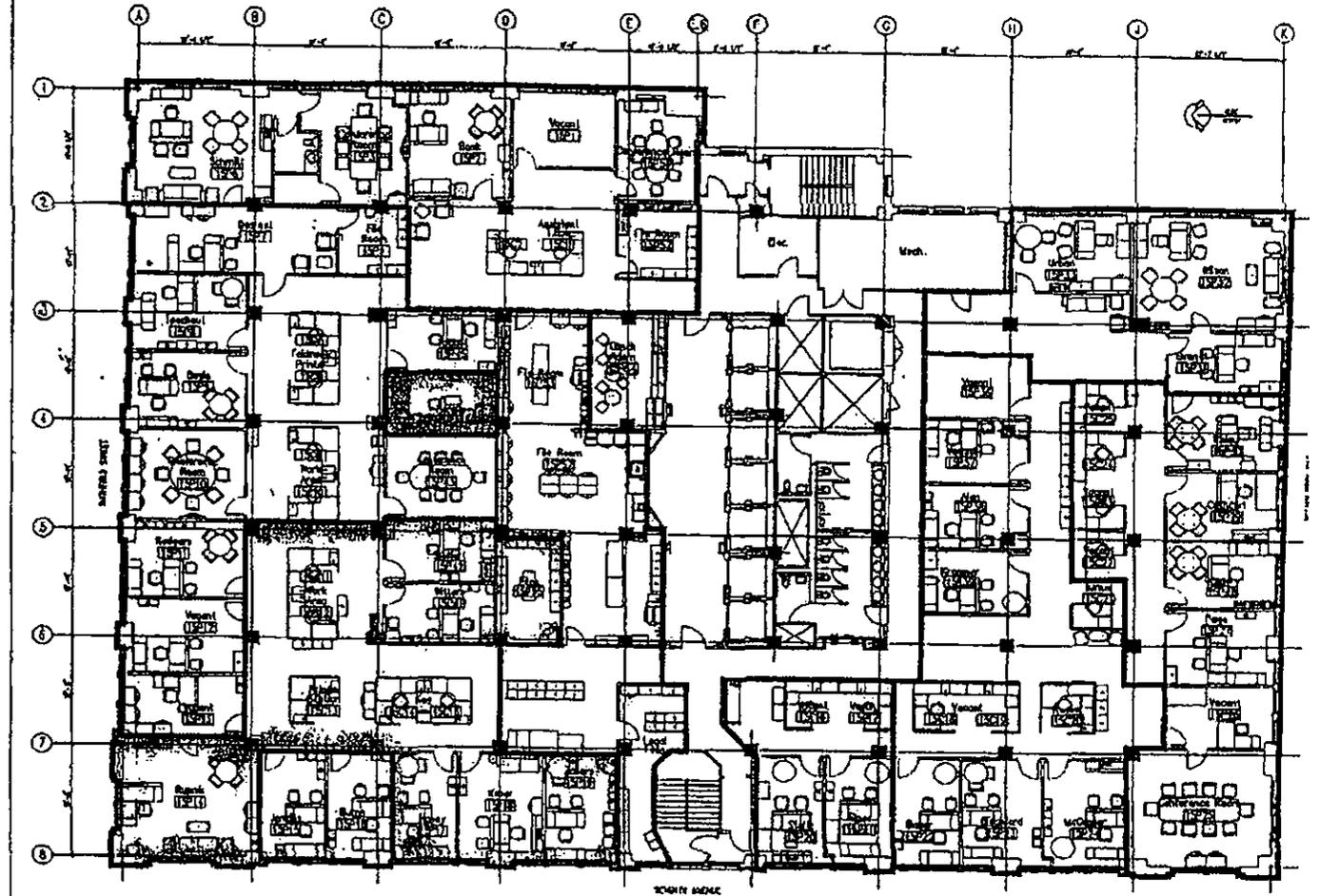
DQE Communications LLC	15 th Floor, 3,720 sq. ft.
DQE Energy Solutions	15 th Floor, 6,536 sq. ft.
DQE Financial Corporation	15 th Floor, 3,184 sq. ft.
Duquesne Light Energy	15 th Floor, 3,136 sq. ft.
Duquesne Power	15 th Floor, 2,629 sq. ft.
Duquesne Light Holdings	13,029 sq. ft.

Also see DFR II-D-8f.

Also see the three attached floor plans. As a description, Duquesne Light Company occupies the remainder of the leased premises at 411 Seventh Avenue except for the space occupied by the five affiliates of Duquesne Light Company noted herein.

DDC COMMUNICATIONS 2998 SQ. FT.
 PAC ENERGY SOLUTIONS 5259 SQ. FT.
 DDC FINANCIAL 7543 SQ. FT.
 SUGUESHC LIGHT-ENERGY 7540 SQ. FT.
 SUGUESHC POWER 2118 SQ. FT.
 SUGUESHC LIGHT CO. 7045 SQ. FT.

SHARED BLDG. BUILDING SPACE 4217 SQ. FT.
 TOTAL FLOOR SQUARE FOOTAGE 21,810 SQ. FT.



411 SOUTH BAY
 OFFICE FURNITURE PLAN
 SCALE: 1/8" = 1'-0"
 10/14/2010

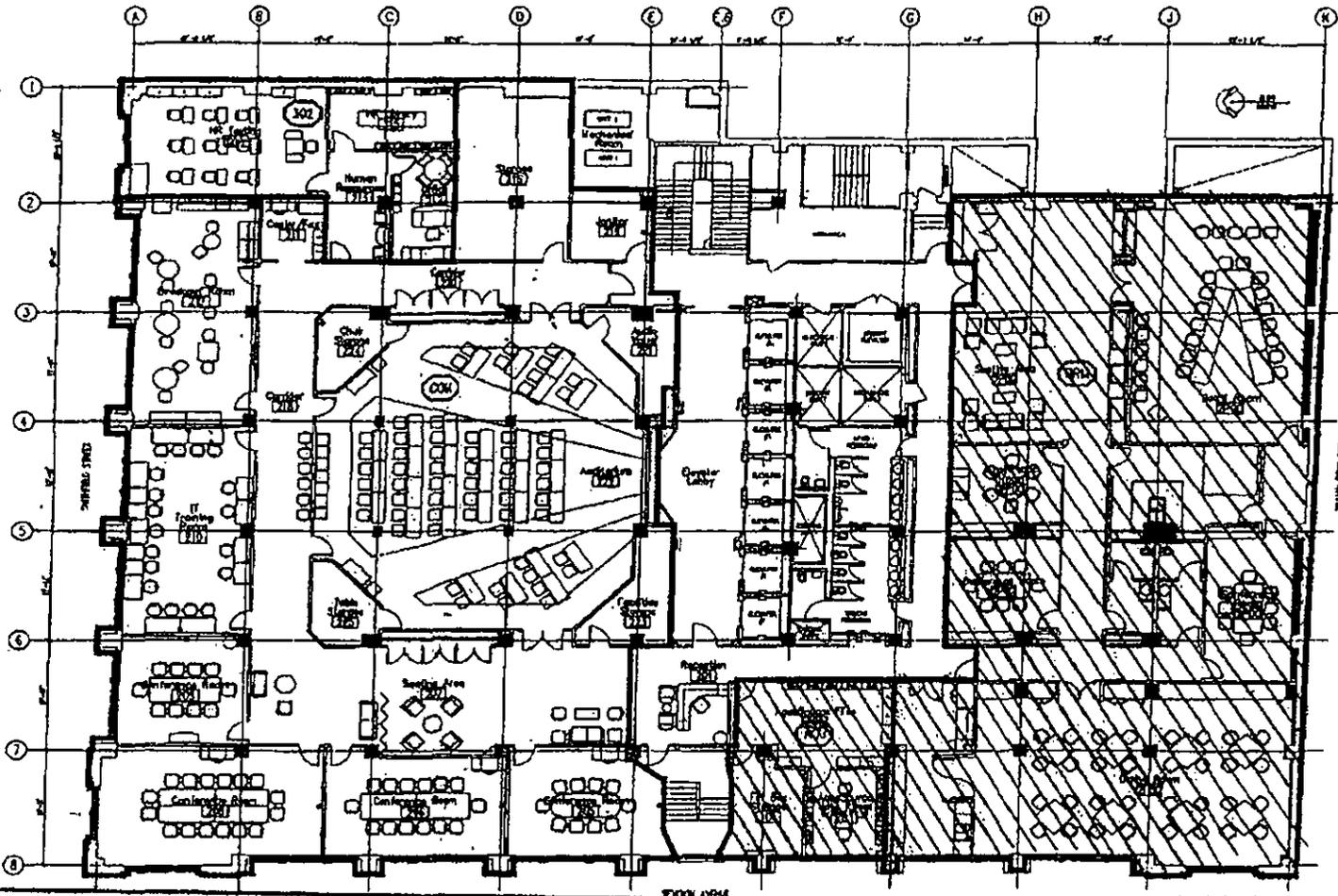


EXHIBIT B-1

300 DENOTES COST CENTER

SQUAREFOOTAGE
 411 SEVENTH AVE.
 2ND FL. FURNITURE PLAN
 SCALE: 1/8" = 1'-0"
 A500 3001

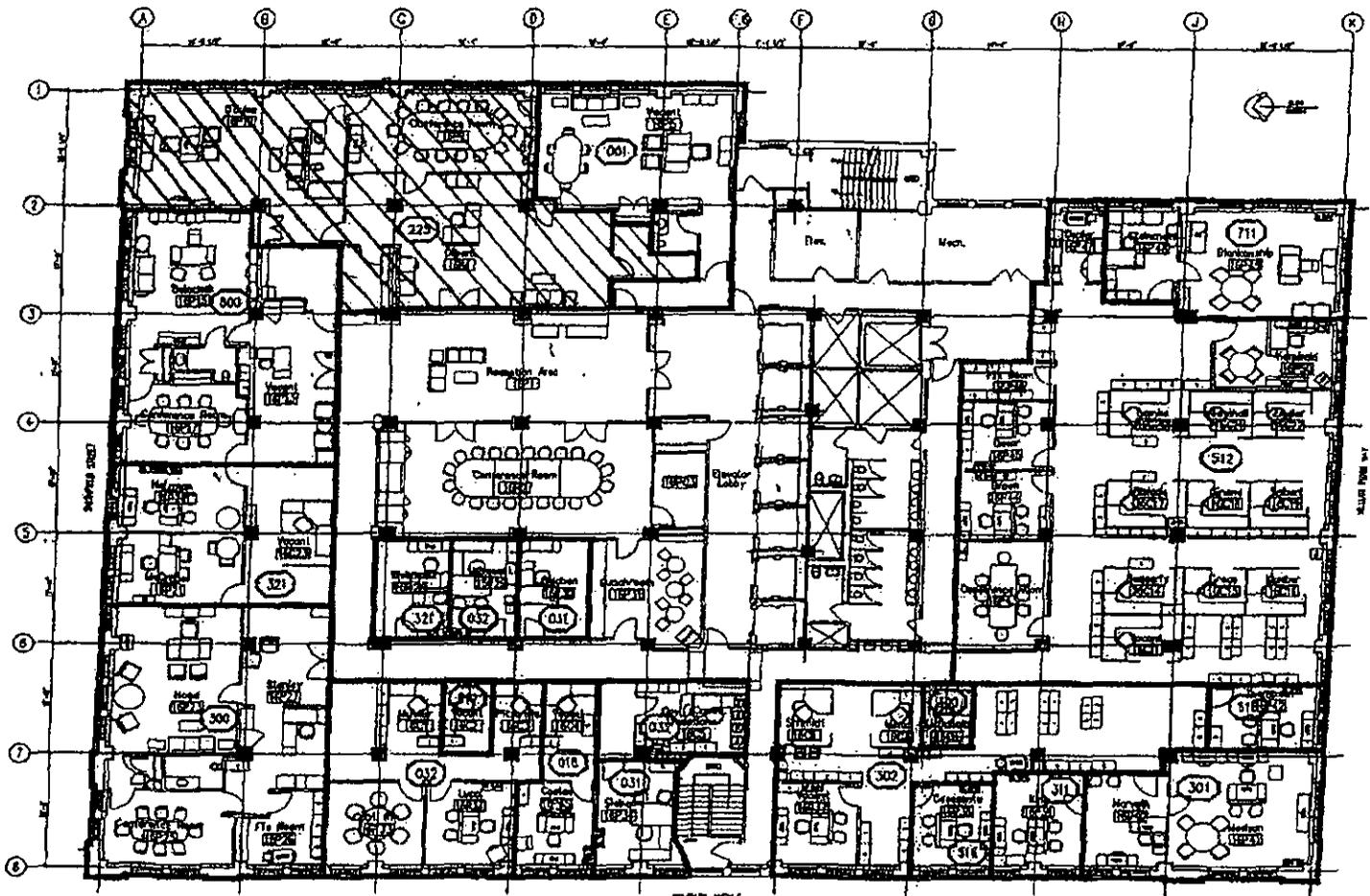


EXHIBIT B-2

XXX DENOTES COS. CENTER

FOURTH FLOOR
 411 SEVENTH AVE.
 TENTATIVE FURNITURE PLAN
 SCALE: 1/4" = 1'-0"
 JAN 15, 1959

SE/RESA EXHIBIT RH-4

Strategic Energy St. No. 1SR

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

SURREBUTTAL TESTIMONY OF
RONALD CARRIER

On Behalf of Strategic Energy, LLC

Duquesne Light Company Base Rate Case
Docket No. R-00061346

August 16, 2006

- 1 Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.
- 2 A. Ronald Carrier. My business address is 2316 Anchor Court, Holt, Michigan, 48842.
- 3 Q. ARE YOU THE SAME RONALD CARRIER WHO SUBMITTED DIRECT AND
4 REBUTTAL TESTIMONY ON BEHALF OF STRATEGIC ENERGY IN THIS
5 PROCEEDING?
- 6 A. Yes.
- 7 Q. WHAT IS THE SUBJECT OF YOUR SURREBUTTAL TESTIMONY?
- 8 A. I am responding to Duquesne Light Company ("Duquesne" or "DLC") witness Neil
9 Fisher's rebuttal testimony that Strategic Energy, LLC's ("Strategic") allegations of
10 potential cross-subsidies to Duquesne's electric generation supplier ("EGS") affiliate,
11 Duquesne Light Energy ("DLE"), are unsupported and not credible.
- 12 Q. DO YOU AGREE WITH MR. FISHER THAT THERE IS NO SUPPORT FOR
13 STRATEGIC'S CROSS-SUBSIDY CLAIMS?
- 14 A. No. Part of the problem is that Mr. Fisher apparently misreads my testimony as claiming
15 only cross-subsidies from Duquesne's distribution rates, when my claims also include
16 direct and indirect cross-subsidies from Duquesne's POLR (generation) rates, Duquesne
17 Power's ("DP") supply procurement activities and Duquesne Light Holding's ("DLH")
18 credit or performance guarantees. This may explain why Mr. Fisher does not address my
19 claims that DLE can receive competitive cost advantages from DLH and its subsidiaries
20 to the extent that DLE does not pay for: 1) costs incurred on its behalf by DP, but
21 included in DLC's POLR rates or absorbed by DP; or 2) credit guarantees provided by
22 DLH to support DP's supply procurement activities on behalf of DLE. Mr. Fisher simply
23 asserts that the charge for services between Duquesne's unregulated affiliates, DP and
24 DLE, is not relevant in this proceeding and not subject to regulatory review.
- 25 Q. DO YOU AGREE WITH MR. FISHER'S ASSERTIONS?

1 A. No, and I note that Duquesne has not disclosed whether there are any such charges.
2 Although I am not a lawyer it seems to me that Mr. Fisher's assertions present the
3 "chicken and egg" dilemma. If DLE does not pay for costs DP incurs on DLE's behalf
4 (because either DLC pays for them in its distribution or POLR rates, or DP absorbs
5 them), or if DLE does not pay for credit guarantees provided by DLH either directly (to
6 DLH) or indirectly (to DP), then DLE is receiving a subsidy – from DLC, DP and/or
7 DLH. However, if the cost allocations and charges, if any, for the service arrangements
8 between and among DP, DLE, DLC and DLH are not relevant and not subject to
9 Commission review in this proceeding, then how can information to establish the extent
10 and amounts of such cross-subsidies be uncovered?

11 **Q. HOW HAS DUQUESNE'S POSITION ON THIS ISSUE AFFECTED**
12 **STRATEGIC'S PROOF TO SUPPORT ITS CLAIMS?**

13 A. As I stated in my initial testimony, the tight time frame for litigating this case has
14 hampered Strategic's efforts to uncover this information over Duquesne's objections.
15 Fortunately, Mr. Fisher's testimony and admissions by Duquesne actually support our
16 claims that DLE is receiving unlawful subsidies from either DLC, DP and/or DLH, by
17 tagging along with DLC on DP's supply procurement activities or riding the coattails of
18 DLC's distribution or POLR service.

19 **Q. HOW DOES MR. FISHER'S TESTIMONY SUPPORT STRATEGIC'S CLAIMS**
20 **OF UNLAWFUL CROSS-SUBSIDIES?**

21 A. Mr. Fisher does not dispute my initial testimony that DP's power purchasing, scheduling,
22 coordination and planning are done by DP for both DLE's load and DLC's POLR load,
23 but he asserts that DLC's full service requirements supply agreement with DP covers all
24 DP's costs associated with DLC's POLR service but does not include DP costs related to
25 DLE load. But Direct Energy witness Lacey's initial testimony shows that DLC's POLR

1 rates include only actual purchased power costs and related taxes.¹ And Duquesne's 2005
2 Form 10-K shows some \$28.4 million in profit from DLC's "POLR/Supply" ("Electricity
3 Supply" business segment, supposedly including the results of DLE), comprising \$19
4 million cash earnings from POLR service to residential and small commercial customers
5 and \$9.4 million non-cash earnings from derivative energy contracts.² As Duquesne's
6 2005 Form 10-K states that DLE provides service to Duquesne's large commercial and
7 industrial customers, this means that DLE did not contribute any earnings in 2005 to
8 Duquesne's \$19 million Electricity Supply business segment profit. In other words, DLE
9 had no profit on its power sales in 2005. This means that DLE is selling power at or
10 below cost – i.e., "dumping" power or engaging in predatory pricing by not pricing its
11 power to cover all costs – because some of the costs are covered by either DLC or DP.
12 Mr. Fisher could be considered to have admitted as much, even as he professes not to be
13 familiar with DLE's pricing strategy, when he asserts that DLE's ability to undercut
14 Strategic's retail prices and successfully capture market share "could be explained by a
15 variety of factors" – but then he mentions only two: 1) as a new EGS, DLE may have
16 "had a strategy to price low in order to capture market share;" and 2) it's possible DLE
17 "chooses to earn lower margins than those required by Strategic's management."³ DLE
18 apparently had both strategies in 2005, and was able to price low because it didn't have to
19 pay for some of its costs.

20 Q. DOES MR. FISHER'S TESTIMONY INCLUDE ANY OTHER EXAMPLES OF
21 UNLAWFUL CROSS-SUBSIDIES AMONG THE DUQUESNE COMPANIES?

¹ Direct Energy St. No. 1 at 10-11.

² Strategic Energy Exh. RC-2 (DLC response to DE III-3).

³ Duquesne St. No. 15-R (Fisher) at 28-29.

1 A. The most obvious one is parent company credit or performance guarantees, which Mr.
2 Fisher admits provides competitive advantages to a retail subsidiary. Mr. Fisher quotes
3 the Form 10-Ks of the parent companies of EGSs in this case (Strategic, Constellation
4 NewEnergy) which disclose that these EGSs receive credit or performance guarantees
5 from their corporate parents. These quotes readily admit that the parent company
6 guarantees provide support for their EGS subsidiaries' operations. Strategic's parent
7 company's 10-K states that these corporate guarantees "support or enhance the
8 creditworthiness otherwise attributed to [Strategic] for a stand-alone basis, thereby
9 facilitating the extension of sufficient credit to accomplish [Strategic's] intended business
10 purposes."⁴ Constellation NewEnergy's parent company's 10-K states that its corporate
11 guarantees are given "in support of the growth of our merchant energy business."⁵ Credit
12 support from Centrica, Direct Energy's parent company, "reduces costs and gives
13 competitive advantage" to its subsidiaries.⁶ Mr. Fisher's analogy thus supports my initial
14 testimony that DLH's credit guarantees provide DLH's subsidiaries with either direct or
15 indirect competitive cost advantages. Mr. Fisher's assertions that "it is not at all clear
16 who [among the EGSs and their parent companies and regulated/unregulated affiliated
17 companies] has a competitive disadvantage with respect to credit and security costs," and
18 that "[o]ne could easily argue DLE is at a competitive disadvantage" are completely at
19 odds with his analogy, unsupported and counterintuitive. He does not provide any

⁴ *Id.* at 27 (quoting Great Plains Energy, Inc. 2005 Form 10-K).

⁵ *Id.* (quoting Constellation Energy, Inc. 2005 Form 10-K).

⁶ *Id.* (quoting "Centrica in North America").

1 explanation as to how a parent company's guarantees puts its subsidiaries at a competitive
2 disadvantage.

3 **Q. WHY DO YOU VIEW DLH'S CREDIT SUPPORT AS AN UNLAWFUL CROSS-**
4 **SUBSIDY WHEN STRATEGIC AND OTHER EGSs ALSO RECEIVE CREDIT**
5 **SUPPORT FROM THEIR CORPORATE PARENTS?**

6 A. It's an "apples to oranges" comparison because there are fundamental differences between
7 the two situations. First, DLE and DP are operating in DLC's service territory, and the
8 Electric Choice and Competition Act, as well as Duquesne's Code of Conduct, require
9 that these affiliates function independently of each other and not provide cross-subsidies.
10 There are no such comparable limitations on the operations of Strategic (or Constellation
11 NewEnergy and Direct Energy) and their affiliates in DLC's service territory. Second,
12 Strategic pays its corporate parent for the credit guarantees.

13 **Q. DOES MR. FISHER'S TESTIMONY REVEAL ANY OTHER CROSS-SUBSIDY**
14 **PROBLEM?**

15 A. Yes. He asserts that whatever costs DP incurs to fulfill its supply obligations to DLC's
16 POLR service are reflected in the total charges paid by DLC to DP -- and thus reflected in
17 DLC's POLR rates -- and that those charges were determined by the PUC to represent
18 "prevailing market prices" for the Small Customer fixed price POLR product over the
19 POLR III period.

20 **Q. WHY IS THIS A CROSS-SUBSIDY PROBLEM?**

21 A. Because rates for post-transition POLR service are to reflect the prevailing market prices
22 for the power plus all reasonable costs. By ignoring the cost component, Mr. Fisher's
23 analysis and conclusion that the total price paid by DLC to DP for power supply and
24 related services reflects prevailing market prices misses the mark. By ignoring the other
25 half of the post-transition POLR pricing standard, Mr. Fisher summarily, and

1 erroneously, dismisses the possibility of a cross-subsidy from DP's power procurement
2 activities. Mr. Fisher also asserts that the failure of the DP/DLC power supply contract to
3 break out the individual cost components is no different from the manner in which EGSs
4 such as Strategic and their wholesale suppliers contract. However, again, this is an
5 invalid "apples to oranges" comparison because DLC and its affiliates operating in DLC's
6 service territory are subject to restrictions and limitations to prevent anticompetitive
7 activities and cross-subsidies that are not applicable to unaffiliated EGSs such as
8 Strategic.

9 **Q. WHAT SHOULD THE COMMISSION DO TO ADDRESS THESE CROSS-**
10 **SUBSIDY PROBLEMS?**

11 A. The Commission should investigate DLC's operations vis-à-vis DLE and DP to uncover
12 and quantify the apparent cross-subsidies among these companies and DLH. I note that
13 the Michigan Public Service Commission's Code of Conduct specifically prohibits the
14 types of cross-subsidies we claim are present among the DLH companies: "An electric
15 utility's or alternative electric supplier's regulated services shall not subsidize in any
16 manner, directly or indirectly, the unregulated business of its affiliates or other separate
17 entities."⁷ In addition, the Michigan Public Service Commission's Code of Conduct
18 spells out how services provided from one corporate affiliate to another should be
19 priced.⁸ Once the extent and amounts of the cross-subsidies are identified, the
20 Commission should require Duquesne to make appropriate adjustments to its distribution
21 rates and to its POLR rates to ensure that these rates reflect all the reasonable costs of
22 providing the respective services – and only the reasonable costs of providing the

⁷ Strategic Energy Exh. RC-3 (Section II (Separation), Subsection B).

⁸ *Id.* (Section III (Discrimination), Subsection C).

1 respective services. For example, any costs incurred by DP on behalf of DLE but
2 included in DLC's distribution or POLR rates should be returned to DLC in the form of
3 reduced charges. This Commission should also consider amending its Code of Conduct
4 along the lines of the Michigan PSC's Code of Conduct to more specifically address
5 cross-subsidy issues.

6 **Q. DOES THIS COMPLETE YOUR SURREBUTTAL TESTIMONY?**

7 **A. Yes.**

Duquesne Light Company
Docket No. R-00061346

DES-III-3
Susan S. Betta
Page 1 of 1

Direct Energy Services
Interrogatories Set III

Answer to Direct I-10: Investor Presentation "Executing on the Basics" (Feb. 14, 2006),
p. 8: "Electricity Supply business earned \$19M in 2005 excluding derivative gains."

3.
 - a. Provide all calculations associated with the conclusion that the "Electric Supply business" earned \$19M, including a detail of the expenses, revenues, taxes and other items allocated to "Electricity Supply" on which this calculation is based.
 - b. Confirm that "Electricity Supply" referenced there includes POLR service. If the service includes any other service, please specify the other services and identify the portion attributable to POLR service.
 - c. Explain the "adjustment" which reduced actual 2005 POLR/supply earnings from \$28.4M to \$19M. (p. 15)
 - d. Explain the main drivers for the projected increase in earnings from POLR/supply from \$19M in 2005 to \$33-36M in 2006.

Response:

- 3.a. Refer to the attached excerpts from the Duquesne Light Holdings and Duquesne Light Company combined Form 10-K for the year ended December 31, 2005 for the detail of the revenue, expenses and taxes used to calculate the earnings for the electricity supply segment for the year ended December 31, 2005. The first excerpt shows the earnings of the Duquesne Light Supply segment (\$28.4 million in total) segregated between earnings from the residential and small commercial customers (\$19.0 million) and non-cash earnings from derivative energy contracts (\$9.4 million). The second excerpt shows the detail of the revenue, expenses and taxes used to calculate the total earnings of \$28.4 million from the Electricity Supply segment. The net income effect of the derivative energy contracts is reflected on a pre-tax basis as an offset to purchased power expense.
- 3.b. The Electricity Supply segment includes POLR service. As disclosed in the Form 10-K referenced above, it also includes the results of Duquesne Light Holdings' unregulated retail electric generation supplier, Duquesne Light Energy. The additional information you requested is non-public information, and will not be provided.
- 3.c. Please refer to the response to question 3.a.
- 3.d. As referenced in slides 30 and 32 of this same presentation, the 2006 estimated earnings from the supply segment were to include approximately \$9 million of earnings from the projected June 2006 acquisition of the Keystone and Conemaugh power stations. This is the primary reason for the projected increase in earnings from the supply segment.

CODE OF CONDUCT

This code of conduct is intended to promote fair competition by establishing measures to prevent cross-subsidization, information sharing, and preferential treatment between the regulated and unregulated operations of electric utilities, alternative electric suppliers, and their affiliates. An electric utility or alternative electric supplier is prohibited from taking punitive action against any individual (including an employee) or entity who files a complaint with the electric utility, the alternative electric supplier, or the Commission, or otherwise causes an alleged violation of this code of conduct to come to the attention of the Commission.

I. Applicability

This code applies to all electric utilities as defined by MCL 460.562 and to alternative electric suppliers, as defined by MCL 460.10g, who, together with their affiliates, provide regulated services in Michigan and unregulated services. As used in this code of conduct, a service is "regulated" if the commission has authority to set the price for the service as of the effective date of this code.

II. Separation

An electric utility or alternative electric supplier that offers, itself or through its affiliates, both regulated and unregulated services shall do so with the structural or functional separation needed to prevent cross-subsidization, information sharing, and preferential treatment between the regulated and unregulated services. This includes, but is not limited to, the following:

- A. An electric utility shall not offer unregulated services or products except through one or more affiliates or through other entities within the corporate structure, such as divisions.
- B. An electric utility's or alternative electric supplier's regulated services shall not subsidize in any manner, directly or indirectly, the unregulated business of its affiliates or other separate entities.
- C. An electric utility or alternative electric supplier shall maintain its books and records separately from those of its affiliates or other entities within its corporate structure. An electric cooperative offering unregulated services shall maintain an accounting system that allocates costs between its regulated and unregulated ventures on a fully allocated embedded cost basis, and any transfers of services, products, or property must be in compliance with the provisions of Section III, paragraph C.
- D. An electric utility or alternative electric supplier and its affiliates or other entities within its corporate structure shall not share facilities, equipment, or operating employees, but may share computer hardware and software with documented protection to prevent discriminatory access to competitively sensitive information.

- E. An electric utility's or alternative electric supplier's operating employees and the operating employees of its affiliates or other entities within its corporate structure shall function independently of each other and maintain separate offices.
- F. An electric utility or alternative electric supplier shall not finance or co-sign loans for affiliates.
- G. An electric utility may transfer employees between the electric utility and any of its affiliates or other entities within the corporate structure as long as the electric utility documents those transfers and files semi-annually with the Commission a report of each occasion on which an employee of the electric utility became an employee of an affiliate or other entity within its corporate structure and/or an employee of an affiliate or other entity within its corporate structure became an employee of the electric utility.
- H. An electric utility and its affiliates or other entities within the corporate structure and an alternative electric supplier and its affiliates or other entities within the corporate structure offering both regulated and unregulated services or products in Michigan shall not engage in joint advertising, marketing, or other promotional activities related to the provision of regulated and unregulated services, nor shall they jointly sell regulated and unregulated services.
- I. An electric utility or alternative electric supplier offering regulated service in Michigan shall not suggest that it will provide any customer with preferential treatment or service by doing business with the electric utility or the alternative electric supplier, affiliates, or other entities within the corporate structure offering unregulated services or products, nor shall the electric utility or alternative electric supplier suggest that any customer will receive inferior treatment or service by doing business with an unaffiliated supplier.
- J. An electric utility or alternative electric supplier offering regulated service in Michigan shall not condition or otherwise tie the provision of a regulated service or the availability of discounts, rates, other charges, fees, rebates, or waivers of terms and conditions for regulated service to the taking of any unregulated goods or services from the electric utility or alternative electric supplier, affiliates, or other entities within the corporate structure.
- K. An electric utility or alternative electric supplier offering regulated service in Michigan shall not allow its affiliates to use its logo unless the affiliate includes, in a clearly visible position and easily readable by customers, the following statement:
 - "(Affiliate name) is not regulated by the Michigan Public Service Commission."

- L. If an electric utility, its affiliate, or other entity within the corporate structure offers an unregulated service, any use of its logo shall include, in a clearly visible position and easily readable by customers, the following statement:
“(Service) is not regulated by the Michigan Public Service Commission.”
- M. None of the provisions of this code shall be interpreted to require a cooperative electric utility or an independent investor-owned utility with fewer than 60 employees to maintain separate facilities, operations, or personnel, used to deliver electricity to retail customers, provide retail electric service, or to be an alternative electric supplier.

III. Discrimination

An electric utility or alternative electric supplier that offers, itself or through its affiliates, both regulated and unregulated services shall not unduly discriminate in favor of or against any party, including its affiliates. This includes, but is not limited to, the following:

- A. An electric utility or alternative electric supplier that offers, itself or through its affiliates, both regulated and unregulated service shall not provide any affiliate or other entity within its corporate structure, preferential treatment or any other advantages that are not offered under the same terms and conditions and contemporaneously to other suppliers offering services or products within the same service territory or to customers of those suppliers. This provision includes, but is not limited to, all aspects of the electric utility's or alternative electric supplier's service, including pricing, responsiveness to requests for service or repair, the availability of firm and interruptible service, and metering requirements.
- B. If an electric utility provides to any affiliate or other separate entity, or customers of an affiliate or other separate entity within its corporate structure, a discount, rebate, fee waiver, or waiver of its regulated tariffed terms and conditions for services or products, it shall contemporaneously provide notice of and offer the same discount, rebate, fee waiver, or waiver to all alternative electric suppliers operating within the electric utility's service territory or all alternative electric suppliers' customers.
- C. If an electric utility or alternative electric supplier offering regulated service in Michigan provides services, products, or property to any affiliate or other entity within the corporate structure, compensation shall be based upon the higher of fully allocated embedded cost or market price. If an affiliate or other entity within the corporate structure provides services, products, or property to an electric utility or alternative electric supplier offering regulated service in Michigan, compensation for services and supplies shall be at the lower of market price or 10% over fully allocated embedded cost and transfers of assets shall be based upon the lower of fully allocated embedded cost or market price.

- D. If an electric utility provides a customer or potential customer with the names of its affiliates or other entities within the corporate structure that are alternative electric suppliers, it shall do so only by distributing their names along with the names of all licensed alternative electric suppliers.
- E. An electric utility or alternative electric supplier offering regulated service in Michigan shall not provide information or consultation to an affiliate or other entity within the corporate structure offering unregulated electric service in Michigan regarding a potential business arrangement between that affiliate or other entity within the corporate structure and a potential customer.
- F. An electric utility or alternative electric supplier offering regulated service in Michigan shall not refer a customer or potential customer to an affiliate or other entity within the corporate structure offering unregulated electric service in Michigan, nor steer a potential customer away from a non-affiliated entity offering unregulated electric service in Michigan, nor shall the electric utility or alternative electric supplier offering regulated service in Michigan provide a customer or potential customer with advice or assistance regarding the selection of or relationship with an affiliate, other entity within the corporate structure, or other service provider offering unregulated electric service in Michigan.

IV. Disclosure of Information

Information obtained by an electric utility or alternative electric supplier in the course of conducting its regulated business in Michigan shall not be shared directly or indirectly with its affiliates or other entities within its corporate structure unless that same information is provided to competitors operating in the state on the same terms and conditions and contemporaneously. This provision includes, but is not limited to, the following:

- A. Customer specific names and addresses shall not be provided to an affiliate or other entity within the corporate structure unless the same information is offered on the same terms and conditions, and contemporaneously, to all competitors.
- B. Customer specific consumption or billing data shall not be provided to any affiliate or other entity within the corporate structure or alternative electric supplier without prior written approval of the customer. Once each calendar year a request for up to 12 months of historic usage or billing data may be made at no cost.
- C. If an electric utility or alternative electric supplier offering regulated service in Michigan provides non-customer specific, or aggregated, customer information to its affiliate or other entity within its corporate structure, it must offer the same information on the same terms and conditions, in the same form and manner, and contemporaneously to all competitors.

- D. An electric utility shall not provide its affiliates or other entities within its corporate structure with information about the distribution system, including operation and expansion, without offering the same information under the same terms and conditions, in the same form and manner, and contemporaneously to all licensed alternative electric suppliers.
- E. An electric utility or alternative electric supplier offering regulated service in Michigan shall not provide any information received from or as a result of doing business with a competitor to an affiliate or other entity within its corporate structure without the written approval of the competitor.

V. Electric Utility – Alternative Electric Supplier Relationship

Except for instances covered by Section 10a(3) of 2000 PA 141 or other instances approved by the Commission, an electric utility shall not in any way interfere in the business operations of an alternative electric supplier. This provision includes, but is not limited to, the following:

- A. An electric utility shall not give the appearance in any way that it speaks on behalf of any alternative electric supplier.
- B. An electric utility shall not interfere in any manner in the contractual relationship between the alternative electric supplier and its customers unless such involvement is clearly permitted in the contract between the customer and the alternative electric supplier or in tariffs approved by the Commission.

VI. Compliance Plans

Each electric utility or alternative electric supplier shall file a code of conduct compliance plan within 60 days of the order on rehearing on this code of conduct by the Commission. The compliance plan shall:

- A. Designate a corporate officer of the electric utility or alternative electric supplier who will oversee compliance with the code of conduct and be available to serve as the Commission's primary contact regarding compliance with the code.
- B. Include an affidavit signed by the designated corporate officer certifying that the electric utility or alternative electric supplier will comply fully with the code of conduct.
- C. Include a clear organization chart of the parent or holding company showing all regulated entities and affiliates and a description of all services and products provided between the regulated entity and its affiliates.

The electric utility or alternative electric supplier shall file revisions to its compliance plan needed to keep the information contained therein current.

In the compliance filing, the electric utility or alternative electric supplier may request a waiver from one or more provisions of this code of conduct. The electric utility or alternative electric supplier carries the burden of demonstrating that such a waiver will not inhibit the development or functioning of the competitive market.

VII. Oversight, Enforcement, and Penalties

- A. An electric utility or alternative electric supplier shall maintain documentation needed to investigate compliance with the code of conduct. All documentation shall be kept at a designated company office in Michigan. The electric utility or alternative electric supplier shall make this information available for review upon request by the Commission or its Staff. The designated officer will either be available or make personnel available who are knowledgeable to respond to inquiries by the Commission or its Staff regarding compliance with the provisions of the code of conduct.
- B. The electric utility or alternative electric supplier shall use a documented dispute resolution process separate from any process that might be available from the Commission. This dispute resolution process shall address complaints arising from application of the code of conduct. The electric utility or alternative electric supplier shall keep a log of all complaints, including: (1) the name of the person or entity filing the complaint, (2) the date the complaint was filed, (3) a written statement of the nature of the complaint, and (4) the results of the resolution process.
- C. Each electric utility or alternative electric supplier shall file an annual report with the commission summarizing the number and types of complaints received and their resolution.
- D. Penalties for violations of the code of conduct will be as provided in Section 10c of the Customer Choice and Electricity Reliability Act, MCL 460.10c.

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interests purchased in the Keystone and Conemaugh power plants on September 1, 2006.

The following table sets forth the MWh supplied to the electricity supply business segment customers.

Third Quarter	MWh Supplied (In Thousands)		
	2006	2005	Change
Retail			
Duquesne Light	1,803	1,860	(3.1%)
Total Retail	2,352	2,161	8.8%
Wholesale			
Duquesne Light	10	4	
Total Wholesale	82	4	

Operating expenses increased \$29.1 million, or 25.6%, compared to the third quarter of 2005. During the third quarter of 2006, purchased power expense included a net \$20.3 million increase over the same period in 2005 related to the change in fair value of certain derivative energy contracts and increased purchased power expense as a result of the increase in MWh supplied at current market rates. Operating expenses for the third quarter of 2006 also include \$1.5 million of fuel and other operating expenses incurred from the interests purchased in the Keystone and Conemaugh power plants on September 1, 2006.

Depreciation and amortization expense in the third quarter of 2006 represents the depreciation and amortization associated with the interests purchased in the Keystone and Conemaugh power plants discussed above.

Nine months ended September 30, 2006. The following table summarizes the income from this segment.

First Nine Months	Earnings (in Millions)	
	2006	2005
Operating revenues	\$227.2	\$193.3
Derivative energy contracts	(11.1)	13.1
Net Income	\$216.1	\$206.4

Operating revenues increased \$28.9 million, or 8.3% in the first nine months of 2006. There was a \$43.7 million increase in the revenue recognized by DLE and the \$2.5 million in wholesale revenue generated from the interests purchased in the power plants discussed above. These increases were partially offset by the \$16.4 million decrease in Duquesne Light's retail sales from the first nine months of 2005 as previously discussed.

The following table sets forth the MWh supplied to the electricity supply business segment customers.

MWh Supplied (In Thousands)

First Nine Months	2006	2005	Change
Retail			
Duquesne Light	4,730	5,391	(12.3%)
DLE	15	15	0%
Total Retail	6,076	6,030	0.8%
Wholesale			
Duquesne Light	48	47	2.1%
Total Wholesale	118	47	148.9%

Operating expenses increased \$54.2 million, or 18.0%, compared to the first nine months of 2005. During the first nine months of 2006, purchased power expense reflected a net \$41.5 million increase over the same period in 2005 related to the change in the fair value of certain derivative energy contracts and increased purchased power expense as a result of the increase in MWh supplied at current market rates. Operating expenses also include the \$1.5 million in fuel and other operating expenses incurred from the interests purchased in the power plants discussed above.

Energy Solutions Business Segment.

Three months ended September 30, 2006. This segment reported income of \$5.1 million in the third quarter of 2006, compared to \$19.1 million in the third quarter of 2005, a decrease of \$14.0 million, or 73.3%. This is primarily due to a 2005 after-tax gain of \$11.7 million on the sale of an investment in a energy facility management project and a \$3.4 million decrease in earnings from the management of synthetic fuel facilities.

Operating revenues decreased \$4.0 million, or 18.4%, compared to 2005. This was primarily due to a \$4.3 million decrease in revenue from the synthetic fuel facilities related to production and price concessions.

Other income decreased \$18.4 million, or 98.9%, compared to 2005 primarily as a result of the \$18

Duquesne Light Company and
DQE Communications Network Services LLC
Docket No. A-110150F0035 and A-311233F0002

STRATEGIC- I-3
Sponsor: John Howells
Page 1 of 1

**RESPONSES TO STRATEGIC ENERGY
INTERROGATORIES – SET I**

- 3 Please provide the total number of employees employed by the Duquesne Companies. Please provide a breakdown of the number employed by each affiliate or subsidiary company, specifically including the number employed by Duquesne Light Energy, Duquesne Light Company, Duquesne Power and DLH.

RESPONSE: See attached. Please also see response to Strategic I-4.

SECTION 2

PROFILES OF ACTIVE RETAILERS



Overview

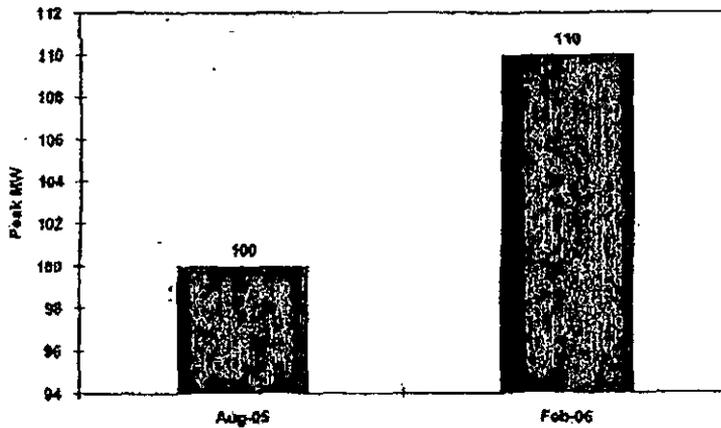
- Offices
 - Headquarters: [REDACTED]
 - Additional Offices: [REDACTED]
- Customers Targeted: commercial and industrial
- State(s) of Operation:
 - Electric: IL, MD

Market Share

- Non-Residential Peak Load: 110 MW¹⁷

Figure 2-5

[REDACTED] Non-Residential Peak MW Load, 2005-2006



¹⁷ Kema Estimate, Feb. 2006.

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interests purchased in the Keystone and Conemaugh power plants on September 1, 2006.

The following table sets forth the MWh supplied to the electricity supply business segment customers.

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Duquesne Light	10	4	
Total Wholesale	82	4	

Operating expenses increased \$29.1 million, or 25.6%, compared to the third quarter of 2005. During the third quarter of 2006, purchased power expense included a net \$20.3 million increase over the same period in 2005 related to the change in fair value of certain derivative energy contracts and increased purchased power expense as a result of the increase in MWh supplied at current market rates. Operating expenses for the third quarter of 2006 also include \$1.5 million of fuel and other operating expenses incurred from the interests purchased in the Keystone and Conemaugh power plants on September 1, 2006.

Depreciation and amortization expense in the third quarter of 2006 represents the depreciation and amortization associated with the interests purchased in the Keystone and Conemaugh power plants discussed above.

Nine months ended September 30, 2006. The following table summarizes the income from this segment.

First Nine Months	Earnings (In Millions)	
	2006	2005
Electricity Supply	\$22.7	\$15.6
Derivative energy contracts	(11.1)	13.1
Total	11.6	\$28.7

Operating revenues increased \$28.9 million, or 8.3% in the first nine months of 2006. There was a \$43.7 million increase in the revenue recognized by DLE and the \$2.5 million in wholesale revenue generated from the interests purchased in the power plants discussed above. These increases were partially offset by the \$16.4 million decrease in Duquesne Light's retail sales from the first nine months of 2005 as previously discussed.

The following table sets forth the MWh supplied to the electricity supply business segment customers.

MWh Supplied (In Thousands)

First Nine Months	2006	2005	Change
Total			
Duquesne Light	4,730	5,391	(12.3%)
Total Retail	6,076	6,030	0.8%
Wholesale			
Duquesne Light	46	47	
Total Wholesale	118	47	

Operating expenses increased \$54.2 million, or 18.0%, compared to the first nine months of 2005. During the first nine months of 2006, purchased power expense reflected a net \$41.5 million increase over the same period in 2005 related to the change in the fair value of certain derivative energy contracts and increased purchased power expense as a result of the increase in MWh supplied at current market rates. Operating expenses also include the \$1.5 million in fuel and other operating expenses incurred from the interests purchased in the power plants discussed above.

Energy Solutions Business Segment.

Three months ended September 30, 2006. This segment reported income of \$5.1 million in the third quarter of 2006, compared to \$19.1 million in the third quarter of 2005, a decrease of \$14.0 million, or 73.3%. This is primarily due to a 2005 after-tax gain of \$11.7 million on the sale of an investment in a energy facility management project and a \$3.4 million decrease in earnings from the management of synthetic fuel facilities.

Operating revenues decreased \$4.0 million, or 18.4%, compared to 2005. This was primarily due to a \$4.3 million decrease in revenue from the synthetic fuel facilities related to production and price concessions.

Other income decreased \$18.4 million, or 98.9%, compared to 2005 primarily as a result of the \$18

Duquesne Light Company and
DQE Communications Network Services LLC
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STRATEGIC- 1-4
Sponsor: Susan Betta
Page 1 of 2

**RESPONSES TO STRATEGIC ENERGY
INTERROGATORIES – SET I**

4. Please indicate the number of employees whose time, duties and/or responsibilities are shared between Duquesne Light Energy, and any other of the Duquesne Companies. For those employees whose time, duties and/or responsibilities are shared between Duquesne Light Energy and any other Duquesne Company, please provide a description of the role and function the employee serves for each Duquesne Company and an estimation of time allocated to each Duquesne Company.

RESPONSE:

The following page provides the number of employees whose time is shared between Duquesne Light Company (DLC) and Duquesne Light Energy (DLE), as only DLC and DLE employees provide services to DLE. In addition, it also shows additional budgeted charges that are allocated to DLE from DLC, including rent, finance charges, and information technology (IT) related charges.

For some individuals who do not perform a daily function that is directly related to an affiliate, but rather perform general oversight functions, they allocate their time out of DLC to the parent company, Duquesne Light Holdings (DLH). Those charges are captured at DLH, and have not typically been re-allocated to the various affiliates, such as DLE, but stay at the holding company level. Therefore there are additional employees who do provide minor amounts of services to DLE beyond what is shown in the attachment. Those charges to DLH are about \$925,000 for 2006.

	Duq. Light Energy	
	%	\$\$\$
Legal		
Director Legal	3%	5,190
Assistant General Counsel	5%	6,641
Assistant General Counsel	3%	4,486
Assistant General Counsel	3%	4,597
		20,915
Corporate Secretary		
Corporate Secretary	2%	3,435
Corporate Records Analyst	3%	2,266
Executive Assistant	1%	546
		6,247
Human Resources		
Director Human Resources	1%	1,897
Manager Human Resources	5%	5,914
		7,810
Finance		
Manager Tax Accounting	1%	669
Tax Specialist	1%	404
Lead Tax Coordinator	1%	501
Staff Accountant	5%	3,085
Coordinator, Accounts Payable	5%	3,016
Supervisor, Disbursements	3%	2,771
Payroll Analyst	10%	6,649
Manager, Disbursements	2%	2,265
Manager, Structured Finance	5%	6,515
Manager Treasury Operations	1%	1,522
Sr. Financial Consul	1%	966
Sr. Financial Consul	1%	980
Sr. Accountant	40%	27,420
Assistant Controller	5%	6,987
		63,752
Corporate Development		
Vice President Corporate Development	10%	34,034
Dir Corporate Development	70%	116,779
		150,813
Susidiary Charges		
IT		
Intel Server Analyst	0%	240
Enterprise Support Center Analyst	1%	1,064
Supplier & Regulatory Systems Support	3%	3,000
EDI Transaction Processing		500
Software Infrastructure		242
Hardware Infrastructure		340
Voice & Data (Ongoing Monthly Charge)		1,000
		6,386
Corporate Development		
Rent	20%	15,784
		15,784
Finance		
Mellon		2,170
Misc.		307
		2,477
Total		274,184

Duquesne Light Company and
DQE Communications Network Services LLC
Docket No. A-110150F0035 and A-311233F0002

STRATEGIC- 1-5
Sponsor: John Howells

**RESPONSES TO STRATEGIC ENERGY
INTERROGATORIES – SET I**

5. Please describe Duquesne Power's wholesale power supply procurement functions. Please indicate all DLH affiliate or subsidiary companies for which Duquesne Power performs any power procurement functions. Does Duquesne Power conduct wholesale power supply procurement for Duquesne Light Energy?

RESPONSE:

Duquesne Power has entered into a full requirements service agreement with Duquesne Light Company to serve POLR III supply at a fixed price. Duquesne Power is responsible for arranging for supply, scheduling the delivery of energy and managing the risk associated with POLR service.

Duquesne Power and Duquesne Light Energy have entered into a Master Power Purchase and Sale Agreement that governs wholesale power supply.

Duquesne Light Company and
DQE Communications Network Services LLC
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STRATEGIC- I-7
Sponsor: John Howells

**RESPONSES TO STRATEGIC ENERGY
INTERROGATORIES – SET I**

7. Please indicate whether DLH, Duquesne Power, or Duquesne Light Company perform any sales, marketing, forecasting, customer service, power procurement, or other support functions related to the provision of unregulated generation supply service to customers of Duquesne Light Energy. If yes, please provide a detailed description of the functions provided on behalf of Duquesne Light Energy.

RESPONSE:

Duquesne Light Energy does not receive sales, marketing, forecasting, customer service, or power procurement related to the provision of unregulated generation supply service from any of the Duquesne companies. Rather than have Duquesne Power act as an agent to procure power for Duquesne Light Energy, Duquesne Light Energy has a full requirements supply agreement with Duquesne Power to serve its customer load obligation. Duquesne Power manages this full requirements load obligation independent of Duquesne Light Energy. Other support functions are charged pursuant to the Administrative Services Agreement approved by the PUC. Please see response to Strategic I-4 for further detail on those charges.

Duquesne Light Company and
DQE Communications Network Services LLC
Docket No. A-110150F0035 and A-311233F0002

STRATEGIC- 1-6
Sponsor: John Howells

**RESPONSES TO STRATEGIC ENERGY
INTERROGATORIES – SET I**

6. Does Duquesne Light Energy receive any financial or credit support, such as letters of credit, loan guarantees, or other credit facilities, from any other Duquesne Company? Please document any financial or credit support given to Duquesne Light Energy by DLH, Duquesne Light Company, Duquesne Power or any other affiliate or subsidiary company.

RESPONSE:

Duquesne Light Holdings provides parent guarantees on behalf of Duquesne Light Energy in support of its membership in the PJM Regional Transmission Organization and also the Midwest Independent Transmission System Operator. No other credit support exists between Duquesne Light Energy and any of the other Duquesne companies.

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Duquesne Light Company :
for Approval of Default Service Plan : Docket No. P-00072247
for the Period January 1, 2008 :
through December 31, 2010 :

SE/RESA EXH. RH-2

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

SURREBUTTAL TESTIMONY OF
RICHARD J. HUDSON JR.

On Behalf of Strategic Energy, LLC and
The Retail Energy Supply Association

Application of Duquesne Light Company and DQE Communications Network
Services, LLC For Certificates of Public Convenience Under Section 1102(a)(3) of the
Public Utility Code Approving the Acquisition of Duquesne Light Holdings, Inc. by Merger

Docket Nos. A-110150F0035 and A-311233F3002

January 23, 2007

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND BUSINESS
2 RESPONSIBILITIES.

3 A. My name is Richard J. Hudson Jr. I am the Market Manager-Regulatory Affairs
4 for Strategic Energy, LLC ("Strategic" or "Strategic Energy"). My business
5 address is 2 Gateway Center, Pittsburgh, Pennsylvania, 15222. My
6 responsibilities include managing the regulatory activities of Strategic Energy in
7 the Commonwealth of Pennsylvania.

8 Q. ARE YOU THE SAME RICHARD HUDSON WHO PREVIOUSLY
9 SUBMITTED DIRECT TESTIMONY IN THIS MATTER ON BEHALF OF
10 STRATEGIC ENERGY AND THE RETAIL ENERGY SUPPLY
11 ASSOCIATION?

12 Yes.

13 Q. ON WHOSE BEHALF ARE YOU PROVIDING THIS SURREBUTTAL
14 TESTIMONY?

15 A. I am testifying again on behalf of Strategic Energy and RESA.¹

16 Q. WHAT IS THE PURPOSE OF YOUR SURREBUTTAL TESTIMONY?

17 A. In my surrebuttal testimony, I respond to the rebuttal testimony of Duquesne
18 Light Company/Macquarie Consortium ("Duquesne/Macquarie") witnesses Neil
19 S. Fisher, Morgan K. O'Brien, Christopher J. Leslie and Susan S. Betta.

20 Q. PLEASE SUMMARIZE YOUR DIRECT TESTIMONY SUBMITTED IN
21 THIS PROCEEDING.

22 A. In my direct testimony, I describe the concerns of Strategic and RESA that the
23 proposed acquisition is likely to result in anticompetitive effects that will prevent
24 retail electricity customers from obtaining the benefits of a properly functioning

¹ RESA member companies include Consolidated Edison Solutions, Inc.; Direct Energy Services, LLC; Hess Corporation; Reliant Energy Retail Services, LLC; Sempra Energy Solutions; Strategic Energy, LLC; SUEZ Energy Resources, NA, Inc.; and U.S. Energy Savings Corporation. The opinions expressed in this filing may not represent the views of all members of RESA.

1 and workable competitive retail electricity market. My direct testimony describes
2 three areas of concern: 1) the proposed transaction will facilitate or exacerbate
3 the direct or indirect subsidization of DLE by other Duquesne companies; 2) the
4 proposed transaction creates a stronger incentive for Duquesne to submit a POLR
5 IV plan that is not in the best interest of promoting a competitive market in the
6 Duquesne service territory; and 3) the proposed economic development rate
7 program, if not properly implemented in a competitively neutral fashion, may
8 frustrate competitive supplier's ability to compete for new industrial load in the
9 Duquesne service territory.

10 **I. RESPONSE TO REBUTTAL TESTIMONY OF NEIL S. FISHER**

11 **Q. WHAT IS YOUR RESPONSE TO MR. FISHER'S ARGUMENTS THAT**
12 **STRATEGIC'S AND RESA'S CLAIMS ARE UNSUPPORTED AND**
13 **BASED ON SPECULATION?**

14 **A.** Mr. Fisher's assessment that our claims regarding the potential cross-
15 subsidization of DLE are unsupported and without merit ignores the record
16 evidence and his own statements, which raise significant concerns regarding the
17 appropriateness of DLE's arrangements and relationships with other Duquesne
18 companies. In attempting to justify how DLE is able to operate as an electric
19 generation supplier ("EGS") and fulfill a substantial load obligation with as few as
20 five employees, Mr. Fisher admits that DLE outsources many of the functions it
21 needs to operate to other Duquesne companies.² Mr. Fisher states that "DLE is
22 provided legal and administrative services from other DLH companies" and that
23 "DLE outsources a significant portion of its supply portfolio management

² DLC St. No. 6R (Fisher) at 7, lines 2-5.

1 activities (including planning, procuring, scheduling, and hedging) and has
2 contracted with DP for full requirements supply.”

3 Mr. Fisher explicitly acknowledges that if other Duquesne companies did
4 not provide these functions for DLE, DLE would be “responsible for managing
5 these obligations and risks, and would require more in-house employees to do so.”
6 Admittedly, a retail supplier could legitimately operate by outsourcing many
7 portfolio management and other business functions to other parties. However, as
8 discussed in more detail in my response to Ms. Betta’s testimony, the fact that
9 DLE appears to be outsourcing every essential business operation and function
10 (except for sales and marketing) to an affiliate raises a very reasonable concern as
11 to whether DLE is actually compensating its affiliates for the true market value of
12 the services and the benefits it receives.³ Under Duquesne’s view, compensation
13 is a loose term. As shown below, Ms. Betta attempts to show that DLE is not
14 subsidized by its affiliates, but she sets forth no evidence of “true” compensation
15 for the value of such services, employees and benefits, focusing entirely on “costs
16 incurred” rather than more expansively examining whether DLE receives indirect
17 or implicit benefits from its affiliate relationships.

18 Finally, I must point out that Mr. Fisher’s argument is replete with
19 statements about what is “possible” that DLE does or what DLE “could” be doing

³ As discussed later in my response to Ms. Betta’s rebuttal testimony, Duquesne appears to have a history of affiliate cost allocation issues and, although it currently has affiliate cost allocation procedures in place, there appears to be no mechanism to account for the indirect benefits that DLE receives from the services provided by other affiliates, such as Duquesne Power.

1 to justify how DLE operates with only five employees.⁴ Such conjecture provides
2 no support for Mr. Fisher's argument.

3 **Q. PLEASE RESPOND TO MR. FISHER'S STATEMENT THAT "DLE**
4 **RECEIVES NO UNFAIR ADVANTAGE BECAUSE DP PROVIDES POLR**
5 **SUPPLY TO DUQUESNE."**

6 **A.** In my direct testimony I pointed out that because Duquesne Power manages
7 DLE's load obligations along with DLC's POLR load, DLE benefits from
8 economies of scale and other efficiencies achieved by Duquesne Power's
9 combining DLE's load with DLC's POLR load. Mr. Fisher's criticism of my
10 testimony on this point shows that he appears to have misunderstood my
11 statements. Mr. Fisher also appears to ignore the obligations with respect to
12 affiliate relationships imposed by the Public Utility Code on Duquesne as a public
13 utility, and the scope of the PUC's merger review authority, as both have been
14 explained to me by counsel.

15 I agree with Mr. Fisher that many wholesale suppliers, not just Duquesne
16 Power, achieve economies of scale and scope, and that DLE's competitors are
17 free to contract with wholesale suppliers that may have built economies of scale
18 and scope through existing supply arrangements. However, no other entity in the
19 Duquesne market is able to achieve the same or similar economies of scale for
20 power delivered into *the Duquesne service territory*. DLC's POLR load makes
21 up 53% of the total load within Duquesne's service territory.⁵ Including DLE's
22 load notably increases the Duquesne companies' market share. Thus, because of

⁴ DLC St No. 6R (Fisher) at 7, lines 15-22.

⁵ Based on the Pennsylvania Office of Consumer Advocates recent publication of customer shopping statistics available at:
<http://www.oca.state.pa.us/Industry/Electric/elecstats/Stat0107.pdf>

1 its affiliate relationship with the dominant generation service provider in the
2 control area (DLC), DLE obtains significant advantages - advantages that are not
3 available to any of DLE's competitors. This clearly sets apart the DLE affiliate
4 relationship from any other participant in the Duquesne market.

5 Furthermore, there are other areas in which DLE may receive an
6 advantage due to Duquesne Power's joint management of its load with DLC's
7 POLR load. As discussed in more detail in my responses to Ms. Betta's
8 testimony, it is likely that DLE essentially receives a "free ride" with respect to
9 power procurement functions that are likely paid for through DLC's POLR rates
10 and/or distribution rates.

11 Mr. Fisher's assumption that DLE could not possibly be subsidized
12 through the DP/DLC full requirements POLR supply contract developed in 2003
13 because "DLE did not even exist" in 2003 belies full knowledge of DLE's history.
14 The Commission's records establish that: 1) DLE, then named "ValuSource
15 Energy Services, LLC," was licensed by the PUC on September 13, 2000 at
16 Docket No. A-110142; 2) ValuSource was wholly-owned by Monongahela Light
17 & Power Company, which in turn was wholly-owned by DLC; 3) ValuSource on
18 June 30, 2004, prior to the Commission's POLR III Order on August 2004,
19 requested that the name on its license be changed to "Duquesne Light Energy,
20 LLC"; and 4) the PUC approved that request by Secretarial Letter dated
21 September 2, 2004. A copy of this Secretarial Letter is attached.⁶

⁶ SE/RESA Exhibit RH-11.

1 Even if no DLE-related costs were considered in the development of the
2 DP/Duquesne POLR supply contract, this does not mean that DP is not
3 subsidizing DLE. As noted in my response to Ms. Betta's testimony, all of DP's
4 upfront costs for power procurement and portfolio management functions may be
5 recovered through DLC's POLR rates, and DLEs use of these services is provide
6 for free.

7 And, while FERC did grant a waiver to DP of the prohibition on sales to
8 affiliates as Ms. Betta states, in that proceeding Duquesne told FERC that the
9 affiliate sale "is not actually a sale but a corporate structure designed to insulate
10 [DLC's retail] ratepayers from the risks undertaken by Duquesne Power."⁷
11 Because DP is providing supply to DLE under the same type of full requirements
12 contract as with DLC, DLE is also insulated from bearing the full risk and
13 associated costs of meeting its load obligation.

14 Finally, Mr. Fisher's argument that other suppliers may achieve similar
15 economies of scale, wholly ignores the fact that the Public Utility Code
16 limitations on DLC's conduct and relationships with its affiliates due to its
17 monopoly retail position are not at all applicable to non-public utilities such as
18 Strategic Energy (and its affiliates) or other RESA members and their affiliates
19 operating in Pennsylvania.

20 **Q. WHAT IS YOUR RESPONSE TO MR. FISHER'S ARGUMENT THAT**
21 **DLE HAS NO COMPETITIVE ADVANTAGE DUE TO CREDIT**
22 **SUPPORT IT RECEIVES?**

⁷ FERC Order Authorizing Disposition of Jurisdictional Facilities and Accepting Market Based Rate Tariff, Docket No. EC04-36-000, August 6, 2004 ("FERC 8/04 Order"), ¶ 34.

1 A. Mr. Fisher goes to great lengths to try to demonstrate that other competitive
2 suppliers also receive credit support from their parent companies. Mr. Fisher
3 even notes that Strategic receives support from its parent, Great Plains Energy.
4 However, Mr. Fisher wholly ignores record evidence that indicates that Strategic
5 compensates its parent for the credits support it receives.⁸ As noted in RESA's
6 responses to Duquesne's interrogatories to RESA in this proceeding, Strategic:

7 "In addition to an annual capacity payment to cover the maximum amount
8 of credit support available, Strategic Energy reimburses GPE for all of the
9 direct costs related to credit instruments issued by third parties for
10 Strategic Energy."
11

12 Currently there is no record evidence to demonstrate that DLE compensates DLH
13 for the direct credit support it receives or for the value of the credit support
14 provided for Duquesne Power that ultimately supports DLE's load service
15 obligations.⁹ This value includes relieving DLE of the need to post credit to
16 counter-parties. Moreover, Mr. Fisher's comparison of the credit support received
17 by competitive suppliers with parent companies in other service territories to the
18 credit support received by DLE for its operations in its public utility affiliate's
19 monopoly service territory is an apples-to-oranges comparison. This is an attempt
20 to turn the scrutiny away from the true conduct at issue, and it ignores the fact
21 that, as stated above, Duquesne and its affiliates are subject to different

⁸ See, SE/RESA Exhibit RH-3 (Surrebuttal Testimony of R. Carrier from Docket No. R-00061346) attached to my direct testimony.

⁹ Ms. Betta's rebuttal testimony states: "A portion of the fees associated with DLH's revolving credit agreement is allocated to the affiliates, who benefit from its availability." DLC St. No. 5R at 7, lines 17-18. Notably absent from Ms. Betta's testimony are any statements explicitly indicating that DLE compensates DLH or its affiliates for the credit support it receives, or for the value of the credit support provided to Duquesne Power that ultimately supports DLE's load obligation.

1 requirements in Duquesne's service territory than is Strategic, or other retail
2 suppliers, who do not have the dominant market share and is not serving in its
3 public utility affiliate's territory.

4 **Q. PLEASE RESPOND TO MR. FISHER'S ARGUMENT THAT THE**
5 **POTENTIAL ANTICOMPETITIVE EFFECTS DISCUSSED IN THE**
6 **STRATEGIC/RESA DIRECT TESTIMONY ARE UNRELATED TO THIS**
7 **PROCEEDING.**

8 **A.** Mr. Fisher essentially argues that the issues presented in my direct testimony
9 regarding the exploitation of the Duquesne companies' cross-subsidization of
10 DLE, and Duquesne/Macquarie's incentive (and apparent intention) to propose an
11 anticompetitive POLR plan, should not be addressed in this proceeding because
12 such anticompetitive effects would exist regardless of the proposed merger.

13 First, Mr. Fisher ignores the fact that Duquesne/Macquarie will have a
14 significant incentive to maximize profits from all possible sources, including
15 Duquesne's generation services, in order to seek to enhance Macquarie's
16 substantial investment in Duquesne.

17 Second, the issues discussed in my direct testimony are entirely relevant to
18 this proceeding. As discussed in my direct testimony, I understand that under
19 Electric Competition Act, the Commission must find that a merger proposal must
20 not result in anticompetitive effects that will prevent retail electricity customers
21 from obtaining the benefits of a properly functioning and workable competitive
22 retail electricity market. Even under Mr. Fisher's assessment that any
23 anticompetitive effects would exist regardless of the approval of the merger, the
24 fact remains that if DLE is being subsidized by its affiliates and
25 Duquesne/Macquarie intends to submit an anticompetitive POLR plan, the

1 proposed merger transaction is predicated either intentionally or unintentionally
2 on the existence and/or persistence of these anticompetitive effects. Even if
3 Duquesne intended to continue these anticompetitive effects regardless of the
4 merger, the merger provides even more incentive for Duquesne to do so because it
5 now must produce the returns built into the acquisition price and expected by
6 Macquarie.

7 Third, even assuming *arguendo* that Mr. Fisher is correct that the issues
8 presented in my direct testimony are entirely unrelated to this proceeding, it is
9 very surprising that Mr. Fisher would suggest that the Commission turn a blind
10 eye to such anticompetitive behavior merely for procedural correctness. The
11 arguments of all the other Duquesne witnesses is that, without this transaction,
12 Duquesne is likely to be a very different company in future years.¹⁰ This
13 transaction that preserves present anti-competitive activities plainly deserves
14 careful review under the PUC's merger review authority, in my opinion.

15 **II. RESPONSE TO REBUTTAL TESTIMONY OF SUSAN S. BETTA**

16
17 **Q. DO YOU AGREE WITH MS. BETTA'S ASSERTION THAT THE**
18 **DUQUESNE COMPANIES PROPERLY ALLOCATE COSTS?**

19 **A.** No. Ms. Betta's testimony essentially argues that because Duquesne has procedures
20 in place to allocate costs among the various Duquesne companies, then there must
21 not be any inappropriate cost allocation occurring. In fact, there are several ways
22 in which Duquesne is likely not accurately allocating to DLE the costs and/or fair

¹⁰ See, e.g., DLC St. No. 1R (O'Brien) at 7, lines 9-23; 8, lines 12-24; 9, lines 15-21.

1 market value of the services and benefits provided to it by other Duquesne
2 companies.

3 It appears that DLE does not compensate its affiliates for all of the costs
4 and/or full market value of the credit support, portfolio management, power
5 procurement, and other business functions provided by other Duquesne
6 companies. Based on Ms. Betta's testimony it appears to be Duquesne's policy to
7 allocate costs out to an affiliate only when there is an incremental or specifically
8 incurred cost associated with the provision of service for an affiliate. Specifically
9 with respect to credit support, Ms. Betta states that Duquesne does not allocate
10 costs to affiliates for the use of parental guarantees because, "since there is no
11 specifically incurred cost related to the issuance of this guarantee, no cost
12 allocation is appropriate."¹¹ Yet Ms. Betta does not deny my testimony that there
13 is clearly a value and benefit to DLE associated with such guarantees, and her
14 statement ignores the real cost in such guarantees – the opportunity cost of tying
15 up the capital required to post the parental guarantee.

16 There is a similar concern with respect to credit support provided for
17 Duquesne Power that ultimately supports DLE's load service obligations. Ms.
18 Betta's testimony indicates that costs associated with the issuance of letters of
19 credit and surety bonds, as well as a portion of the cost of DLH's revolving credit
20 facility, are allocated to affiliates that receive this credit support. However, this
21 allocation procedure most likely does not allocate costs for credit support to
22 affiliates, like DLE, that indirectly benefit from such credit support.

¹¹ DLC St. No. 5R (Betta) at 7, lines 17-20.

1 There is also a similar concern for the costs associated with the power
2 procurement and portfolio management functions that Duquesne Power performs
3 for both DLC and DLE. First, it is important to note that since Duquesne Power
4 only has two (2) employees itself, it is unclear who actually performs the portfolio
5 management activities (scheduling, hedging, forecasting, etc.,) that it does for
6 DLE and DLC. As most employees in the Duquesne companies are within DLC,
7 it appears that DLC employees perform these functions. However, it is evident
8 that, no matter which Duquesne company actually performs these functions, these
9 functions are done jointly for both DLE and DLC. It is likely that DLC's POLR
10 rates cover all of the upfront costs of Duquesne Power's provision or arrangement
11 of these power procurement functions because DLE is not allocated any portion of
12 these power procurement costs. As Duquesne Power only has two employees, it
13 is highly unlikely that it is performing all of these functions itself.

14 Duquesne Power may be outsourcing these functions to a wholesale
15 counterparty, to DLC, or to another entity, but because Duquesne Power's full
16 requirements agreement for DLC's POLR load was established *prior* to DLE's
17 agreement with Duquesne Power, it is likely that all of the costs associated with
18 the provision of these portfolio management services are recovered through
19 DLC's POLR rates.¹² While there may be no incremental cost incurred by
20 Duquesne Power to also provide these power procurement functions for DLE's

¹² If these power procurement services are ultimately being performed by DLC employees, then DLC's distribution rates are recovering the costs of (and unlawfully subsidizing) DLE's portfolio management functions.

1 load, there are very real benefits and value to DLE by the provision of these
2 services for DLE, as explained above.

3 As discussed above, DLE outsources a substantial amount of its business
4 functions to its affiliates. If DLE were outsourcing power procurement and other
5 business functions to a non-affiliate, there would be less concern because a non-
6 affiliate has the appropriate business incentive to price those services, functions
7 and benefits at their true market value. As noted in my direct testimony and not
8 rebutted by the Duquesne witnesses, there exists an inherent profit maximization
9 motive than can lead to direct or indirect cross-subsidization and/or cost shifting
10 between regulated utilities and their unregulated marketing affiliates.¹³ It is not
11 Strategic's or RESA's position that affiliate transactions necessarily result in
12 cross-subsidies. However, in this situation, where DLE's affiliates perform
13 essentially all necessary business functions for DLE's service in DLC's service
14 territory (except for sales and marketing), there are substantially more
15 opportunities and incentives for inappropriate cross-subsidies and affiliate
16 arrangements to occur.

17 **Q. DO THE FERC AND PA PUC AUDITS SUPPORT MS. BETTA'S**
18 **CONCLUSION THAT FERC AND THE PA PUC FOUND NO**
19 **INSTANCES OF CROSS-SUBSIDIZATION WITH RESPECT TO RETAIL**
20 **COMPETITION?**

21 **A.** No. The FERC audit cannot be verified because the final audit report is not
22 available but, regardless, as explained below, FERC's cross-subsidization inquiry
23 is narrowly focused and does not address the effects of cross-subsidization on

¹³ "An economic analysis of marketing affiliates in a deregulated electric power industry" by Jason Abel for the National Regulatory Research Institute; this document is available at: <http://www.nrri.ohio-state.edu/dspace/bitstream/2068/565/1/98-07.pdf>.

1 retail competition. According to FERC's August 2004 order granting DP market
2 based rate authority, FERC has allowed sales by a power marketer to its affiliated
3 public utility (and has waived code of conduct requirements) when there are no
4 captive wholesale customers and when retail ratepayers are protected by a rate
5 freeze or the availability of retail choice.¹⁴ And, as FERC stated in its December
6 2006 order authorizing the merger (and as I note below), whether retail customers
7 are actually protected by the availability of retail choice is an issue for the
8 respective state commission.

9 The PUC audit is not an effective evaluation of DLH's current affiliate
10 relationships. Most of the information reviewed in the audit is for earlier periods
11 before (even as DLC's witnesses state) DLE had significant operations.
12 Therefore the PUC could not possibly have reached any conclusions regarding the
13 cross-subsidization and affiliate relationship concerns presented in my direct
14 testimony. Also, DLH's corporate family has changed dramatically since then, as
15 the description of the Duquesne companies in the FERC orders referenced by
16 DLC demonstrates.¹⁵ Even in the report, the audit noted serious concerns
17 regarding DLC's affiliate relationships – "Affiliate Relationships" are rated as
18 "Significant Improvement Necessary." And currently Ms. Betta's rebuttal

¹⁴ FERC 8/04 Order, ¶ 39. I also note that in this order, FERC expressed increased concern with the potential adverse impact affiliate transactions may have on wholesale customers and wholesale competition, and FERC initiated a generic rulemaking to address these concerns. *Id.*, ¶ 41.

¹⁵ For example, in the August 2004 FERC Order granting market based rate authority to Duquesne Power, the Sunbury generation station is owned by Duquesne Power: FERC 8/04 Order, ¶s 18, 34. In FERC's December 2006 Order authorizing the Duquesne Macquarie merger, the Sunbury generation station is owned by Duquesne Keystone, LLC, which is owned by Duquesne Generation Company. FERC Order Authorizing Merger, Docket No. EC06-160-000 ("FERC 12/06 Order"), ¶s 1 n. 1; 2 n. 8; 3.

1 testimony admits there are problems with Duquesne's present cost allocation
2 methods.

3 The FERC approval of the merger contemplates PA PUC review of these
4 issues in this proceeding because FERC essentially deferred to the PUC on cross-
5 subsidy issues. FERC's order noted that the PA PUC has the authority to approve
6 mergers and review cross-subsidization and affiliate abuse concerns, and that any
7 ratepayer protections FERC would impose would "complement, and not nullify,
8 those imposed by state commissions." FERC's order essentially deferred the
9 issue to the PA PUC because Pennsylvania is a retail choice state and there are no
10 captive (as defined by FERC) retail customers for FERC to protect from affiliate
11 abuse concerns. In rejecting the argument that Duquesne's Retail customers are
12 effectually "captive" and therefore at high risk for cross-subsidization abuses,
13 FERC expressly stated that "it is not the role of this Commission to evaluate the
14 success or failure of a state's retail choice program."¹⁶ Therefore, it is clear that
15 FERC deferred to the PA PUC's authority on this issue.

16 **Q. WHAT IS YOUR RESPONSE TO THE RECOMMENDATIONS OF MS.**
17 **BETTA AND MR. FISHER THAT THERE ARE NO AFFILIATE ABUSE**
18 **OR CROSS- SUBSIDIZATION ISSUES TO ADDRESS IN THIS CASE?**

19 **A.** I disagree, as explained above, and recommend that to provide a level playing
20 field for Duquesne's competitors to enable them to provide Duquesne's retail
21 customers with the benefits of a properly functioning and workable competitive
22 retail electricity market, we recommend that the Commission initiate an
23 investigation into the relationships between and among the Duquesne companies

¹⁶ FERC 12/06 Order, ¶ 38.

1 to determine the extent to which DLE's unregulated operations are being
2 supported, either directly or indirectly, by other Duquesne companies, and in
3 particular DLC and DP. The Commission should condition its approval of the
4 proposed merger on the outcome of this investigation. Once these issues have
5 been thoroughly evaluated, the Commission should choose from the following
6 remedies: (i) requiring the structural and/or functional separation of DLE's
7 operations from the other Duquesne companies; (ii) implementing stricter Code of
8 Conduct rules; and (iii) requiring that DLE be barred from transacting with its
9 affiliates, including Duquesne Power, for its wholesale power procurement.

10 **III. RESPONSE TO REBUTTAL TESTIMONY OF CHRISTOPHER J.**
11 **LESLIE**

12
13 **Q. PLEASE SUMMARIZE MR. LESLIE'S RESPONSE TO YOUR**
14 **TESTIMONY.**

15 **A.** Mr. Leslie, who is an executive of the Macquarie Group, claims that because
16 Duquesne/Macquarie is allegedly not anticipating increased profits from
17 Duquesne's POLR service or DLE in the next few years, RESA's concerns are
18 unfounded. Mr. Leslie did not understand my testimony. I pointed out that
19 because the new Duquesne/Macquarie entity will have a need to try to realize a
20 new, higher required return on its investment in order to make the transaction a
21 success (in light of Macquarie's above book value purchase price), it will have an
22 incentive to use its existing retail generation market power to increase its market
23 share or profitability in the generation market.

24 Mr. Leslie has not presented any information that would relieve me of that
25 concern. First, Macquarie's projections for POLR and DLE revenues may be
26 higher than that which Duquesne would have realized without the merger, even if

1 they are lower than present levels, due to a Macquarie direction to Duquesne to
2 exploit its dominant market position. Second, while Macquarie has not projected
3 increased revenues from Duquesne's generation services, after it takes control of
4 the Company its continuing need to meet its income targets could give it the
5 incentive to consider ways to maintain or grow its profits from this part of
6 Duquesne's business, including the exploitation of Duquesne's dominant retail
7 generation market position and control of bottleneck facilities to expand its
8 market share.

9 Finally, the use of anticompetitive behavior does not necessarily have to
10 produce business growth or profit. Indeed, some techniques (such as pricing
11 below true cost) could reduce profits in the short-term – but eliminate competitors
12 and increase profitability of the dominant firm in the longer term. This is
13 precisely why Mr. Leslie's statements of assurance, based upon Macquarie's
14 revenue projections for the next 3-4 years, is not particularly relevant to the
15 Commission's inquiry. Since the merger is proposed for the long-term, the
16 Commission's inquiry should also look to the longer term potential
17 anticompetitive effects.

18 **IV. RESPONSE TO REBUTTAL TESTIMONY OF MORGAN K. O'BRIEN**

19 **Q. DO YOU SUPPORT MR. O'BRIEN'S COMMITMENT THAT THE**
20 **ECONOMIC DEVELOPMENT PROGRAM WILL BE IMPLEMENTED**
21 **IN A COMPETITIVELY NEUTRAL MANNER?**

22 **A. Yes. Strategic and RESA are very encouraged by Mr. O'Brien's commitment that**
23 **the economic development program be implemented in a competitively neutral**

1 manner and that participation in the program will not be conditioned on
2 customer's purchase of energy from Duquesne or DLE.

3 **Q. DO YOU HAVE ANY RECOMMENDATIONS AS TO HOW THE**
4 **PROGRAM COULD BE IMPLEMENTED N A COMPETITIVELY**
5 **NEUTRAL MANNER?**

6 A. Yes. As noted in my direct testimony, one very simple way to make the
7 economic development program competitively neutral would be for Duquesne to
8 offer the discount on eligible customers' distribution rates or for Duquesne to sell
9 its 50 MW block of power reserved for the program on the open market and use
10 the proceeds to provide the rebates to eligible customers.

11 **Q. DOES THIS CONCLUDE YOUR SURREBUTTAL TESTIMONY?**

12 A. Yes.



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

SEPTEMBER 2, 2004

A-110142

MARTIN L RYAN
DUQUESNE LIGHT ENERGY LLC
MAIL DROP 8-2
411 7TH AVENUE
PITTSBURGH PA 15219

Re: Electric Generation Supplier Services License A-110142

Dear Mr. Ryan:

On September 13, 2000, the Commission issued a license at Docket No. A-110142, authorizing ValuSource Energy Services, LLC the right to begin to offer, render, furnish, or supply electric generation supplier services to commercial, industrial and governmental customers within the Commonwealth of Pennsylvania.

On June 30, 2004, ValuSource Energy Services, LLC filed a request that the Commission change the name on its license to provide electric generation supplier services from ValuSource Energy Services, LLC to Duquesne Light Energy, LLC.

Duquesne Light Energy, LLC has provided proper documentation as required by this Commission.

Therefore, the Commission approves, by this Secretarial Letter, the change of ValuSource Energy Services, LLC's name on its license for the provision of electric generation supplier services to commercial, industrial and governmental customers within the Commonwealth of Pennsylvania at Docket No. A-110142 to Duquesne Light Energy, LLC.

Sincerely,

James J. McNulty
Secretary

LICENSE ENCLOSED

cc: Kerry Klinefelter, Bureau of Fixed Utility Services
Scott Rhodes, Secretary's Bureau

APR 26 2007

HBJ

BEFORE THE
PENNSYLVANIA PUBLIC UTILITY COMMISSION

Petition of Duquesne Light Company :
for Approval of Default Service Plan :
for the Period January 1, 2008 :
through December 31, 2010 :

Docket No. P-00072247

SURREBUTTAL TESTIMONY OF
RICHARD J. HUDSON JR.

RECEIVED
MAY - 3 2007
PUBLIC UTILITY COMMISSION
SECRETARY'S BUREAU

On Behalf of

Strategic Energy, LLC

and

the Retail Energy Supply Association

DOCUMENT
FOLDER

April 20, 2007

DOCKETED
MAY 08 2007

1 Q. PLEASE STATE YOUR NAME, BUSINESS ADDRESS AND BUSINESS
2 RESPONSIBILITIES.

3 A. My name is Richard J. Hudson Jr. I am the Market Manager-Regulatory Affairs
4 for Strategic Energy, LLC ("Strategic" or "Strategic Energy"). My business
5 address is 2 Gateway Center, Pittsburgh, Pennsylvania, 15222. My
6 responsibilities include managing the regulatory activities of Strategic Energy in
7 the Commonwealth of Pennsylvania.

8 Q. DID YOU SUBMIT TESTIMONY IN THIS PROCEEDING?

9 A. Yes, I submitted direct testimony on behalf of Strategic Energy and the Retail
10 Energy Supply Association ("RESA").¹

11 Q. WHAT IS THE PURPOSE OF THIS SURREBUTTAL TESTIMONY?

12 A. The purpose of my testimony is to respond to the arguments presented in
13 Duquesne's and other parties' rebuttal testimony. More specifically, I respond to
14 the testimony of Duquesne witness Susan Betta concerning Duquesne's cost
15 allocation procedures and the likelihood that the Duquesne companies are
16 inappropriately cross-subsidizing the unregulated operations of Duquesne Light
17 Energy ("DLE"). I also point out that Reliant witness Jim Ajello agrees that there
18 needs to be a more thorough review of affiliate relationships, such as those at
19 issue with the Duquesne companies. I also respond to the testimony of Duquesne
20 witness Neil Fisher and OSBA witness Brian Kalcic concerning Duquesne's
21 proposed default service pricing structure for small C&I customers.

¹ RESA's members include Consolidated Edison Solutions, Inc; Direct Energy Services, LLC; Hess Corporation; Reliant Energy Retail Services, LLC; Sempra Energy Solutions; Strategic Energy, LLC; SUEZ Energy Resources NA, Inc. and US Energy Savings Corp. The opinions expressed in this filing represent the position of RESA as an organization but may not represent the view of all members of RESA. In addition, Reliant Energy Retail Services, LLC, is not participating as part of RESA in this proceeding.

1 Q. ON WHOSE BEHALF ARE YOU TESTIFYING IN THIS PROCEEDING?

2 A. As with my direct testimony, Part I of my surrebuttal testimony below is
3 submitted on behalf of Strategic Energy and the RESA. Part II of my testimony is
4 submitted on behalf of Strategic Energy only.

5 **PART I**

6 **(ON BEHALF OF STRATEGIC ENERGY AND RESA)**

7
8 Q. **IN HER REBUTTAL TESTIMONY, MS. BETTA CONTINUES TO**
9 **ASSERT THAT THE COMMISSION'S AND FERC'S AUDIT REPORTS**
10 **PROVE THAT DUQUESNE'S COST ALLOCATIONS ARE**
11 **APPROPRIATE. WHAT IS YOUR RESPONSE?**

12 A. Despite the fact that the PA PUC's audit focused on a period of time before DLE
13 began actively marketing in late 2004 and thus cannot represent an accurate
14 review of Duquesne's affiliate relationships, Ms. Betta's testimony continues to
15 state that the PA PUC has found that Duquesne's cost allocations are appropriate,
16 even with respect to DLE. The fact that the PA PUC auditors conducted
17 fieldwork in 2004 and 2005 does not alter the fact that the primary focus of the
18 audit was the 1999-2003. In fact, on pages 2-3 the audit report clearly states that
19 the focus of the review was for the 1999-2003 period, and documents and
20 information for more recent years were only considered as those documents were
21 available.² Furthermore, Ms. Betta's assertions that the audit found that
22 Duquesne's affiliate cost allocation arrangements were appropriate is incorrect.
23 The audit report found noted serious concerns regarding DLC's affiliate

² For example, DLE is not included in the description of the Duquesne companies ("Background", p.9), is not shown on the Duquesne Light Holdings, Inc. "Corporate Entity Chart" exhibit (p.11), and is not listed in the Duquesne Light Company "Affiliated Interest Income and Expense" exhibit.

1 relationships – "Affiliate Relationships" are rated as "Significant Improvement
2 Necessary" in the report (p.4).

3 Ms. Betta also relies on a FERC draft report to support the claims that Duquesne's
4 affiliate relationships are appropriate. However, this FERC report still has not
5 been made available to the parties, even in draft form, despite attempts to obtain a
6 copy through formal discovery.

7 **Q. DOES MS. BETTA'S TESTIMONY CONFIRM YOUR ALLEGATIONS**
8 **THAT OTHER DUQUESNE COMPANIES PROVIDE ESSENTIALLY**
9 **EVERY BUSINESS AND OPERATIONAL FUNCTION FOR DLE?**

10 A. Yes. Ms. Betta admits that during 2005 and 2006 Duquesne Power managed, or
11 otherwise provided for, a significant portion of DLE's supply portfolio
12 management activities, and she admits that "without these arrangements, DLE
13 would be responsible for actively managing these obligations and risks, and
14 would likely require more in-house employees to do so."³

15 **Q. DO YOU AGREE WITH MS. BETTA'S ASSERTION THAT DLE FULLY**
16 **COMPENSATES ITS AFFILIATES FOR THE SERVICES IT RECEIVES?**

17 A. No. As record evidence demonstrates, Duquesne's allocation procedures are
18 arbitrary and provide no account for the fair market value of the services and
19 support that DLE receives. For example, in an interrogatory response from the
20 merger case,⁴ DLE is shown to have benefited from the services of fourteen (14)
21 of Duquesne Light's finance, tax, and accounting employees. However, this

³ Betta rebuttal at p. 6.

⁴ DLC Response to Strategic Energy Set I, Question 4, included in my direct testimony exhibit in this case, SE/RESA Exh.RH-1 (see SE/RESA Exhibit RH-8 to R. Hudson direct testimony (Public Version) in A-110150F0035, A-311233F3002 (SE/RESA St. No. 1)).

1 interrogatory response shows that DLE is only allocated a total of \$63,752 for
2 these finance related services. Even assuming that DLE, if it operated
3 independently from its affiliates, needed only one finance or accounting
4 professional to handle its finance and accounting activities, it would likely cost
5 more than the \$63,752 that was allocated.⁵ Similarly, record evidence shows that
6 DLE was only allocated a total of \$25,894 in 2006 for costs associated with DLH
7 employees' salaries and benefits and directors' fees and compensation.⁶

8 According to Ms. Betta's testimony in the merger case, this allocation includes
9 the costs of Duquesne's *executive management* and employees such as herself,
10 who provide general oversight functions for the Duquesne companies, including
11 DLE. According to Exhibit SSB-1R, this allocation is based on a percentage of
12 total assets and has no relation to the amount of time is spent providing services
13 or oversight functions for a specific affiliate. Nor does this allocation take into
14 account the fair market value of the services provided to DLE. I find it difficult to
15 believe that \$25,894 would even cover the cost associated with Ms. Betta's cost
16 allocation review and related testimony for this proceeding and the merger
17 proceeding, if DLE had paid for Ms. Betta's services as a consultant.

18 Furthermore, based on record evidence it appears that DLE was allocated \$26,252
19 in rent charges for 2006.⁷ Record evidence also shows that DLE has 3,136 square

⁵ Information from www.salary.com shows that the average salary for a senior level finance professional in Pittsburgh is between approximately \$99,000 to \$125,000, not including benefits.

⁶ Betta rebuttal, Exhibit SSB-1R.

⁷ DLC Response to Strategic Energy Set I, Question 4 from the merger proceeding (see footnote 3 above) shows a rent allocation to DLE of \$15,784. Ms. Betta's testimony (Exhibit SSB-2R) in this proceeding shows an additional allocation of \$10,468 in charges

1 feet of office space at Duquesne's headquarters in downtown Pittsburgh. Based
2 on an average rent cost of \$21.46 per square foot⁸ for the central business district
3 in downtown Pittsburgh, the annual cost of the office space that DLE occupies
4 should be at least \$67,299, and this number does not even take into account any
5 additional rent allocation for Duquesne Light employees whose time is spent
6 providing services to DLE.

7 In yet another example, Ms. Betta's testimony in this proceeding notes that DLE
8 was allocated \$62.84 for the cost of office supplies and other miscellaneous
9 expenses that Duquesne Light employees use in providing services for an affiliate.
10 As Ms. Betta admits and record evidence demonstrates, Duquesne Light provides
11 substantial administrative and business support for DLE. I find it difficult to
12 believe that Duquesne Light employees only use a total of \$62.84 worth of office
13 supplies in carrying out these functions – this amount would not even cover a
14 single cartridge of copier toner.

15 **Q. WHAT DO YOU CONCLUDE FROM THE ABOVE EXAMPLES?**

16 **A.** While Duquesne may have cost allocation procedures in place, these cost
17 allocation arrangements are arbitrary and do not account for the true cost and/or
18 fair market value for the services that other Duquesne companies, especially
19 Duquesne Light, provide for DLE. Consequently, it is highly likely that DLE's

to cover rent expense related to DLC employees whose time is allocated to providing
services for DLE.

⁸ According to statistics reported by the Pittsburgh Regional Alliance,
www.pittsburghregion.org.

1 unregulated operations are being subsidized by Duquesne Light's regulated POLR
2 or distribution rates.

3 **Q. MS. BETTA STATES THAT THERE CAN BE NO CROSS-**
4 **SUBSIDIZATION CONCERNS VIS-À-VIS DLC, DLE AND DUQUESNE**
5 **POWER BECAUSE DUQUESNE POWER HAS SEPARATE SUPPLY**
6 **CONTRACTS WITH DLC AND DLE. WHAT IS YOUR RESPONSE?**

7 **A.** Ms. Betta assumes that because Duquesne Power has separate contracts with
8 Duquesne Light and DLE, there can be no cross-subsidization occurring due to
9 Duquesne Power's joint provision of power procurement and portfolio
10 management services for both DLE and Duquesne Light. I disagree. As noted in
11 my earlier testimony it is likely that all, or a substantial portion, of the upfront
12 costs associated with Duquesne Power's portfolio management activities are
13 covered under its arrangement with Duquesne Light for POLR supply, and DLE
14 is able to "get a free ride" for many of these services. A good analogy would be
15 sharing a taxi to the airport. If I have already paid for a taxi ride to the airport, an
16 extra passenger could essentially ride along for free, yet the taxi would incur no or
17 very little additional cost to carry the extra passenger. Ms. Betta's testimony
18 alludes to the fact that Duquesne Power may have a third-party contract for
19 supply portfolio management,⁹ which would make sense, since Duquesne Power
20 only has 2 employees. Therefore, it is likely that Duquesne's POLR rates cover
21 all of the costs that Duquesne Power incurs under this third-party arrangement for
22 portfolio management, and there is no or limited incremental cost to also manage
23 DLE's load. Consequently, the fact that Duquesne Power has separate supply

⁹ Betta rebuttal at 5, "...and/or the parties that Duquesne Power may contract with to help it manage its supply portfolio..."

1 contracts with Duquesne Light and DLE is no guarantee that Duquesne's POLR
2 rates are not subsidizing DLE's operations.

3 **Q. DOES MS. BETTA'S TESTIMONY RESPOND TO YOUR CONCERN**
4 **REGARDING PENNSYLVANIA'S CODE OF CONDUCT**
5 **REQUIREMENTS?**

6 A. No. While Ms. Betta attempts to demonstrate that DLE compensates its affiliates
7 for the services it receives, she does not respond to the question of how
8 Duquesne's affiliate arrangements can adequately satisfy the current Pennsylvania
9 Code of Conduct requirement. As noted in my direct testimony, the current
10 Pennsylvania Code of Conduct requires employees of regulated utilities, such as
11 Duquesne, to insure that their employees function independently of other related
12 companies.¹⁰ As Ms. Betta admits, other Duquesne companies including
13 Duquesne Light - provide substantial administrative, business and operational
14 support for DLE. Therefore it would be difficult if not impossible under such
15 arrangements to adequately ensure that the employees of the respective Duquesne
16 companies function independently. As discussed in my direct testimony, a
17 thorough Commission review of Duquesne's affiliate relationships and cost
18 allocation procedures is necessary as a first step toward addressing these issues.
19 Then, a stricter Code of Conduct may be implemented as one option, in addition
20 to other measures, to mitigate the anticompetitive impacts of the inappropriate
21 cross subsidization of DLE.

22 **Q. DOES ANY OTHER WITNESS SUPPORT A CODE OF CONDUCT**
23 **REVIEW?**

¹⁰ 52 Pa. Code § 54.122(11).

1 A. Yes. Reliant witness Jim Ajello supports a statewide proceeding to consider a
2 stricter code of conduct to govern the relationships between regulated and
3 unregulated affiliate companies, including the Duquesne companies.

4 **PART II**

5 **(ON BEHALF OF STRATEGIC ENERGY)**

6

7 **Q. WHAT IS THE PURPOSE OF THIS PART OF YOUR TESTIMONY?**

8 A. In this part of my testimony, I respond to the arguments of OSBA witness Mr.
9 Kalcic and Duquesne witness Mr. Fisher against Strategic Energy's
10 recommendation for quarterly solicitations to set default service rates for small
11 C&I customers.

12 **Q. IS THERE INFORMATION NOT AVAILABLE WHEN YOUR DIRECT**
13 **TESTIMONY WAS PREPARED THAT SUPPORTS YOUR VIEW THAT**
14 **DEFAULT SERVICE RATES SHOULD ADJUST FREQUENTLY TO BE**
15 **BOTH MARKET-REFLECTIVE AND MARKET-RESPONSIVE?**

16 A. Yes. Industry and policy experts from the Department of Justice, the Department
17 of Energy, the Department of Agriculture, the Energy Information
18 Administration, the Federal Trade Commission, and the Federal Energy
19 Regulatory Commission ("FERC") served on a task force that was created by the
20 Energy Policy Act of 2005 and required to conduct a study of wholesale and retail
21 electricity markets in the United States. This report was recently finalized and
22 filed with FERC on April 5, 2007. Among the findings of the report are:

- 23
- 24 • "The POLR service price must closely approximate a competitive
 - 25 market price if it is to provide economically efficient incentives for
 - 26 consumption and supply decisions and thereby maximize welfare. This
 - 27 price will vary over time as supply and demand change."
 - 28 • "A fixed or infrequent updated price creates incentives for customers
 - to move back and forth from POLR service to alternative suppliers,

1 based on which offers a lower rate. This repeated switching may
2 create additional costs for both POLR and alternative suppliers.”

- 3 • “The frequency with which the POLR service price changes...can
4 affect the competitive dynamics between different suppliers.”
- 5 • “If retail prices fall too far below wholesale prices...alternative
6 suppliers will be unlikely to enter or remain as active retailers”¹¹

7 Based on my review of this report, it is apparent that the Task Force agrees that
8 frequently adjusted default service prices are more efficient than using a fixed
9 price as a proxy for market prices.

10 **Q. WHAT IS YOUR RESPONSE TO MR. FISHER’S STATEMENT THAT**
11 **STRATEGIC ENERGY WANTS TO APPLY A “HARD AND FAST”**
12 **RULE TO PREVAILING MARKET PRICE STANDARD?**

13 **A.** Mr. Fisher criticizes Strategic Energy for wanting to apply a “hard and fast” rule
14 to the definition of what prevailing market price means in terms of setting default
15 service rates. Strategic’s position is based on the plain words of the Electric
16 Choice Act which state that default service is the service of “last” resort as an
17 alternative to service from competitive suppliers, not the service of “first” resort
18 equivalent to pre-Electric Choice Act bundled basic service. Admittedly,
19 Strategic’s position is less flexible than Mr. Fisher’s and Duquesne’s approach to
20 the prevailing market prices standard, which is the exact opposite of a “hard and
21 fast” rule. Under Duquesne’s approach, prevailing market prices is an essentially
22 boundless concept which can mean setting default service rates through a process
23 completely at the discretion of the default service provider, including setting fixed
24 rates for any extended term of service (here, three years, but in Duquesne’s POLR

¹¹ Report to Congress on Competition in Wholesale and Retail Electric Energy Markets at pp. 98-108, available at http://elibrary.FERC.gov/idmws/file_list.asp?accession_num=20070405-4006.

1 III case, six years) and “engineering” a rate based upon subjective considerations
2 and adjustments.

3 **Q. IN YOUR OPINION, WHY DOES DUQUESNE WANT A MORE**
4 **FLEXIBLE DEFINITION OF PREVAILING MARKET PRICES?**

5 A. Duquesne wants the prevailing market price standard to be implemented in a
6 subjective and flexible manner so it can avoid procuring its default service supply
7 through a competitive procurement process and retain Duquesne Power as the
8 sole procurement source for its default service supply. As stated in my testimony
9 in the Duquesne/Macquarie merger proceeding, Duquesne has a significant
10 financial interest in preserving Duquesne Power as the sole procurement source
11 because this protects the margin that Duquesne earns in its default service supply
12 business.¹²

13 **Q. MR. FISHER AND MR. KALCIC CRITICIZE YOU FOR REFERRING**
14 **TO THE DEFAULT SERVICE ANOFR AND POLICY STATEMENT**
15 **ORDERS FOR SUPPORT FOR QUARTERLY PRICING FOR SMALL**
16 **C&I CUSTOMERS, EVEN THOUGH STRATEGIC ENERGY DOES NOT**
17 **SUPPORT ALL ELEMENTS OF THESE ORDERS. WHAT IS YOUR**
18 **RESPONSE?**

19 A. While it is true that there are elements of the ANOFR and Policy Statement that
20 Strategic Energy expressed concerns about in its comments on those orders, in my
21 opinion, I continue to believe that quarterly solicitations to set default service
22 rates for small C&I customers are entirely consistent with the vision for default
23 service as articulated in the ANOFR and Policy Statement orders. Mr. Fisher
24 states that our proposal to set default service rates through quarterly solicitations
25 is inconsistent with the ANOFR and Policy Statement Orders because our

¹² SE/RESA Exh. RH-1 (see SE/RESA St. No. 1, Docket Nos. A-110150F0035, A-311233F0002, at pp. 6-7).

1 proposal does not include the use of long-term laddered contracts. I disagree.
2 The ANOFR proposed regulations do not specify the contract term for default
3 service supply, but importantly, do specify that default service rates adjust at least
4 quarterly for residential and small C&I customers. Discussion regarding the use
5 of longer-term laddered contracts is reserved to the Policy Statement and, even
6 then, it appears that the Commission expects default service plans to rely more on
7 shorter duration purchases where retail markets are more developed. Unlike most
8 major utilities in Pennsylvania, Duquesne's rate cap has already expired,
9 Duquesne has gone through three "transitional" default service plans, and
10 residential/small C&I customers are already shopping, albeit not at levels to
11 support sustainable retail competition. Therefore, it is appropriate in Duquesne's
12 fourth "transitional" POLR service plan to have default service rates that adjust
13 quarterly based on quarterly solicitations and not the laddering of longer-term
14 supply contracts.

15 **Q. BOTH MR. KALCIC AND MR. FISHER IMPLY THAT QUARTERLY**
16 **SOLICITATIONS WOULD RESULT IN HIGHER DEFAULT SERVICE**
17 **RATES. DO YOU AGREE?**

18 A. No, I do not. Mr. Kalcic's and Mr. Fisher's speculation that quarterly
19 solicitations would result in higher default service rates is unsupported.¹³ The
20 only justification that Mr. Kalcic gives for this speculation is that conducting
21 quarterly solicitations would entail additional costs (which he does not quantify)
22 that would be recovered through default service rates. While I agree with Mr.
23 Kalcic that the additional administrative costs of conducting repetitive,

¹³ Kalcic rebuttal at p. 2; Fisher rebuttal at p. 31.

1 standardized quarterly solicitations would have to be recovered through default
2 service rates, this bears little relation to whether default service rates would be
3 higher or lower than Duquesne's proposal in any given quarter. Additionally,
4 under Duquesne's proposal, Duquesne Power is collecting 0.15cents/kWh (small
5 C&I customer) and 0.3 cents/kWh (residential customer) regulatory review period
6 risk premiums in its default service rates. If Duquesne conducted standardized
7 quarterly solicitations for its default service, there would be no need for these
8 regulatory review period risk premium payments to Duquesne Power, and it
9 stands to reason that these risk premiums exceed the costs of the solicitations and
10 that elimination of these premiums would reduce default service rates. In addition
11 to the regulatory review period risk premium, there are unknown returns and
12 premiums built into Duquesne's "black box" rate for default service energy
13 supply. With Duquesne Power as the sole procurement source and the default
14 service rates that are engineered in an attempt to meet the requirement that supply
15 be procured at prevailing market prices, there is no guarantee that the rates
16 proposed by Duquesne are lower than rates that would result from competitive
17 quarterly solicitations. In fact, Mr. Fisher asserts that Duquesne has no incentive
18 to offer default service rates that are "low".¹⁴

19 **Q. DOES THIS CONCLUDE YOUR TESTIMONY?**

20 **A. Yes.**

¹⁴ Fisher rebuttal at p. 24: "...Duquesne Power has no incentive to offer rates below market prices" "This should alleviate concerns that the rate is set "too low.""